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HOW TO BUILD A 3-FUND PORTFOLIO

Less can be more for wealth building when it comes to structuring a portfolio.

By: Rebecca Lake - February 15, 2019

A simple portfolio of just three funds may be all that's needed to achieve investment goals and generate a return.

"The three-fund portfolio allows investors to gain exposure to three of the largest asset classes by purchasing three securities: U.S. equity, international equity and bonds," says Tom Desmond, executive director of Ally Invest Advisors. "Investors modify their risk by using different percentage allocations."

Tony Drake, CEO and founder of Drake and Associates in Waukesha, Wisconsin, says this strategy is often called the lazy portfolio because of its simplicity. "The concept is based on boiling down to three inverse asset classes that are very different," he says. "The theory is that when one goes up, another will go down."

Drake says it's an ultra-simplistic approach, but there is a layer of complexity when it comes to choosing the three funds to include. Like any other investment plan, there are advantages and disadvantages to consider.

Some of the appeal of this approach includes low management costs and low investment minimums, says Diane Brewer, CEO of Retirement Services of America in Santa Barbara, California.

"A three-fund portfolio is most optimal for a smaller investor, so they achieve maximum diversification with a small amount of investment for lower cost," Brewer says.

This approach can be more cost and tax-efficient if the funds included are exchange-traded funds. ETFs, which are baskets of investments that trade on a stock exchange, typically have a lower turnover rate than standard mutual funds. Assets within the fund are traded less often, resulting in fewer taxable events.

Drake says that since it's "essentially investing in the market as a whole," there is a little risk of underperforming the market. He says this method also eliminates the risk of a financial advisor attempting to outperform an index.

Experts add that portfolio management may also be easier.

Matthew Crum, founder of True North Financial Services in Kinnelon, New Jersey, says one of the most important responsibilities in portfolio management is to rebalance it periodically to bring it back to its target allocation. "Monitoring and rebalancing a portfolio with three funds is a much easier task to complete than it is with a portfolio of 10 funds," he says.

Here are a few aspects that investors should weigh if they are considering this direction:

- It's not right for everyone.
- Careful construction matters.
- This strategy is for a long-term focus.

It's Not Right for Everyone

Christy Smith, founder and principal of Presley Wealth Management in Denham Springs, Louisiana, says the biggest disadvantage associated with three-fund investing is the lack of risk control. She uses the recent uptick in interest rates as an example.

"While someone could up the percentage held in the bond portfolio, in a rising rate environment this could still result in limited upside potential or even losses," Smith says. "And unlike an actively managed account, the portfolio is not able to quickly adjust to changing market conditions."

A three-fund strategy can be limiting in a different way. Investors may have difficulty "diversifying into the many multiple specific sectors available in the market," Brewer says, especially if the funds or ETFs included have a narrow scope.

Drake says this method is more suitable for a longer investing horizon.

"A three-fund portfolio is a better option for someone who wants to 'set it and forget it'," he says. "It's much more appropriate for someone with a good appetite for risk; for example, a younger investor who isn't troubled by the swings of the market."

He says someone who's getting closer to retirement on the other hand, may find this approach elevates risk at the wrong time.

Careful Construction Matters

Smith says the first rule in building a three-fund portfolio is proper asset location. Specifically, that means understanding the difference between holding funds in a qualified or nonqualified account.

"With a nonqualified account, you must take into consideration the turnover rate and the tax consequences within each of the three funds," Smith says. "Look for low turnover fund families to minimize the tax implications."

Taking a holistic view of investment accounts can help, Desmond says.

"Attempting to generate the greatest potential for after-tax returns requires one to look at the assets in each category to gauge how that impacts them specifically," he says.

Crum says it's equally important to avoid funds that may change significantly over time, potentially skewing away from your target asset allocation. He adds that an index fund portfolio may be attractive, but investors should be aware of how that affects their strategy in varying assets.

"Many investors discuss the Standard and Poor 500 as the U.S. stock market; however, the S&P 500 is primarily composed of the largest companies in the U.S.," Crum says. "If an investor chose to own an S&P 500 index fund rather than a U.S. total stock market fund for U.S. exposure, they would be missing out on large portions of the market, like small- and mid-sized companies that may offer some diversification benefits to the overall portfolio."

On a granular level, Brewer says to weigh risk tolerance and time horizon against historical performance, track record and cost of individual funds or ETFs. "Take into consideration who is the larger manager on the block, such as size of the fund, and be certain it meets your personal investment objectives," she says.

This Strategy Is for a Long-Term Focus

Investing in three-funds requires a willingness to see market ups and downs through.

"In volatile markets, investors must have patience and not make knee-jerk reactions to turbulence," Smith says. "The truly passive investor will leave the allocations intact," while someone more hands on may want to rebalance among the three funds to combat market risk.

Staying informed on market conditions and researching funds thoroughly can minimize the potential for spur-of-the-moment decision-making.

"You must not make trades based on emotion," Brewer says. "Instead, allow due diligence to be your guide."

While market volatility can be worrying, keeping the underlying principles of three-fund investing in mind can make it easier to stay the course.

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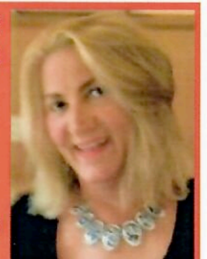

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