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GETTING GOING

By JONATHAN CLEMENTS



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And Now, It's Time to Pick Your Supporting Cast

It's time to go to the bench.

Last week, I talked about building the core of your portfolio using the "Big Three" investments: High-quality U.S. bonds, U.S. stocks and developed foreign-stock markets. Together, these three sectors might account for 70% or 80% of your portfolio.

BUILDING THE RIGHT PORTFOLIO

Second in a four-part series



Tim Foley

But what about the other 20% or 30%? With this money, you may want to round out your portfolio by purchasing small positions in some of the global market's more intriguing sectors. The goal: to lower your portfolio's risk level and bolster its return.

To that end, experts advocate adding everything from foreign bonds to gold stocks to emerging-market debt. But today, I am focusing on my four favorites: real-estate investment trusts, inflation-indexed Treasury bonds, high-yield junk bonds and emerging-market stocks.

Odds are, your employer's retirement plan doesn't include mutual funds that specialize in these four sectors, so you will have to buy into them using other money. But that could be a smart move. Here's why:

Staking a Claim

If you own the Big Three and you want to add just one other fund, my top choice would be a mutual fund that invests in real-estate investment trusts, or REITs.

How come? If you are heavily invested in paper assets, like bonds and stocks, you

can reduce risk by adding companies with exposure to real assets, such as gold, commodities and real estate. For instance, when the economy is in turmoil and most paper assets are getting hammered, gold shares and energy stocks sometimes post startling gains.

But an even better choice, I believe, is the equity REITs. An equity REIT makes money by buying and then renting out shopping centers, office buildings, warehouses, apartments and other properties. The rent collected is passed along to shareholders as fat dividends, currently averaging 6%.

"You get the yield and you benefit from the appreciation of the underlying real estate, which should at least keep up with inflation," says Art Canter, an investment adviser in Boca Raton, Fla.

That appreciating real estate might drive REIT share prices higher by, say, 3% a year. Throw in the 6% dividend and you are looking at a potential long-run total return of 9%.

During the recent bear market, REITs proved their worth, notching handsome gains even as most other stocks tanked. But because of those gains, REITs are no longer a screaming bargain. Nonetheless, even at today's richer prices, I would consider allocating 5% or 10% of your stock portfolio to a REIT mutual fund.

Fending Off Inflation

Inflation-indexed Treasury bonds may be a paper asset. But I think of them in the same camp as REITs and other real assets. The reason: Like real assets, inflation-indexed Treasuries should perform well at times of economic turmoil, especially accelerating inflation.

Role Players

Looking to round out your portfolio? Check out the no-load funds below.

Fund	Annual Expenses	Minimum Investment	Phone
Emerging-Stock Markets			
SSgA Emerging Markets	1.25%	\$1,000	800-647-7327
Vanguard Emerging Markets Index	0.57	3,000	800-662-7447
High-Yield Junk Bonds			
Northeast Investors Trust	0.70	1,000	800-225-6704
TIAA-CREF High-Yield Bond	0.34	2,500	800-223-1200
Inflation-Indexed Bonds			
TIAA-CREF Inflation-Linked	0.30	2,500	800-223-1200
Vanguard Inflation-Protected	0.22	3,000	800-662-7447
Real-Estate Investment Trusts			
TIAA-CREF Real Estate	0.45	2,500	800-223-1200

Suppose inflation picks up. That will drive interest rates higher, depressing the value of stocks and conventional bonds.

But in that same scenario, you should get decent performance not only from real assets, but also from inflation-indexed Treasury bonds.

With these bonds, the value of your principal is stepped up along with the consumer price index. In addition, you collect a small yield, which represents your return above inflation.

Because of that built-in inflation protection, inflation-indexed bonds can be a great diversifier for a portfolio that is heavily invested in the Big Three. My advice: Allocate maybe a third of your bond exposure to inflation-indexed Treasuries.

Reaching for Yield

Unlike with REITs and inflation-indexed bonds, you won't get much extra diversification by adding high-yield junk bonds. Still, I would consider stashing a sliver of your portfolio in this sector.

To be sure, junk bonds are risky, with issuers frequently defaulting on their interest payments. But to compensate for that risk, junk bonds offer eye-popping yields, currently 9%. Because of defaults, you probably won't pocket the full 9%. Even so, I figure there's a good chance that junk-bond returns over the next 10 years will rival those of the broad stock-market averages.

Indeed, you should view junk bonds not as bonds, but as a substitute for stocks. "I look at junk as an equity-style investment with a high cash flow and low upside," Mr. Canter says. "If people want a higher cash flow, I'll take 5% or 10% of their stock portfolio and put it in junk."

Gunning for Growth

REITs, inflation-indexed Treasuries and junk bonds are best held in an individual retirement account or some other tax-sheltered account, because all three will generate hefty tax bills each year.

Looking for an investment for your taxable account? Consider allocating up to 5% of your total stock exposure to a fund that invests in Brazil, China, Mexico and other emerging-stock markets. While emerging-markets funds may not be that tax-efficient, the tax bills involved should be smaller than those from junk, REITs and inflation bonds.

Be warned: Emerging-markets funds aren't for the faint of heart. But if you can hang tough through the wild share-price swings, you should earn handsome long-run returns.

Even after posting impressive gains this year, emerging-market stocks still appear reasonably cheap. Moreover, in the decades ahead, the countries involved should grow far faster than the U.S., Europe and Japan, where economic growth is likely to be restrained by a rapidly aging population.

"We are great believers in emerging markets," says Richard Schroeder, a financial planner in Amherst, N.Y. "On their own, they're very volatile. But put them in a portfolio and they will give you extra diversification, because much of the time they move very differently from U.S. stocks."

*Next week: Keeping your portfolio in balance. Meanwhile, read the first part of this four-part series, "[The First Step to Investing: Choose Your Cornerstones](#)."*¹

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