AAII SAN DIEGO CHAPTER
FUNDAMENTALS OF INVESTING
APRIL 15, 2023

AAII: AMERICAN ASSOCIATION OF INDIVIDUAL INVESTORS

- https://www.aaii.com Trial membership for $2 for a month
- https://invest.aaii.com/membership/

San Diego Chapter

- Meets at Good Samaritan Episcopal Church in La Jolla
- Meetings are broadcast on Zoom
- Special Interest Groups typically meet on Zoom
  - Risk Management
  - Options Trading
  - Fundamentals of Investing
- https://aaiisandiego.com/

Presenters:

- Thomas Jones
- Steve Rawlinson

AAII Local Chapters

Disclosure

The instructors in these classes are not professional investors nor do they have paid teaching experience. The opinions expressed are their own and are presented in good faith but no representation is made as to accuracy or astuteness. The material presented is for information purposes only. The instructors do not intend to provide any specific financial advice or any basis for making financial decisions.

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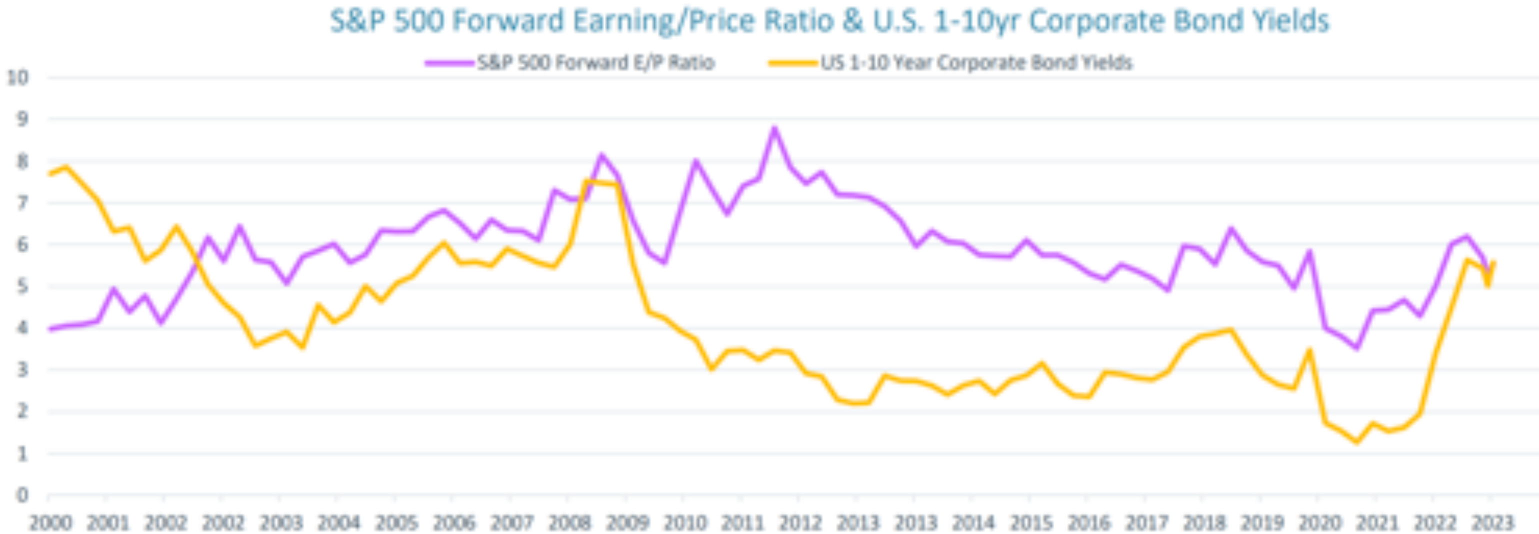
Bond Yields Look Attractive Relative to Stocks

Corporate yields relative to stock forward E/P levels are at their highest levels since 2008.

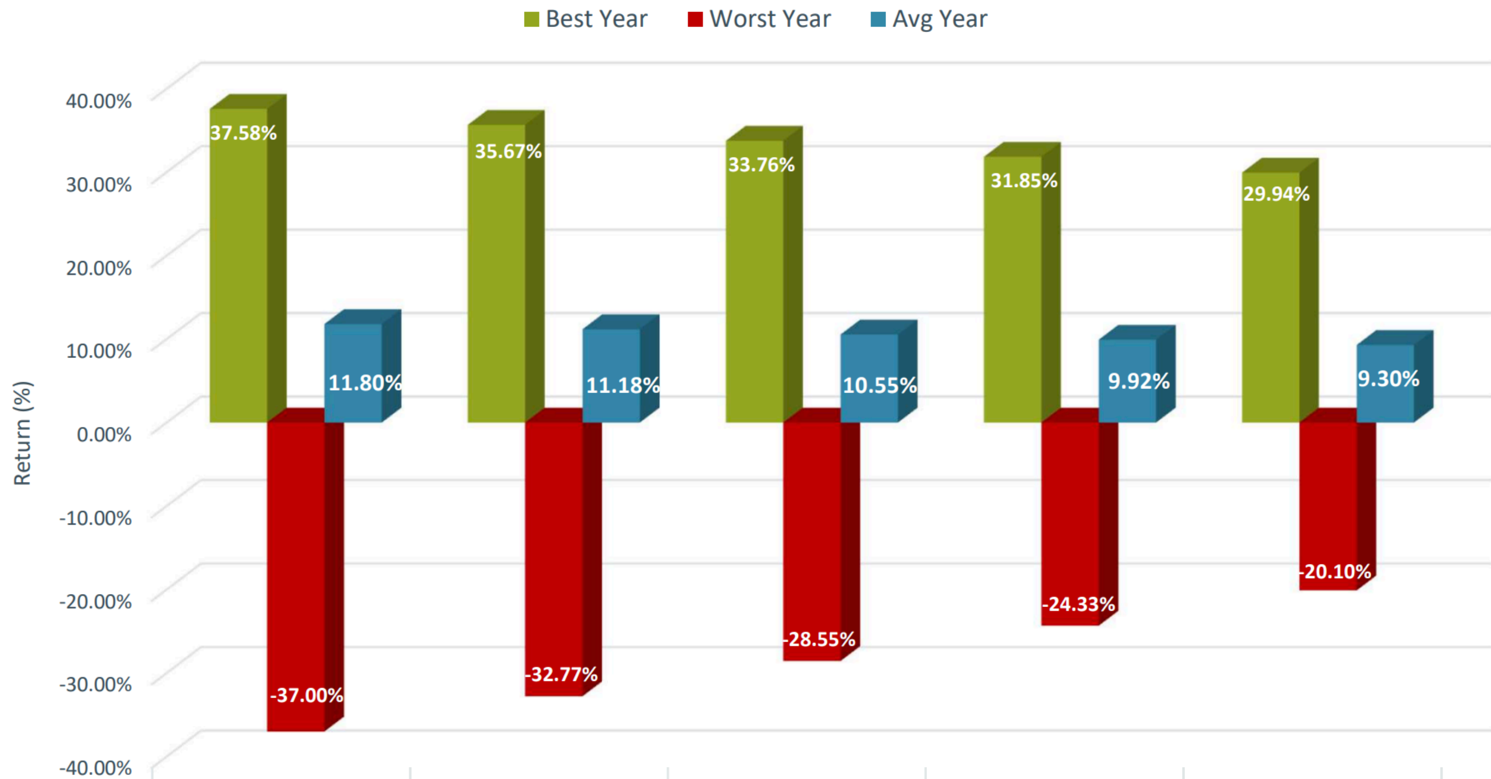


Source: Bloomberg. Data as of February 28, 2023.

Why Invest in Bonds?

Portfolio diversification and cushion in periods of stock market weakness.

Range of Annual Returns (1989-2022)



	100% Stocks	90% Stocks 10% Bonds	80% Stocks 20% Bonds	70% Stocks 30% Bonds	60% Stocks 40% Bonds
Best Year	37.58%	35.67%	33.76%	31.85%	29.94%
Worst Year	-37.00%	-32.77%	-28.55%	-24.33%	-20.10%
Avg Year	11.80%	11.18%	10.55%	9.92%	9.30%

Source: Bloomberg. Data as of December 31, 2022. Past performance is no indication of future results. All investments have risk of loss.

9.3/11.8 = 78.81%   20.1/37.0 = 54.32%

Investible Assets

- **Bonds**
- **Real Estate**
- **Works of Art**
- **Collectibles**
- **Jewelry**
- **Sports Franchises**
- **Tulip Bulbs (400 years ago)**
- **Stocks (But you already knew that)**
- **Yourself**
- ***(This is not a complete list.)***

Beware Hedge Funds

- Red flag: You have to have high net worth or high level of income
- They charge 2% per annum + 20% of the profits (but don't refund 20% of the losses.) No wonder hedge fund managers get rich.
- Buffet made a bet with a hedge fund manager that the S&P 500 Index would beat that manager's choice of hedge fund over a specified period of time. Buffet won.
- Hedge funds take big risks and can go broke.
- Example: Long Term Capital Management
  - Nobel Economics Prize winners Myron Scholes and Robert Merton were on the Board of Directors.
  - Earned 21% in 1st year, 43% in 2nd, and 41% in 3rd.
  - Done in by Asian and Russian financial crises
  - Bailed out by Federal Reserve, liquidated and dissolved

Beware of Annuities

- You pay a fixed sum of money to an annuity operator and receive a schedule of payments.
- Many annuities offer no inflation protection.
- Annuity contracts are complex documents. You are at a disadvantage understanding them. Study them carefully.
- The cost of getting out of an annuity is high.
- Maybe not all annuities are bad. Maybe you can find some decent annuities at a reputable discount broker. If a salesman is helping you to buy, you are paying for his work. Even if there is no commission, the annuity has to pay him and it comes out of the assets in your annuity.
- The solvency of the annuity issuer is an issue.
- <u>Annuities are sold, not bought.</u> (So said Blair Duquesnay.)

Buy when there is blood on the streets

- Health care stocks in 1993
- Kennedy Assassination, Nov. 22, 1963
- Airline stocks on Sept. 17, 2001 (But which airline?)

But sometimes it does not work

- Petrograd, Russia, October 1917

Time will tell about this …

- Silicon Valley Bank failure, March 10, 2023

Not likely to be a good time to buy when things are looking great

So the market is dangerous!
What do we do about that?

- Diversify.
- Stick with index funds that track broad segments of the market, or stocks that you understand.
- Diversify.
- Invest for the long run and expect short-term bumps along the way.
- Diversify.
- Read articles from sources like AAII to learn ways to optimize your returns and handle drawdowns.
- Diversify.
- A higher return should be the reward you get for accepting higher risk.
- Did I tell you to diversify?

Diversify

Types of risk in individual stocks:

1. **Company risk (CEO dies, CFO embezzles, something unfortunate happens and lawsuit is filed)**

2. **Industry risk (Product goes out of style with consumers, competitor goes bankrupt)**

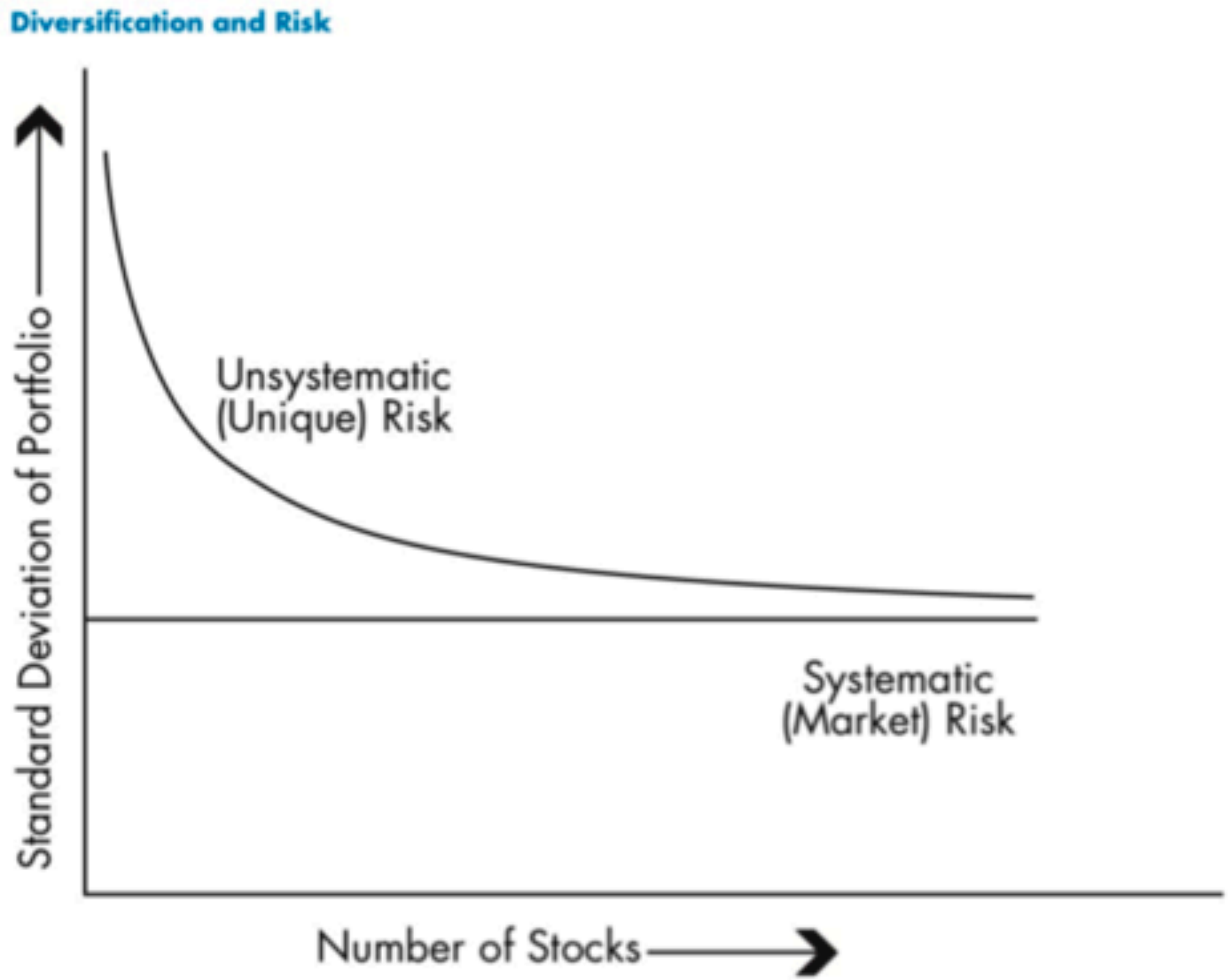
3. **Country risk (Socialists take over the country)**

4. **Market risk (Systematic risk)**

5. **Can diversify risks 1-3, but not systematic risk**

6. **Beta is a measure of systematic risk**

Diversification Payoff



God wants you to diversify.
It says so in the Bible.

Make seven or eight portions; you know not what misfortune may come upon the earth.

Ecclesiastes 11:2
Roman Catholic Bible

The Easiest Way to Diversify

- Buy Mutual Funds or ETFs.
- Years ago that was the only way to go for portfolios of modest size. There were commissions and they were steep. Funds provide instant diversification. Commissions are gone now, but funds are a more efficient way to diversify.
- There are funds and ETFs of all types. You can buy funds in stocks of specified capitalization (large, medium, or small) or specializing in growth or value or concentrating in one particular industry. You can also invest in funds that stick with domestic stocks or funds in stocks of foreign developed countries or funds in stocks in emerging markets. This allows you to control how you diversify: You can overweight in some areas and underweight in others.
- Most ETFs track indexes and have modest expense ratios. Some mutual funds track indexes and others are actively managed. Actively managed funds have higher expense ratios. Steve does not like actively managed funds.
- Steve likes ETFs. Mutual funds are OK in an employer provided retirement account. Actually, they are OK for true investors who don’t trade often.

Why Steve Prefers ETFs

- ETFs tend to have lower expense ratios.
- ETFs have fewer tax events because trading shares of the fund for shares of the securities is tax-free. (Not an issue in 401(k)s or IRAs)
- I can hedge risks with ETFs using options. Some ETFs trade actively and have well-priced options. (But some don't.)
- I can place limit orders on my ETFs. I would get the price at the end of the trading day on a mutual fund with no control over whether I buy at a desired price.
- I can buy an ETF one day and sell it the next day without penalty.
- Mutual funds have to maintain some cash in case redemptions at the end of the day exceed purchases. ETFs don't have to worry about that so can have all of their funds working.
- One exception is that mutual funds in junk bonds track better the desired index than ETFs.
- Some of the reasons I prefer ETFs are not important for true investors.

Asset Allocation

- You need to decide how you want to allocate your investments.
- You can allocate among various types of securities including equities, bonds, and cash.
- A portion of your equity portfolio should be in US domestic stocks. Another portion should be in foreign developed countries. Yet another portion should be in emerging markets.
- You should have some of your assets in midcap and small cap stocks.
- You need to decide how to split your allocation between growth and value.
- You may want to have some emphasis on particular industries. For example, Steve has a portion of his investments in Energy.
- You can find index ETFs that specialize in each of these areas. There may be multiple choices in some areas; in those cases, you may want to look at the expense ratios.

Aggressive Investor

90% Diversified Stock

Suggested Allocation Breakdowns

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

Characteristics

Growth:	Substantial
Income:	Very Low
Risk:	Substantial Year-to-Year Volatility of Portfolio Value
8%	Average Annual Growth in Value
-38%	Bad Year

Moderate Investor

60% Diversified Stock

Suggested Allocation Breakdowns

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

Characteristics

Growth:	Moderate
Income:	Low
Risk:	Moderate Year-to-Year Volatility of Portfolio Value
7%	Average Annual Growth in Value
-21%	Bad Year

Conservative Investor

40% Diversified Stock

Suggested Allocation Breakdowns

20%	Large-Cap Stocks
10%	Mid-Cap Stocks
0%	Small-Cap Stocks
10%	International Stocks
0%	Emerging Markets Stocks
40%	Intermediate Bonds
20%	Short-Term Bonds

Characteristics

Growth:	Low
Income:	Moderate
Risk:	Low Year-to-Year Volatility of Portfolio Value
6%	Average Annual Growth in Value
-12%	Bad Year

Taxes

- Long-term capital gains and qualified dividends are taxed at a reduced rate.
- The rate you pay depends on your Adjusted Gross Income and can vary from 0% to 20% with a 3.8% surtax on AGIs that are real high.
- Long-term is 1 year.
- Long-term used to be 6 months, and the long-term rate was considerably lower than ordinary income rates, but Congress got greedy in search of more revenues. But qualified dividends in the old days were taxed at the same rate as other dividends.
- There are politicians who have proposed stretching long-term out for a longer length of time, but the votes to do that are not there currently.
- Decent brokers provide year-end 1099s that show your interest, dividend, short-term and long-term capital gain liabilities. Generally speaking, you don't have to keep careful records of the dates of your stock purchases. (But it is a good idea to do it anyway.)
- Holding stocks for a long time is a good idea, and the tax code does a limited job in encouraging it. But your taxes aren't affected by length of holding stocks in tax-deferred accounts.

Common Mistakes

- Picking a strategy or advisor based upon inadequate look-back information
- Listening to hot tips
- Falling in love with your stocks
- Combining your money and your morals
- Buying whatever is fashionable
- Reaching for yield
- Trading frequently
- Taking risks beyond your risk threshold. Beware of margin.
- Not reading our suggested papers

Keep Up to Date

- Our investment environment keeps changing
  - We had high commission rates years ago, and now they have come down to zero. (But watch out for the SEC.)
  - ETFs did not exist years ago. Neither did index funds.
  - We can have our broker handle our mutual fund transactions now. We used to deal directly with the funds, and it was a pain in the ***.
- We must keep reading sound papers and books about investing to keep up with the changing environment.

You Can Do This

- You don’t need to be male.
- You don’t need STEM skills.
- We encourage you to save the investment advisory fee and manage your own investments. There may be special circumstances where you need an advisor, and that is OK.
- If you are married, work with your spouse. Two heads are better than one (even if one is a better investor than the other). In the event of death or disability of one, the other needs to be up to speed. A period of grief over the loss of a loved-one is no time to learn how to invest.
- Nobody cares more about your investments than you do.
- Nobody understands your risk tolerance as well as you do.
- If you are retired, managing your portfolio is your full-time job.
- You can buy small/micro-cap stocks without moving the price.

Don’t Underestimate Women

- Women in the investment management business have had a better track record than their male counterparts.

- Women are smarter about risk management. They take risks, but only when the payoff warrants the risk. Men tend to take risks foolishly.

- Women favor funds. Men are more likely to pick “lottery style” stocks.

- Women trade less frequently.

- Men don’t like to admit their investment mistakes. Their effort to cover up their mistakes is costly.

- Some men can control their emotions. That is one reason why Warren Buffet, Charlie Munger, Peter Lynch, Benjamin Graham, and other men have been so successful. Few women or men will ever match those guys.

Do You Need An Advisor?

There are special situations in which an investment advisor would be a good idea. Some examples:

- You do not have desire, time, or knowledge to manage your own portfolio.
- You do not have the ability to remove your emotion from the investment process.
- The portfolio is too large and you feel it is beyond your capabilities (i.e., the responsibility is too great).
- Your spouse has zero interest in managing investments. You need to have an arrangement in place to cover your sudden death or disability.
- You are on a committee that runs a non-profit organization that has investible funds. Your committee can establish an investment policy, but it should hire a professional to implement the policy. You do not want amateurs taking responsibility for the management of these funds.

Choosing An Advisor

- Learn principles of sound investing so that you can understand what the advisor’s strategy is and decide whether his strategy makes sense.

- Interview the advisors. Find out how they make their decisions and why. Find out what they charge, but don’t make the mistake of picking the cheapest just because he is the cheapest.

- Find out if the advisor invests his own money alongside the clients’ (i.e., is he asking you to take a risk that he isn’t willing to accept for himself?)

- Do the risk and return characteristics of the advisor’s strategy meet your personal risk and return objectives? What is the maximum drawdown that you as a client might expect and is that acceptable?

- Are you comfortable working with the advisor? Is your spouse? 80% of widows change investment advisors after their husbands die.

Fundamental Investing Principles

- Focus on living beneath your means so you can . . .
- Save money and invest it relentlessly over time using . . .
- A working knowledge of the financial markets to . . .
- Help achieve your long-term financial goals.

Fundamentals of Investing
Class 2 – 15 Apr 2023

Dollar-Cost-Averaging

- Markets rise and fall during the year.
- Dollar-Cost-Averaging forces you to:
  - Buy more shares when the security is lower in price, and
  - Buy fewer shares when the security is higher in price.
- Invest money on a regular schedule without regard to whether the market is up or down.
- For example, invest a fixed amount of money on a regular basis, like $100 on the 15th of every month, and make it automatic.
- This is also an example of "Pay Yourself First" and it should be free to do with your broker.

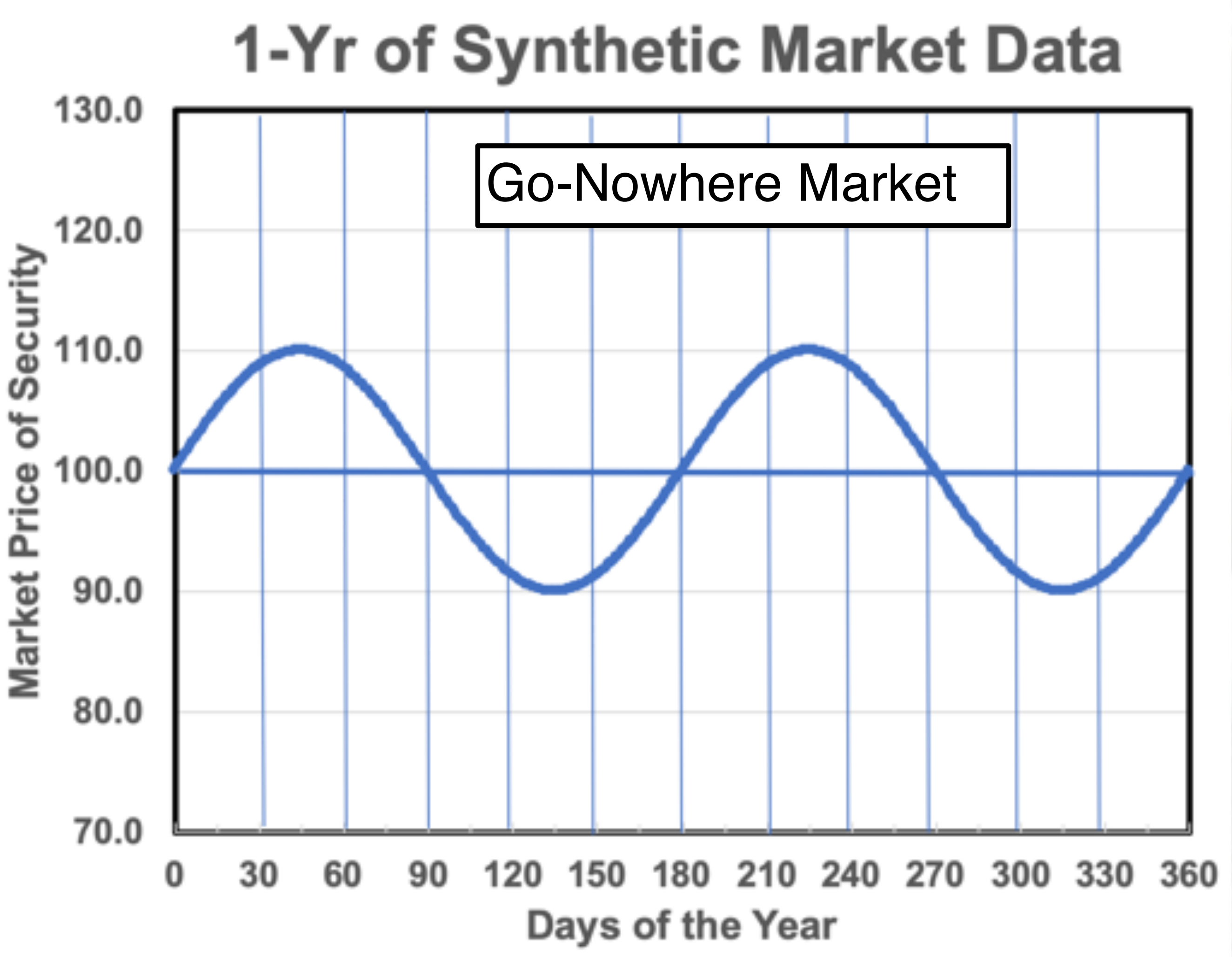
Long-Term Investing vs. Lump-Sum Investing

- If you are currently saving and investing from your income long-term, you are automatically dollar-cost-averaging – this is what you should be doing.

- What if you receive a large lump-sum of money – What to do besides spend it?
  - Invest it all at once?
    - You won't know if you bought high or low until time passes.
  - Invest a small amount on a regular, scheduled basis – dollar-cost-average into the markets.

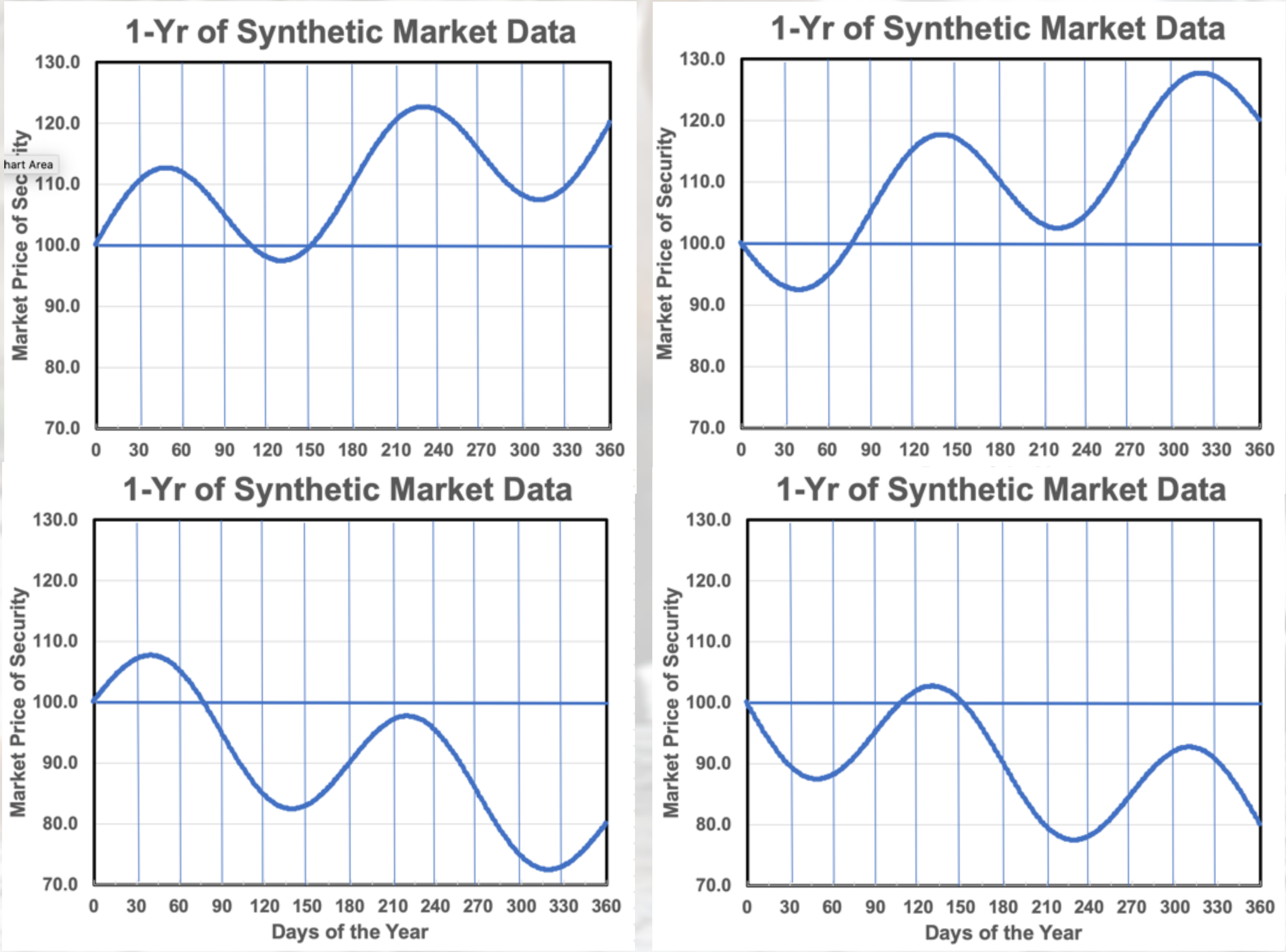
Fundamentals of Investing
Class 2 – 15 Apr 2023

Dollar-Cost-Averaging



- Putting $12,000 in at the beginning buys 120 sh worth $12,000 at year end.
- Invest $1,000 each month for 12 months buys 120.60 sh worth $12,060.45 (+ 0.5 %)
- N = Amt /Price - # of sh varies inversely with price.

Fundamentals of Investing
Class 2 – 15 Apr 2023



Market Simulation in Variety of Markets

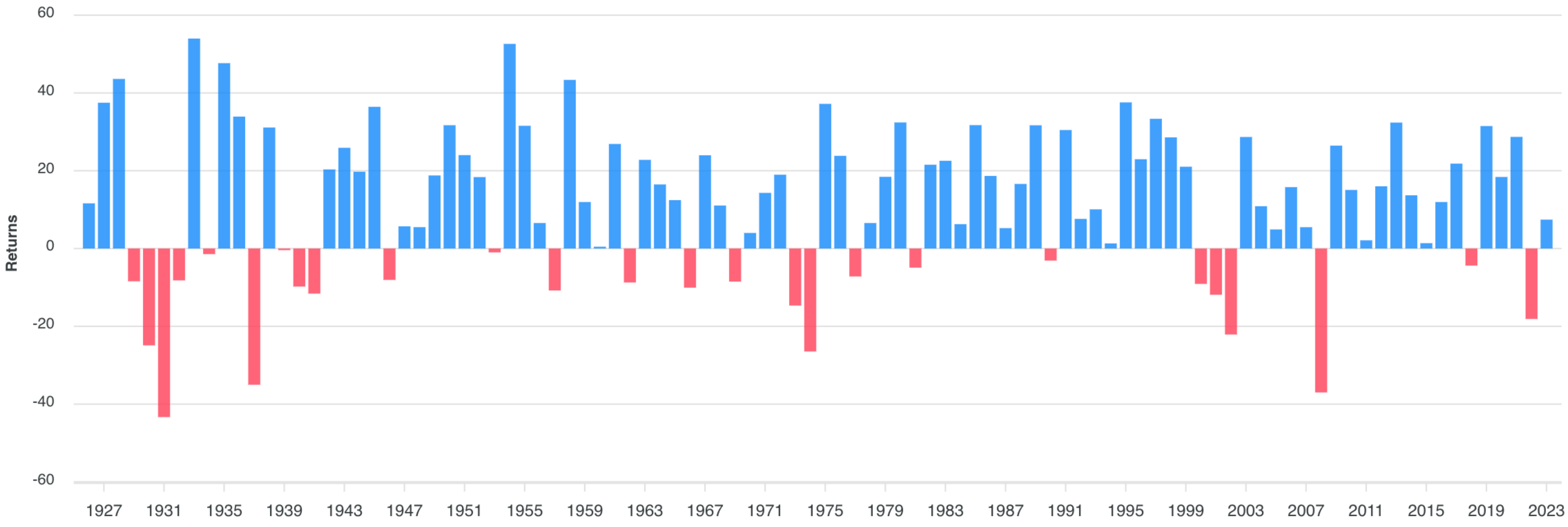
Numerical Example for 1 Year

Market Return	Market Starts	Dollar-Cost-Averaging Balance at End of Year	All-In at Start Balance at End of Year
20 %	Up	$13,251 (+10.4 %)	$14,400 (+20 %)
	Down	$13,315 (+11.0 %)	
0 %	Up	$12,060 (+0.5 %)	$12,000 (0 %)
	Down		
-20 %	Up	$10,719 (-10.7 %)	$9,600 (-20 %)
	Down	$10,640 (-11.33 %)	

Fundamentals of Investing
Class 2 – 15 Apr 2023

S&P 500 Total Returns

The total returns of the S&P 500 index are listed by year. Total returns include two components: the return generated by dividends and the return generated by price changes in the index. While most individuals focus only on the price returns of the index, dividends play an important role in overall investment returns.



Ref: https://www.slickcharts.com/sp500/returns

Fundamentals of Investing
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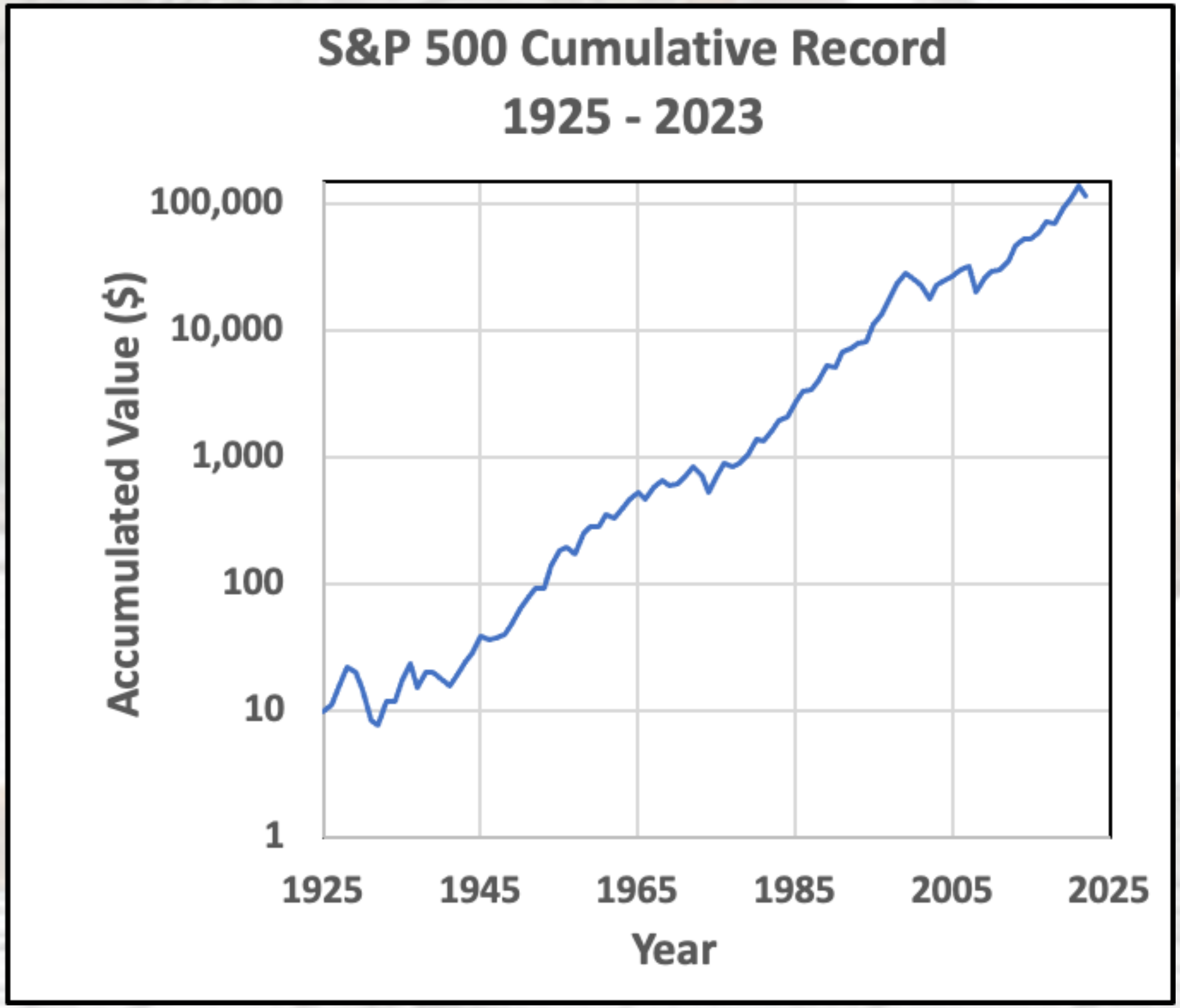

97-Year Cumulative Record for the S&P 500:
Ave Rtn: 12.90 %
Std Dev: 18.50 %

Compounded Annual Growth Rate (CAGR): 10.21 %

Fundamentals of Investing
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Market Statistics over 97 Years

History of S&P 500 since 1925 – 97 yrs. (Total Returns):

- Ave. Return: 12.01 %
- Standard Dev: 19.67 %
- CAGR: 10.12 %

Just the up Years: 71 (73 % of years):

- Ave. Return: 21.3 %
- Standard Dev: 12.7 %
- CAGR: 20.6 %

Just the down Years: 26 (27 % of years):

- Ave. Return: -13.43 %
- Standard Dev: 11.21 %
- CAGR: -14.26 %

Useful Facts:

- Markets are up 73 % of the time and
- CAGR of up yrs is 20.6 %.

- Markets are down 27 % of the time and
- CAGR of down yrs is – 14.26 %.

Conclusion:

- Most investors should be mostly invested most of the time.

Ref: https://www.slickcharts.com/sp500/returns

Dollar-Cost-Averaging vs. All-In Up Front for Investing a Lump Sum

Pros of Dollar-Cost-Averaging

- Establishes an automated investing habit.
  - Best way to invest regular income for the long term.
- Maintains flexibility in investment choices.
- Small increase in return in a volatile go-nowhere market.
- Reduces losses in down markets (27 % of markets).
- May reduce anxiety (sleep better at night).

Cons of Dollar-Cost-Averaging (Favoring All-In)

- Market statistics favor investing lump sum at once.
- Lowers returns in up markets (73 % of markets).
- May increase anxiety (raise your stress level).

Fundamentals of Investing
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Preview of Retirement - Savings, Investments, and Withdrawals (Planned for Class 4)

- Planning for Retirement.
- Social Security
- Saving & Investing for Retirement
- Can I Retire Now? What's My Number?
- The 4 % Rule
- How Long will my Money Last in Retirement? Please don't ask.
- How to ensure you never run out of money in retirement.
- RMDs and Automatic Retirement Withdrawals
- Unplanned Retirements
- What I Did.
- Tax Considerations in Retirement.
- Investing in Retirement.
- Longevity considerations.

Fundamentals of Investing
Class 2 – 15 Apr 2023

Investing in Individual Stocks (Planned for Class 5)

- Who should invest in individual stocks?
- How much should you invest?
- Stock Selection Methodologies.
- Diversification.
- Managing a stock portfolio.
- When to Sell.
- Limiting / Controlling losses.
- Preserving gains.
- Pitfalls to Avoid.
- Taxes.