Building and Managing Your Portfolio

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Building and managing your portfolio

Here's our long-awaited guide to portfolio construction. We hope you find it useful.

BEFORE YOU BEGIN

Before you read this report, it would be helpful to have read the *Membership Companion*, and *Value Investing Fundamentals* special reports. These are available from the website in the Special Reports section. They'll help you understand Intelligent Investor's investment philosophy, article categories and recommendations.

> ***Golden Rule No. 1: Never, ever go back to square one.***

INTRODUCTION

We live in an age of instant gratification. Instant noodles, instant win lotteries, speed dating, and instant home loan approvals are just some of the things people demand of modern life. You can even get a drive-through marriage in America (where else?).

So wouldn't it be fantastic if there was a computer program that produced an 'instant portfolio'? Just plug in how much cash you've accumulated, what your portfolio objectives are, tell it your risk profile, and press 'Go'. Hey presto! – out rolls a printout of the stocks and how much money you should allocate to each.

Unfortunately life isn't that simple. But, while putting together a portfolio takes a little time, it doesn't have to be difficult. The topic of building and managing a portfolio is perhaps the one that Intelligent Investor gets asked about more than any other, but we can't do it justice in an email reply of three paragraphs. So that's what this special report is about.

In the pages that follow, we'll look at building a portfolio of stocks and how you should manage that portfolio, and we'll examine the model portfolios run by Intelligent Investor. This report isn't just for people starting out – experienced investors should get something out of it too. The principles of building a portfolio and maintaining it are inextricably linked.

Before we get started, though, we have to point out what we can't help with. As a sharemarket publication, Intelligent Investor can only provide general advice on matters related to the sharemarket. In other words, you subscribe to us for general advice on listed securities. If you need help understanding your individual risk profile, or with broader asset allocation issues – what proportions of your portfolio should be allocated to shares, property, or fixed interest – we recommend you see a financial adviser. Ditto if you haven't yet decided whether to invest in shares directly or whether managed funds might be more suitable. We assume that, by the time you get to us, you're already interested in buying stocks listed on the Australian Securities Exchange (which, by the way, isn't suitable for everyone). So let's get started.

WHAT'S A PORTFOLIO?

The meaning of 'portfolio' seems to be something that investors are just expected to know. But in researching this report, we headed to the glossary on the Australian Securities Exchange's website to help define the term. Somewhat strangely, it didn't even appear, so let's propose a definition.

For our purposes, a portfolio is a group of two or more securities held by a person. Just consider what this means for a minute. Why would you buy more than one stock? The answer is because investing in any company involves risk and uncertainty. A business may face new competition after you've bought your shares, an exceptional managing director might leave, or the stock may have been overpriced in the first place. All these things, and innumerable others, can lead to a stock price declining and, in some cases, even a company going bankrupt.

As an aside, it's worth noting that many people underestimate risk in the sharemarket. Most of us are optimists by nature, so we often forget that it's normal for individual share prices to move 50% or more annually. Our optimism tends to be reinforced when the market has been rising for a few years and everyone is feeling better off.

But large household name companies can go bankrupt – just look at HIH Insurance. Other blue chips, such as Pacific Dunlop (now **Ansell**), have never regained their former share price heights. Then there's the risk of the left-field event. In April 2003, a well-respected second-line drug manufacturer, Pan Pharmaceuticals, was dealt a mortal blow when its manufacturing licence was suspended because of quality concerns. These risks mean that owning just one stock is a *really bad idea*.

So you buy more than one stock to reduce risk. One of the golden rules of portfolio management, and we'll come back to it numerous times in this report, is: Never, ever, go back to square one. If you own shares in just one company, and it performs poorly or goes bankrupt, you've lost your savings – and you're back to square one. You might not believe that people invest their life savings in just one stock – but they do. And we've heard some shocking tales of misery when that company went bankrupt. We'll get to the vital – and much misunderstood – topic of diversification shortly but, in essence, having a portfolio of stocks helps prevent you going back to square one. Now let's press on.

GETTING STARTED

We're going to assume you've already saved some money. If you haven't, the best way is to arrange a direct debit from your salary to a savings account that you've set up for the sole purpose of accumulating funds for investment. Once you have enough money – and we'll get to that shortly – you're ready to buy your first stock, right?

Well, curb that enthusiasm just a tad. Here's a charming story about a real member of the Intelligent Investor family who called us a little while back. One day she rang out of the blue and said: 'I've been subscribing for the past three years; I've read all the books on your reading list; and I think I'm just about ready to buy my first stock.' We think this member is destined to become an excellent investor.

Learning about companies, how to analyse them and, hardest of all, about your own psychology, takes years, not weeks. So read as much as you can about investing, including Intelligent Investor itself, company announcements and annual reports, and the books on our reading lists (which are available on our website under the Special Reports tab). Financial newspapers are also a good source of information, but bear in mind that their purpose is to sell newspapers rather than tell you whether a particular company is a good investment, so we suggest you read them with a highly sceptical eye.

This vital step – educating yourself – is the one that many investors neglect. It's strange how many doctors, lawyers, and engineers understand that mastery of their disciplines takes decades and more, and yet think they can invest successfully by spending twenty minutes a week reading the financial pages. As famed US fund manager Peter Lynch counselled in his book *One Up on Wall Street*: 'Invest at least as much time and effort choosing a new stock as you would choosing a new refrigerator'. (In case you're wondering, we suggest that means at least several hours, not 30 minutes.)

Of course, this is one of the main purposes of Intelligent Investor – to give you a narrowed-down list of promising stocks to investigate. But no sharemarket publication is a substitute for your own research and analysis and, over time, your own investing experience.

The sharemarket can be an expensive place to learn lessons about company valuation and your own psychology. But, once you're comfortable that you know at least the basics, you're ready for the next step in building your portfolio.

MY INVESTMENT PLAN

- What's my time horizon?
- What's my risk profile?
- What return do I want?
- Do I prefer growth or income?
- Any other criteria?

> ***According to the Australian Securities Exchange, over the 20 years to December 2009, Australian shares returned a gross average annual return of 9.7%. At that rate, your money will double about every seven years.***

DEVELOP YOUR INVESTMENT PLAN

As with most endeavours, it's important to think about your portfolio objectives. The tricky bit is that your portfolio needs to reflect your financial situation, financial objectives, and risk profile. Your friends' and neighbours' financial objectives – and their tolerance for risk – may well be quite different from yours. A portfolio is a very individual thing and, indeed, no two are the same.

There are numerous questions you'll need to ask yourself while developing your plan. And we've listed some of the most important ones here:

- ***What's my time horizon?*** As you've already decided to invest in shares, it necessarily means you're willing to commit your funds to stocks for at least three to five years – and preferably more. Your time horizon depends on your age and your ultimate intentions for the money. If you're young and want to buy a house in five years, then you'll want your deposit to grow, but without too much risk (remember: never, ever go back to square one). Or, if you've just retired, your life expectancy these days is such that you'll probably need your capital to last for 20 years or more.
- ***What's my risk profile?*** This is a biggie. As we said earlier, most people underestimate the risks of investing in shares. If you're retired and seeking income, then you might want a conservative-type portfolio that produces mainly income, with low capital volatility. But if you're 30 and expect to work for another 30 years, then you can afford to buy some higher growth stocks, such as second-line companies and even the occasional speculative stock.
- ***What sort of returns do I want?*** You should be realistic here. According to the Australian Securities Exchange, over the 20 years to December 2009, Australian shares returned a gross average annual return of 9.7%. At that rate, your money will double about every seven years. Very successful investors can manage returns of 15% a year over the long run, while only the investing equivalents of Tiger Woods have ever achieved long-term returns of 20% or more. If you're expecting to make 30% a year, then we wish you luck – because that's what such a return would be.
- ***Do I want income or growth?*** While most of us want a bit of both, there is a trade-off. If you're looking for high growth, then your portfolio's income component might be less than 2% a year. Whereas if you're looking mainly for income, then the growth component of your return might be around 2–3% a year. Don't forget that conservative, income-oriented portfolios generally produce lower overall returns. As a very rough rule of thumb, we'd suggest growth investors should aim for an after-inflation total return of 6–8% a year, whereas income-oriented investors should aim for an after inflation total return of 4–5%. If you set realistic expectations, you're less likely to be disappointed.
- ***What other criteria am I looking for?*** One of Intelligent Investor's analysts has a preference for companies with owner-managers (management teams that own a significant proportion of their company's stock). So his investment plan reflects the fact that he looks primarily for companies with this characteristic.

TABLE 1: SELECTED RECOMMENDED STOCKS

COMPANY	ASX CODE	ISSUE	RECOMMENDED PRICE	LOW PRICE ($)	DECLINE (%)	PRICE NOW ($)
COMPUTERSHARE	CPU	101/Apr 02	2.56	1.53	–40.2	10.61
ARISTOCRAT LEISURE	ALL	122/Mar 03	1.76	0.76	–56.8	3.66
LEIGHTON HOLDINGS	LEI	146/Mar 04	10.84	7.83	–27.8	28.95
ARB CORPORATION	ARP	210/Oct 06	3.7	2.55	–31.1	5.7
COCHLEAR	COH	218/Feb 07	59.33	42.86	–27.8	74.32
PLATINUM	PTM	240/Jan 08	4.06	2.75	–32.3	4.68
CORPORATE EXPRESS	CXP	259/Oct 08	4.49	2.73	–39.2	5.67
MACQUARIE GROUP	MQG	262/Nov 08	26.44	15.75	–40.4	37.12

We suggest you write all these objectives down in an 'investment plan'. That way, you're less likely to stray into unfamiliar and potentially risky territory. For example, if you decide you're a conservative investor looking primarily for income, your plan should prevent you from buying shares in an oil stock that doesn't pay dividends. Buying all Intelligent Investor's recommendations isn't a good idea, because not all of them will be suitable for you. Instead, you need to pick and choose the ones that fit your objectives and risk profile.

While we're on the subject of risk, it's vital you understand the inherently volatile nature of stocks. As we mentioned earlier, having a portfolio is all about reducing risk. But individual stocks within your portfolio – including the ones Intelligent Investor recommends – will sometimes initially decline by 25%, 30% or even more (although some will rise much, much more than that over time). *This is completely normal.* Indeed, volatility must be expected.

If a 25% decline in a stock you own over six months causes you a lot of heartache, then consider the following three issues. First, be aware that you're already focusing on too short a time horizon. Second, consider that the stock – or direct share investing in general – might not suit your risk profile. And third, remember that it's your overall portfolio performance that matters, not the performance of any individual stocks within it.

Investing is all about seeing the 'big picture'. That means focusing on your total portfolio performance over at least a three-to-five year period. An individual stock's performance over a short period is nothing more than a distraction. And you should work to overcome this myopia if your reasons for buying it remain sound. Table 1 is a list of selected stocks that fell sharply after being recommended before going on to post strong gains.

> **"*Investing is all about seeing the 'big picture'. That means focusing on your total portfolio performance over at least a three-to-five year period. An individual stock's performance over a short period is nothing more than a distraction.*"**

HOW MUCH DO I NEED?

By now, you may have realised that a well-designed portfolio doesn't just happen. Your desire to 'BUY SOMETHING NOW' needs to be tempered by education and experience and, without some objectives, you could end up with a portfolio that's a dog's breakfast. And now we're getting into the nitty-gritty – how much money do you need to start?

Clearly everyone's circumstances will be different. These days many people are setting up self-managed superannuation funds (more on this topic later) which, according to those who should know, usually require a portfolio of perhaps $50,000–$100,000 to justify the additional administration and accounting costs. Other people might retire with a superannuation payout of more than $1m and need to fund their retirement. Then there's the uni student who has managed to save up $10,000 from working weekends and wants to start investing early (an extremely smart decision, it must be said).

Whichever category you're in, the same practical principles apply, which we'll get to shortly. But if we were to put a figure on it, $10,000 is about the minimum you should start with. If you've accumulated much less than this, you'll have trouble getting sufficient diversification. And that seems as good a place as any to begin the next topic.

WHY DIVERSIFY?

Diversification describes the lowering of price risk through the ownership of more than one stock. A portfolio, which by definition contains more than one stock, is therefore 'diversified'. But there are varying degrees of diversification and, generally speaking, the higher the number of stocks, the less volatile your portfolio will be.

Diversification is all about making sure that the returns from your stocks aren't highly 'correlated'; that is, that they don't move in tandem. For example, if you owned a three-stock portfolio of **Harvey Norman**, **Woolworths**, and **David Jones**, you wouldn't be very well diversified, despite all of them being large, blue chip companies. The reason is that they are all retailers, whose profits are driven by consumer spending. The idea behind diversification is to own shares in companies that aren't affected by the same things. If there was a prolonged recession, you'd expect the profits – and probably the share prices – of all three of these companies to suffer (although by varying degrees).

HOW MANY STOCKS SHOULD I OWN?

So how much diversification do you need? Or, to put it another way, what's the number of stocks you should own? Various arcane academic studies have examined this topic, and the conclusions have been pretty clear. You get substantially all the benefits of diversification by owning about 10–12 mostly uncorrelated stocks. In other words, you don't need to own any more than

HOW MANY STOCKS?

Between 10 and 12 is the theoretical optimum. But consider:

- The size of your porffolio
- Your risk profile
- The inherent diversification within the companies chosen;
- The allocation of funds between stocks and sectors

More than 25 is probably too many for most people.

10–12 stocks to have sufficient diversification. Adding more stocks to a portfolio after this number won't help reduce your risk substantially.

Of course, academic studies are based on a number of assumptions, which may or may not apply to a real portfolio. For example, they assume the investment of equal amounts into stocks in unrelated industries. In real life, this isn't likely to be exactly how you invest. So what are some practical things to consider when deciding how many stocks you should own?

First, the size of your portfolio makes a difference. Someone young with $10,000 to invest shouldn't usually buy 10 stocks. To do so would mean incurring 10 lots of brokerage, which is an insidious cost many underestimate (more on this on page 11). And, over time, a young person should try to build their portfolio value by periodically investing their savings. While you'll initially have insufficient diversification, you should probably buy two to three stocks with your $10,000, with the intention of adding to the portfolio as your savings accumulate.

Moving up the scale, someone with $50,000–$100,000 to invest should probably aim for 7–10 stocks as they probably remain in the accumulation phase of their portfolio too. While a retired income-seeking investor with $500,000–$1,000,000 to invest might prefer more than 20 stocks to keep volatility to a minimum and ensure the failure of any one company doesn't cause undue damage to the portfolio.

These suggestions are only general guidelines, of course, and we'll get to the related topic of capital allocation later. Over time you'll decide how many stocks suit you, but these give you an idea if you're starting out.

How many stocks you own also depends on another consideration – your risk profile. A 30-year-old, growth oriented investor with 10 years of investing experience should be able to cope with a less diversified – and therefore more volatile – portfolio than a 70-year-old, income-oriented person with little investing experience.

Third, bear in mind that there may be inherent diversification within the companies you are considering. For example, a three-stock portfolio of **Australian Foundation Investment Company** (AFIC), **Wesfarmers** and **Westfield Group** is probably more diversified than a five-stock portfolio of **Bank of Queensland**, **Alumina**, **David Jones**, **West Australian Newspapers** and **Telstra.** That's because the three companies, which consist of a listed investment company, a diversified industrial with retail and resource interests, and an international property group have more underlying diversity in their businesses than the other five.

Finally, the allocation of funds between stocks and sectors should be considered. A portfolio of 15 stocks, but with 60% of the portfolio's value in one of the stocks, will probably be inadequately diversified (assuming the big holding isn't something like AFIC). Or a portfolio with 15 stocks, but with 60% of the value invested in three stocks in the retail sector, may also be inadequately diversified. When thinking about the amounts you invest in any stock, ask yourself this question: 'If my largest two investments went belly up tomorrow, would it damage my future financial security beyond repair?' If the answer is yes, then you are probably not sufficiently diversified.

> ***When thinking about the amounts you invest in any stock, ask yourself this question: 'If my largest two investments went belly up tomorrow, would it damage my future financial security beyond repair?***

Okay, so we've worked out that having some portfolio diversification is a good thing. But before we start choosing which stocks to buy, let's bust a few diversification myths.

DIVERSIFICATION MYTH NO. 1: TOO MUCH IS NEVER ENOUGH

There is one problem with diversification – you can have too much of a good thing. Many experienced investors are critical of over-diversification and they have, as we'll find out here, some pretty good reasons.

Warren Buffett, whose portfolios have been typically quite concentrated, has said: 'Wide diversification is only required when investors do not understand what they are doing.' Peter Lynch, author of *One Up on Wall Street*, agrees: 'A foolish diversity is the hobgoblin of small investors'. While there is no 'right' number of stocks to own, it's fair to say that much more than 25 is probably too many.

First of all, keeping track of all your investments simply becomes too hard. And we're not just talking about the hazard of your filing cabinet stuffed to overflowing with dividend statements, annual reports and contract notes. To have the best chance of success, investors should only buy businesses that they understand. As the number of stocks in your portfolio increases, it becomes less and less likely that you will understand each of them well. Information overload can be a hazard of investing, and the fewer stocks you own, the better eye you can keep on them. Believe us, it's much easier to read 10–15 annual reports a year than the hundreds we wade through at Intelligent Investor (not that we're complaining – it's what you pay us for).

THE DIVERSIFICATION PARADOX

There's an even more important reason why you shouldn't over-diversify. It's a bit of a paradox, but you don't really want to reduce volatility to nothing. And the reason? By limiting your downside, you must necessarily limit your upside.

We'll illustrate using a simple example. Let's say you have a portfolio of 50 stocks where 49 of them produce a zero return for the year, while one of them doubles. The annual return on your portfolio will be only 2%. But if you have a portfolio of 10 stocks where nine of them produce a zero return and one doubles, your total return will be 10%.

So, rather than diversify for the sake of it, concentrate on making fewer, better, decisions. In *One Up on Wall Street*, Peter Lynch described his search for 'tenbaggers' – the stocks that rise tenfold. You only need to buy a few of these in a lifetime to increase your overall returns significantly. In preparing this special report, one of the analysts at Intelligent Investor described this portfolio management principle particularly succinctly:

'You invest in a number of businesses that take your fancy. You plant the seeds, some grow and do okay, some die

off, and a very few grow beyond your wildest dreams. On this basis, for an investment in each stock, the downside is limited while the upside is unlimited.'

Unless you place meaningful amounts in your best stock ideas, your overall returns can't benefit from the ones that double, triple or more. You'll probably have greater overall volatility along the way with a relatively concentrated portfolio, of course. But the more stocks you have, the less will be the effect of the ones that 'grow beyond your wildest dreams'.

DIVERSIFICATION MYTH NO. 2: JUST BUY STOCKS IN DIFFERENT SECTORS

But here's an even scarier myth. It's especially worrisome because it's pushed by brokers and financial planners, who will happily tell you 'just buy stocks in different sectors'.

Superficially, it makes sense. If you're starting out, you think that diversification comes about by buying stocks in different sectors. The more sectors you have, the more diversified your portfolio will be. But this ignores our second golden rule of portfolio management: 'never, ever buy a stock unless it is undervalued'.

> ***Golden Rule No. 2: Never, ever buy a stock unless it is undervalued.***

Too many investors think that a diversified portfolio should consist of a stock in each sector, such as banks, insurance, retailing, resources, utilities, health, food manufacturing, building materials, business services and media, for example. But this really is the wrong way to think about it.

Certainly you'll prefer a spread of stocks in different sectors over time. But it's very unlikely that every sector will offer value at any one point in time. Buying a stock to 'get some sector diversification' would be foolhardy if the sector itself is highly priced.

Also, structural changes to industries over time can mean that choosing your stocks by sector alone is a risky strategy. Utilities, such as gas and electricity providers, for example, were once considered safe, reliable, and income producing. That was until takeovers, mergers and the 'quest for growth' saw debt levels and complexity rise significantly. And, in the food sector, there are relatively few listed companies left.

Choosing a stock based on its sector, then, is a strategy fraught with risks. Rather, try not to have any preconceived notions about how your portfolio will look two or three years hence.

So what's the alternative? How exactly do you choose stocks for your portfolio? Let's move on to the next section, where we'll answer exactly these questions.

WHICH STOCKS SHOULD I BUY?

Let's recap the story so far. We've seen that education, formulating an investment plan and considering diversification are three very important steps before you even buy a stock. But now we're getting down to the nitty gritty – how do you decide which stocks to buy?

The answer is that it depends on your education and experience, your investment plan, and how much diversification you already have. There are some other portfolio principles you should follow, and we'll get to them shortly, but first of all consider this portfolio building idea suggested by Warren Buffett: imagine you have a 20-stock punch card for life. For each company you buy, your card is punched by your broker (who, we suspect, would need to find a new source of income under this transaction-unfriendly system). Once the card is punched 20 times, you've reached your limit. You're no longer allowed to buy another stock. Ever.

The advice is probably not meant to be taken completely literally, but it should get you thinking the right way. If you were restricted to buying only 20 stocks over the course of your life, which ones would you buy?

For one thing, you wouldn't make hasty decisions. You'd patiently research each company very, very carefully to make sure you didn't waste the opportunity. No doubt you'd want it to be an excellent business with a sustainable competitive advantage, because you'd probably be holding onto it for a long time. And you'd want each new stock to be very cheap, otherwise you'd just invest in one of the companies you already owned.

Next time you buy a stock, think about that punch card and see where it takes you. Are you buying because you've got the cash and are impatient to act? Or are you buying it because someone told you it's 'the next big thing'? If it isn't a high quality, well-managed, excellent business trading well below its underlying value, then you should think about whether it's really the best use for your money.

PRACTICAL PORTFOLIO PRINCIPLES

Now that we're thinking the right way, let's press on. In this section we'll outline some practical principles to follow before you buy your first stock, or add a new one to your portfolio. Follow these basic principles and you'll be well on the way to deciding if a stock is right for you.

Portfolio Principle No. 1: Only buy undervalued stocks

A little earlier, we mentioned the second golden rule of portfolio management (and buying shares in general) – never, ever buy a stock unless it is undervalued. It sounds simple, and perhaps downright obvious, but you'd be surprised how many people buy a stock for some other reason – such as 'it's going up' (perhaps it *has* in the past, but that doesn't mean it will in future).

Of course, working out whether a stock is undervalued isn't easy. That's why you subscribe to Intelligent Investor – to learn how to analyse companies, and to find out which stocks we think are undervalued.

At a practical level, then, you can take it that we think a stock is undervalued, and suitable for purchase now, if we have some sort of buy recommendation on it, whether that be Strong Buy, Buy, Long Term Buy, Speculative Buy or Buy for Yield.

The highest returns will come from buying only the most undervalued stocks. So if you're looking for the strongest possible returns, you might want to restrict your buying to those stocks in the Buy and Strong Buy categories. Bear in mind, though, that at times of buoyant market sentiment we'll have relatively few of these recommendations. Please refer to our *Membership Companion* for a full explanation of how our recommendation system works.

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Portfolio Principle No. 2: Only buy stocks consistent with your investment plan

The second general principle follows from the work you put in earlier. If you're serious about putting together a sound portfolio, you'll have developed an investment plan that considers the issues we discussed earlier, such as your objectives and risk profile.

The stocks you buy, then, should obviously be consistent with this plan. For example, if you've decided you're a conservative investor looking for a yield of 5% from your portfolio, you should concentrate on stocks that help to meet that aim. You'd perhaps consider banks, listed property trusts, high-yielding blue chip industrial stocks, and income securities for example. Conversely, you'd avoid speculative stocks, resources and high-growth businesses. Just make sure that any stocks you select also conform with Portfolio Principle No. 1 – there's no point buying them unless they are also undervalued.

Our risk ratings will help you make selections here. If you're a conservative investor, you probably don't want to buy anything with a fundamental or share price risk rating of four or above. The ancient Greeks may have implored their peoples to 'Know thyself ' but, in selecting stocks, the aphorism must be 'Know thy risk profile'. Many investment errors are made simply because people choose stocks that aren't consistent with their tolerance for risk. Don't let that be you.

Portfolio Principle No. 3: Buy opportunistically

It's tempting when you have some cash for investment to want to act. But high quality, well-managed, undervalued companies aren't available on call. So it's essential that you train yourself to wait for good opportunities to present themselves.

Excellent buying opportunities often follow bad news, which causes a company's share price to fall sharply. Some of Intelligent Investor's best recommendations have resulted from 'bad news', such when we upgraded bionic ear implant manufacturer **Cochlear** on news of a US Department of Justice inquiry in issue 147/Mar 04 (Buy – $19.04), or airport owner MAp Group during the global financial crisis in issue 267/Mar 09 (Buy – $1.715).

Intelligent Investor's members sometimes complain that we have relatively few large company buy recommendations at any point in time. But that's because you need to be opportunistic, acting on our recommendations when we make them. Over the past few years, members acting on our upgrades could have bought into high quality large companies such as **Aristocrat Leisure**, **QBE Insurance**, **CSL**, **Foster's Group**, **Harvey Norman**, **Insurance Australia Group**, MAp Group, **Metcash**, Cochlear and **Woolworths**, amongst others.

So what if you face the pleasant scenario of having a large chunk of cash available for investment? This is the position many people find themselves in at retirement, or when they have first set up a self-managed superannuation fund. In our view, the worst thing you can do is invest immediately in a broad range of stocks and sectors (see Diversification Myth No. 2 on page 7). Instead, we suggest you take your time, building up your portfolio as good buying opportunities present themselves.

A sound portfolio will take years rather than weeks to build, so don't be afraid to take your time. In the stockmarket, patience really is a virtue.

Portfolio Principle No. 4: Allocate capital appropriately

How you allocate your investment capital between individual stocks, and different types of stocks, can make a big difference to your risk – and your overall returns.

You should probably think in terms of a portfolio hierarchy. The idea is to initially invest the majority of your capital in very high-quality companies. Once you have those stocks in place, and a bit of experience as well, you can add some good smaller companies. And as your experience grows, you may want to add a speculative stock or two to your portfolio. As you slide down the hierarchy, from high-quality large companies to speculative smaller companies, the amount of capital you place in a stock should decrease.

Using the classifications of stocks we use in Intelligent Investor, Table 2 is an illustration of how the hierarchy might work for an 'average' investor seeking mainly growth, with five years of investing experience and $150,000 in capital.

At the top are the high-quality large companies, which should make up the lion's share of your portfolio. Beneath that, if you're comfortable with more risk, you might then invest in some second line companies (as long as they're undervalued of course). At the very bottom of the hierarchy

are the 'high stakes' speculative stocks. If you buy them at all, you should only ever allocate a small proportion of your portfolio to them. As we say in our *Membership Companion*, and our initial reviews of these speculative stocks, 2–3% should do it.

TABLE 2: ILLUSTRATIVE CAPITAL ALLOCATION

	CAPITAL ALLOC. ($)	NO. OF STOCKS	% OF PORT.	AVRG. ALLOC. PER STOCK
BLUE CHIP INDUSTRIALS	100,000	7	66.7	14,286
SECOND LINE INDUSTRIALS	25,000	2	6.7	12,500
BLUE CHIP RESOURCES	12,000	2	8.0	6,000
SECOND LINE RESOURCES	6,000	1	4.0	6,000
HIGH STAKES (SPECULATIVE)	7,000	2	4.7	3,500
TOTAL	**150,000**	**14**		

You also need to allocate capital to individual companies appropriately. When Intelligent Investor upgrades a stock, we'll sometimes suggest portfolio limits (such as 3%, 5%, or 8%). If you invest too much at the very beginning, say 10–15% for example, you won't have much 'wiggle room' to buy more later if the opportunity gets even better. This is particularly the case with the least undervalued stocks, such as those with Long Term Buy recommendations, which can get even cheaper before they recover. This is why we sometimes suggest a limit of, say, 5% on our initial buy recommendation, before moving to 8–10% as the story unfolds.

Clearly this presents a problem for investors with small portfolios. And the smaller it is, the more difficult it is to allocate capital appropriately. Returning to our previous example of someone starting out with $10,000, with two to three stocks they are investing 33%–50% of their capital in each stock.

Somewhat ironically, it's this investor, full of enthusiasm but usually inexperienced, who is forced to take the biggest risk. So it's vital that this investor takes time to find the best value, high-quality businesses for their two or three stocks. Indeed, those with small portfolios should consider the inherent diversity of listed investment companies. All too often, though, these investors end up choosing a couple of speculative stocks, hoping to make a bundle. And they might get lucky, but there's a high probability that they'll violate our first golden rule: Never, ever go back to square one.

Before we move onto the next important step – managing and maintaining your portfolio – there are a couple of other topics we need to cover. As they don't fit anywhere else, here's as good a place as any to examine three questions: 'How much cash should I hold?', 'Should I borrow?' and 'What if I have a self-managed superannuation fund?' Let's jump straight in.

KEY PRINCIPLES

- Only buy undervalued stocks
- Only buy stocks consistent with your investment plan
- Buy opportunistically
- Allocate capital appropriately

You should probably think in terms of a portfolio hierarchy. The idea is to initially invest the majority of your capital in very high-quality companies. Once you have those stocks in place, and a bit of experience as well, you can add some good smaller companies.

HOW MUCH CASH SHOULD I HOLD?

If only there was a definitive answer to this question. As with many of the topics we've already discussed, how much cash you keep at any one time will depend, to a large extent, on your risk profile and objectives.

What we would say, though, is consistent with Portfolio Principle No. 3 – you probably want some cash on hand to take advantage of any buying opportunities that might appear. Undervalued stocks can appear without warning, and sometimes you only have a relatively short time – such as a few weeks – to act. If you dither around deciding what to sell, you're more likely to miss the opportunity than if you have the cash readily available.

So we suggest that you probably aim to keep at least 5–10% in cash for these opportunities. Bear in mind that this is cash that you have designated for your listed stock portfolio. Cash that you will use for living expenses, or for other investment purposes, should be kept separate. And when we talk about cash, we mean 'cash' – the sort you hold in an at-call bank account or cash management trust that you can access within a day or so.

Of course, there are times when you might want to hold much more cash. When markets are buoyant and value is hard to find, you might naturally find you're holding more cash than you might otherwise, perhaps 15–25%. Indeed, some investors, if they can't find any stand-out opportunities, are happy holding up to 50% of their stock portfolio in cash. After all, there's no point buying a stock that isn't consistent with Portfolio Principle No. 1: Only buy undervalued stocks.

But there are some disadvantages to holding cash, too. It's notoriously difficult to pick the direction of markets – in fact, we'd say it's nigh on impossible. So waiting for a market downturn to buy means you are likely to miss good opportunities. We suggest you ignore market gyrations and just focus on buying high-quality undervalued stocks as they appear. Peter Lynch has said he prefers to be 'caught with his pants up', which means he keeps himself pretty much fully invested so as not to miss the big sharemarket runs that boost long-term returns.

The big downside to holding cash is 'cash drag'. You're unlikely to earn much more than 3–6% a year on your cash over the long term. Whereas, if you're a growth investor, you should probably aim for an after-inflation long-term return of 6–8% annually (see page 4). The more cash you hold, the harder your stocks have to work to generate this return.

Instead of holding cash, then, some people choose to hold 'cash substitutes'. These can include investments such as income securities or takeover arbitrage plays, which should generate higher returns than cash, but which you can sell if you need the money to take advantage of a great buying opportunity. Of course, these cash substitutes aren't actually cash and, while they may be less volatile than other listed securities, you might incur a loss if you have to sell them.

SHOULD I BORROW?

Having cash for investment is a nice position to be in. But sometimes you just don't have enough to take advantage of the buying opportunities you've identified. Or you might want to diversify more than you otherwise could with a small portfolio. It's then that you might consider the idea of borrowing to buy shares.

It sounds risky – and it is. But we wouldn't say 'Don't borrow under any circumstances', as several analysts at Intelligent Investor have used prudent borrowing to build up their portfolios. First and foremost, be aware that borrowing magnifies your potential downside, not just your upside, and it significantly increases your chances of breaking the first golden rule of portfolio management. Remember? (We'll repeat it one last time: Never, ever go back to square one.)

> ***First and foremost, be aware that borrowing magnifies your potential downside, not just your upside, and it significantly increases your chances of breaking the first golden rule of portfolio management.***

There are two main methods of borrowing. One is to use a margin loan, which we consider the riskier of the two methods. The reason is that the margin loan provider can force you to stump up cash for a margin call to return the debt level to a certain proportion of the portfolio, or sell your shares at the worst possible moment (when their prices are plummeting). The other is to borrow using the equity in your home or an investment property. While you don't have a margin loan provider breathing down your neck at the first sign of market turmoil, if you overstretch yourself and can't meet the repayments, your bank (or perhaps your spouse) will make a margin loan provider look like Mary Poppins.

We suggest you don't borrow at all unless you meet the following criteria:

- You have surplus cash flow from a salary (or similar) to service the debt;
- You've had at least a few years of investing experience;
- You could recover from a total wipeout, which means you're either a high-income earner, or you have a long time before retirement (at least 15–20 years);
- You keep borrowings to less than 50% of the portfolio value;
- You have access to sufficient cash to meet a margin call in the event of a market meltdown.

Break these criteria, and we're sorry to say it, but you're putting your entire portfolio at risk. Ignore them at your peril.

WHAT IF I HAVE A SELF-MANAGED SUPER FUND?

There's little doubt that, whatever its flaws, Australia's compulsory superannuation system is a great idea. But we find it a little strange that the legislation allows anyone, as long as they have enough money to justify the compliance costs, to establish and run their own superannuation fund. It's called, as you might expect, a self-managed super fund (or SMSF).

There are rules, of course, including the very important one that super funds can't borrow. But those rules don't go far enough in our opinion, as they don't tell you how to build and manage a portfolio (which is, after all, why you're reading this report). And we've occasionally been alarmed by some of the questions we've had from our newer members, who have just rolled over a few hundred thousand dollars from a conventional fund manager to a SMSF, in the hope of investing the funds better themselves.

We're not about to venture into the pros and cons of self-managed super, as you should see an accountant or financial adviser if you're considering it. But, in our view, running a SMSF should only be undertaken if you already have significant investing experience. Some of the questions we've received indicate this isn't always the case. While your fund manager might not be performing well, is it a good idea to place your future financial security in the hands of someone who has far less investing experience (you)?

If you have some experience, though, then the very nature of a superannuation fund, which is designed to provide for your retirement, will dictate your investment strategy. It will obviously be a very long-term portfolio, so buy stocks on the basis you might hold them for decades. And, as it's vital you don't blow up your retirement assets, you'll want a reasonably diversified portfolio with capital allocated appropriately (see Portfolio Principle No. 4 on page 8). Finally, while you'll want to invest reasonably conservatively, your main objective will be growth, so don't fill your SMSF with cash or income securities. Unless you're nearing retirement and plan to start taking an income from the fund in a few years, growth-oriented stocks will be the way to go.

THE NEXT STEP: PORTFOLIO MANAGEMENT

> ***To achieve excellent results, it's important to become very accomplished at doing absolutely nothing.***

If you've read the foregoing sections, you're well on your way to a sensibly constructed portfolio. On the other hand, if you've jumped to this section because you already have a portfolio, we still strongly suggest you read what's gone before. The guidelines for building a portfolio also provide vital clues on how to manage it.

As you've probably realised, a portfolio doesn't happen overnight, but nor does it stay static. It evolves over time, and various transactions may be required as it grows or changes. In this section we'll look at some of the changes you might have to make.

As we've already indicated, most people should try to build up a 'core' of high-quality, large companies over time. In terms of percentages of your total share portfolio, and depending on your objectives and risk profile, these core holdings might represent anywhere between 50–100% of your portfolio value. These are your 'punch card' stocks – the high-quality businesses that you know very well, that you selected with great care, and that you'll be reluctant to part with. Ideally, you should never have to sell your core holdings, as long as they don't become absurdly overpriced.

After all, the best returns come from holding quality businesses for the very long term. Fiddling with the quality stocks in your portfolio risks interfering with the natural growth of the stocks that might 'grow beyond your wildest dreams'. To achieve excellent results, it's important to become very accomplished at doing absolutely nothing.

BROKERAGE AND TAXES

There are two other very good reasons why you should cultivate lethargy. Frequent trading results in two insidious drags on your portfolio – brokerage and taxes. The more you trade, the more you enrich your broker, and the less money your portfolio will have working for you. If you trade 20 times a year using an online broker, that's an annual drag on your portfolio of $400–$600. A full-service broker will cost much more. While it may not seem like much, with a $50,000 portfolio generating a gross annual return of 10%, $600 of brokerage costs would knock your total return down to 8.8%. With smaller portfolios, the drag will be much worse.

Then there's the impact of taxation. Once again, if you're too quick to realise profits, you'll end up giving away chunks of your portfolio to the tax man. The longer you defer paying taxes on your profits, the more of your portfolio is working for you in the long run. And, remember, if you don't sell, you don't pay taxes. So why not just watch your dividends roll in?

Your core portfolio, then, shouldn't change a great deal over time. But, at times, you will need to make adjustments to some of the stocks you hold. So what are some of these situations when you will need to act?

- ***One of your stocks becomes overvalued***.

  This one's easy – you sell all or some of it and start (patiently) looking for an alternative (see below). In a practical sense, you'll know that we consider this a wise course of action when we recommend Take Part Profits or Sell (our *Membership Companion* should be consulted for how to use our various sell recommendations). But, whatever you do, don't sell just because you have a profit, or just because the stock has doubled (or even tripled). The underlying value of a quality company will tend to rise over time, so to sell just because the share price has gone up means you'll risk missing the really big winners.
- ***One of your stocks has grown to represent too large a proportion of your portfolio***. This is a tricky one, as 'too large' a proportion is subjective. Some of the analysts at Intelligent Investor are comfortable with more than 30% of their portfolios in one, high quality company (usually because the share price has grown over many years). On the other hand, if a speculative stock grew from 3% of your portfolio to 15% in a year, then you should give serious consideration to pruning it back. Of course, the stock's underlying value should drive your ultimate decision. But, in general, if one stock grows to 25–30% of your portfolio, then its effect on your future returns will be highly significant.
- ***One of your companies is subject to a takeover or a buyback***. What to do in these situations is beyond the scope of this report but, if you accept the offer, a takeover or buyback will sometimes release cash for further investment (see next point).
- ***One of your companies launches a rights issue to raise cash***. Whether you take up or sell your rights on market (the latter option is only available if the rights issue is 'renounceable') will depend on how much capital you've already allocated to this stock (See Portfolio Principle No. 4 on page 8). A rights issue is one of the situations in which our earlier advice to concentrate on doing nothing is unwise and, because you usually need to act quickly, it's a good reason why you should have some cash readily available.

> *There's little point holding small stakes in companies that are fully valued, so sell them and redeploy the cash elsewhere.*

- *You have accumulated some cash and want to invest it*. Simply run through the portfolio principles on page 8 again. Bear in mind that the best stock to buy may be one you already own. If you have sufficient diversification, and think one of your existing holdings remains undervalued, why not top up? Whether the price has fallen or risen should be irrelevant – if the stock is still undervalued, and it won't represent too large a chunk of your portfolio, then beefing up an existing holding can be a smart choice.
- *Your portfolio has become too unwieldy*. Sometimes it's easy to let the number of stocks in your portfolio balloon to 30 or more. While you might like to have small amounts in a range of stocks to keep an eye on them, don't let your portfolio run wild. There's little point holding small stakes in companies that are fully valued, so sell them and redeploy the cash elsewhere. And remember that, as your portfolio grows, you will need to increase the amount of capital you allocate to each purchase. Otherwise, your portfolio can easily become an over-diversified hodgepodge.
- *You need to raise some cash for some other purpose*. Ideally, you shouldn't need to dip into your stock portfolio regularly for living expenses or capital purchases (such as a car). But if you don't have available cash, then selling some stocks may be your only option. The least undervalued stocks should obviously be the first to go, but you'll also need to consider the balance of your overall portfolio to make sure that any sales don't leave you insufficiently diversified.

These, then, are the major decisions you will have to take as your portfolio evolves. Over time, wise capital allocation and sound diversification will become second nature. But, if it all seems a bit abstract, then some practical examples might help – and that's exactly what Intelligent Investor's model portfolios are for.

INTELLIGENT INVESTOR'S MODEL PORTFOLIOS

For illustrative purposes, Intelligent Investor has run model Growth and Income portfolios since August 2001, with each portfolio beginning with capital of $100,000. We 'manage' these portfolios, 'buying' stocks that we think fit the criteria of each portfolio, and 'selling' stocks if they become overvalued, or our reasons for buying them no longer hold. If you're looking for a practical illustration of managing a portfolio, then keeping a close eye on these two portfolios should help immensely.

This section contains a snapshot of these portfolios at the time of writing. Over time, they will evolve as purchases and sales are made. So bear in mind that they may have changed by the time you read this, perhaps significantly. The changes we make to our portfolios can be found on the front page of every issue of the newsletter, and an up-to-date list of current holdings is always available under the Portfolios tab on our website. If you're keen to see how they have evolved over time, you can download our six-monthly *Portfolios Update* – which are mailed out to print edition members after 30 June and 31 December every year – from the Special Reports section of our website.

Now let's take a look at how each portfolio currently stands, and find out a little about why they look like they do.

INCOME PORTFOLIO

Our Income Portfolio, as its name suggests, is focused towards providing secure levels of preferably fully franked income from companies with a minimal risk of bankruptcy. As such, it's particularly suitable for people aiming to live off the income from their investments. While this is our most conserva tive portfolio, it has, somewhat anomalously, consistently outperformed the Growth portfolio. More usually, we'd expect such a portfolio to underperform its racier counterpart.

Our Income portfolio, as its name suggests, is focused towards providing secure levels of preferably fully franked income from companies with a minimal risk of bankruptcy.

Signs of conservatism can be seen in the types of stocks held, including the fact some of them are very defensive (such as **Metcash** and **Foster's Group**) and the diversity of the portfolio. Overall the Income portfolio holds 21 stocks, rather more than we suggested on page 5.

Appropriate diversification, though, requires that the stocks be 'mostly uncorrelated'. In other words, they shouldn't be affected by the same factors. Within the portfolio we have two property groups, **Westfield Group** and **Australand**, five income securities (the securities with five letter ASX codes), and five infrastructure companies (**Australian Infrastructure Fund**, **Challenger Infrastructure Fund**, **MAp Group**, **Prime Infrastructure** and **Spark Infrastructure**).

While the biggest holding (**Platinum Asset Management**) accounts for 6% of the portfolio, in aggregate the infrastructure stocks account for a little less than 10%. Even if the infrastructure sector experienced problems (and debt levels tend to be high), the total weighting is low enough to ensure this conservative portfolio shouldn't suffer undue damage.

It's not the number of stocks that matter, then, but how they are correlated. Overall, the Income portfolio is reasonably well-diversified, but not as highly diversified as the number of stocks alone might indicate.

While the idea is to keep trading to a minimum and maintain the core holdings, we have changed the composition of the portfolio significantly in recent years. Having become less comfortable with the banking sector and **Telstra**, we currently have no exposure to these companies, which in the past have been favourites of income investors. As always, we will reconsider them at the right price.

Consistent with Portfolio Principle No. 3 (see page 8), we've taken advantage of difficult market conditions by buying a range of listed income securities and infrastructure stocks opportunistically. Both sectors suffered during the global financial crisis, allowing us to buy them at excellent prices.

Our investment plan for the Income portfolio originally forced us to pick only companies that pay fully franked dividends. But we adjusted this rule so that, while we will continue to focus on fully franked dividends, other good dividend payers are allowed (Westfield Group, **QBE Insurance** and the infrastructure stocks are examples).

While we've endeavoured to select stocks with minimal risk of bankruptcy, things have occasionally gone awry. For

INCOME PORTFOLIO

COMPANY NAME (ASX CODE)	PURCHASE PRICE ($)	PRICE ($) AT 30/6/09	LAST RECOMM.—ISSUE # (PRICE AT REVIEW)	SHARES	VALUE ($)
AUSTRALAND (ALZ)	2.23	2.42	Long Term Buy—296 ($2.50)	1,560	3,775.20
AUSTRALAND ASSETS (AAZPB)	67.00	82.96	Buy for Yield—296 ($83.00)	80	6,636.48
AUSTRALIAN INFR. FUND (AIX)	1.49	1.70	Hold—298 ($1.82)	2,500	4,250.00
CHALLENGER INFRA. FUND (CIF)	1.53	1.38	Buy for Yield—292 ($1.415)	2,400	3,312.00
CORPORATE EXPRESS (CXP)	3.74	5.67	Hold—295 ($5.62)	1,650	9,355.50
DEXUS RENTS (DXRPA)	70.00	83.00	Hold—279 ($83.00)	56	4,648.00
FOSTER'S GROUP (FGL)	5.13	5.65	Long Term Buy—296 ($5.52)	1,250	7,062.50
INFOMEDIA (IFM)	0.52	0.28	Hold—290 ($0.255)	42,500	11,687.50
MAP GROUP (MAP)	2.36	2.69	Long Term Buy—298 ($2.85)	3,280	8,823.20
METCASH (MTS)	3.93	4.19	Long Term Buy—297 ($3.95)	1,240	5,195.60
PLATINUM ASSET MMT (PTM)	4.30	4.68	Hold—298 ($5.00)	3,200	14,976.00
PRIME INFRASTRUCTURE (PIH)	3.55	3.26	Hold—295 ($4.16)	1,200	3,912.00
QBE INSURANCE (QBE)	20.64	18.20	Buy—298 ($18.81)	700	12,740.00
SERVCORP (SRV)	3.35	2.68	Long Term Buy—294 ($3.56)	1,800	4,824.00
SEVEN NET. TELYS4 (SVWPA)	84.11	77.25	Hold—292 ($86.25)	93	7,184.25
SOUTHERN CROSS SKIES (SAKHA)	71.00	91.25	Hold—282 ($83.40)	55	5,018.75
SPARK INFRASTRUCTURE (SKI)	1.05	1.15	Buy for Yield—291 ($1.260)	3,550	4,064.75
STW COMMUNICATIONS (SGN)	0.73	0.92	Hold—298 ($1.01)	7,000	6,405.00
WASHINGTON H SOUL PATTS. (SOL)	9.03	12.95	Hold—281 ($13.25)	700	9,065.00
WESTFIELD GROUP (WDC)	19.40	12.18	Long Term Buy—298 ($12.92)	1,086	13,227.48
WILSON INV. FUND (WIL)	0.93	0.63	Long Term Buy—279 ($0.730)	10,000	6,300.00
CASH (LIFETIME DIVIDENDS RECEIVED)					**90,053.95**
CASH (AVAILABLE FOR INVESTMENTS)					**5,063.86**

> *The Growth portfolio is probably most suited to someone who is looking to build up their assets, who doesn't need a great deal of income, and who can tolerate higher than average volatility and the occasional complete loss.*

example, we invested in the corporate bonds and convertible notes of Timbercorp, which fell into administration in 2009. While we're still hopeful of receiving some value for the bonds eventually, Timbercorp's failure is a blight on the record. But the important lesson has been that a 6% portfolio weighting to this company helped limit the damage.

One of our aims in the Income portfolio has been to stay fully invested and here we've been reasonably successful lately. Our cash balance (excluding the value of dividends, which we assume are spent on living expenses) is currently negligible. Occasionally takeovers, such as Colorado in 2007 and the impending takeover of **Corporate Express**, will release cash for investment elsewhere.

Overall, we've been very pleased with the progress of the Income portfolio. While it's been a struggle to keep turnover down, the portfolio has so far managed to achieve its aims without any major setbacks.

GROWTH PORTFOLIO

The model Growth Portfolio, by contrast, is a portfolio of 'best ideas'. In other words, we haven't restricted it to conservative or income-producing stocks. That suggests it should outperform the Income portfolio over long periods, although that hasn't been the case so far. The Growth portfolio is probably most suited to someone who is looking to build up their assets, who doesn't need a great deal of income, and who can tolerate higher than average volatility and the occasional complete loss.

Once again, the portfolio, with 29 stocks, looks more diversified than it actually is. Whereas the Income portfolio has only one stock that accounts for more than 6% of the portfolio, the Growth portfolio has four (**ARB Corporation**, which accounts for around 9%, Cochlear, Corporate Express, which is about to be taken over, and Platinum Asset Management). Another three high quality stocks represent more than 5%, so it's significantly more concentrated than the Income portfolio.

GROWTH PORTFOLIO

COMPANY NAME (ASX CODE)	PURCHASE PRICE ($)	PRICE ($) AT 30/6/09	LAST RECOMM.—ISSUE # (PRICE AT REVIEW)	SHARES	VALUE ($)
ARB CORPORATION (ARP)	3.05	5.70	Hold—293 ($6.00)	3,000	17,100.00
ARISTOCRAT LEISURE (ALL)	4.44	3.66	Long Term Buy—290 ($4.27)	1,100	4,026.00
AUSTRALAND (ALZ)	0.48	2.42	Long Term Buy—296 ($2.50)	2,180	5,275.60
AWE (AWE)	2.55	1.78	Speculative Buy—299 ($1.84)	2,025	3,594.38
BRICKWORKS (BKW)	12.45	11.95	Long Term Buy—292 ($12.65)	400	4,780.00
CATALPA (CAH)	1.49	1.63	Speculative Buy—294 ($1.60)	1,300	2,112.50
COCHLEAR (COH)	19.04	74.32	Hold—298 ($76.33)	200	14,864.00
CORPORATE EXPRESS (CXP)	4.31	5.67	Long Term Buy—295 ($5.57)	2,300	13,041.00
ELDERS PREF. SHARES (ELDPA)	55.55	40.95	Speculative Buy—298 ($48.00)	70	2,866.50
FLIGHT CENTRE (FLT)	11.70	16.63	Hold 296 ($16.37)	200	3,326.00
GOODMAN PLUS (GMPPA)	36.21	68.50	Hold—286 ($63.00)	55	3,767.50
HARVEY NORMAN (HVN)	2.63	3.31	Long Term Buy—299 ($3.38)	2,650	8,771.50
INFOMEDIA (IFM)	0.53	0.28	Hold—290 ($0.255)	25,800	7,095.00
ING PRIVATE EQUITY (IPE)	0.23	0.24	Hold—287 ($0.295)	8,700	2,088.00
INTEGRA (IGR)	0.24	0.30	Speculative Buy—294 (0.265)	8,200	2,460.00
MACQUARIE GROUP (MQG)	28.50	37.12	Long Term Buy—299 ($36.42)	150	5,568.00
MAP GROUP (MAP)	1.72	2.69	Long Term Buy—298 ($2.85)	4,027	10,832.63
OCEANIA CAPITAL (OCP)	2.79	1.51	Long Term Buy—297 ($2.07)	720	1,087.20
PLATINUM ASSET MMT (PTM)	5.49	4.68	Hold—298 ($5.00)	2,700	12,636.00
PRIME INFRASTRUCTURE (PIH)	3.36	3.26	Hold—295 ($4.16)	1,000	3,260.00
QBE INSURANCE (QBE)	21.55	18.20	Buy—298 ($18.81)	550	10,010.00
RHG GROUP (RHG)	0.40	0.62	Hold—290 ($0.625)	10,000	6,200.00
SERVCORP (SRV)	2.96	2.68	Long Term Buy—294 ($3.56)	1,636	4,384.48
SILVER LAKE (SLR)	1.17	1.76	Hold—297 (1.82)	1,700	2,983.50
SONIC HEALTHCARE (SHL)	10.03	10.43	Long Term Buy—298 ($10.85)	1,000	10,430.00
STW COMMUNICATIONS (SGN)	1.13	0.92	Hold—298 ($1.01)	10,000	9,150.00
TAP OIL (TAP)	0.53	0.86	Speculative Buy—296 ($0.85)	4,600	3,933.00
TREASURY GROUP (TRG)	13.49	5.06	Long Term Buy—297 ($5.05)	1,000	5,060.00
WESTFIELD GROUP (WDC)	13.15	12.18	Long Term Buy—298 ($12.92)	695	8,465.10
CASH					**6,438.97**
TOTAL					**195,606.86**

The large number of stocks is explained by the fact we've taken a 'portfolio within a portfolio' approach to some niche areas of the market. Recognising that riskier stocks don't always work out, we've diversified our capital within the oil stock sector (AWE and Tap Oil), speculative gold stocks (**Catalpa**, **Integra** and **Silver Lake**), private equity plays (**ING Private Equity** and **Oceania Capital**) and riskier income securities (**Goodman PLUS**, and **Elders Preference Shares**). These higher risk stocks, and others such as **RHG**, would rarely be considered for the more conservative Income portfolio.

Buying large 'blue chip' companies opportunistically has been an important part of building the Growth portfolio. For example, we bought positions in Cochlear, **Sonic Healthcare**, **Prime Infrastructure** and MAp Group when the news was pretty grim. Buying on bad news has generally resulted in excellent prices for these quality stocks.

> ***A sound portfolio should take many years to build. And once you've built it, it will naturally evolve and change over time.***

We've made our fair share of dud investments over the years, including Miller's Retail (now **Specialty Fashion Group**), Croesus Mining and Timbercorp in particular. But we've limited our risk by making sure the position sizes weren't too large. Careful capital allocation is, as we said earlier, absolutely vital.

While the intention is for the Income portfolio to remain fully invested, we usually like to maintain some cash in the Growth portfolio. The current cash holding of approximately $6,400 provides some flexibility to take advantage of any opportunities, as will the cash released by the impending takeover of Corporate Express.

The Growth portfolio has suffered from a few poor decisions over the years, but overall the successes have more than offset the mistakes. And while the stocks are, on average, riskier than those in the Income portfolio, prudent capital allocation has limited the fallout from the occasional error.

MODEL PORTFOLIO WRAP-UP

Our model portfolios have evolved and changed substantially over the years. And thankfully they have also grown significantly in value because we've bought quality stocks at excellent prices – and let time work its magic.

Of course, you can't simply replicate these portfolios as they stand. Stocks that we bought at much lower levels don't necessarily represent good value now, which is why many carry hold rather than buy recommendations.

But you can of course follow the changes to the portfolio. If we add a stock to one or both of the portfolios, it means we have a high degree of confidence that it will perform well over the long term (although you'll need to decide whether it's suitable for you). We also hope that, over time, the portfolios will provide useful examples of how stock portfolios can be managed in practice.

ODDS AND ENDS

The topic of building and managing a portfolio is vast, and there are some issues we haven't covered in this report. If you're wondering about some other portfolio-related issues, you might find them here:

- *Choosing a broker*. Before you buy shares, you'll obviously need a broker. You can get a list from www.asx.com.au, then call them or visit their websites to find out if they offer particular services you want, such as research. But here's one tip – whether you pay $20 or $30 for a transaction isn't really that important in the long run – so long as you keep your trading down – so don't spend too much time worrying about which one's the cheapest.
- *Portfolio management software*. The analysts at Intelligent Investor don't use any portfolio management software, preferring to record their portfolio details and transactions in simple spreadsheets. Many software programs include a lot of features, so we suggest you work out which ones you'll really need before buying a complicated program. You may not use a lot of the bells and whistles.
- *Record keeping*. Keeping adequate records is an important part of portfolio management, particularly for tax purposes. All those contract notes and dividend statements really start to accumulate. So, if your filing system leaves a bit to be desired, perhaps it's another thing you should work on. Otherwise, you can expect dirty looks from your accountant at tax time.
- *Taxation*. Your tax situation and the structure of your portfolio (for example, whether it's in your own name or a superannuation fund) will have some bearing on your portfolio. We strongly suggest you retain a good accountant to help you structure your tax affairs and provide advice on tax-related portfolio decisions (such as whether you realise losses for tax purposes).
- *Reviewing your portfolio*. Many people don't have time to keep a close watch on their portfolio (indeed, that's probably a good thing). But we suggest you review your portfolio every three to six months to ensure it's consistent with your objectives and risk profile, and to undertake any housekeeping (such as realizing tax losses etc.)

IN CONCLUSION

In an age of instant noodles, speed dating and fast home loan approvals, building a portfolio is one thing that simply can't be rushed. Not only must you educate yourself about investment, define your objectives and develop an investment plan, you must heed the important principles of diversification and wise capital allocation.

In fact, a sound portfolio should take many years to build. And once you've built it, it will naturally evolve and change over time. But, however much effort you put into managing your portfolio, we hope its ongoing maintenance is an enjoyable process.

By owning a range of well-managed, quality businesses, you're participating in the growth of the country – and becoming wealthier at the same time.

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