

# Putting It All Together

Morningstar Research | Tom Whitelaw

In this article, we will look at how an investor can build a balanced portfolio of equity funds. The funds included here are used purely for illustrative purposes, but you can use the same principles and tools to make sure your portfolio is in good shape. How you go about it will depend on your personal circumstances, your existing holdings, your time horizon, and your appetite for volatility.

Our fund picks come from six broad Morningstar Category groups: U.S. large cap, U.S. mid-cap, U.S. small cap, foreign stock (world ex-United States), world stock (everything), and emerging markets.

The list excludes specialist sector and country funds because they are often best used tactically, or to fill a hole in a portfolio. Here, though, we aim to layer in broad diversification that enhances investment results through thick and thin, obviating the need for tactical adjustments or hole-filling.

Among the 886 U.S.-domiciled equity funds and exchange-traded funds that Morningstar covers across the six categories above, we have made our selections from the 216 strategies we regard as best in class, signified by Morningstar Analyst Ratings of either Gold or Silver.

## U.S. Large Cap

Two Gold funds that stand out from the abundance of U.S. large-cap options are **Dodge & Cox Stock** DODGX and **T. Rowe Price Blue Chip Growth** TRBCX. They are excellent strategies in their own right and complementary when combined. Indeed, as their active share exceeds 88%, the funds' overlap in holdings is less than 12%, a figure that includes both the stocks shared in common and their respective portfolio weightings. That's very small given both managers are trying to beat the S&P 500 benchmark.

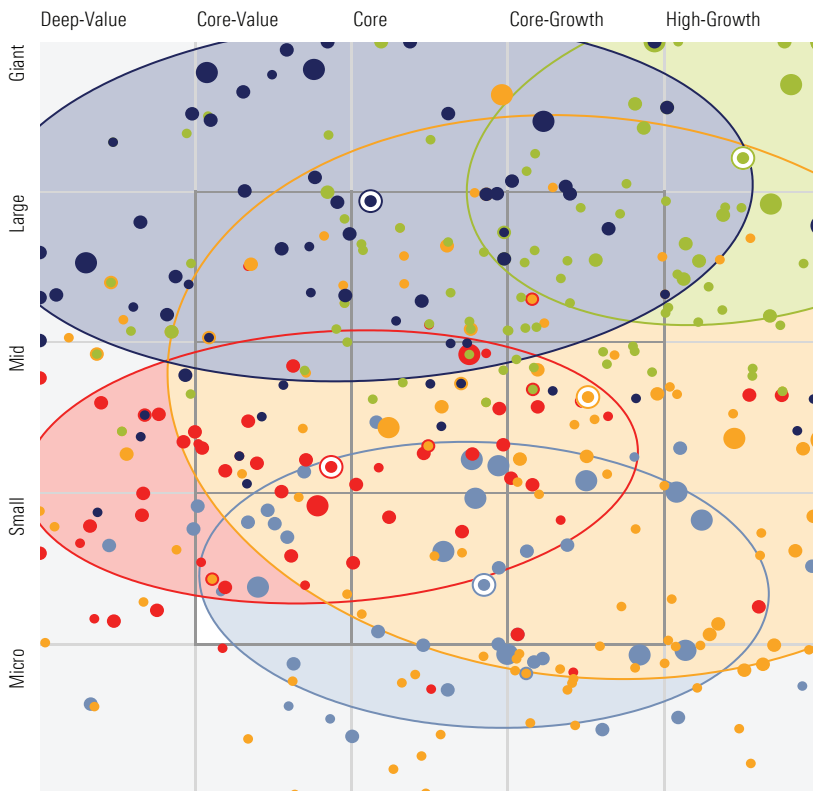
Dodge & Cox Stock and T. Rowe Price Blue Chip Growth fall short in providing exposure across the market-cap spectrum, though. Large- and mega-cap stocks predominate in both portfolios, accounting for 95% and 90% of assets, respectively. Thus, we turn to U.S. small- and mid-cap funds to find further diversification.

## U.S. Mid-Cap and U.S. Small Cap

**Primecap Odyssey Aggressive Growth** POAGX, **Diamond Hill Small-Mid Cap** DHMAX, and **Mairs & Power Small Cap** MSCFX are three such strategies that have almost no overlap between them. All three are closed to new investors, but you can use other funds in a similar fashion. Primecap's holdings range across the market-cap spectrum and tilt strongly toward growth. The fund has a volatile profile to match. The Diamond Hill fund's more steady value orientation adds some balance. It is also more of a dedicated small- and mid-cap option, sticking to companies with market caps ranging between \$500 million and \$10 billion. The Mairs & Power fund is a little different still. On average, it invests in companies whose market caps are much smaller than all the other funds discussed. In addition, around 80% of its assets are in firms near the shop's Upper Midwest location. The fund's distinctive regional focus allows better access to management, employees, and their local communities, which gives Mairs & Power's fundamental research an edge.

The holdings-based style map shows that our model portfolio invests in companies across the market-cap and style spectrum. This model portfolio owns 398 individual stocks, ranging from global powerhouses, like **Amazon.com** AMZN and **Alphabet** GOOG, to relative unknowns, such as **Rex Energy** REXX and **CyberOptics** CYBE.

Not only do we have name diversification, but the performance patterns of the five chosen strategies are also relatively uncorrelated. Keeping correlations in check allows for a smoother return profile from the portfolio's U.S. funds, which makes it less likely that an investor will get spooked out of the market after a bad year.



Investment Name	Date
● Dodge & Cox Stock	12/31/2017
● T. Rowe Price Blue Chip Growth	12/31/2017
● Primecap Odyssey Aggressive Growth	12/31/2017
● Diamond Hill Small-Mid Cap I	12/31/2017
● Mairs & Power Small Cap	12/31/2017

**% Market Value**  
 ● 3.00 and up   ● 1.00 - 2.99   ● up to 0.99   ● Centroid

in common. So, we're getting genuine diversification here, too.

Owning a global fund introduces a dynamic element into your portfolio based on the manager's view of opportunities at home and abroad. If the U.S. market looks expensive or there are better overseas options, the Oakmark fund will vary its U.S. weighting accordingly, which has ranged from 42% to 61% since 2012.

### Emerging Markets

Adding an emerging-markets strategy is the final layer of diversification. Although four of the eight funds we've chosen so far have some exposure to companies domiciled in developing economies, the highest weighting is only just over 7%. That's perhaps too small a stake for the overall equity portfolio as these companies are uniquely positioned to tap into the robust growth rates anticipated for their respective countries and regions. Silver-rated **Harding Loevner Emerging Markets HLEMX** can provide the missing exposure. Its inclusion, however, could amplify the portfolio's risk profile beyond tolerable limits if not done in proper proportion. And that brings us to an age-old allocation question.

### Portfolio Weightings

How big a weighting should each category group be within the overall portfolio? The equity portion of the Morningstar Balanced Indexes provides a starting point. Its roughly 60/40 split between domestic and international stocks makes sense for U.S. investors and broadly matches the MSCI World Index. Assuming a larger-cap skew should provide ballast in tougher times, therefore, the two large-cap U.S. equity funds have the biggest weightings at 15% each, while the seven remaining funds receive a 10% allotment apiece. ■■

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### Foreign Stock

With the U.S. portion of the portfolio set, we turn to funds within the foreign-stock categories that hold little to no U.S. companies. **Causeway International Value CIVVX** and **MFS Institutional International Equity MIEIX** fit this bill and do so with consistent and distinctive style purity. The two funds' respective value and growth orientations help minimize any unintended style overlaps that may reduce diversification and increase risk.

### World Stock

Because world-stock funds can invest anywhere they like, adding them to a portfolio runs the risk of duplicating positions already held in its domestic and foreign portions. Even so, the category includes some excellent managers who use their flexibility well and can add value. **Oakmark Global Select OAKWX** complements the Causeway and MFS strategies nicely, and there is minimal holdings overlap.

The same holds true in a comparison with our domestic large-cap picks Dodge & Cox Stock and T. Rowe Price Blue Chip. As of March 2018, the Oakmark fund's active share was over 90% with both, as the three held only Alphabet

## Important Disclosures

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