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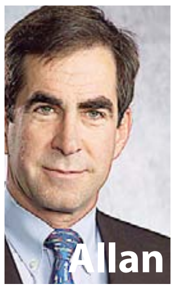
Revisiting the portfolio designed by a second-grader



ROTH

A couple of years ago, before my son turned 8, we sat down and discussed how to make money grow. I wrote about the portfolio he designed.

Well, now that Kevin is 10, let's take a look at how his portfolio is doing.

- During the two year period, his portfolio has grown 34.1 percent, which equates to a 15.8 percent annual return, according to Morningstar.
- He bested the S&P 500 common benchmark by 2.23 percent annually, and did so with less risk.
- His portfolio was picked up by Paul Farrell of Dow Jones MarketWatch, and is one of eight portfolios reported on regularly.
- Kevin's portfolio is in second place among the eight, beating others designed by billion dollar portfolio managers, famous authors and money managers. These are some of the world's best investors.
- Kevin even had a brief brush with the media and was interviewed on the radio, as well as receiving a call from a national television talk show.

What was this portfolio?

Now before you think this is a columnist bragging about the sophistication of his kid, let me explain that this is actually a columnist bragging about the simplicity and common sense of his kid. See for yourself. Kevin's portfolio was comprised of the following:

- Vanguard Total Stock Market Index (VTSMX) 60 percent
- Vanguard Total International Stock Index (VGTSX) 30 percent
- Vanguard Total Bond Market Index (VBMFX) 10 percent

Portfolio Construction Examples

	High Risk	Med Risk	Low Risk
Vanguard Total Stock Market Index VTSMX	60%	40%	20%
Vanguard Total Intl Stock Index VGTSX	30%	20%	10%
Vanguard Total Bond Market Index VBMFX	10%	40%	70%

Note: Similar portfolios can also be built using Fidelity index funds or with iShares or Vanguard Exchange Traded Funds (ETFs).

Not exactly rocket science when it turned out that all Kevin needed was two simple lessons:

Don't play a loser's game. I explained to him that higher fees nearly guaranteed giving away your money long-term. We searched for funds with the lowest costs.

Don't put all of your eggs in one basket. He knows what happens if all your eggs are in one basket and you drop it — omelets anyone? So we found the funds that invest in the entire U.S. stock market, the rest of the world market and put some in the entire U.S. bond market.

With only three funds, he built a portfolio that:

- Owns the entire world and has maximum global diversification.
- Has less than 0.25 percent annual expenses, both hidden and disclosed.
- Is extremely tax-efficient.
- Automatically rebalances within U.S. and international markets.

What do his classmates think?

Kevin doesn't go around saying his portfolio is up 34.1 percent. He doesn't like talking about it at all.

Yet, his friends have learned about his investing skills and one thing really impressed them. Kevin owns a piece of nearly every large company in the entire world. As one classmate questioned — "Even the toy department at Wal-Mart?" Yes!

It's not about what Kevin knows

Kevin has been a successful investor because of what he doesn't know. He doesn't have these "hunches" that the market is going to triple or that the next Great Depression is just around the corner.

Unlike his dad, he isn't motivated by financial freedom and doesn't follow the market indices like breadcrumbs in the woods. Kevin doesn't even look at his portfolio. Basically, he has the luxury of not caring. Ah, youth.

Now admittedly, as Kevin get's older, he will start caring and be motivated by the same things that impact us adults in investing — fear and greed. At the moment, the money isn't real to him since he can't go out and spend it.

In another decade or so, he will have people calling on him with expert financial advice and financial products too good to be true. He might even start watching Cramer or whoever the flavor-of-the-month market guru is in 20 years. It's my hope that whenever he is tempted to do that, that he will recall the two lessons we discussed just before his 8th birthday.

What this means to us adults

As noted in the chart, the second-grader portfolio can work for anyone. Kevin has many years before he needs his investment cash so he can afford to take a lot of short-term risk. But the same three funds can also be used to construct portfolios with any level of risk.

Knowledge can be a dangerous thing to adults in investing. We know far too much, or think we do, to be able to invest as effectively as an 8 year old.

We just can't resist the temptation to make things complex when they don't need to be. We understand that our portfolio is driving our ability to realize our dreams. If only we also realized that the hot tip de jour or the latest glitzy investment seminar is only pandering to our desire to outsmart the market, rather than just take what it has to give.

The best we can do is attempt to ignore our instincts and keep things as simple as possible. Great diversified portfolios really can be constructed with a handful of funds and different mixes.

Kevin's second-grader portfolio really can work for you no matter where you are on the risk dial.

In the words of MarketWatch's Paul Farrell (when I asked him if he had any advice for Kevin) ... "Why is it the so-called adults have to make things so dang complicated?"

Allan Roth is a CPA and Certified Financial Planner. He is the founder of Wealth Logic LLC, an hourly based financial planning and licensed investment advisory firm, and is an adjunct finance faculty member at the University of Colorado at Colorado Springs. He can be reached at 955-1001 or at ar@DareToBeDull.com

Wall Street Fantasy vs. Reality

Wall Street Wisdom	Reality
One size fits all never works.	Different allocations of these funds fit nearly everyone's risk levels.
You are guaranteeing that you will not beat the market.	You are guaranteeing you will beat most investors for the given risk level.
You can't diversify with only three funds.	You can't diversify more with 1,000 funds.
Investing isn't this simple.	Investing should be radically simple.
This is a boring strategy	This is a really boring strategy. It just works.

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