How to Get Lucky With Your Portfolio

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Smart Investors
Create Their Own Luck

To Get Lucky, Focus On:

- Diversification
- Management
- Security and Fund Selection
- Controlling Costs

Diversification

The concept of diversification won
Harry Markowitz a Nobel Prize.

Markowitz showed that risk can be lowered and returns can be increased at the same time.

(There is always an optimum level
of risk and reward.)

Diversification

- Risk is lowered and return is increased when several different investments are combined
- Another benefit is that some part of the portfolio will be in favor at any given time

Correlations of Various Assets Relative to Large-Cap Stocks

- Large-Cap Stocks: 1.00
- Small-Cap Stocks: 0.79
- Long-Term Corporate Bonds: 0.23
- Long-Term Government Bonds: 0.11
- Intermediate-Term Government Bonds: 0.08
- Treasury Bills (Real Interest Rates): 0.09

Inflation-Adjusted Correlations from the 2011 Ibbotson SBBI Classic Yearbook

Diversify Across All of Your Accounts

- All your investments contribute to your overall wealth
- This includes your brokerage account, your 401(k) plan, and employee stock options
- Manage all of your assets as a single portfolio

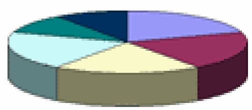
Think Outside of Your Portfolio

- Diversify away from your job (and your 401k matching contributions)
- If you own a house, you're invested in residential real estate—and your geographic area
- Any other sources of income (royalties, etc.)?

AAII Has Allocation Models

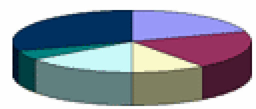
Suggested Allocation Breakdowns

Aggressive



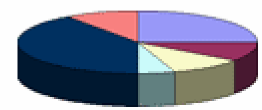
- 20% Large-Cap Stocks
- 20% Mid-Cap Stocks
- 20% Small-Cap Stocks
- 20% International Stocks
- 10% Emerging Markets Stocks
- 10% Intermediate Bonds
- 0% Short-Term Bonds

Moderate



- 20% Large-Cap Stocks
- 20% Mid-Cap Stocks
- 10% Small-Cap Stocks
- 15% International Stocks
- 5% Emerging Markets Stocks
- 30% Intermediate Bonds
- 0% Short-Term Bonds

Conservative



- 25% Large-Cap Stocks
- 10% Mid-Cap Stocks
- 10% Small-Cap Stocks
- 5% International Stocks
- 0% Emerging Markets Stocks
- 40% Intermediate Bonds
- 10% Short-Term Bonds

Source: http://www.aaii.com/asset-allocation

Portfolio Management

- What are your financial goals?
- Keep emotions out of investing decisions
- Regularly review your portfolio

What Are Your Goals?

- Need cash soon for a big expense?
- Want to build long-term wealth?
- Need portfolio income now and for the next 10 - 30 years?
- A mixture of goals?

Tolerance for Risk Depends On:

- Age
- Health
- Wealth

(Longer investment horizons and greater wealth increase the ability to handle risk.)

Don’t invest in a security or fund that keeps you up at night.

But if you want to beat inflation, you have to accept some volatility and down markets.

Keep Your Emotions at Bay

- It’s okay to be scared by volatile markets
- It’s not okay to let emotions determine your investing decisions

Psychologists say people make more rational decisions when they are not in a crisis situation.

So, have a plan for selling before you buy a stock, bond or fund.

My Favorite Investing Tool

(It’s a spiral notebook)

What I Write Down

- The reasons why I bought an investment
- The reasons why I would sell an investment
- Research notes about what I own and what I've looked at

Write down everything that matters to your portfolio, rather than keeping it in your head.

This includes any next actions you need to take.

It’s more important to remember birthdays and anniversaries than the details of your portfolio.

You should also set up reminders in your calendar to look at your portfolio and review it.

Buy & Hold Is Not Buy & Forget

- Track your investments for any changes that make them less attractive
- Ensure that your asset allocations remain on track to meet your financial goals
- Vote your proxy statements and read the annual reports
- No one cares more about your wealth than you do, so treat investing like a business

Active or Passive?

- Active investing involves selecting the specific assets you want to invest in
- Passive investing means mimicking the performance and volatility of a major index, such as the S&P 500

Active Investing Advantages

- Provides the opportunity to outperform the major indexes
- Alternatively, you could create a portfolio with less risk and volatility
- Gives you more control over the portfolio

Active Investing Disadvantages

- Greater chance of underperforming the major indexes
- Transaction and tax costs are higher
- Requires more time and effort
- Risk of incorrectly timing the market and missing out on big moves

Passive Investing Advantages

- Eliminates the risk of picking the wrong securities
- Diversification is provided by the sheer number of securities that comprise a major index
- Transaction and tax costs are lower
- Your returns will closely follow the market's performance

Passive Investing Disadvantages

- Passive strategies are not designed to beat the market
- Tracking errors could result in returns that are different than you expect (e.g., ETFs)
- When the index falls in value, so does your net worth

How Do You Choose?

- Do you have the time and inclination to research individual securities and funds?
- How good have your previous stock and bond picks been relative to the broad market?
- If you consider yourself a market timer, how many times did you buy at market bottoms and sell at market tops?

You Can Choose Both

- Choosing both allows you to take advantage of each strategy’s strengths
- Active management gives you the opportunity to beat the market
- Passive management assures that no matter what, part of your portfolio will always track the market’s performance

Rebalance Your Portfolio Regularly

- Rebalancing forces you to buy low and sell high
- Simply rebalancing large-cap stocks and bonds provides better returns and lower volatility
- Vanguard suggests annual or semiannual rebalancing when allocations are off target by 5% or more*

*"Best Practices for Portfolio Rebalancing," Vanguard, 2010

The Rebalancing Advantage

- A portfolio split evenly between Vanguard 500 (VFINX) and Vanguard Total Bond Market (VBMFX) at the start of 1988
- Without rebalancing, the portfolio had an annualized return of 8.5%
- Rebalancing annually to a 50%/50% split resulted in an annualized return of 8.8%, and lowered the portfolio's volatility

*Returns through December 31, 2010

The Rebalancing Advantage

- The portfolio was expanded to include small-cap, international developed market and emerging market stocks
- Rebalancing produced a <u>higher return</u> than not rebalancing (9.7% versus 9.4%)
- Rebalancing also <u>lowered volatility</u>

*Returns through December 31, 2010

What About the Lost Decade?

- The portfolio with just VFINX (S&P 500) and VBMFX (bonds) returned 3.2% with rebalancing, versus 3.1% without
- The fully diversified portfolio returned 6.6% with rebalancing, versus 4.5% without

*Annualized returns for December 31, 1999, through December 31, 2009

Rebalancing Is a Long-Term Strategy

- Rebalancing and diversification provide the most benefits over the long term
- Performance may be hurt over periods of a few years because the best-performing asset class is being sold
- The alternative to rebalancing is to correctly time the market on a consistent basis

Stock Selection

- Strong Business Model–products fulfill needs, barriers to entry exist, and the company is profitable
- Good Financials–positive cash flow, adequate cash, low debt, rising sales and profits
- Attractive Valuation–both price-to-book (P/B) and price-to-earnings (P/E) ratios are reasonable

Bond Selection

- Fiscally Sound–generates enough cash to cover interest payments and repay debt
- Valuation–price is not excessively above par value
- Yield–high yields are a sign of higher risk

Fund Selection

- Comparatively Low Expenses–applies to both mutual funds and ETFs
- Performance–returns should be consistently better than those of category peers
- Stable Management Team–an actively managed fund's performance depends significantly on the current manager

Security and Fund Selection

In all cases, a stock, bond or fund should add to your portfolio's diversification.

A Fund Might Be Better If

- You lack enough information to properly analyze a security
- You lack the knowledge to determine whether a security is a good investment
- It's cheaper to achieve diversification through a fund than through buying individual securities

I Use Funds For

- The passively managed portion of my portfolio
- Bond investing
- International investing

Controlling Costs

- Every dollar in costs you do not spend is a dollar you get to keep
- Over time, these savings can have a significant impact on your wealth
- Costs can be direct, such as brokerage commissions
- Costs can also be indirect, such as management fees

Direct Costs

- Brokerage commissions
- Bid-ask spread
- Trading costs, which depend on liquidity
- Taxes, including capital gains and dividends

Indirect Costs

- Mutual fund and ETF management fees
- Embedded capital gains for mutual funds
- Custodial or account management fees
- Advisory fees

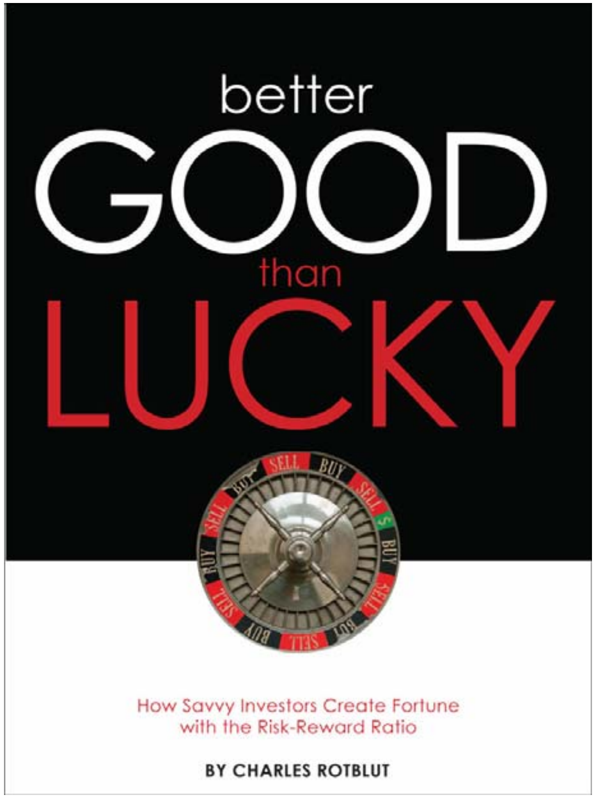
Cost Management

- Higher fees can be justified if the value received exceeds the extra cost (e.g., a good advisor, convenience, etc.)
- Consider the risk-adjusted return before avoiding a more costly investment
- Periodically review all portfolio expenses to ensure they are justified

Resources on AAII.com

- Financial Planning: http://www.aaii.com/financial-planning
- Asset Allocation Models: http://www.aaii.com/asset-allocation
- Model Portfolios: http://www.aaii.com/model-portfolios

My Book



(W&A Publishing / Trader's Press, 2010)

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