Model Portfolios for Every Financial Stage

Asset allocation is one of the most important financial decisions that you can make. The general asset classes that you invest your money into and the fraction of your investments that they each represent are a greater determining factor of your financial success than the specific funds or stocks that you pick, whether they are actively or passively managed, or what type of account you put them in. Therefore, this is the first topic that I wanted to tackle for Pathway to FI readers.

I have studied this concept throughout my investing career and carefully selected three model portfolios that map to the four stages on the Pathway to FI. They were made as simple as possible without sacrificing the key features that they seek to provide, which I describe in detail in my white paper. You will notice that these portfolios diverge significantly from the conventional wisdom that financial planners and mainstream media typically preach, which goes something like this: “your portfolio should be a mix of stocks and bonds, the ratio of which is a function of your age”. They are also more complex than the simple advice given by the Financial Independence Retire Early (FIRE) community: “put all of your money in a Total Stock Market fund until you have enough to retire, and then consider some bonds—no more than 25%—to smooth the ride”. Don’t get me wrong, these are both perfectly acceptable approaches. The thing is, they are both sub-optimal, and we now have tools and data at our disposal to show that investors can do better with a high probability while simultaneously having more peace of mind when the stock market is down 40%, 50%, or more.

Let me introduce the Pathway to FI model portfolios.

		Large Cap Blend	Small Cap Value	Inter-national	Real Estate	Utilities	Long Term Bonds	Gold
Stage 1/2	**Trailhead/Ascent**	35	30	25	5	5		
Stage 3	**Summit**	25	25	20	5	5	10	10
Stage 4	**Descent**	20	20	16	10	10	12	12

Figure 1 – Pathway to FI Model Portfolios

The first thing that jumps out is that Stages 1 and 2, when you are building toward financial security and independence, share a single portfolio. Notice that although five asset classes are represented, this is a 100% stock portfolio. The different asset classes serve to diversify across company size, country, and industry. Until you reach the Summit of financial independence, you want to be very aggressive and stick with high growth investments. Bonds and alternative assets that are not actively producing profits have no place in your portfolio at these stages, in my opinion.

At the Summit of FI, you can throttle back the market risk and volatility and increase the likelihood that your money will last a lifetime as well as the theoretical Safe Withdrawal Rate that you can enjoy in retirement. Therefore, the Stage 3 portfolio further diversifies into small positions in gold and bonds, which are uncorrelated and sometimes inversely correlated with the stock market. They tend to go up during bad economic times when stocks are plummeting and investors are looking for a safer place to put their money.

During the Descent, where you are now relying on your portfolio to support your daily lifestyle and your biggest concern is Sequence of Returns Risk—the risk that the market declines significantly within the first 10 years of retirement—you can take more risk off the table and further diversify into uncorrelated asset classes. The Stage 4 portfolio does this. Note that it still maintains 76% in common stocks to provide enough growth in the event of a very long, 40+ year retirement.

For a detailed analysis of the historical performance of these portfolios relative to a few traditional and popular portfolios, refer to my white paper.

There are many nuances around these portfolios and modifications that can be made if you like to geek out on this like me or if you have a situation or preference requiring a more aggressive or conservative approach than I have presented here. I will save those discussions for another time. Meanwhile, as a Subscriber to Pathway to FI, I will give priority to your email questions and comments if you contact me at blake@pathwaytofi.com. Let me know what you think!