THE WALL STREET JOURNAL.

October 23, 2005

Don't Ask Too Much From One Investment

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You can have it all. You just can't have it all in one investment.

As we manage our money, we strive both to score big gains and to limit losses. Trouble is, we don't just look for this mixture of performance and safety in our overall portfolios.

Rather, we hunt for these attributes in every investment we buy -- and that, unfortunately, is usually a prescription for performance mediocrity.

All Mixed Up

The problem: When upside potential and downside protection are wrapped together in a single package, you can end up with a costly, complicated investment where it isn't clear what you are getting or how it fits into your portfolio. Consider four examples.

- **In recent years**, equity-indexed annuities have exploded in popularity. These annuities allow you to capture part of the stock market's gain, while guaranteeing you will at least break even or earn a modest rate of interest.

There's nothing special about this. In fact, you could get similar results by owning a mix of stock and bond funds.

But what mix? That's part of the problem. While the equity-indexed annuity will limit your downside, it's often tough to figure out how much of the stock market's upside you will capture.

This much, however, is clear: These things aren't cheap. Indeed, on an equity-indexed annuity, the sales commission alone can run around 7% and it occasionally tops 10%.

- **I frequently suggest** that retirees buy "immediate fixed" annuities that pay lifetime income, thus locking up a healthy stream of income that they can't outlive. But seniors resist the idea, fearing they will buy the annuity and die soon after.

As a result, most immediate-annuity buyers opt for downside protection, in the form of a guarantee that the payments will last for, say, 20 years. That way, should they die before the 20 years are up, their heirs will continue to get the monthly checks.

Purchasers usually have to pay for this guarantee by taking a cut in the annuity's income. But that, of course, defeats the point of the exercise, which is to get yourself a fat check every month.

My advice: Unless the cut in income is modest, forget the guarantee. Instead, buy the annuity purely for income and then earmark other assets for your heirs.

- **Investors are often advised** to diversify their U.S.-stock holdings by moving 20% or 25% into a foreign-stock fund. Yet many people can't quite bring themselves to follow this advice.

Some eschew pure foreign-stock funds and instead buy more-sedate global funds, which include a mix of U.S. and foreign stocks. Others try to limit volatility by purchasing international funds that hedge their currency exposure.

But with either strategy, you dilute the benefits of investing abroad.

When you purchase a foreign-stock fund, the hope is that your foreign fund will post gains when your U.S. stocks are suffering, thus providing downside protection.

What if your fund hedges its currency exposure or includes U.S. stocks in its portfolio? The fund itself may perform less erratically -- but it probably won't be nearly as effective in reducing your portfolio's overall volatility.

- **We buy insurance** to protect against financial disasters. What if disaster doesn't strike? True, buying the insurance proved unnecessary. But rather than regretting that small financial loss, we should consider ourselves lucky.

Yet life-insurance agents are forever arguing that policyholders are "wasting money" when they buy term-life insurance, which provides a death benefit and nothing more, and that they should instead purchase cash-value life insurance.

Cash-value policies involve far heftier premiums, because they combine the downside protection of the death benefit with the upside potential of an investment account.

Sound enticing? Unfortunately, these policies often turn out to be a costly way to buy insurance and a rotten way to make your money grow.

Staying 'Pure'

Combining performance and safety in a single product isn't always a bad idea. For instance, balanced funds and lifecycle funds include a mix of stocks and bonds, and these funds can be a fine investment.

Still, as I see it, a great portfolio consists of a series of distinct bets, each of which is designed to play a particular role. You buy insurance in case disaster strikes. You purchase an immediate annuity to generate retirement income. You buy U.S. stocks to earn long-run inflation-beating gains. You add foreign stocks to diversify your U.S. holdings.

This is another reason to purchase my favorite investment, index funds, which buy the stocks or bonds that make up an index in an effort to replicate the index's performance. If you purchase an index fund that tracks real-estate investment trusts, or emerging markets, or the U.S. bond market, you know precisely what you are getting and there's no risk your results will get messed up by the manager's incompetence.

Indeed, if you favor index funds and other relatively "pure" investments, you should enjoy three key advantages.

First, your investment costs will tend to be lower, and that should translate into higher long-run returns.

Second, it's a lot easier to control your portfolio's risk level. Suppose you ignore my advice and stash money in a traditional "whole life" cash-value policy.

With these policies, you are effectively buying bonds along with insurance. But what role does this bond investment play in your portfolio? Should you consider your policy's value when calculating your portfolio's stock-bond split -- or should you ignore it?

Third, if you avoid combination investments, you have greater control over what to sell.

Suppose U.S. stocks are in a slump but foreign stocks are riding high, and you want to trim your foreign holdings while leaving your U.S. shares to recover. That's simple enough if you own a pure foreign-stock fund.

If you own a global fund, however, and you go to sell, you will be bailing out of both highflying foreign stocks and beaten-down U.S. shares. To maintain your U.S. stock exposure, you could always sink more money into a U.S.-stock fund. But isn't this getting sort of messy?

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