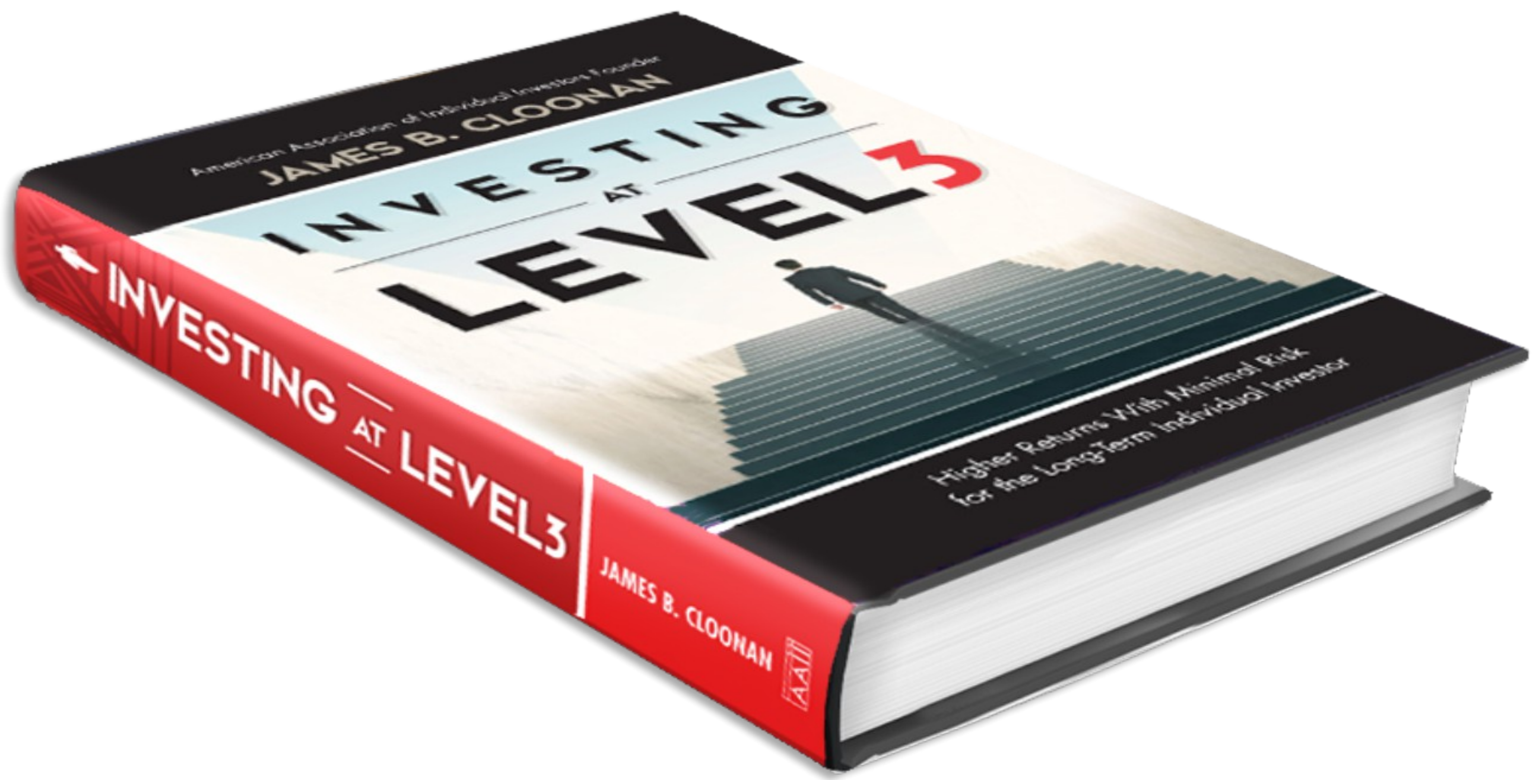
Book Review of *Investing at Level 3*



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Book Objectives:

1) Show that most of what we have been taught about investing is not effective for the long-term individual investor.
2) Offer alternative approaches that can significantly increase the ultimate wealth and retirement income of investors
3) Show how this can be done while effectively controlling real risk as opposed to the “ghost risk” of short-term volatility
4) Provide a framework within which the above objectives can be accomplished while overcoming significant psychological barriers and ignoring the continuous excess costs, harmful noise and misdirection coming from the investment services industry.

Levels of Investing:

Level 1: Unorganized investing driven by impulse and emotion.

Level 2: Evolved from modern portfolio theory and is academic in origin. An improvement over Level 1, but not good enough.

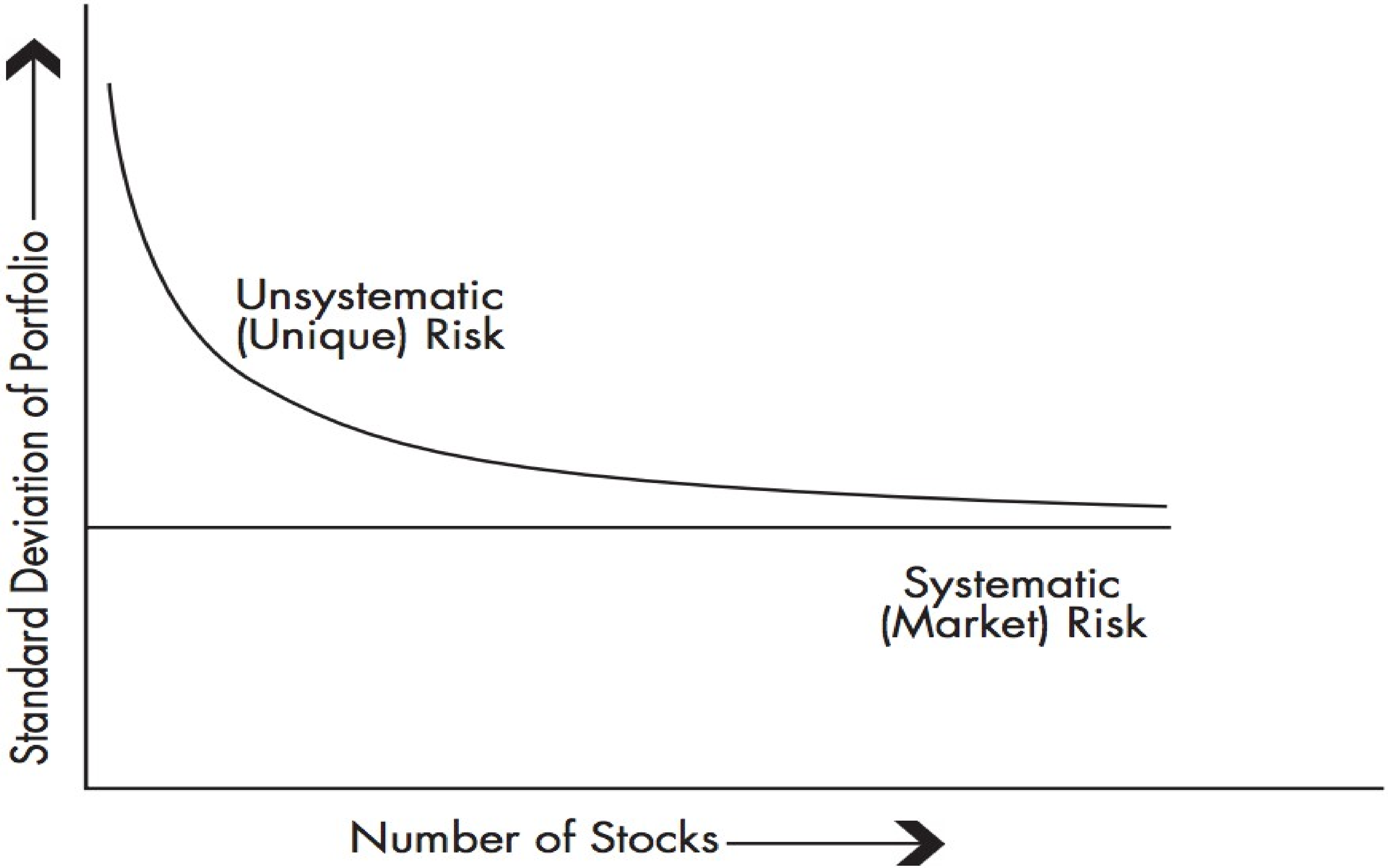
Level 3: New strategy proposed in this book.

Problems with Modern Portfolio Theory

- Confusion of risk and variance
- Cost of risk aversion overlooked
- Diversification overdone
- Market is not efficient

FIGURE 1.2

Diversification and Risk

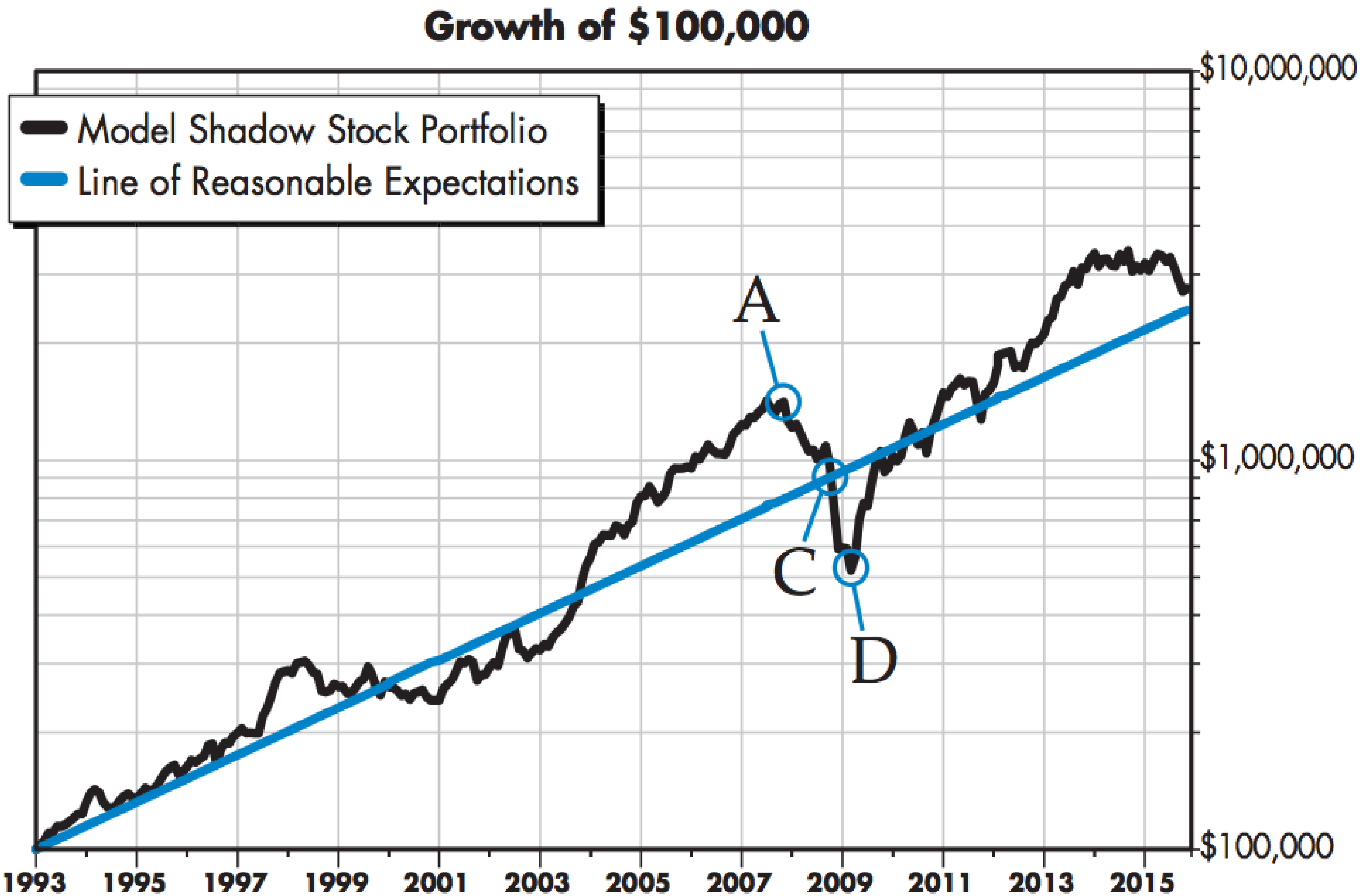


Limits of Fundamental and Technical Analysis

- Very little evidence that charts can predict future price movements
- If chart analysis works, large computer systems can do it and beat individual investors
- Momentum not a strong indicator, but it works better than some fundamental techniques
- Fundamental indicators can be useful, but mutual funds tend not to use them effectively

Premise for Level 3: The market will always come back from a drop to a higher level than before. One should ride through drawdowns and not panic. Don't sell at the bottom.

Model Shadow Stock Portfolio on Log Scale



Source: AAII

Analysis of Past Crashes

- 1929 Not happening again because of current government policies. Besides, no matter what you do, it is not safe in a situation like that. I think it is naive to believe that current government policies will protect us from this happening again.
- 1968 Short duration. Not a problem for Level 3.
- 1972 Serious pullback, but equal-weighted Wilshire 5000 recovered within 3 ½ years.
- 1987 Short duration. Not a problem for Level 3.
- 2000 An equal-weight portfolio actually went up during this time. Only tech stocks took a big hit.
- 2007 Serious pullback, but Model Shadow Stock Portfolio recovered within 2 years.

Expected returns:

- Safe investing in short-term debt: 4%*
- Level 2: 8%
- Level 3 Passive: 12%
- Level 3 Active: 16%

Level 2 reduces returns by attempting to protect against drawdowns. Examples include allocations such as 60/40; the 40% in fixed income reduces expected returns.

* Yeah, I don't know how you get 4% these days, either.

Level 3 Passive Techniques:

- Invest all funds in Guggenheim S&P 500 Equal Weight ETF (RSP)
- Can put some funds in some other suggested ETFs, including one REIT.

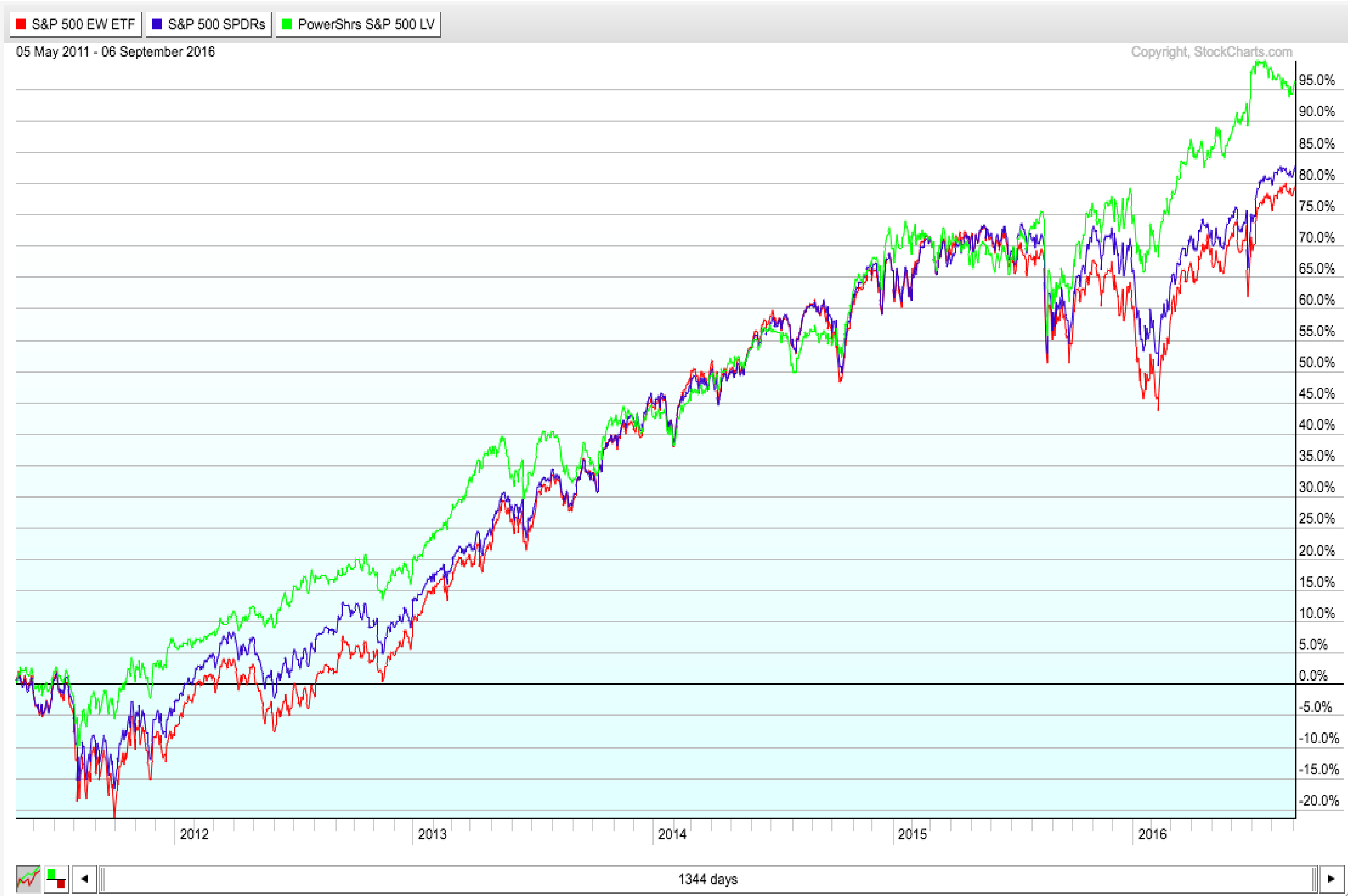
Level 3 Active Techniques:

- Use AAII stock screens
- Use AAII Stock Investor Pro and create your own screens
- Use screens from https://www.magicformulainvesting.com/

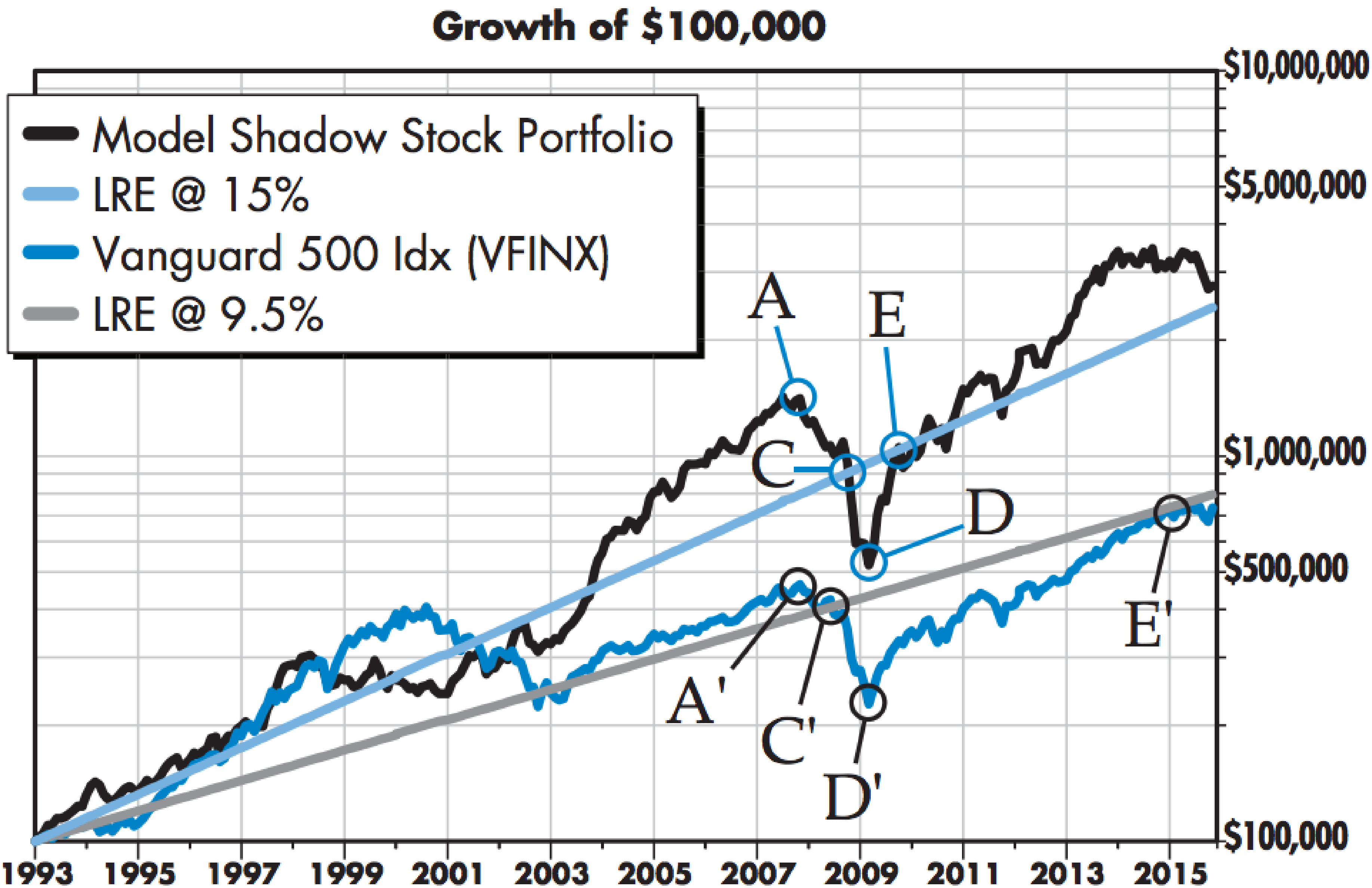
Equal-Weighted vs. Cap-Weighted Market ETFs

Source: StockCharts.com

PerfChart of RSP, SPY, SPLV

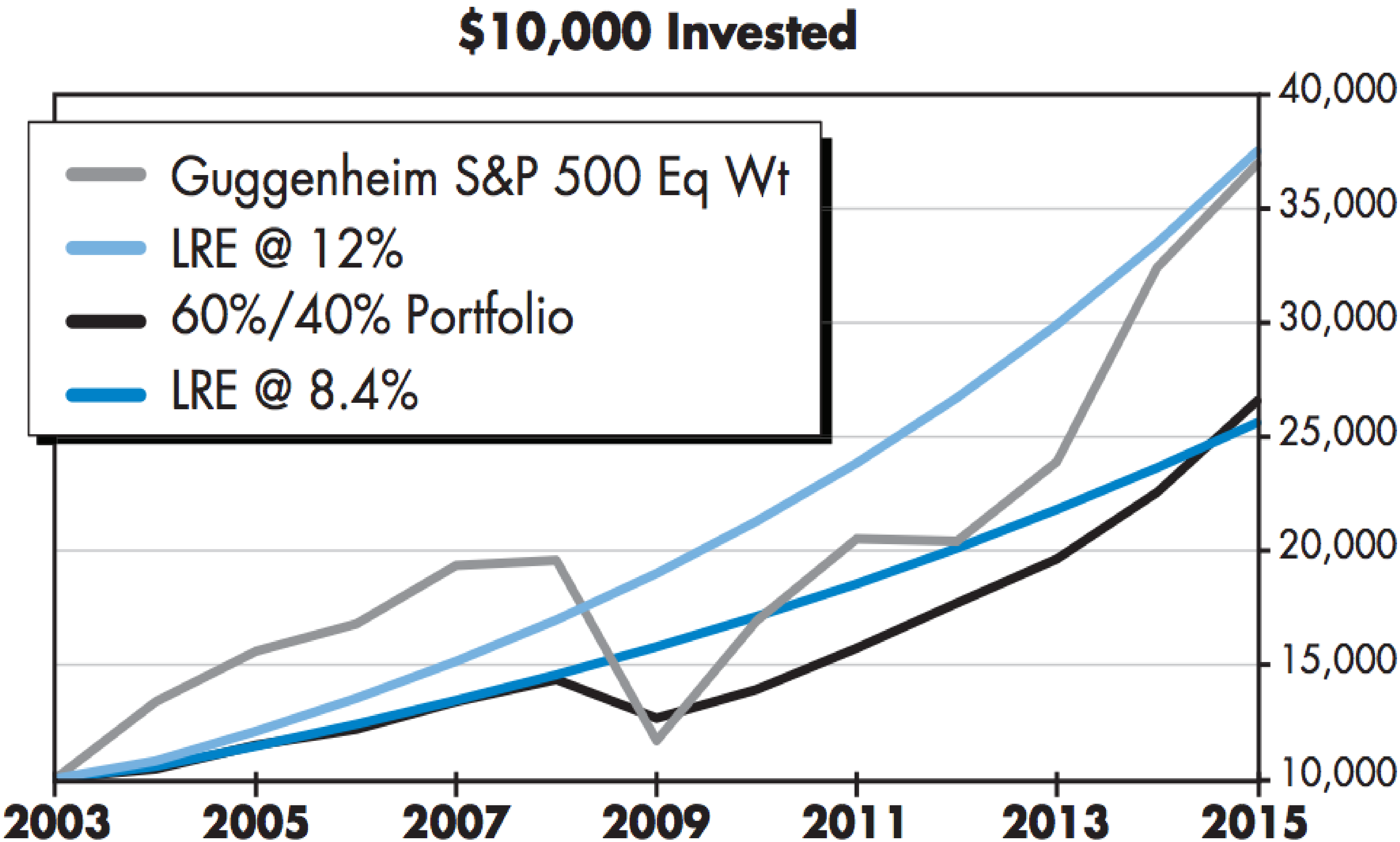


Model Shadow Stock Portfolio vs. Vanguard 500 Index Fund



Source: AAII

Guggenheim S&P 500 Equal Weight ETF vs. 60% Stock/40% Bond Portfolio

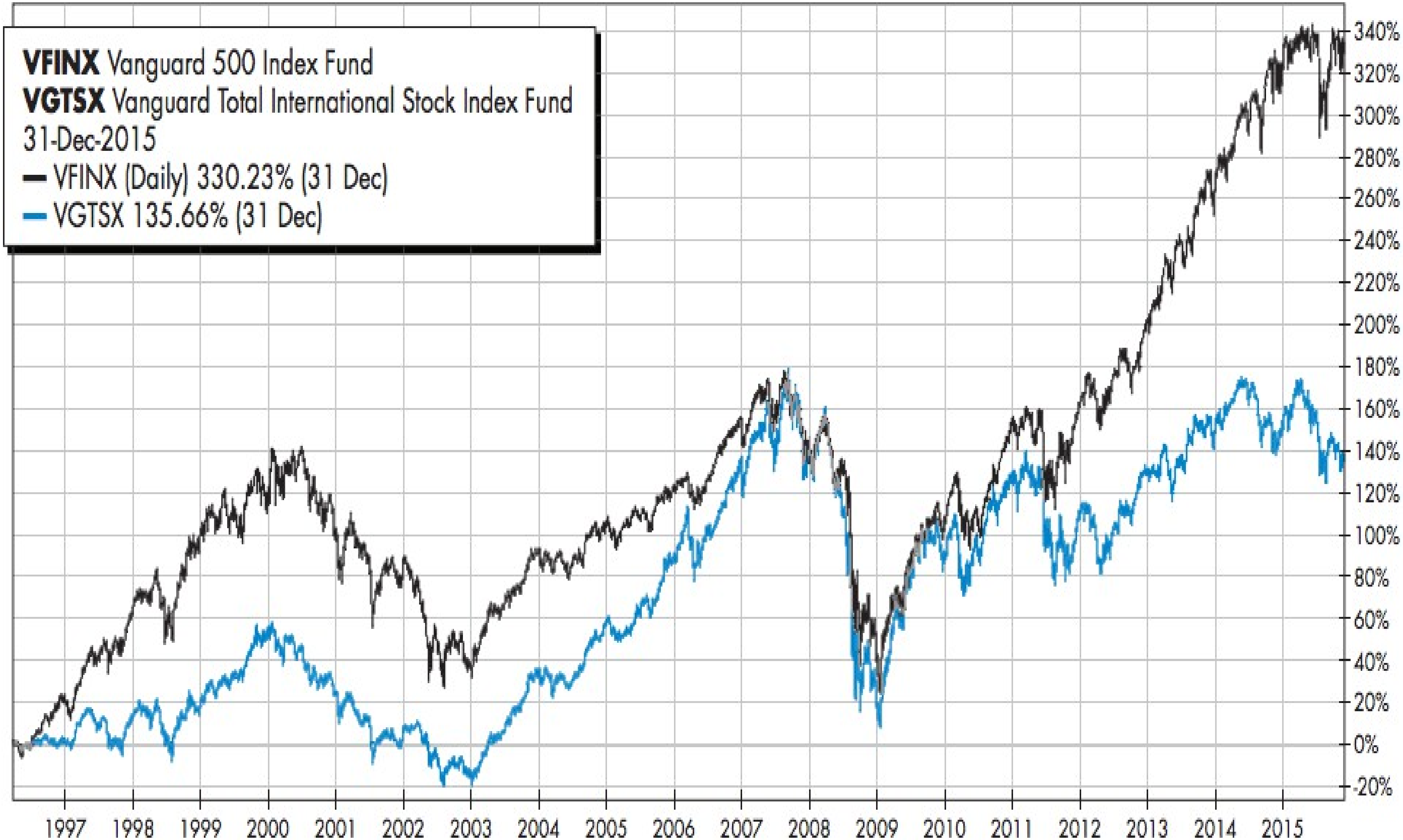


Source: AAII

Important aspects of Level 3 Investing:

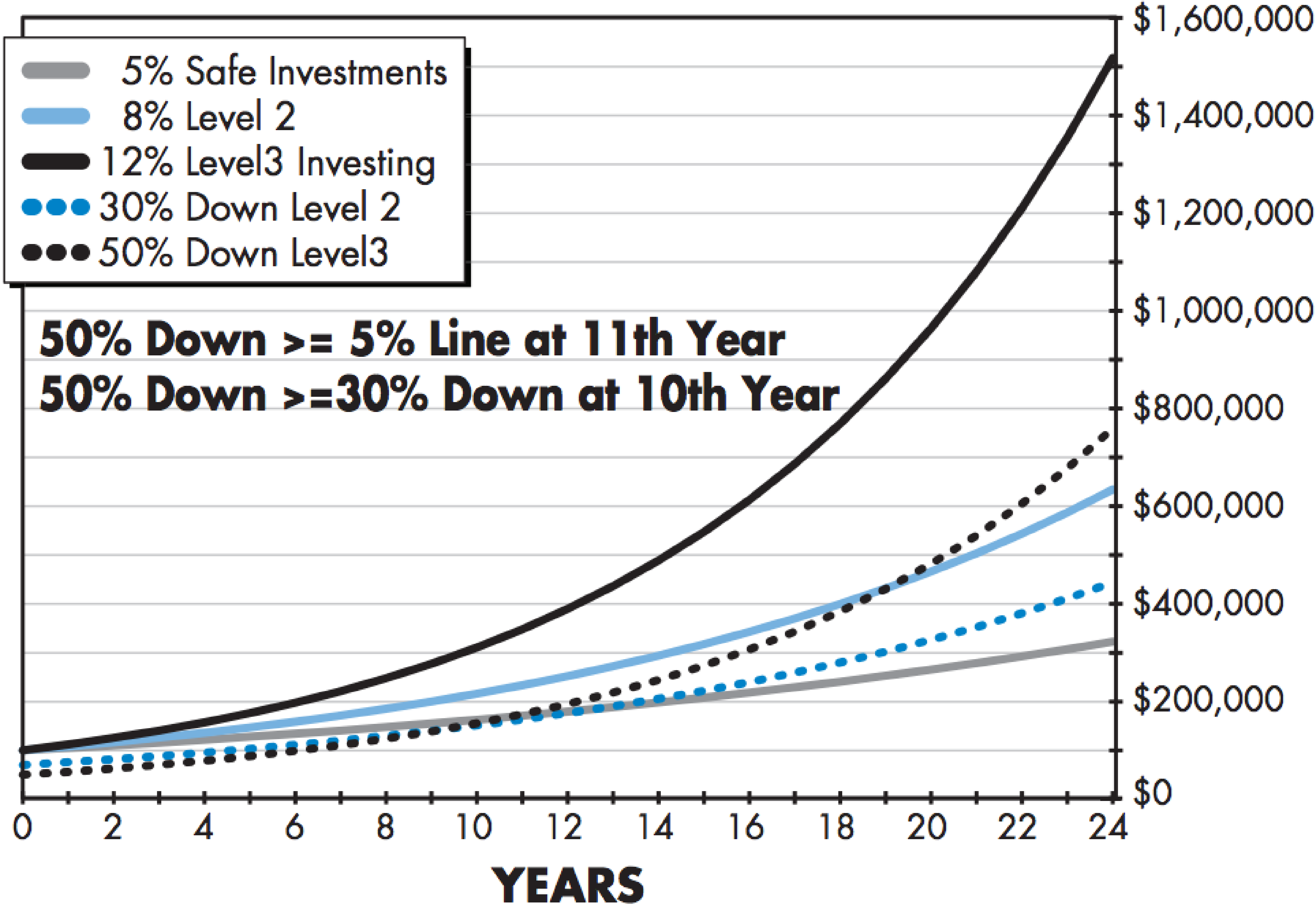
- While you are working and are more than 4 years away from retirement, you should have 100% of your savings invested in equities. You can consider leveraging up to 125%, but read the cautionary notes in the book. 150% is going too far; a big bear market will wipe you out.
- As you approach retirement, you can set aside a “safe fund” of very low volatility investments, but be aware that you reduce your return.
- As you draw out funds in retirement, draw from your equities as long as the market is not dropping. While the market is dropping, draw from your “safe fund”.

Comparing Domestic and Foreign Stock Performance



Source: StockCharts.com

A Comparison of the Approaches



Psychological Pitfalls to beware of:

- We are more anxious to avoid losers than to embrace winners
- We don't have a well-defined strategy
- We don't stick to our strategy
- We use heuristic approaches which give us flawed estimates
- We are overconfident
- We watch CNBC

To order the book:

- Level3investing.com

Acknowledgments

Picture on page 1 and graphs on pages 5, 7, 11, 13, 14, 16, and 17 were obtained from author's web site: Level3Investing.com

Graph on page 12 was obtained from stockcharts.com