
Smart Investing: Seeking Reward While Reducing Risk

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"As in driving, the secret to success is not
making big mistakes."

Source: Charles Ellis, "My Investment Letter: Words of Advice for My Grandchildren,"
AAII Journal, October 2013



The optimal strategy is not one that maximizes return, but rather one that helps you stick to your long-term investing plan and achieve your goals.



Our Brain's Two Systems



SYSTEM 1:
Quick, Intuitive



SYSTEM 2:
Slow, Deliberate

Source: "Thinking, Fast and Slow," Daniel Kahneman (Farrar, Straus and Giroux, 2011)



Our Brains Rationalize

Overconfidence



We humans are likely to believe our decisions are correct



Our Brains Rationalize

Confirmation Bias

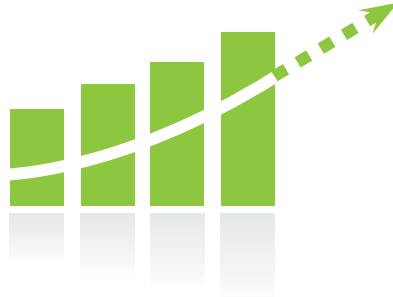


We look for information confirming our beliefs



Our Brains Rationalize

Recency Bias



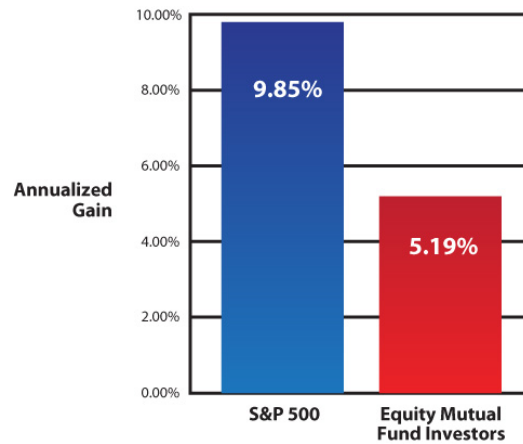
We assume present conditions will continue into the future



We Experience Bounded Rationality



The Impact of Behavioral Errors



Source: "2015 Dalbar QAIB Highlights Futility of Investor Education," Dalbar, data from 1995 to 2014

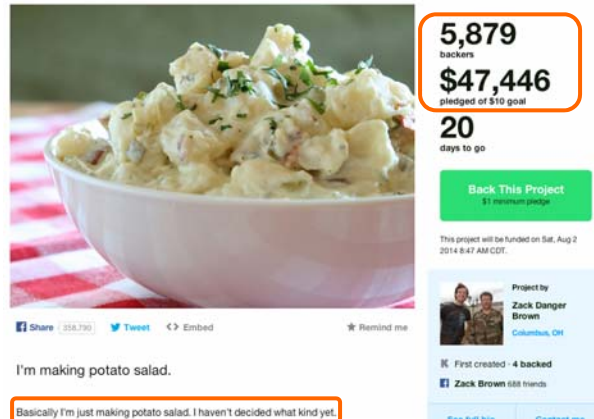


Economic and financial theory assumes humans act in rational ways.

Behavioral scientists have evidence suggesting otherwise.



Was This Rational?



A screenshot of a Kickstarter campaign for a potato salad. The main image shows a white bowl of potato salad on a red and white checkered tablecloth. To the right, a summary box displays: 5,879 backers, \$47,446 pledged of a \$10 goal, and 20 days to go. Below the image are social media sharing options (Share, Tweet, Embed) and a 'Remind me' button. The project description reads: 'I'm making potato salad.' A red box highlights the text: 'Basically I'm just making potato salad. I haven't decided what kind yet.' The project is by Zack Danger Brown from Columbus, OH, and has 4 backers.

Source: Kickstarter, July 12, 2014; \$55,492 pledged in total



We Do Not Consider Expected Outcomes

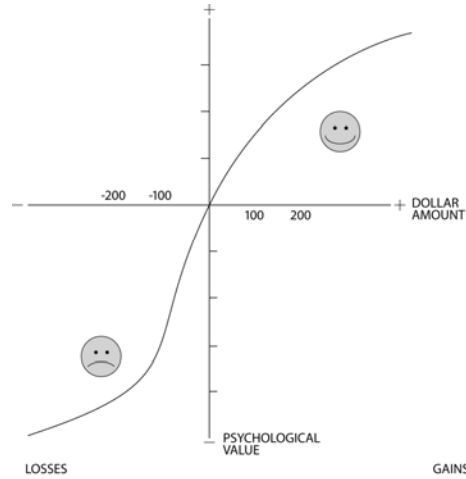


A red advertisement for the Powerball Historic Jackpot. The text reads: 'POWERBALL HISTORIC JACKPOT \$1.5 BILLION'. Below this, it says 'BUY NOW' and 'NEXT DRAWING: JAN 13'. The background features a red sunburst pattern.

Source: Illinois Lottery, January 12, 2016; Overall odds of winning are 1:24.9 (4%)



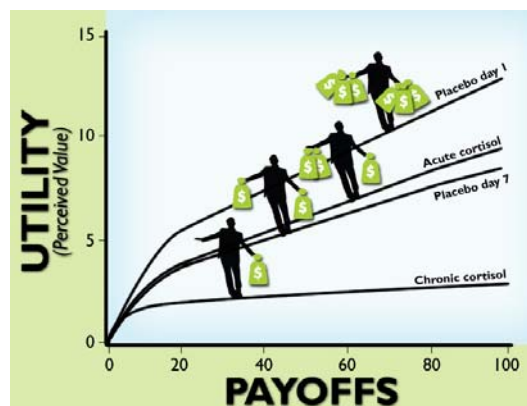
We Are Risk-Averse



Source: "Prospect Theory: An Analysis of Decision under Risk," Daniel Kahneman and Amos Tversky, *Econometrica*, March 1979



Biology Makes Us Risk-Adverse



Source: "Cortisol Shifts Financial Risk Preferences," Narayanan Kandasamy et al., *Proceedings of the National Academy of Sciences of the United States of America*, March 4, 2014.

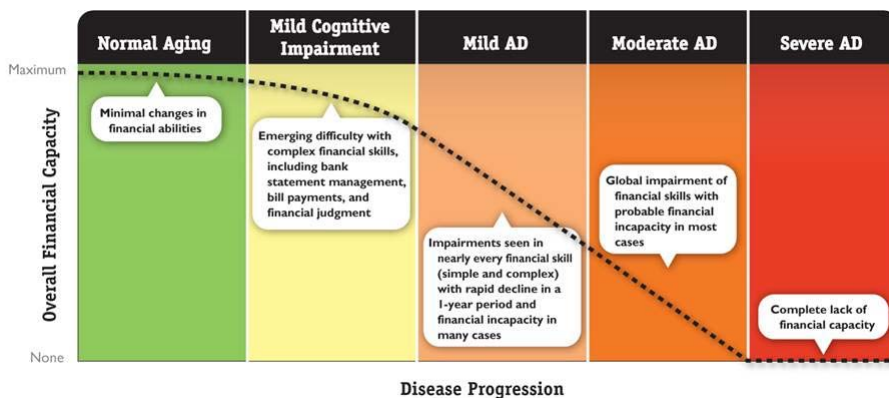


Cognitive Decline

- The ability to make sophisticated decisions peaks at age 53
- Approximately 1 in 9 Americans age 65 or older have Alzheimer's disease according to the Alzheimer's Association



Cognitive Impairment Affects Financial Skills



Source: "Finances in the Older Patient With Cognitive Impairment," Eric Widera, Veronika Steenpass, Daniel Marson, and Rebecca Sudore, JAMA, February 16, 2011.



Simplify your strategy and be cautious
about making big changes as you age



Keeping Emotions at Bay

- Acknowledge your emotional state
- Take a deep breath and slow down; wait a day or longer before making changes to your portfolio
- Realize your biggest risks are long-term and unpredictable, not short-term
- Sell investments that keep you up at night



Use the Power of the Written Word to
Your Advantage



Write and maintain emergency instructions
on how to manage your portfolio.



Need another reason for writing down instructions for managing your portfolio?

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



All AAI Portfolios Have Written Buy and Sell Rules

Shadow Stock Portfolio Rules

- > PURCHASE & SALES RULES
- > STOCK ORDER RULES
- > MANAGEMENT RULES

Purchase & Sales Rules

Stock purchases must meet these criteria:

- No bulletin board or pink sheet stocks will be purchased.
- Price-to-book-value ratio must be less than or equal to 1.00. (This figure will change gradually with changes in overall market values.)
- Market capitalization must be between \$30 million and \$300 million. (This figure will change gradually with changes in overall market values.)
- The firm's last quarter and last 12 months' earnings from continuing operations must be positive and, if there are earnings estimates, the estimates must be positive for the current quarter and year.

Model Shadow Stock rules located at <http://www.aaii.com/model-portfolios/stock-rules>



My Favorite Investing Tool



(It's a spiral notebook)



AAII Dividend Investing Log

| Date | News/Research Notes | Link |
|-----------|---|---|
| 8/12/2015 | New, post-DirecTV merger guidance: This year, the company anticipates adjusted earnings to range between \$2.62 and \$2.68 per share. This is above the I/B/E/S consensus estimate of \$2.60. Consolidated revenues should rise by double-digits and free cash flow should be about \$13 billion or better. Over the next three years (2016 through 2018), AT&T anticipates revenue growth to be in line with GDP growth or better. Adjusted earnings per share should rise at mid-single digit rate or better aided by a projected \$2.5 billion in cost savings by 2018 related to the DirecTV merger. Cash flow should improve with the company targeting a free cash flow dividend payout ratio in the 70s percent range or better. | http://about.att.com/ |
| 9/1/2015 | AT&T (T) recommends shareholders reject the unsolicited "mini-tender" offer made by TRC Capital Corp. The offer is to purchase up to three million of outstanding AT&T shares at a price of \$31.30 per share, which is below the stock's current price. | http://www.sec.gov/ |
| 9/9/2015 | Apple announced iPhone Upgrade Program with allows users to get unlocked phones on installment, upgrade every 12 months and not be tied to any carrier. Prices are same as AT&T Next plus the cost of Apple Care | http://www.apple.com |
| 9/10/2015 | CFO Stephens upbeat on Apple Upgrade Program, thinks it could provide a bigger inventory of used phones and shifts cost of financing to Apple; adds that most phones are sold thru AT&T stores | http://seekingalpha.com |
| 9/16/2015 | CFO John Stephens: there is a \$17 difference in content costs between DirecTV & U-verse; sees opportunity in cross-selling products; customers are holding onto cell phones "longer than we expected." Next plan billings to balance outlays in 2016; Mexico to EBITDA positive in 2017, profitable in 2017 | http://seekingalpha.com |
| 9/17/2015 | Verizon CEO warns that 2016 earnings "may plateau at 2015 levels;" the warning seems to be more related to Verizon-issues than industry headwinds | http://www.verizon.com |



What I Write Down

- The reasons why I bought an investment
- The reasons why I would sell an investment
- Updated news and fundamental data about the investments I own and monitor
- Research notes about what I've looked at



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

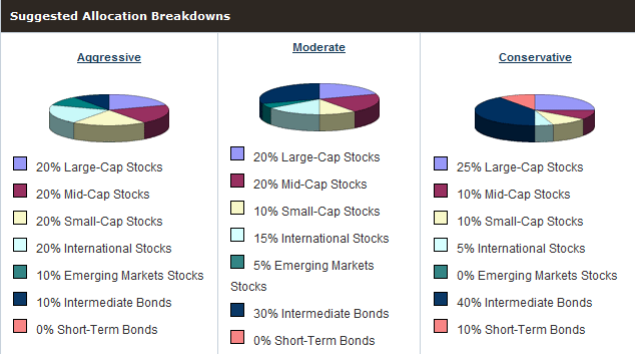
It's more important to remember birthdays and anniversaries than the details of your portfolio.



Among the things to write down is your long-term allocation strategy



AAII Allocation Models



AAII Asset Allocation Models located at <http://www.aaii.com/asset-allocation>



My 403(b) Allocation

- 20% Vanguard 500 (VFINX)
- 20% Vanguard Small-Cap Value (VISVX)
- 20% Vanguard REIT (VGSIX)
- 20% Vanguard FTSE All-World ex-U.S. Small-Cap (VFSVX)
- 20% Vanguard Intermediate-Term Investment-Grade (VFICX)



Key Points About Diversification

- The mix of stocks, bonds and cash will have the biggest impact on your returns
- Nobody knows how much inflation or interest rates will rise in the future



Diversify, Then Rebalance



Benefits of Rebalancing

- Prevents allocation drift, maintaining diversification benefits
- Gives you a strategy for volatile markets
- Forces you to buy low and sell high
- Vanguard suggests annual or semiannual rebalancing when allocations are off target by 5% or more*

Source: "Best Practices for Portfolio Rebalancing," *AAII Journal*, May 2011



Rebalancing and Returns

- A \$100K portfolio based on AAI's moderate allocation model
- No retirement withdrawals taken
- 5% threshold used for rebalancing
- Performance calculated from 1988 – 2015
- Vanguard index funds used to avoid impact of active management



Results From 28 Years of Data

| Non-Withdrawal Portfolio Portfolio Strategy | Rebalance at 5% Thresholds | No Rebalancing |
|--|-------------------------------|-------------------|
| Ending Portfolio Value | \$1,151,368 | \$1,203,796 |
| Total Return | 1,051.4% | 1,103.8% |
| Standard Deviation | 12.3% | 14.0% |
| Annualized Return | 9.1% | 9.3% |
| Largest Drawdown | (\$204,880) | (\$253,424) |
| Largest Annual Loss | (26.9%) | (32.8%) |
| Ending Equity Allocation | 69.9% | 86.0% |
| Ending Fixed-Income Allocation | 30.1% | 14.0% |

Source: "Rebalancing Update: Retirement Adjustments Necessary," by Charles Rotblut, *AAII Journal*, April 2015; Updated January 11, 2016



Other Allocation Approaches

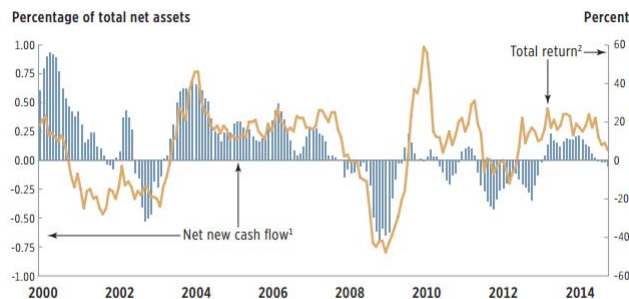
- Allocate solely to one asset class
- Set allocation and (mostly) do nothing
- Rebalance to a glide path
- Segment portfolio (bucket, by goal, core and satellite, etc.)
- Tactical strategies

Source: "Choosing the Right Portfolio Allocation Approach for You," by Charles Rotblut, *AII Journal*, October 2014



Don't Buy High and Sell Low

Net New Cash Flow to Equity Funds is Related to World Equity Returns
Monthly, 2000-2014



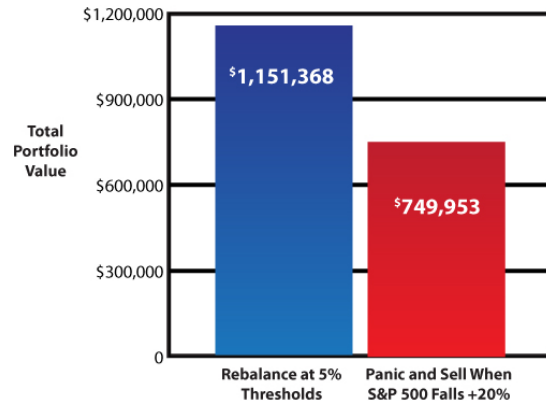
¹ Net new cash flow is the percentage of previous month-end equity fund assets, plotted as a six-month moving average.
² The total return on equities is measured as the year-over-year percent change in the MSCI All Country World Daily Total Return Index.

Sources: Investment Company Institute and Morgan Stanley Capital International

Source: 2015 Investment Company Fact Book, Investment Company Institute



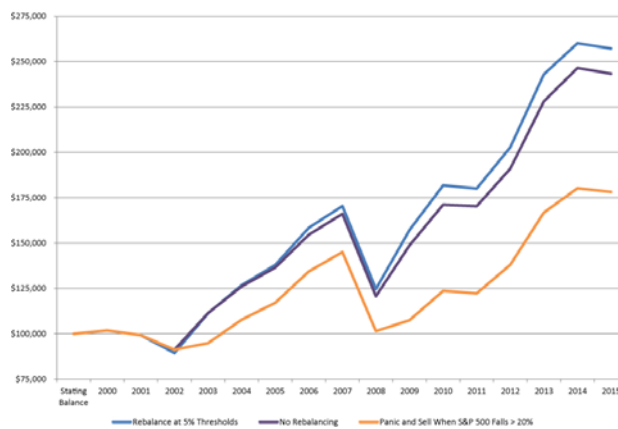
Panicking Is Very Costly



*Allocation shifted to all bonds in 2003 and 2009 and back to target allocation in 2004 and 2010; Source: *AII Journal*, May 2014; Updated January 11, 2016



What If Your Timing Is Bad?



*Allocation shifted to all bonds in 2003 and 2009 and back to target allocation in 2004 and 2010; Source: *AII Journal*, May 2014; Updated January 11, 2016



Another way to avoid a behavioral-related return gap is to have the correct mix of passive and active investments.



Passive vs. Active

- Passive—Gives you the index's returns, easy diversification, lower tax and transaction costs, requires less time and effort
- Active—More control, can beat the market or reduce volatility, requires more time and effort



How Do You Choose?

- Do you have the time to research individual securities and funds?
- How good have your previous stock and bond picks been relative to the broad market?



Choose Both Passive and Active

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



Index funds (passive investments) should be your default option when you can't find an attractive stock, bond or fund to buy.

Source: "Dishonesty, Choices and Investing," Dan Ariely, *AAII Journal*, June 2012



My Stock Picking Strategy



My Risk-Reward Criteria

Price to Book < 3
Price to Earnings < 20
Cash From Operations = 3+ Years
Sales Growth = 3+ Years
Net Income Growth = 3+ Years
EPS Growth = 3+ Years

Earnings Estimates Revised Up
Good Business Model
Current Ratio > 1.0
Debt to Equity < 0.50
Return on Equity > Peers
Adds Portfolio Diversification



Revised Risk-Reward Criteria

Price to Book < 3
Price to Earnings < 20
Dividend Growth = 1+ Years
Earnings Estimates Revised Up
26-Week RSI Rank > 60%
Market Cap < \$1 Bil Preferred
Operating Margin Rank > 60%
Return on Equity Rank > 60%
Intangibles < 50% of Equity

Current Ratio > 1.0
Debt to Equity < 0.50
Times Interest Earned > 2
Sales Growth = 3+ Years
EPS Growth = 3+ Years
Free Cash Flow = 3+ Years
EPS Up Year-Over-Year
EPS Up Quarter-Over-Quarter



There are many stocks whose potential rewards outweigh their risks. They may not be perfect, but they are capable of building wealth.

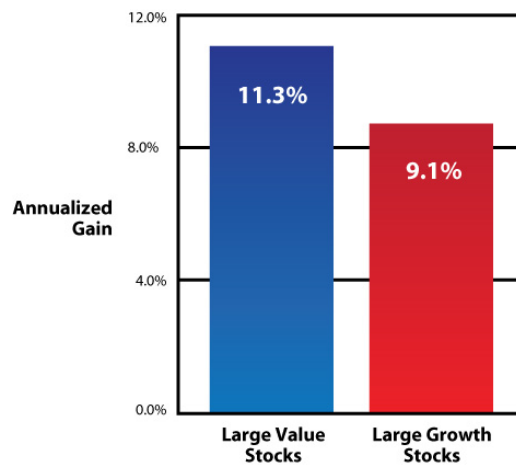
Source: "Better Good than Lucky," Charles Rotblut, *W&A Publishing*, 2010



A New Strategy



Value Beats Growth



Source: "2015 Ibbotson Classic Year Book," Morningstar, data from 1928 to 2014



High Valuations
=
High Expectations
=
More Room for Disappointment

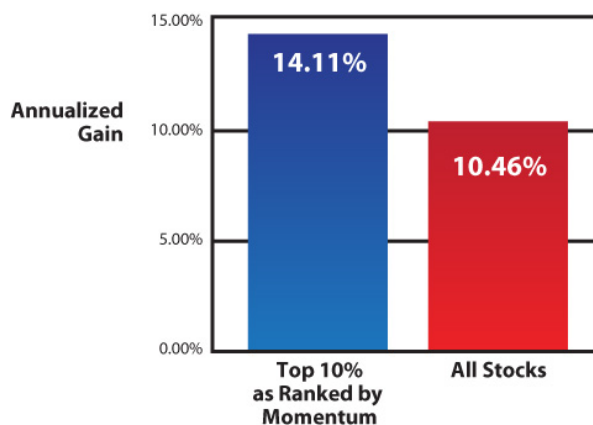


Valuation Considerations

- Relative or absolute (e.g., cheapest 40% or below a certain number)?
- Combine valuation measures (e.g., price-to-book with price-to-sales or price-to-earnings)
- Some stocks are cheap for a reason



Momentum



Source: "What Works on Wall Street," James P. O'Shaughnessy, McGraw-Hill, 2011, data from 1927 to 2009



Momentum Considerations

- Stocks with 26-week relative strength rankings of 60% or higher tend to outperform
- Earnings estimate revisions also impact price movement
- Tends to be uncorrelated with valuation
- Momentum strategies have more turnover, and therefore are more costly



Overlay Quality Factors






- Manageable level of debt; adequate interest coverage
- Current ratio above 1.0
- Above-average asset turnover
- Above-average operating margin
- Friendly to shareholders (pays a dividend and/or buys back shares)
- Positive free cash flow

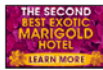


Negative Cash Flow

RadioShack Files for Chapter 11 Bankruptcy After Striking Deal to Sell Some Stores

By REBECCA R. RUIZ and MICHAEL J. DE LA MERCED FEBRUARY 5, 2015 5:47 PM 14 Comments

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A sign indicating a "Clearance Blowout" at a RadioShack store in Miami. The retailer had not turned a profit since 2011. Joe Raedle/Getty Images

Source: New York Times, February 5, 2015



J.C. Penney's Poor Cash Flows

| | | Current | 01/31/2015 | 02/01/2014 | 02/02/2013 | 01/28/2012 |
|-------------------------------|--------|---------|------------|------------|------------|--------------|
| Period Length | | | 52 weeks | 53 weeks | 53 weeks | 52 weeks |
| Update Type | | | | | | Reclassified |
| CASH FLOW STATEMENT | | | | | | |
| Total Cash from Operations | \$M | 189.0 | 239.0 | -1814.0 | -10.0 | 820.0 |
| Total Cash from Investing | \$M | -160.0 | -142.0 | -789.0 | -293.0 | -870.0 |
| Total Cash from Financing | \$M | -92.0 | -294.0 | 3188.0 | -274.0 | -1065.0 |
| Net Change in Cash | \$M | -63.0 | -197.0 | 585.0 | -577.0 | -1115.0 |
| Depreciation and Amortization | \$M | 620.0 | 631.0 | 601.0 | 543.0 | 518.0 |
| Capital Expenditures | \$M | 252.0 | 252.0 | 951.0 | 810.0 | 634.0 |
| Common Dividends Paid | \$M | 0.0 | 0.0 | 0.0 | -86.0 | -178.0 |
| Exchange Rate Effects | \$M | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Cash Flow per Share | \$/Shr | -0.20 | -0.65 | 2.35 | -2.63 | -5.13 |
| Free Cash Flow per Share | \$/Shr | -0.21 | -0.04 | -11.09 | -4.13 | 0.04 |

Source: Stock Investor Pro, October 9, 2015



Consider the Business Model

Fitbit shares tumble but sales and profit beat

Published: Aug 5, 2015 4:46 p.m. ET

f14 t19 s3

Aa



By
CAITLIN
HUSTON

Fitbit reported \$400 million in sales in its first report as a public company.

Shares of Fitbit Inc. FIT, +2.11% initially rose 5%, but then fell 12% in after-hours trade Wednesday, after the company reported second-quarter profit and sales that blew past estimates.

Source: MarketWatch, August 5, 2015



Excluded Companies

- Financial companies
- Price below \$4
- Not followed by analysts
- Non-exchanged listed (OTC)
- Russia- and China-based



Stocks: When to Sell

- The reason you bought the stock no longer applies (follow your sell rules)
- The valuation becomes excessive
- Business conditions, the fundamentals or the outlook deteriorates
- The dividend is cut or suspended
- You need to rebalance



A Few Final Words of Investing Advice



“If you don’t know what is going to happen,
don’t structure your portfolio
as though you do!”

Source: “The Purgatory of Low Returns,” James Montier, GMO Quarterly Newsletter, July 2013



Be a Proactive Investor

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



2 Rules for Investing Success

- Rule #1: Develop a consistent, well-defined approach to investing
- Rule #2: Stick to Rule #1

Source: James Cloonan, "Adherence to Rules Helps Model Shadow Stock Portfolio's Performance," *AII Journal*, October 2012



AAII Resources



AAII Email Updates

Observations on What's New With Social Security

Thursday, November 12, 2015



Charles Rittell, CFA
AAII Journal Editor

Over the past few weeks, Social Security has been in the financial news headlines for two reasons. The first is because there will be no increase in benefits next year, something that impacts everyone regardless of age. The second—which impacts those who are married or divorced and have yet to claim benefits—is the ending of “file and suspend” and restricted applications. I discuss both this week and include links to helpful articles as well as point out a few online tools.

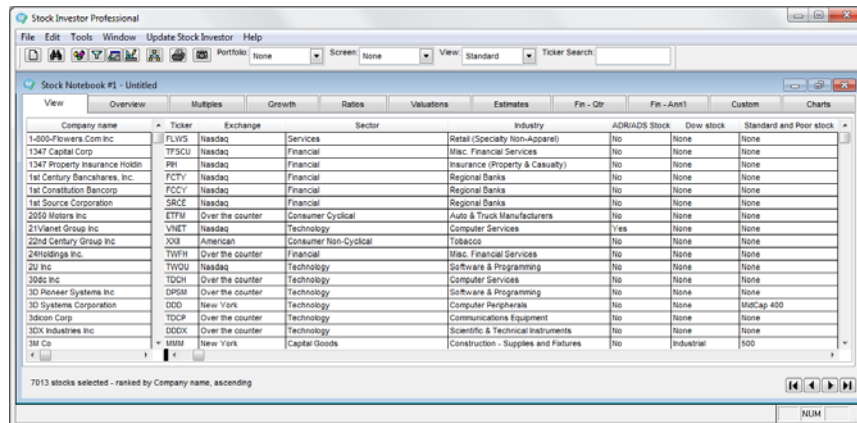
I'll start with COLA. COLA stands for cost-of-living adjustment. There won't be one next year. Social Security benefits will be unchanged from 2015. Those of you who are retired will likely take exception to the government's assumption that there isn't enough inflation next year. This is because the inflation you perceive is influenced by what you spend your money on and what prices you pay attention to. This basket of goods and services can differ from what the government uses to determine if there has been enough inflation to warrant a COLA. It also points to the inherent challenge of calculating the rate of inflation, which is dependent on the goods and services measured and the weighting assigned to them.

If you are, say, 25 instead of 75, you may not think this applies to you. It does because COLA compounds. If the COLA raises the monthly benefit—to use a very simple example—from \$1,000 to \$1,030, then the next COLA will be calculated based on the higher \$1,030 benefit. Next year's lack of a COLA keeps the lifetime income stream from Social Security for every American currently receiving benefits or likely to receive benefits in the future from increasing in 2016. (What you earn in eligible income will still impact your benefit if you haven't claimed. The discussion of Social Security solvency is a completely separate topic, though the current estimated threat is a 25% reduction in benefits starting in 2034 if nothing is done, according to the Social Security and Medicare Boards of Trustees.)

www.aaii.com/email/signup



Stock Investor Pro



www.aaii.com/stock-investor-pro, \$198 per year



AII Stock Screens

Data as of 12/31/2015

| YTD | 3-Year | 5-Year | 10-Year | Inception | Risk Index | Category | Alphabetical |
|---|-----------------------|--------|---------|-----------|------------|------------|------------------------------------|
| Screen Performance Snapshots (click tabs to change sort order) | | | | | | | |
| Screen | Annual Price Gain (%) | | | | | Risk Index | Category |
| | YTD | 3 Yr | 5 Yr | 10 Yr | Inception | | |
| 1. O'Neil's CAN SLIM Revised 3rd Edition How to implement William O'Neil's revised CAN SLIM approach to screen for fast-growing stocks. | 32.1% | 40.1% | 15.6% | 12.2% | 18.7% | 1.86 | Growth With Price Momentum |
| 2. Fisher (Philly) A perspective on the evolution of the investment philosophy of a successful money manager who learned from his mistakes. | 22.7% | 19.1% | -3.8% | 1.3% | 4.9% | 2.21 | Growth & Value |
| 3. Stock Market Winners A screen that tries to interpret and apply successful trading rules in the real market environment. | 19.2% | 20.8% | 19.4% | 13.2% | 20.4% | 1.43 | Growth & Value With Price Momentum |
| 4. T. Rowe Price Price's long-standing approach focus's on Growth stocks but avoids over glamorized stocks. | 17.4% | 16.3% | 23.8% | 7.0% | 10.4% | 1.65 | Growth & Value |
| Benchmark: S&P 500 | -0.7% | 12.7% | 10.2% | 5.1% | 4.2% | 1.00 | |

(<http://www.aaii.com/stock-screens>)



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