

Developing an Asset Allocation Strategy Using Morningstar Tools: A Project for the Beginning Personal Financial Planning Course

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In this paper we discuss the importance of Internet-based resources for use by students in completing assignments. We explore the possibility of incorporating Morningstar.com into the personal financial planning course as the basis of a portfolio allocation project using an extensive case scenario that we have developed. We illustrate the use of a scoring guide to facilitate grading of the project, thus providing ready-made case analysis for use in the personal financial planning course.

Introduction

Although Internet-based business ventures have experienced dramatic ups and downs over the first half of this decade, free, fee-for-service, and/or subscription-based online investment analysis and portfolio management resources have been widely utilized as an increasing number of investors have access to the World Wide Web. A number of surveys and reports demonstrate that both individuals and financial professionals use, and are quite satisfied with, such sites. Examples include the following:

- A Securities Industry Association [SIA] survey found that eleven percent of *all* U.S. equity trading volume takes place on the Internet [SIA, 2002].
- CyberAtlas [2002] reported that thirty-five percent of high-income professionals queried use the Internet for financial planning assistance. Other findings reported in this study indicate eighty-one percent of those who perform financial tasks on the Internet use it to research specific investments; fifty-four percent use it for portfolio tracking; and forty-six percent trade securities online.
- The Association for Finance Professionals [AFP] reported that eighty percent of finance professionals obtain information related to financial services from Internet-based resources [AFP, 2002].
- One 2003 study showed that online brokerage was among the top five sectors of the economy in terms of customer satisfaction, loyalty, and (potential for) future economic growth [Cox, 2003].
- Laise and Mauldin (2005) open their report on finding an online broker with the statement, "Online traders have never had it so good. Commissions are dirt cheap, and the sites are flooded with new features."

When the broad use of online investment analysis and portfolio management resources by individual and professional investors is coupled with the fact that college students are extremely comfortable with the use of technology (particularly the Internet), the need for instructors of personal financial planning courses to incorporate the use of web-based information, data, and applications in their courses and assignments becomes quite apparent.

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Since the assortment of online resources is so broad, however, the problem is not one of locating resources; instead, it is one of developing efficient and effective ways to use a particular resource or set of resources to enhance student learning. In this paper, we demonstrate how selected tools offered by one well respected and highly popular website, *Morningstar.com*, might be incorporated into an asset allocation project suitable for use in a junior-level personal financial planning course.

Purposes of the Project

As will become evident to the reader, the project discussed in this paper has several purposes. One of these purposes is to give students the opportunity to put into action some of the asset allocation concepts they have encountered in their personal financial planning textbook. To achieve this objective, we assign each student a particular “investor scenario” (or profile) and then ask each student to develop a well thought out asset allocation plan for the individual or family described in the scenario. Examples of two of these scenarios are included later in this paper.

Since mutual funds are the investments of choice for a substantial proportion individual investors, particularly in 401(k) plans, yet another purpose of this project is to expose students to the world of mutual fund investing. To help accomplish this objective, we limit long-term investments in the project to mutual funds.

Because students are required to select from the mutual fund universe for long-term investments, and because Morningstar is a (or perhaps “the”) leading information resource for mutual fund investors, a third purpose of the project is to help students become more familiar with Morningstar’s resources. We strive to accomplish this purpose, and to achieve another purpose as well – acquainting students with some of the types of investor resources that are available on the Internet – by directing them to specific tools and information that are available on the Morningstar website, *Morningstar.com*. As we designed this project, we realized that *Morningstar.com* became the project’s driving force, or focal point, because through it the other purposes are achieved. Consequently, the primary focus of this paper is to demonstrate how we use Morningstar.com to achieve the aforementioned purposes.

An Overview of Selected *Morningstar.com* Mutual Fund Selection Tools

Morningstar.com includes two online mutual fund selection tools that are incorporated into this project: the “Basic Fund Screener” and the “Interactive Mutual Fund Scorer.” Each of these tools is described in the following paragraphs.

The “Basic Fund Screener”

Screeners are employed in the investment world to narrow down a universe of possible investments to a small group of alternative investments that meet a set of criteria established by the investor. *Morningstar.com*’s “Basic Fund Screener” allows the user to establish screening rules in each of the following categories and sub-categories:

- 1) Fund Type
 - a) Fund Group – All, Domestic Stock, International Stock, Taxable Bond, Municipal Bond
 - b) Morningstar Fund Category – All, Large Value, Large Blend, Large Growth, Mid-cap Value, Mid-cap Blend, Mid-cap Growth, Small-cap Value, Small-cap Blend, Small-cap Growth, plus an extensive variety of sector and international categories.

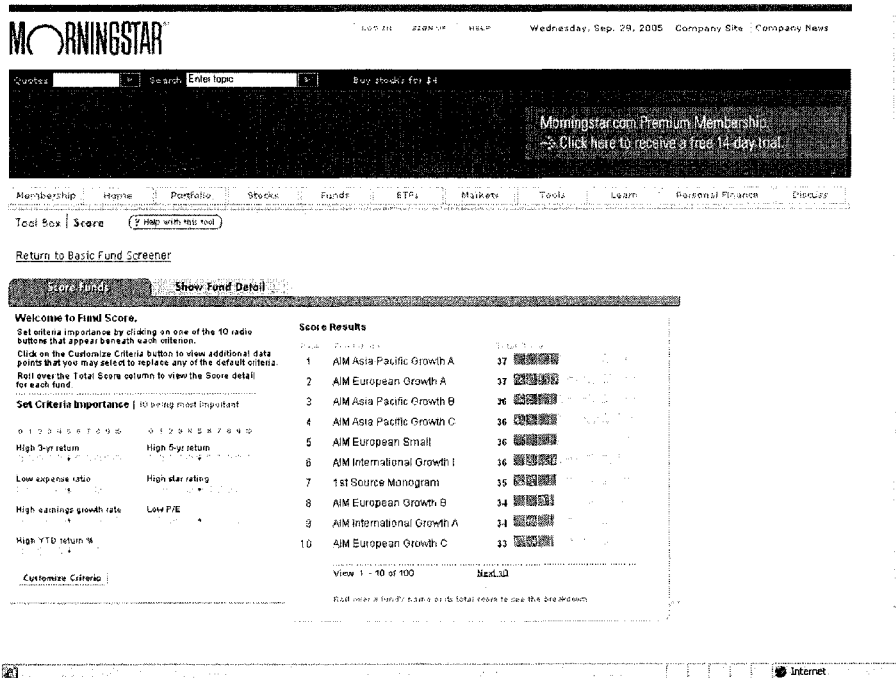
- c) Manager tenure greater than or equal to – Any, Category Average, 1 Year, 3 Years, 5 Years, 10 Years.
- 2) Cost and Purchase
 - a) Minimum initial purchase less than or equal to – Any, \$10,000, \$3,000, \$2,000, \$1000, \$500.
 - b) Loan Funds – All, No-load Funds Only
 - c) Expense ratio less than or equal to – Any, Category Average, 2.0%, 1.5%, 1.0%, 0.50%.
- 3) Ratings and Risk
 - a) Check all the ratings you would like to include - *, **, ***, ****, *****, and/or New, unrated funds.
 - b) Morningstar risk better than or equal to – Any, Low, Below Average, Average, Above Average, High.
- 4) Returns
 - a) Year to date return greater than or equal to – Any, Category Average, S&P 500, or specify a percentage.
 - b) 1-year return greater than or equal to – Any, Category Average, S&P 500, or specify a percentage.
 - c) 3-year return greater than or equal to – Any, Category Average, S&P 500, or specify a percentage.
 - d) 5-year return greater than or equal to – Any, Category Average, S&P 500, or specify a percentage.
 - e) 10-year return greater than or equal to – Any, Category Average, S&P 500, or specify a percentage.
- 5) Portfolio
 - a) For Stock Funds
 - i) Turnover less than or equal to – Any, Category Average, 150%, 100%, 75%, 25%.
 - ii) Total assets less than or equal to – Any, \$200 mil., \$500 mil., \$1 bil., \$5 bil.
Average market capitalization – Any, less than or equal to \$250 mil., less than or equal to \$1 bil., less than or equal to \$10 bil., greater than or equal to \$250 mil., greater less than or equal to \$1 bil., greater than or equal to \$10 bil.
 - b) For Bond Funds
 - i) Average credit quality – Any, AAA or higher, AA or higher, A or higher, BBB or higher, Below BBB.
 - ii) Duration – Any, Less than or equal to 3 years, Less than or equal to 5 years, Less than or equal to 10 years, Greater than or equal to 10 years,

One final point that should be mentioned is that *Morningstar.com* also includes a “Premium Mutual Fund Screener” that allows the user to be much more detailed in the specification of the screening criteria. This tool is not employed in the project because it only is available for a fee.

The “Mutual Fund Scorer”

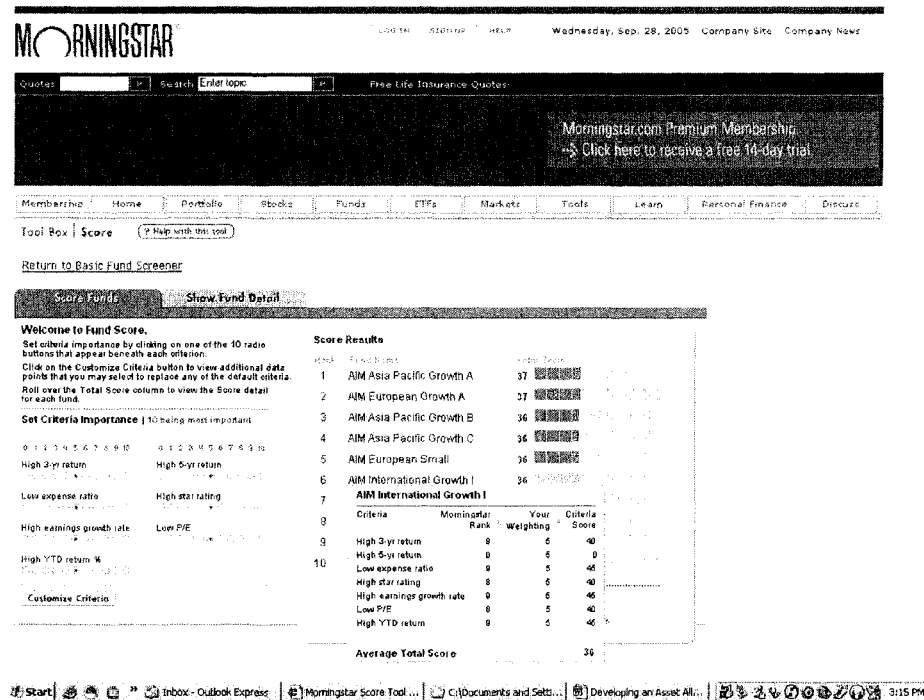
Morningstar.com's "Mutual Fund Scorer" is an interactive tool that scores and ranks and set of mutual funds based on a set of criteria established by the user. A total score is obtained by computing the weighted total score for a fund based on it's Morningstar ranking for a particular criterion and the weight (0 through 10) given that criterion by the user. Figure 1 provides an example of the "Fund Scorer."

Figure 1: The "Mutual Fund Scorer"



The scorer is interactive in that the user can change the importance (i.e., weight) of a criterion by clicking a radio button under that criterion (0 through 10), and immediately see how that change in weighting affects the scores and their rankings in the list to the right of the criteria. The user can "mouse over" one of the stocks in the list of scores to see how that fund's score was computed. Figure 2 shows the result of a sample "mouse-over."

Figure 2: The “Mutual Fund Scorer” with Sample Score Calculation Shown



The “Mutual Fund Scorer” allows to user to select as many as 8 criteria from a total of forty organized into the following categories: Performance, Risk and Other Statistics, Portfolio Statistics, and Management and Operations.

The Project Itself

The following outline depicts the asset allocation project as we have conceived it. Naturally, the individual instructor can edit it as he/she sees fit to suit his/her particular interests and needs.

- 1) Introduction
- 2) Rules of the Game
 - a) Report Format
 - i) Spiral Bound
 - ii) Table of Contents
 - iii) Each section identified with a tab
 - iv) 12 point, Times New Roman Font
 - v) Double-spaced
 - vi) One-inch margins all around the page

- (1) A pop-up window will tell you that Morningstar's Analysts have prepared some "starter screens" for you. Those screens are listed on the left-hand side of the pop-up window.
 - (2) Click on one of the five starter screens, and then click the "Show Screen Results."
 - (a) Carefully review the results of the starter screen you've selected, making sure you review each of the views that are available in the drop down "View" list.
 - (b) Click on each column heading in the screen results list, noting how clicking on each heading re-arranges the list.
 - (c) After this extensive review, prepare (in your own words) a one-page summary/explanation of the different Fund Screener Results views and how they might benefit the investor.
 - (d) Include your summary as Section Two of your report.
 - (3) Click on the "Score These Results" link at the top of the Fund Screener Results window. (When a dialog box saying, "You have not selected any funds. As a result, the tool will score the first 100 funds in your results screen" is displayed, click "OK.")
 - (a) Carefully review the resulting "Fund Score" results, making sure you do the following:
 - (i) "Mouse-over" the bar chart on the right side of the page.
 - (ii) Click on a few of the radio buttons on the left side of the page.
 - (iii) Click on the "Customize Criteria" link.
 - (b) After this extensive review, prepare (in your own words) a one-page summary/explanation of the different Fund Screener Results views and how they might benefit the investor.
 - (c) Include your summary as Section Three of your report.
- 3) Developing an Asset Allocation Strategy
- a) In the context of the "Stage of Life and Financial Condition" scenario provided by your instructor, develop an asset allocation plan for the individual(s) described in that scenario.
 - b) For purposes of this project, assume the following:
 - i) "Cash" will be stored in a money market mutual fund.
 - ii) "Savings" will be placed in FDIC insured CDs of the appropriate maturity.
 - iii) "Long-term investments" will be comprised of mutual funds.
 - c) Using what you have learned in this course about asset allocation and mutual funds, and using the Morningstar mutual fund selection tools that were the object of part "c" of this project, develop an asset allocation plan for the long-term investments of the individuals described in your scenario. To do this, you must consider a variety of factors, including (but perhaps not limited to) the following:
 - i) age of the investor(s)
 - ii) life cycle stage of the investor(s)
 - iii) level of income
 - iv) income stability
 - v) present net worth
 - vi) investor's risk tolerance
 - vii) tax considerations

- vii) investment time frame
- viii) investment objectives (What do I want this portfolio to accomplish?)
- d) Provide a written summary (5- to 10-pages in length of the asset allocation plan for the individual(s) described in the scenario you were given. At a minimum, your summary should address the following topics:
 - i) The scenario itself as provided by your instructor.
 - ii) Your analysis of the scenario.
 - iii) Savings/investments objectives.
 - iv) Your recommendations for:
 - (1) Cash
 - (2) Savings
 - (3) Long-term investments
 - (4) Your mutual fund choices for long-term investments.
 - (5) How you used Morningstar Tools to select the funds.
 - (6) What other information (Morningstar or otherwise) you used to make your selections and why it helped.
 - v) Given your responses to “c” and “d,” why you think/hope the funds you chose will meet the investment objectives of the individuals in your scenario. (If you were a financial planner, this would be one of the things you would want to tell your clients.)
- 4) Include your summary as Section Four of your report. Provide a one- to two-page written summary of what you learned from this project, how you think this knowledge might be of benefit to you in the future, and how you think this project could be changed to make it an even more beneficial experience. Include your summary as Section Five of your report.

A Sample “Stage of Life and Financial Condition” Scenario

We assign each student in the class a “Stage of Life and Financial Condition” scenario from several we have developed. We have found that publications such as *Money*, *SmartMoney*, and *Kiplinger Personal Finance* periodically contain articles with titles such as “One Family’s Finances” that can be used as a basis for developing additional scenarios to add to our collection. Generally, these articles will summarize the family’s (or individual’s) stage of life and financial condition, and then will report on what one or more financial “experts” advise to get the family’s finances in order. The following paragraphs provide one of the scenarios we assign. **The**

Beaman Family’s Finances

Jim Beaman’s wife died in a car accident three years ago and Joyce Schyler’s husband died of cancer two years ago. After meeting at a church gathering, the couple started dating and soon realized that they wanted to spend the rest of their lives together. Jim is 44, owns a construction company, and has two boys (ages 14 and 16) while Joyce is a 40-year-old elementary school teacher with one girl (age 11).

Their wedding is planned for next month, and the couple decided that it would be prudent to meet with a financial advisor ahead of the nuptials. Their financial objectives are to combine households, provide for a comfortable retirement for the two, and pay the majority of the college costs for their three children.

The profits of Jim's construction company have benefited from the recent real estate boom and his latest net income was \$325,000. Jim paid himself a salary of \$120,000 out of the \$325,000 and plans to spend the remainder on some dirt moving equipment and two lots in a new housing subdivision. Jim and Joyce are both concerned, however, that there may be a bubble in the market that could burst at any time. In fact, just five years ago, Jim's net income was only \$175,000. Joyce's salary is currently \$35,000 per year.

Jim owns a 4-bedroom home with a market value of \$350,000 that the couple will live in. The outstanding mortgage is \$200,000. Joyce's 3-bedroom home is currently listed with a real estate agent for \$169,900. Joyce paid off the mortgage with the proceeds of an insurance policy when her husband died. Jim drives a 2004 Ford pickup and owes \$20,000 against it. Joyce drives a 1999 Ford Taurus which is paid off.

Jim is a bit of a risk taker and his current retirement account consists of an IRA with a balance of \$137,000. He currently directs 100% of the funds into high growth stocks. When Jim received the proceeds of the insurance policy on his wife, he decided to earmark the money as a "college fund" and invested it in growth stocks. The last statement showed a balance of \$54,000.

Joyce is much more conservative in her investment strategies and has directed her retirement account through her employer to a 50/50 split between a bond fund and stock fund. She has consistently invested \$150 per month for the last 18 years and her retirement account balance now stands at \$90,000. Her first husband was less inclined to look to the future and chose to "spend it now." He even balked at the idea of a life insurance policy, but Joyce insisted. After paying off the house two years ago, Joyce has been able to deposit \$100 per month in a money market account and her last statement showed \$2,423.

Jim's construction business currently has a net worth of \$430,000. He has \$4,000 in his private checking account and usually carries credit card debt of \$1,500 on a consistent basis from month to month. His monthly personal bills run about \$8,000 per month. Joyce has \$750 in her checking account, with credit card debt of around \$200. Her personal bills have been running about \$1,000 per month. They estimate that their combined household goods would have a market value of approximately \$20,000.

Grading and Scoring Issues

The project we describe above requires the student to perform various tasks and present them in a specific format. We believe this specificity is important, as a financial planner must be consistent in the form of the presentations that they provide to clients. To facilitate scoring, we recommend incorporation of a scoring guide. To illustrate this approach, we have developed one below that ties to the project described above

Evaluating the Financial Planning Project Scoring Guide

| Project Section | Project Requirements | Points Possible | Points Earned |
|--|--|-----------------|---------------|
| Sec. 0 - Professionalism of Report | Spiral Bound | 1 | /1 |
| (Total Points Possible: 5) | Table of Contents | 1 | /1 |
| (NOTE: All requirements for Section 0 must be met to be eligible for scoring of the remaining sections) | Sections Tabbed | 1 | /1 |
| | 12-Point Times New Roman Font | 1 | /1 |
| | Double Spaced | 1 | /1 |
| | 1-Inch Margins | 1 | /1 |
| Sec. 1 – Fund Screener | Description of Fund Screener Function | 10 | /10 |
| (Total Points Possible = 10) | | | |
| Sec. 2 – Fund Screener Result Views | Different Fund Screener Result Views and How They Might Benefit the Investor | 10 | /10 |
| (Total Points Possible = 10) | | | |
| Sec. 3 – Fund Screener Result Views | Different Fund Screener Result Views and How They Might Benefit the Investor | 10 | /10 |
| (Total Points Possible = 10) | | | |
| Sec. 4 – Asset Allocation Plan | Description of Scenario | 5 | /5 |
| (Total Points Possible = 55) | Your Analysis of the Scenario | 10 | /10 |
| | Savings/Investments Objectives | 5 | /5 |
| | Your Recommendations for: | | |
| | Cash | 5 | /5 |
| | Savings | 5 | /5 |
| | Long-Term Investments | 5 | /5 |
| | Mutual Fund Choices for Long-Term Investments | 10 | /10 |
| | How You Used Morningstar.com to Select the Funds | 5 | /5 |
| | What Other Information You Used to Make Your Selections | 5 | /5 |
| Sec. 5 – Summary of Project Benefits | One to Two Page Summary of Benefits of the Project and Suggestions for Improvement in the Future | 10 | /10 |
| (Total Points Possible = 10) | | | |
| | Totals | 100 | /100 |

Summary and Conclusions

In this paper we discussed the Morningstar.com website. We also provided a specific case scenario that an instructor could discuss in their classroom. We showed how a project can be assigned that requires students to perform a thorough financial analysis for the family discussed in the case. Finally, we developed a scoring guide that could be used to facilitate grading of the various components of the final written financial plan. We believe that Morningstar.com is a useful tool in collecting and analyzing the necessary information to make realistic financial plans, and believe that the financial planning project described above provides a worthwhile experience for students.

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