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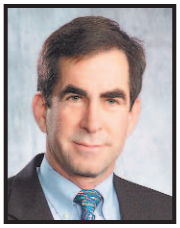
2nd-grader's portfolio takes on Wall Street



ALLAN ROTH

Last year, I told people that my son, Kevin, would be able to design a portfolio that could beat the vast majority of portfolios before he turned 8 years old. Well last month was his birthday and he met that goal.

But before he could design this portfolio, he had to learn two important lessons:

1. Don't play a loser's game.
2. Don't put all of your eggs in one basket.

These two lessons translate to finding the funds with the lowest costs and maximum diversification. Now he is ready to take on Wall Street with only three funds.

- Vanguard Total Stock Market Index (VTSMX)
- Vanguard Total International Stock Index (VGTSX)
- Vanguard Total Bond Market Index (VBMFX)

At such a young age, Kevin can afford to take the high risk proportions of these funds (as shown in the chart), but different mixes of these funds can meet just about any level of risk.

Am I oversimplifying things? I think not. Let's look at each one.

Vanguard Total Stock Market Index

This may be the mother of all index funds. It owns the entire U.S. stock market. It totally accepts American capitalism and takes all the return the market has to give. In this one fund, Kevin has bought all sectors and styles of U.S. stocks that, according to MarketWatch Columnist, Paul B. Farrell, automatically rebalances for you. Morningstar analyst, Sonya Morris, points out that this rebalancing occurs without having to sell anything and recognize capital gains taxes.

Vanguard Total International Stock Index

In the interest of having enough baskets, Kevin wants some of his eggs overseas. This fund is the international equivalent to the U.S. Total Stock fund.

Vanguard Total Bond Market Index

This fund invests in all taxable U.S. bonds, both government and private. It's the bond equivalent to the Total U.S. Stock fund, and reduces short-term risk.

Why this portfolio?

Clearly, my son doesn't understand that he has implemented modern portfolio theory by buying dozens of asset classes with lower correlations. Wall Street Journal reporter Andrew Blackman points out that this portfolio has ultra low stated costs, hidden costs and taxes. Blackman notes that the low stock turnover generates far less in taxes, which can be as important as fees. Kevin only knows this portfolio best meets his goals of playing a winner's game and putting his eggs in as many baskets as possible.

What makes an 8-year-old a great investor?

Kevin has big advantages over you and me. First of all, he's not emotionally attached to his money. It doesn't faze him when the market goes up or down. Second, he has better things to do with his time than watch CNBC. Thus, he has the luxury of thinking long-term, obsession-free. Finally, he hasn't made the investing mistakes I have made so he doesn't have a tax legacy to worry about.

If it's so simple that an 8 year old can do it, why don't many advisors recommend this portfolio? Perhaps, because it's hard to argue that the investor should pay so much money for something this basic and easy. In other words, the status quo has no incentive to tell you about this. Even Vanguard's personal planning group would put you in a more complex portfolio.

Vanguard spokesperson, John Demming, notes that once an efficient portfolio is built, it then leverages the force of inertia in favor of the investor. By doing virtually nothing, Kevin can double the expected real return of most investors and harvest the power of compounding for decades.

Lessons learned from an 8-year-old investor

Both Blackman and Farrell point out that the first thing Kevin is doing right is starting to save at an early age. Not only does this allow for more of that compounding magic, it also builds a discipline that is much harder to teach at a later age.

So what have we learned? With only three funds, we can build 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.

Simple though this may be for most 8-year-olds, it's harder for you and me. We have to sell assets to build this portfolio, which causes taxable consequences. We are also emotionally attached to our money, and much more likely to make the mental mistakes explained in behavioral finance.

Is it a fair comparison to put a child's portfolio design against the likes of Goldman Sachs or Merrill Lynch? Of course not.

The Wall Street portfolios are burdened with fees and taxes nearly four times greater than Kevin's, and are mathematically destined to lose this zero-sum game. Apparently, an 8-year-old can better understand the arithmetic of investing more easily than us adults.

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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 be at the market.	You are guaranteeing you will beat most investors for the given risk level.
You can't diversify with only 3 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.

EXAMPLES OF PORTFOLIO CONSTRUCTION

	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%
	100%	**100%**	**100%**

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