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INVESTING IN FUNDS: A MONTHLY ANALYSIS**Mixing It Up
Stocking Up**

With inflation a serious worry, nervous investors may have too much to lose by moving heavily into cash

By **SHEFALI ANAND**
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Investors who recently have pulled money out of the stock market and moved it into safe investments like certificates of deposits are in danger of falling behind inflation, says Richard Schroeder, a financial planner at Schroeder, Braxton & Vogt Inc.

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In putting money in a 2% certificate of deposit today, when core inflation is about 4%, "you're absolutely guaranteeing a loss" in purchasing power, says Mr. Schroeder, citing research that shows stock-market returns have beaten inflation over the long haul. "It absolutely is the wrong time to throw money at a short-term fixed-rate investment."

In this column, we feature model portfolios from financial advisers who invest in mutual funds and exchange-traded funds. Mr. Schroeder, 54 years old, was a personal-finance columnist for the Buffalo News for 12 years, beginning in 1984, and became a certified financial planner in 1995. Four years later, he merged his practice with another advisory firm to form Schroeder, Braxton & Vogt, based in Amherst, N.Y. The firm manages \$221 million for about 436 clients.

In recent months, when clients have asked Mr. Schroeder if they should become more conservative in their investments, he pulls out studies showing that, between 1926 and 2007, the Standard & Poor's 500-stock index returned an annualized 7.1%, adjusted for inflation.

"Effects of inflation are enormous, and I'll do anything to try and alleviate that," says Mr. Schroeder. He recommends a mutual fund that invests in inflation-protected securities, in addition to funds with exposure to commodities, which are often considered inflation hedges.




Here, Mr. Schroeder shares a model "normal" portfolio, with 51% in U.S. and foreign stocks, 40% in bonds and a money-market account, and 9% in alternative investments. He expects the portfolio to return around 8% annualized over the next 10 years, assuming an inflation rate of 3.5%.

U.S. STOCKS: The portfolio has a 31% allocation to U.S. stocks, all of it through mutual funds offered by Dimensional Fund Advisors, of Santa Monica, Calif.

Mr. Schroeder is a big believer in academic research that indicates investors can beat the broad market over very long periods by investing in "value" stocks, which are

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companies, particularly small ones, that trade at cheap prices. Dimensional Fund Advisors, founded in 1981 and a favorite of many financial advisers, advocates this investment approach, taking a middle path between "active" money management, in which stock pickers use research to pick individual shares for a portfolio, and a "passive" index-based style.

Several theories aim to explain why value stocks, especially those of smaller companies, prevail over very long periods. One is that they carry a risk premium to reflect that they aren't as immediately desirable as those of bigger or flashier companies. Another says value stocks are deservedly cheaper -- the companies are of low credit quality, so they trade at a discount relative to "growth" stocks to induce investors to buy them.

Another theory suggests that value stocks are frequently "mispriced," perhaps because the market has overreacted to bad news. In any case, the outperformance can take decades to show up.

Dimensional uses computers to screen stocks for particular size, risk and return metrics, settling on broad buckets of stocks for the individual funds.

The firm focuses heavily on sales to institutional clients like pension funds and endowments. It sells to small investors through 401(k) plans and fee-only advisers, who are put through a boot camp that teaches the theories behind the company's strategy. It wants buy-and-hold types to help keep stock turnover and transaction costs low, believing low costs are essential to investment success.

Mr. Schroeder's U.S. stock allocation is divided thus: 13% in DFA US Large Cap Value Portfolio, 11% in DFA U.S. Large Company Portfolio, 4% in DFA US Small Cap Value Portfolio, and 3% in DFA US Micro Cap Portfolio.

INTERNATIONAL STOCKS: The portfolio has a 20% allocation to foreign funds, of which 16% is devoted to funds that invest in developed countries and the rest in developing-market stock funds.

While Mr. Schroeder likes passive funds such as the DFA ones, he makes an exception on the international side for Tweedy, Browne Global Value Fund. The fund is managed by a team that hunts for cheap stocks and holds them for long periods. Mr. Schroeder says the team holds stocks for so long that the fund has some of the low-turnover features of a passive fund.

The fund closed to new investors three years ago, because the managers said they weren't able to find companies that met their valuation criteria. It reopened earlier this year, a sign that they are finding more investment opportunities. "That makes me feel better about the markets" says Mr. Schroeder. The fund has a 11% allocation in the portfolio.

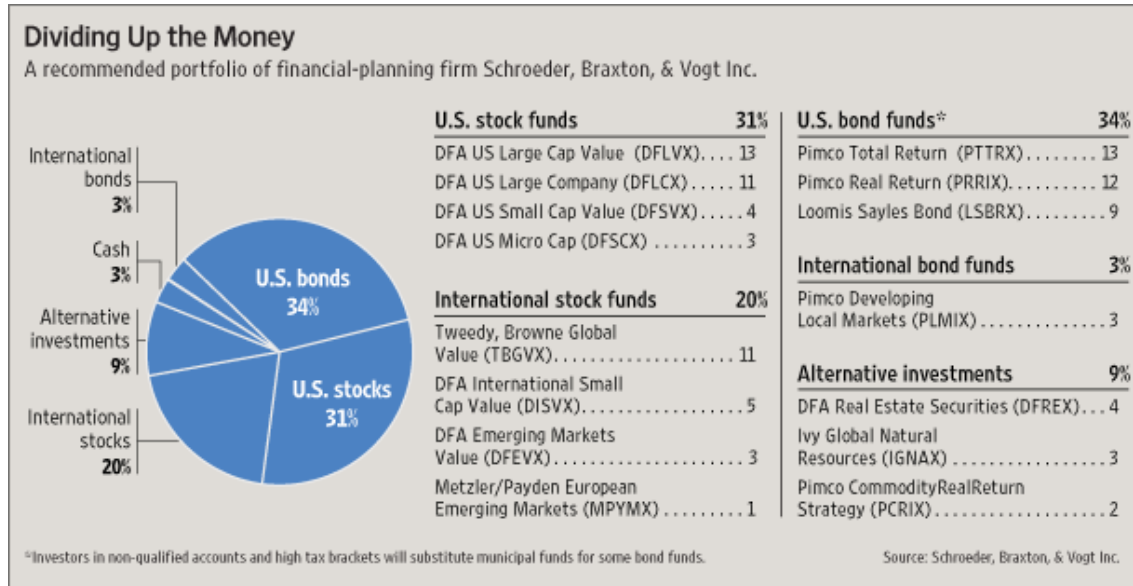
Two Dimensional funds figure in this portion of the portfolio: DFA International Small Cap Value Portfolio, at 5%, and DFA Emerging Markets Value Portfolio, at 3%.

Mr. Schroeder says Dimensional's emerging-markets fund has strict rules about which developing countries it can invest in, based on factors like ease of trading in the local stock market and ownership rights. As a result, it doesn't invest in countries like Russia and some Eastern European nations. So, in late 2006, he gave a 1% spot in the portfolio to Metzler/Payden European Emerging Markets Fund to "broaden slightly our emerging-market exposure." As of earlier this year, the fund had just over a fourth of its money invested in Russia, and about a fifth in Poland.

BONDS: The portfolio's investment in bonds is primarily through the family of funds at Allianz SE's Pacific Investment Management Co., or Pimco. Pimco's "integrity, plus their size, gives them the reach and expertise that other places don't have," says Mr. Schroeder.

The two largest bond allocations are to Pimco Total Return Fund, at 13%, and Pimco Real Return Fund, which invests in inflation-linked securities, at 12%. There is a 9% allocation to Loomis Sayles Bond Fund.

Like Pimco Total Return, this fund gives the manager flexibility in buying various types of bonds.



There is a 3% allocation to foreign bonds, through Pimco Developing Local Markets Fund. It invests in short-term bond instruments of developing countries

in their local currencies.

For investors in high marginal tax brackets, and for portfolios not held in tax-advantaged accounts like an Individual Retirement Account, Mr. Schroeder replaces the total-return funds with tax-exempt municipal bond funds. He uses short and medium-term funds from Vanguard and Dimensional.

The advisers typically keep 3% of the portfolio in money-market mutual funds to meet short-term cash needs.

ALTERNATIVE INVESTMENTS: Mr. Schroeder puts 4% of the portfolio in a real-estate fund because he has "always believed it's another legitimate asset class that offers diversification." Despite serious woes in the U.S. mortgage market and overbuilding of houses and condominiums in some regions, he hasn't changed the firm's allocation to DFA Real Estate Securities Portfolio.

The portfolio has a 2% allocation to Pimco CommodityRealReturn Strategy Fund, which holds futures and other instruments to track an index of commodity prices. Mr. Schroeder says that, unlike some other commodity funds, the Pimco fund isn't too tied to energy companies because the underlying index doesn't invest more than 25% in any one commodity.

The remaining 3% of the portfolio is invested in Ivy Global Natural Resources Fund, which buys stocks of companies in the commodity business. Its investments in timber and water-related stocks make it a good complement to the Pimco fund, says Mr. Schroeder.

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