

# Thomas Nogales Financial, LLC

## Create a Winning Investment Portfolio with Asset Allocation - v1.4

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During the years 2000, 2001, and 2002, investors in the largest U.S. stock mutual funds lost over 40% of their assets. The foreign stock markets did even worse with some large mutual funds losing 50%. People with money in IRAs and 401k plans were devastated and many had to delay their retirements or go back to work to make ends meet. With losses like this, it's no wonder that many people said "never again" and placed their cash into money markets and other safe, but low return, investments. Others just shrug their shoulders and say "we're in stocks for the long term" and hope things will work out by the time they retire. Both attitudes are understandable and both are wrong.

Small investors lost so much money because their portfolios were concentrated in large company stocks through major mutual funds. Unlike the very wealthy who get professional advice and allocate their money among various assets classes, small investors loaded up on the most popular funds and got clobbered.

I'll show you in this article how to allocate your money for superior short and long term results. Using this information, your largest one-time yearly loss over three decades would have been about 4%. Your average annual return would have been over 9% with a much reduced exposure to stocks. You would have made money in 2000-2002.

You don't need to be an expert on the markets, you don't need a commission based financial advisor, and you don't have to study anything. You only have to invest like the rich and adjust your portfolio once a year. I will show you how to do it cheaply and provide convincing evidence that it works. This method is common knowledge among the financial experts who advise pension funds and people of wealth.

It's important to understand this information but it's more important to act on it. Nothing will change unless you act. Passivity sets you up as a victim to be exploited by the sharks in the financial services industry. Sadly, many middle class people with savings and inheritances are skimmed over 2% yearly in expenses while receiving self-serving financial advice from Wall Street. Even worse, many people buy annuity products from insurance companies and lock in a rate of return far below what an asset allocation strategy can provide. Don't be a victim.

Allocating your money among assets classes does not guarantee high returns and it may not compare favorably with what some fund accomplished last year. Over any three year period it will provide results similar to the best mutual funds and with less risk. For people who want to live their lives creatively or focus on family and a career, it's a time proven way to invest and has been adopted by many of the world's most wealthy people.

### **Why Asset Allocation**

Money is basically printed paper issued by a government. People trust it will hold some value. You can buy things with it and even receive interest by lending it. But, governments continually

inflate their currency and presently in the U.S inflation runs about 2.5% per year. Over time, this inflation feeds into the price of goods and society adjusts to it. Stock values actually do quite well with mild inflation as it gets priced in. As a stock holder, you get the growth in the dividend, the intrinsic value, and the worthless inflation.

Institutions that manage money have to keep it invested. They know that holding cash guarantees a loss of purchasing power. So, assets are in a state of flux and money moves between them seeking the highest return. Bond yields change depending on things like war, the credit worthiness of the bond issuer, and inflation. Stocks react to fear and euphoria about the economy. REITs (Real Estate Investment Trusts) go up and down based on rental income and interest rates. Foreign markets move at different times than American markets. Commodities react promptly to world demand. Gold is a store of value with universal acceptance. If you're in all the assets, you get the average return of all regardless of which is up or down in any month.

Many research studies have been done on asset allocation. Researchers conclude that an investor's rate of return is dependent on how the assets are allocated. Also, the returns on assets are not predictable even if you know with a high level of confidence that one asset usually outperforms another. Stocks alone may outperform over the long run but they've also had long periods of very poor performance. What if you may need your cash in five or ten years? And remember - in the long run we're all dead.

The benefits of asset allocation haven't been explained to the investing middle class. The result is that investors over-reach for returns and then panic only to incur devastating losses. What investors really need is good return with balanced risk. You can get this balance in a portfolio much less volatile than one concentrated in a single asset class. A great boxer rarely wins easily against a fine opponent but, instead, gradually let's his skill outperform. Asset allocation doesn't guarantee you'll never take a punch but you'll never be knocked out of the game.

Let me also state that great economies come and go. Over the last few centuries great powers like France, England, Spain, Russia, etc have all gone from world leaders to bankrupt in less than thirty years. The USA currently has serious fiscal problems, deep political polarization, and a growing financial divide. For investors, it's critical to think globally and not assume the future will be like the past.

Much change lies ahead and it's prudent to diversify some money out of U.S. based assets. Asia has clear cost advantages in manufacturing and nations in the East will create much value for investors. Wise U.S. investors will want to be a part of it and that means thinking broadly and considering assets like commodities and foreign stocks. In Asia, people appreciate gold as a store of value much more than Americans. It's very volatile but also a wonderful hedge against foolish government policies and has saved countless people during troubled times.

Asset allocation works best when money is placed into quality, concentrated, vehicles for each asset class. Properly balanced, some go up and some go down but the average works to the investor's advantage each year and over long periods of time.

### Examples of Asset Classes

The secret to investing and avoiding big losses is diversification of assets. A portfolio comprised of 60% S&P500 stocks and 40% bonds is poorly diversified and can be crushed during market crashes. There's more to investments than stocks and bonds but, with proper allocation among just these two, disastrous losses can be avoided. Add more assets to the mix and risk drops dramatically. Over the last ten years, all the financial tools needed to construct a secure, world-class, portfolio have become available to everyone.

Table 1 below shows some broad asset classes and their returns from 1982 to 2005. Table 2 describes the assets. Notice the large swings in returns from year to year. These yearly variations in returns are normal and unpredictable.

**Returns by Asset Class 1982 - 2005**

Asset / Year	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
US Total Bond	32.6	8.2	15.1	22.1	15.3	2.7	7.9	14.5	9.0	16.0	7.4	9.7
MSCI EAFE	-1.9	23.7	7.4	56.1	69.4	24.7	28.3	10.5	-23.4	12.1	-12.2	32.5
S&P 500	21.5	22.6	6.3	31.7	18.7	5.2	16.6	31.7	-3.1	30.5	7.6	10.1
Russell 2000 Growth	21.0	20.1	-15.8	31.0	3.6	-10.5	20.4	20.2	-17.4	51.2	7.8	13.4
Russell 2000 Value	28.5	38.6	2.3	31.0	7.4	-7.1	29.5	12.4	-21.8	41.7	29.1	23.9
Russell 2000	25.0	29.1	-7.3	31.0	5.7	-8.8	24.9	16.2	-19.0	46.0	18.4	18.9
Gold	-18.3	12.9	-14.9	-12.0	15.9	21.4	-2.1	-12.8	0.7	-5.5	-5.0	4.7
REIT	12.0	12.0	12.0	12.0	12.0	12.0	12.0	12.0	12.0	12.0	12.0	12.0
Foreign Bonds*	15.0	6.0	9.4	8.5	7.8	8.0	7.7	8.4	9.4	8.2	7.3	5.5
Shrt Trm Bonds	12.8	12.4	14.2	14.9	11.4	4.5	7.0	11.4	9.2	13.1	7.2	7.1
Commodity Futures	1.8	19.3	-6.4	4.4	6.8	32.1	24.5	4.6	7.8	-3.4	3.7	8.8
Money Market 3mo	11.1	10.7	9.5	7.5	6.0	5.8	6.7	8.1	7.5	5.4	3.4	3.0

**Table 1.** \* see footnotes

1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
-2.3	18.5	3.6	9.6	8.7	-0.8	11.6	8.4	10.3	4.1	4.2	2.4
7.8	11.2	6.0	1.8	20.0	27.0	-14.2	-21.4	-15.9	38.6	20.8	15.6
1.3	37.6	23.0	33.4	28.6	21.0	-9.1	-11.9	-22.1	28.7	10.7	4.8
-2.4	31.0	11.3	12.9	1.2	43.0	-22.4	-9.2	-30.3	48.5	14.3	8.6
-1.5	25.7	21.4	31.8	-6.4	-1.5	22.8	14.0	-11.4	46.0	22.3	6.1
-1.8	28.4	16.5	22.4	-2.5	21.2	-3.0	2.5	-20.5	47.2	18.3	7.4
6.7	0.0	1.0	-14.7	-11.1	-5.3	0.2	-2.3	13.6	17.2	4.8	25.0
0.8	18.3	35.7	18.7	-18.2	-6.4	25.9	15.5	5.2	38.5	30.8	11.9
-7.3	21.2	18.9	9.6	10.0	1.6	9.9	9.0	7.7	3.6	6.7	5.7
0.4	12.9	4.5	7.0	7.6	2.1	8.8	8.9	6.1	3.4	1.7	1.3
7.6	8.7	17.1	5.0	-13.1	16.7	13.2	-11.9	12.1	21.9	4.1	20.5
4.2	5.1	5.0	5.1	4.8	4.6	5.8	3.4	1.6	1.0	1.4	1.8

Our goal is to create a portfolio that balances itself to market conditions to achieve a relatively smooth growth stream with less big ups and downs. Sure, some years will be better or worse than others but over any five year span the results will quite satisfactory.

### Description of the Asset Classes

<b>Total US Bond</b>	US government bonds over 1 year maturity
<b>MSCI Foreign Stock</b>	The Morgan Stanley- Europe, Asia index. i.e. foreign stocks
<b>S&amp;P 500</b>	Standard & Poors index of the 500 largest U.S. public companies
<b>Russell 2000 Growth</b>	Growth oriented small stocks in the Russell 2000 index
<b>Russell 2000 Value</b>	Small stocks of the Russell 2000 index with lower price/earnings ratios
<b>Russell 2000</b>	The smallest 2000 stocks in the Russell 3000 index
<b>Gold</b>	Returns are calculated on year-end closing exchange prices.
<b>REIT</b>	Real Estate Investment Trust index. These are public companies that invest in real estate
<b>Foreign Bonds</b>	Bonds of foreign governments
<b>Short Term Bonds</b>	US Treasury Bonds with a maturity under three years
<b>Commodity Futures</b>	An index of commodity <u>futures</u> – <u>not</u> spot commodities

Table 2.

Table 3 below shows the yearly data from Table 1 sorted with the highest returning asset at the top. Do you see any consistency or predictability about these returns? There are some but it's not very obvious. In general, an asset's ranking year to year is all over the place.

Notice that the Russell 2000 Value stocks (green) usually outperform the Russell 2000 Growth Stocks (dark blue) and have less losing years. With small company stocks, buying value (green) usually beats trying to guess which company will grow the fastest. Gold (yellow) has performed poorly relative to financial assets over the last twenty years in terms of U.S. dollars. Commodity Futures tend to move with gold but have fewer losing years. Notice also that Value stocks (green), Gold (yellow), Commodities (lime), and REITs (orange) don't move in step with the popular S&P 500 stocks (in white). Bonds (light blue) rarely had a losing year and often perform very well when the S&P 500 does poorly. This lack of correlation is what we're looking for. When the asset classes are mixed together their average return is smoothed out.

### Asset Classes Sorted by Yearly Return

Asset / Year	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
US Total Bond	32.6	38.6	15.1	56.1	69.4	32.1	29.5	31.7	12.0	51.2	29.1	32.5
MSCI EAFE	28.5	29.1	14.2	31.7	18.7	24.7	28.3	20.2	9.4	46.0	18.4	23.9
S&P 500	25.0	23.7	12.0	31.0	15.9	21.4	24.9	16.2	9.2	41.7	12.0	18.9
Russell 2000 Growth	21.5	22.6	9.5	31.0	15.3	12.0	24.5	14.5	9.0	30.5	7.8	13.4
Russell 2000 Value	21.0	20.1	9.4	31.0	12.0	8.0	20.4	12.4	7.8	16.0	7.6	12.0
Russell 2000	15.0	19.3	7.4	22.1	11.4	5.8	16.6	12.0	7.5	13.1	7.4	10.1
Gold	12.8	12.9	6.3	14.9	7.8	5.2	12.0	11.4	0.7	12.1	7.3	9.7
REIT	12.0	12.4	2.3	12.0	7.4	4.5	7.9	10.5	-3.1	12.0	7.2	8.8
Foreign Bonds*	11.1	12.0	-6.4	8.5	6.8	2.7	7.7	8.4	-17.4	8.2	3.7	7.1
Shrt Trm Bonds	1.8	10.7	-7.3	7.5	6.0	-7.1	7.0	8.1	-19.0	5.4	3.4	5.5
Commodity Futures	-1.9	8.2	-14.9	4.4	5.7	-8.8	6.7	4.6	-21.8	-3.4	-5.0	4.7
Money Market 3mo	-18.3	6.0	-15.8	-12.0	3.6	-10.5	-2.1	-12.8	-23.4	-5.5	-12.2	3.0

Table 3.

1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
7.8	37.6	35.7	33.4	28.6	43.0	25.9	15.5	13.6	48.5	30.8	25.0
7.6	31.0	23.0	31.8	20.0	27.0	22.8	14.0	12.1	47.2	22.3	20.5
6.7	28.4	21.4	22.4	10.0	21.2	13.2	9.0	10.3	46.0	20.8	15.6
4.2	25.7	18.9	18.7	8.7	21.0	11.6	8.9	7.7	38.6	18.3	11.9
1.3	21.2	17.1	12.9	7.6	16.7	9.9	8.4	6.1	38.5	14.3	8.6
0.8	18.5	16.5	9.6	4.8	4.6	8.8	3.4	5.2	28.7	10.7	7.4
0.4	18.3	11.3	9.6	1.2	2.1	5.8	2.5	1.6	21.9	6.7	6.1
-1.5	12.9	6.0	7.0	-2.5	1.6	0.2	-2.3	-11.4	17.2	4.8	5.7
-1.8	11.2	5.0	5.1	-6.4	-0.8	-3.0	-9.2	-15.9	4.1	4.2	4.8
-2.3	8.7	4.5	5.0	-11.1	-1.5	-9.1	-11.9	-20.5	3.6	4.1	2.4
-2.4	5.1	3.6	1.8	-13.1	-5.3	-14.2	-11.9	-22.1	3.4	1.7	1.8
-7.3	0.0	1.0	-14.7	-18.2	-6.4	-22.4	-21.4	-30.3	1.0	1.4	1.3

It's critical to understand that asset classes have performed very differently across prior decades and especially in prior centuries. Do not project your personal experiences forward in time as a certainty of how things will be. The next thirty years will be very different from the last thirty if financial history is any guide.

### Creating a Balanced Asset Mix

My job is to convince you to adopt asset allocation and to show you a simple and cost effective way to do it. Keep in mind that some asset classes will outperform over extended periods but you never know which ones. A mix of high quality assets that usually don't move together

generally produces good average results. We can construct an excellent portfolio with various mixes. I'll show you some and will finally make a recommendation.

Table 4 below shows the average returns for each asset class and the number of years with a loss. We placed an asterisk in the loss column for REITs because the data prior to 1995 is not compatible due to tax law changes. Annual returns for this period were estimated at 12% annually but that's open to debate. We gave REITs the benefit of the doubt.

#### Average Return of Investments over Time Periods

Asset / Year	Average				1982-2005
	Since 1982	20 Yrs	10 Yrs	5 Yrs	Yrs w/Loss
US Long Bond	10.0	8.0	6.2	5.9	2
MSCI EAFE	13.5	12.0	7.8	7.5	5
S&P 500	14.4	13.2	10.7	2.0	4
Russell 2000 Growth	10.5	9.8	7.8	6.4	6
Russell 2000 Value	16.0	14.2	14.5	15.4	6
Russell 2000	13.2	11.9	10.9	11.0	6
Gold	0.8	2.6	2.8	11.7	9
REIT	13.4	13.6	15.8	20.4	2
Foreign Bonds	8.2	7.9	8.3	6.5	1
Short Term US Bonds	7.9	6.8	5.1	4.3	0
Commodity Futures	8.6	9.3	8.6	9.3	3
Money Market 3mo.	5.4	4.5	3.4	1.8	0

Table 4

#### Returns from a Twelve Asset Portfolio

Below, we add up the returns from all twelve asset classes for each year and get the average return.

#### Annual Returns

1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
13.4	18.0	2.6	19.8	15.0	7.5	15.3	11.4	-2.4	18.9	7.2	12.5

1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
1.1	18.2	13.7	11.9	2.5	10.3	4.1	0.4	-3.6	24.9	11.7	9.3

#### Average Returns Compared to the S&P500 stock index

	Average				
	Since 1982	20 Yrs	10 Yrs	5 Yrs	Yrs w/Loss
12 Asset Portfolio	10.2	9.5	8.5	8.5	2
S&P500	14.4	13.2	10.7	2.0	4

Over the last 100 years, U.S. stocks have returned about 11%. Our portfolio in Table 3 is 45% in stocks with the balance in REITs, Gold, Commodities, and Bonds. Over 20 years it had 2 losing years but very good returns overall. It has much less stock risk than the S&P 500 index.

There's a problem though with the 12 Asset Portfolio. We're heavily weighted with the three classes of Russell small cap stocks and for that reason it's not a good portfolio.

### Let's Use Small Cap Value Stocks and Eliminate Gold and Foreign Bonds

Let's only use the Russell 2000 Value stocks and eliminate the other Russell indexes. Research has shown that Small Value stocks correlate less with the S&P500 stocks and offer good returns. Large well known companies on average command a higher Price/Earnings ratio and our small stocks have the lowest PE. This reduces our risk. Take a look at Table 1 and see how the Value stocks went opposite the S&P500 during the down market years of 2000-2002. Also from Table 1, we see that Commodities do better than gold. We'll remove Foreign Bonds because the yearly returns are too similar to US Bonds.

The Seven Asset portfolio below in Table Five has seven equally weighted assets and it reduces our stock exposure to 42% (S&P500, Russell 2000 Value, and Foreign Stocks).

Asset / Year	Since 1982	Average			1982-2005
		20 Yrs	10 Yrs	5 Yrs	Yrs w/Loss
US Long Bond	10.0	8.0	6.2	5.9	2
Foreign Stocks	13.5	12.0	7.8	7.5	5
S&P 500	14.4	13.2	10.7	2.0	4
Russell 2000 Value	16.0	14.2	14.5	15.4	6
REIT	13.4	13.6	15.8	20.4	2
Commodity Futures	8.6	9.3	8.6	9.3	3
Money Market 3mo.	5.4	4.5	3.4	1.8	0

Table 5.

### Annual Returns from the Seven Asset Portfolio

1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
15.1	19.3	6.6	23.5	19.4	10.8	17.9	13.4	-1.7	16.3	7.3	14.3

1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
2.6	17.9	16.0	15.1	3.5	8.7	8.0	-6	-2.9	25.5	13.5	9.0

### Average Returns

	Since 1982	20 Yrs	10 Yrs	5 Yrs	Yrs w/Loss
7 Asset Portfolio	11.6	10.7	9.6	8.9	3
12 Asset Portfolio	10.2	9.5	8.5	8.5	2
S&P500	14.4	13.2	10.7	2.0	4

This Seven Asset portfolio had only three small losing years and the returns are quite good considering the low percentage of stocks. This portfolio is more balanced and the returns are better because poorer performing assets are eliminated.

### A Balanced Portfolio with High Returns and Low Risk

Let's create a portfolio with a focus on balanced risks and returns. This portfolio is 45% in stocks, 10% in commodities, 10% in REIT, 30% in bonds, and 5% in cash. A Money Market Fund is offered by all mutual fund companies. They pay much more interest than a bank account and you can write checks against this type of fund.

### The TNF Balanced Portfolio

Asset Percentages	Since 1982	Average			1982-2005
		20 Yrs	10 Yrs	5 Yrs	Yrs w/Loss
US Long Bond – 30%	10.0	8.0	6.2	5.9	2
MSCI EAFE – 15%	13.5	12.0	7.8	7.5	5
S&P 500 – 15%	14.4	13.2	10.7	2.0	4
Russell Value – 15%	16.0	14.2	14.5	15.4	6
REIT – 10%	13.4	13.6	15.8	20.4	2
Commodities – 10%	8.6	9.3	8.6	9.3	3
Money Market - 5%	5.4	4.5	3.4	1.8	0

Table 6.

### Annual Returns of the TNF Balanced Portfolio - 1982 to 2005

82	83	84	85	86	87	88	89	90	91	92	93
19.0	18.9	8.2	26.8	21.4	8.9	17.5	14.8	-2.1	19.0	7.8	15.3
94	95	96	97	98	99	00	01	02	03	04	05
1.3	20.1	14.1	15.7	6.2	7.9	7.8	0.4	-2.3	24.4	12.9	8.0

### Average Returns

	Since 1982	20 Yrs	10 Yrs	5 Yrs	Losing Yrs
TNF Balanced	12.2	11.0	9.5	8.7	2
S&P500	14.4	13.2	10.7	2.0	4

The TNF Balanced Portfolio has less than ½ the stock risk of the S&P500 and less losing years yet the returns are fantastic. The down years are very small compared to the big swings of a stock index. Losing 20% of your portfolio just before retirement would indeed be a disaster. The TNF portfolio will make sure you're on the beach and not behind a desk.

This portfolio was also tested over a twenty year period from 1968 to 1987 and it only had a small loss in 1974 when the S&P500 lost 26%.

Most pension and endowment funds seek an average long term return of 8%. They are realistic about the returns on various asset classes and always use asset allocation. The TNF Balanced Portfolio provides broad diversification, excellent risk adjusted returns, and is only 45% invested in stocks. What's better – anyone can do this.

### **How to Build the TNF Balanced Portfolio Using Index Funds**

It's important to use index funds because they have the lowest cost structure and by their nature are devoid of asset imbalance and manager bias. Most of the TNF Balanced Portfolio can be constructed using efficient Vanguard Index Funds. Vanguard is a leader in indexing and is committed to low costs. Other fund families like Fidelity and American Century offer similar funds but the costs will be a bit higher.

Vanguard Total Bond Market Index Fund (VBMFX) – 30%  
Vanguard Total International Stock Index Fund (VGTSX) – 15%  
Vanguard 500 Index Fund (VFINX) – 15%  
Vanguard Small Cap Value Index (VISVX) – 15%  
Pimco Commodity Fund (PCRD / PCRIX) – 10%  
Vanguard REIT Index (VGSIX) - 10%  
Vanguard Federal Money Market (VMFXX) – 5%

PCRD / PCRIX can be purchased through a Funds Network available from Fidelity Investments, Vanguard, and many other mutual funds. Always confirm before buying that there are no front/back-end load fees. Buy the Institutional/Retail class shares, not the Advisor Class shares. It's best to hold this fund in a tax deferred account because it pays out its gains as dividends.

### **The ETF Approach** (percentages as of July 2006)

It's also possible to use Exchange Traded Funds rather than mutual funds to build this portfolio. I've listed some similar ETFs and the percentages to use if more than one is required. This will assist non-US investors and those who prefer to use a brokerage account rather than a mutual fund. Some of the ETFs are marketed by Vanguard and correlate with their corresponding mutual fund.

**Bonds:** AGG

**S&P500:** SPY or IVV

**Small Cap Value:** VBR (preferred) or JKL or IWN or IJS

**Foreign Stock:** 3 ETFs: Europe(VGK 57%) + Pacific(VPL 29%) + Emerging Mkt (VWO 14%)

**Commodity:** 2 ETFs: Energy(VDE 22%) + Materials(VAW 78%)

**REIT:** VNQ

### **Commodities and Natural Resources**

Our portfolios include commodity futures because it's a distinct asset class with global markets. Every country needs industrial metals, paper, wheat, etc. A *future* in commodities is a contract to purchase a commodity at a later date. This is much different than buying a commodity at the

*spot* price. Using futures, a mutual fund can create an index fund without ever owning the underlying product.

Commodities have performed well over the last 30 years and have poor correlation with both stocks and bonds. This is exactly what we want. TNF prefers to invest in commodity futures rather than an ETF that holds the stocks of companies involved in their manufacture and distribution. Those stocks are often already represented in the S&P00. At the present time, there is only one index futures fund that the small investor can buy – Pimco Commodity Real Return (PCRDY / PCRIX). Use ETFs if you can't buy the Pimco fund. We strongly advise against speculating in spot market commodities.

### **Other Ways to Asset Allocate**

There are different ways to allocate the asset classes depending on your level of risk tolerance. The portfolio I've proposed is focused on balance with reasonable returns. It's fine to increase the stock percentage to over 50% but be prepared for more volatility and larger down years. Minor changes like changing the weighting of foreign stocks to 20% and the S&P500 to 10% won't be disastrous. Likewise, you could replace VFINX or part of VGTSX with funds or ETFs that buy large cap dividend stocks.

*If avoiding all losing years is critical, I'd suggest a portfolio 30% in stocks (VGTSX, VFINX, VISVX), 30% in bonds (VBMFX), 10% in REITs (VGSIX), 10% in Commodities (PCRIX), and 20% in the Money Market (VMFXX). This portfolio never had a losing year and the returns were 9.5%, 8.3%, and 7.6% over 20, 10, and 5 years. This is very respectable performance.*

### **Tax Consequences of Buying Gold**

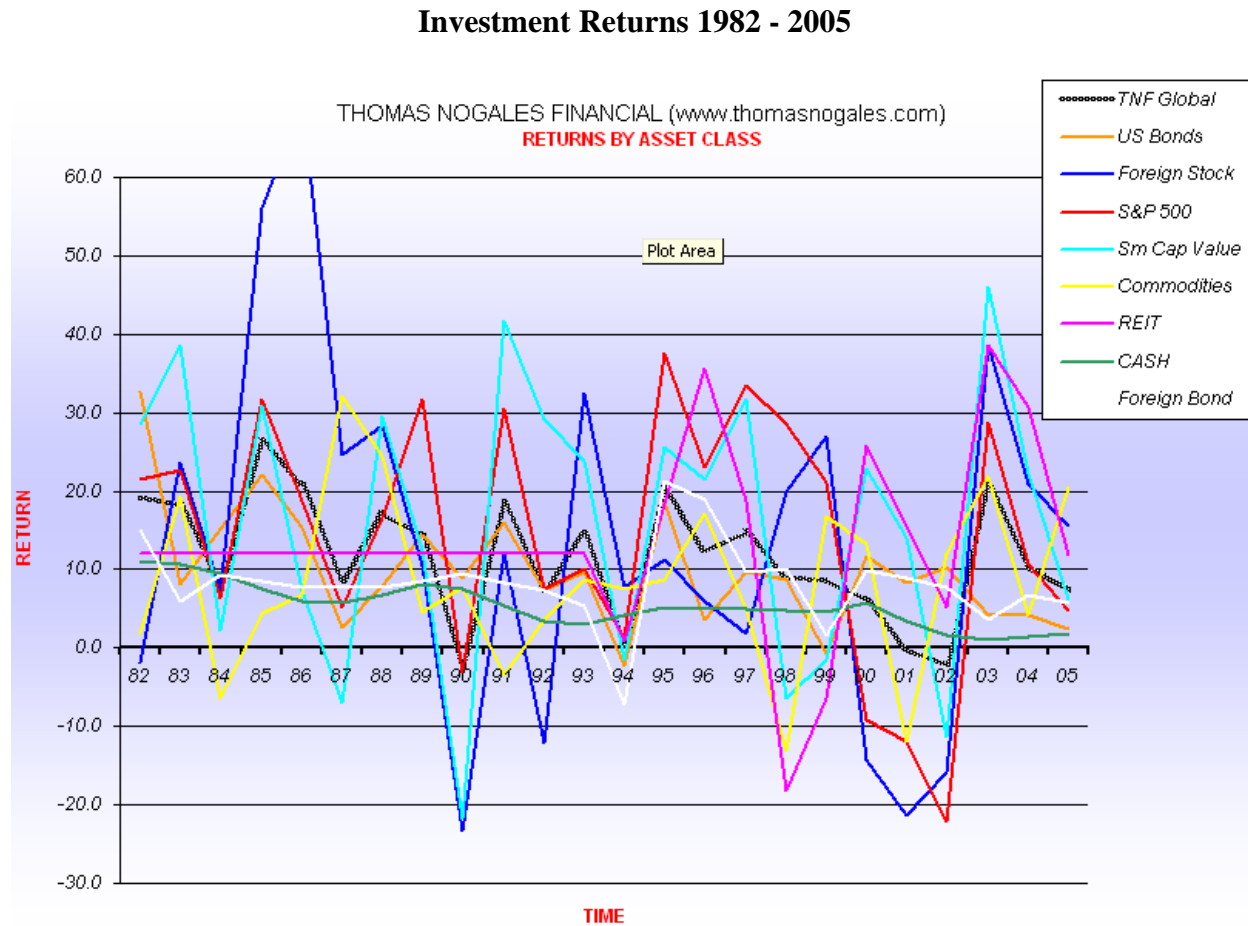
Some investors may wish to own gold in addition to or instead of a commodities fund. A commodity futures fund is more balanced than buying bullion but gold does have some unique advantages. There are two ways to buy gold. The new streetTracks fund with symbol GLD buys actual bullion for your account. This is purchased through a brokerage account in your IRA or a taxable account. (We don't advise buying gold mining stocks as they may have company risks and other management issues unrelated to pure gold.) The other way to buy gold is one ounce gold coins through a local or online dealer. Coins normally retail at a 4-5% markup over the gold price and the dealers buy from you at the spot price. For a list of large dealers visit: <http://www.gold.org/value/invest/wherebuy/index.html> or for a quick price check [www.kitco.com](http://www.kitco.com) or [www.monex.com](http://www.monex.com). Some States charge sales tax on gold coins whereas online dealers don't if their offices are in a different state from you.

Profits on gold are taxed at your full income tax rate if held in a taxable account. There is no capital gains treatment for tax purposes on gold as the IRS considers it a "collectible". Therefore, try to buy GLD shares in your IRA.

If using taxable money, buy one ounce gold coins: U.S. Gold Eagle, South African Krugerrand, or the Canadian Maple Leaf – all have worldwide acceptance.

### Rebalancing the Portfolio

Once each year, rebalance the portfolio to the recommended percentages. This step causes you to sell some of your winners and buy assets that are cheaper. The chart below shows clearly how volatile the performance of individual assets can be and why rebalancing is necessary.



### Enhance Your Returns with Market Timing

Some investors wish to set aside a portion of their portfolio for other opportunities and some choose to boost returns with a proven method of market timing. Our web site ([www.thomasnogales.com](http://www.thomasnogales.com)) provides market timing alerts for the S&P500 index and the bond market. These asset classes amount to over 40% of the TNF Balanced Portfolio. Exiting the stock market during danger periods and when bonds face rising rates will greatly improve overall returns. (Our models do not correlate with the Russell 2000 Value stocks or REITs. Large cap foreign indexes often move with US markets.)

TNF also provides an indicator that warns of impending stock market crashes. Subscribers to our web site receive email alerts whenever our models change their status. These alerts are of immense value because they protect your capital from disaster.

### **Financial Crisis or Great Opportunity Ahead**

We recommend the Balanced Portfolio because the varied asset mix has produced good returns with safety for thirty years. What lies ahead makes balance a necessity.

In July 2006, the Federal Reserve published a report by Professor Laurence J. Kotlikoff warning that within the next few years, the US must develop a financial plan to deal with the massive, unfunded, generational cash outlays directly ahead. These outlays will start when the baby boom generation starts collecting benefits. The Federal Reserve estimates this amount to be \$65 Trillion dollars. The US doesn't have that money and simply can't pay it. The FED recommends unprecedented changes to social security, Medicare, the nation's tax system, and permitting the outright sale of US assets to Asians. They warn that if this isn't done, the US will soon be acknowledged as bankrupt and interest rates will soar as foreign nations shun our debt. Mind you, this warning isn't coming from a doom-and-gloom book author but from the United States Federal Reserve! The FED article is titled: "Is the US Bankrupt?" [http://www.thomasnogales.com/documents/is\\_the\\_united\\_states\\_bankrupt.pdf](http://www.thomasnogales.com/documents/is_the_united_states_bankrupt.pdf)

For the FED to take this stance in opposition to the cavalcade of lies and special interests pushed by both political parties and to call the politicians irresponsible, is simply incredible and reveals the magnitude of FED concern. Financial fears are already taking their toll on the dollar and bonds will follow unless the nation acts soon.

Dealing effectively with the \$65 Trillion dollar problem means Americans can expect in the future higher taxes and a lower level of retirement benefits from the government. Not dealing with the problem will result in rapidly rising inflation and interest rates because the FED will be forced to print money to pay off bond debt. In short, if the FED inflates, the US dollar will plummet. There will be a concomitant decline in consumer spending that will devastate foreign economies dependent on the US.

TNF believes the US government will take action but not before 2009 (after the 2008 election). At that point, they'll have, at most, three years to stabilize things. Crisis conditions will likely be required to force a bipartisan political conciliation (considering the deep political polarization within the US). Politics being what it is, a permanent fix is not a certainty and that could lead to prolonged market volatility.

It's hard to predict how stocks will fare in the years ahead. On the one hand, stocks do represent an ownership interest and have performed well during previous periods of gradually rising inflation. But, rapidly rising US inflation would undermine consumer confidence and corporate profits and lead to a deep economic contraction.

We face a financial crisis unless the politicians act responsibly and soon. The real question for investors right now is whether owning "stuff" or holding cash is the best bet.

Cash, gold, and foreign currencies would perform well during the early stages of a financial crisis. Stocks would get slammed as the consumer withdraws and profits decline. Bonds and all holders of debt will be hurt badly if the FED inflates. As of this report date, the TNF Interest Rate Model is already warning of rising rates. Money markets are preferred to long term bonds until the cycle reverses.

In a recovery, stocks would sell at a deep discount and then rise dramatically as foreigners were allowed to accumulate control of US companies. Interest rates could drop from very high levels providing once-in-a lifetime capital gain opportunities for those with cash and courage.

We face a very different world over the next twenty years with a transition to a global economic system and diminished US political and economic hegemony. Diversification of assets is critical and that means holding some foreign equities. Being debt free is a very good idea.

We hope the government acts very quickly to head off this financial crisis by adopting generational accounting. In contrast to President Bush's crony plan to create private accounts managed by Wall Street to replace social security, the FED article suggests worker money should be invested in a world stock index and managed at no cost by the government. This idea would be welcomed by all developed nations and could provide tremendous support and increased stability to stock markets around the world.

### **Summary**

I hope I've convinced you that asset allocation is a better idea than placing all your cash into popular mutual funds. You are quite capable of managing your own investments and avoiding high fees if you follow the rules of asset allocation to achieve your financial objectives. Paying someone a fixed percentage of assets each year to manage your money is costly and unnecessary. Discuss your investment plan with a financial advisor, a trusted securities broker, or your accountant if you wish. There may be specific issues depending on your age or other circumstances that should be considered.

The US will have to adopt generational accounting, change its old age programs, tax system, and open markets to foreign ownership if it's to avoid bankruptcy. The next five years are critical and you should expect volatile markets.

Be sure to rebalance your portfolio yearly and resist the temptation to excessively overweight one asset class or the other. Concentrating your money in one asset class (other than your home) can lead to higher risk than necessary. Use index funds or an ETF whenever possible to keep costs down. Managed funds are acceptable if costs are low.

Portfolio returns can be enhanced by using the Thomas Nogales Financial market timing models to manage your allocations to bonds and large capitalization US stocks. We also provide a market crash alert, timing alerts, and a monthly eletter by email to our web site subscribers.

Asset allocation should remain your core plan. It's easy to understand and just as easy to implement. It could be the most important financial decision you make.

Good luck!

**Tom Gleason, Manager**

Thomas Nogales Financial, LLC [www.thomasnogales.com](http://www.thomasnogales.com) July 2006  
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**Notes:**

The returns on REITS prior to 1995 are estimated and were obtained from published data deemed reliable. Gold returns are based on the year end price of spot gold in London. Commodity Futures returns are from the National Bureau of Economic Research. The foreign bond returns prior to 1994 are the average of year-end yields for bonds in major European countries and Japan; afterwards from the pforx fund. Short Term US government bond returns prior to 1994 are averaged from low cost mutual funds and afterwards are from an index fund. All other rate of return data is based on indices.

An excellent research paper on commodity returns was published by the Yale International Center for Finance: Facts and Fantasies about Commodity Futures [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=560042](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=560042)

The historical returns on the asset classes are not predictive of future results. All data in this report is believed accurate but errors may exist and thus it can't be guaranteed. We recommend that your investment plan should be reviewed by a financial advisor with no financial conflicts of interest.

Managed mutual funds are subject to investment policy changes, hidden advisor fees, and over concentration in asset classes. Use index funds whenever possible to minimize costs and eliminate manager bias. If your investment advisor is against index funds then proceed very carefully.

**Disclaimer:**

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Investing involves risk and the future performance of our models cannot be guaranteed. TNF is not a registered investment advisor and nothing published by TNF should be considered personalized investment advice. Any investment recommendations made by TNF should be made only after consulting with your investment advisor and only after reviewing the prospectus or relevant financial statements of the company. TNF does not receive any compensation for mentioning stocks, funds, or financial products.