AAII SAN DIEGO CHAPTER
FUNDAMENTALS OF INVESTING
MAY 20, 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

Presenters:

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.

Any fees that are collected are voluntary contributions and support the chapter. The instructors do not receive financial remuneration for the time and effort spent teaching these classes.

Flexible Meeting Fees

Please contribute based on the value you received from today's meeting. We appreciate your support.

https://www.aaiisandiego.com

Upcoming Chapter Events

July 8, 2023 (Saturday) @ 9 AM PST: Speaker will be Katie Stockton.

September 9, 2023: (Saturday) @ 9 AM PST: "AAII's Essential Investing Principles and Strategies" by Ray Rondeau, Senior Technical Analyst, AAII

October 21, 2023: (Saturday) @ 9 AM PST: Speaker will be Kevin Carter.

November 11, 2023: (Saturday) @ 9 AM PST: Details TBD.

What We Learned Last Saturday

May 13, 2023 (Saturday) @ 9 AM PST: "5 Must-Knows About Retirement Spending" by Christine Benz, DIrector of Personal Finance and Retirement Planning, Morningstar, Inc. The presentation explained 5 things to know in managing one's withdrawal rate after retiring. There was an explanation of how bucket investing can help with the asset allocation for a balanced portfolio and a slide that illustrated why a balanced portfolio offers the highest safe withdrawal rate. She addressed issues with stock market volatility, inflation, and variation in interest rates. | Slides

Part One: Factors

What Factor Investing Is

- Factors are subsets of the investment market.
- The theory is that certain factors outperform the market over a long period of time.
- If your time horizon is 80 years or longer, that theory works.
- If your time horizon is less than 20 years, you may see factors that should outperform actually underperform. A factor that gets too popular will underperform.
- You select several factors and divide your portfolio among them.
- Andrew Berkin and Larry Swedroe have written the book on Factor Investing: Your Complete Guide to Factor-Based Investing

Examples of Desirable Factors

- Small Cap Stocks
- Value Stocks
- Stocks with Momentum (Consider MTUM and IMTM)
- Profitable Stocks: High Margins; High Asset Turnover; Low Financial Leverage; Strong Balance Sheet; Low Macroeconomic Risk; Low Stock-Specific Risk
- Quality Stocks: High Return on Equity; Low Debt/Book Value; Low Earnings Variability

Characteristics of Selected Factors

Berkin and Swedroe look for factors with these characteristics:

- **Persistent –** Holds across long periods of time and different economic regimes
- **Pervasive –** Holds across countries, regions, sectors, and even asset classes
- **Robust –** Holds for various definitions (e.g., there is a value premium whether it is measured price-to-book, earnings, cash flow, or sales)
- **Investable –** Holds up not just on paper, but also after considering actual implementation issues, such as trading costs
- **Intuitive –** There are logical risk-based or behavioral-based explanations for its premium and why it should continue to exist.

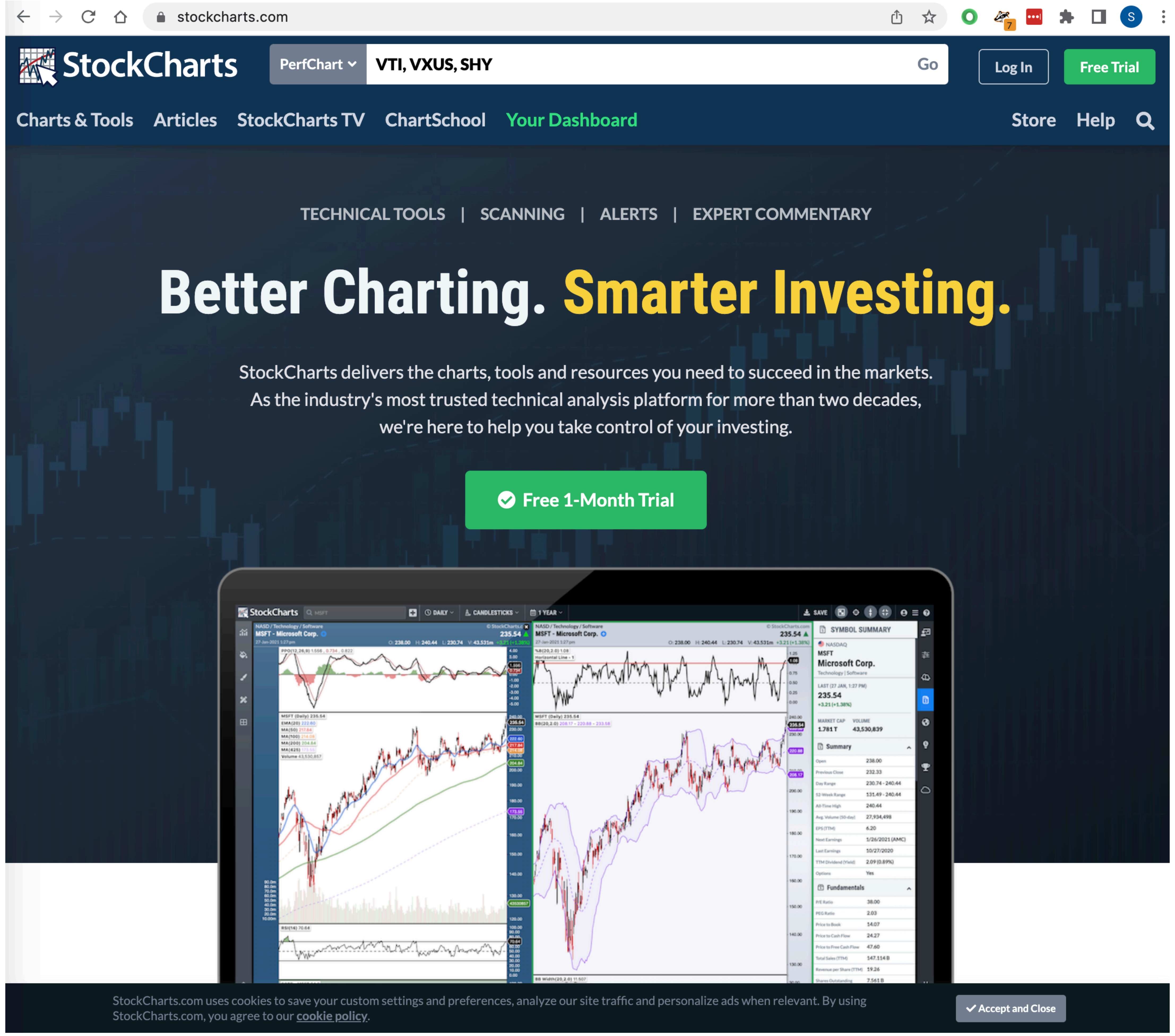
Momentum Investing Explained

- The momentum investing presented here makes use of funds. We do not bother to select individual stocks.
- Momentum investing assumes that winners of the recent past will continue to be winners in the near future. This works when the market maintains a consistent direction. Does not work when the market gets choppy.
- Momentum investing works best with ETFs that track stock indices. It does not work as well with individual stocks. It also does not work well with mutual funds because you will be trading monthly.
- Two approaches to momentum investing will be presented here.
- Also presented will be moving averages.

Recommended Reading

- One approach to momentum is described in a book by Gary Antonacci: Dual Momentum Investing
- Gary Antonacci has a website: https://www.optimalmomentum.com/
- Another approach to momentum is described in a book by Brian Livingston: Muscular Portfolios
- Brian Livingston has a website: https://muscularportfolios.com/
- Brian Livingston is a past president of the Puget Sound Chapter of AAII.

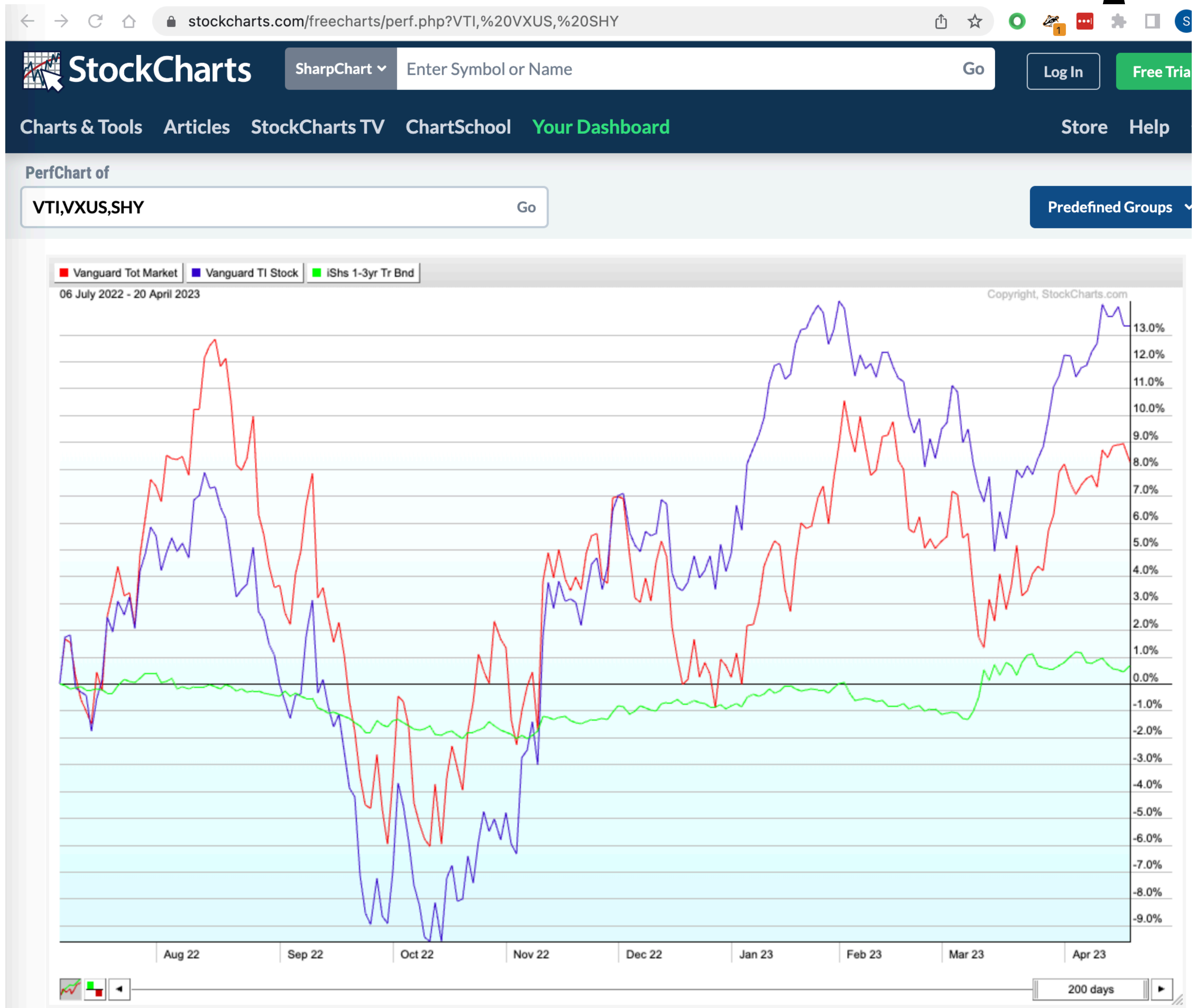
Dual Momentum: Step 1 with stockcharts.com



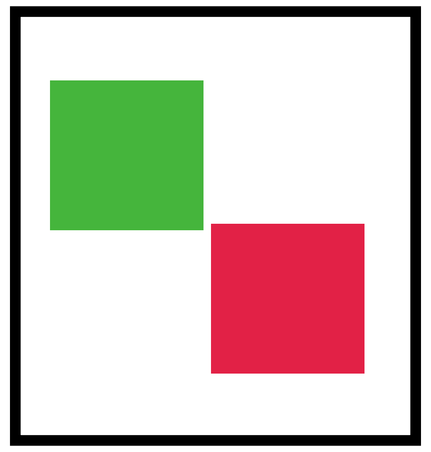
- Use https://stockcharts.com to identify which fund has the most momentum.
- Select PerfChart in the grey box at the top left.
- Enter the funds in the white box at the top.
- Click “Go” in the white box.
- VTI is a mostly U. S. fund.
- VXUS is mostly foreign.
- SHY is in Treasury Securities.

Part Two: Momentum

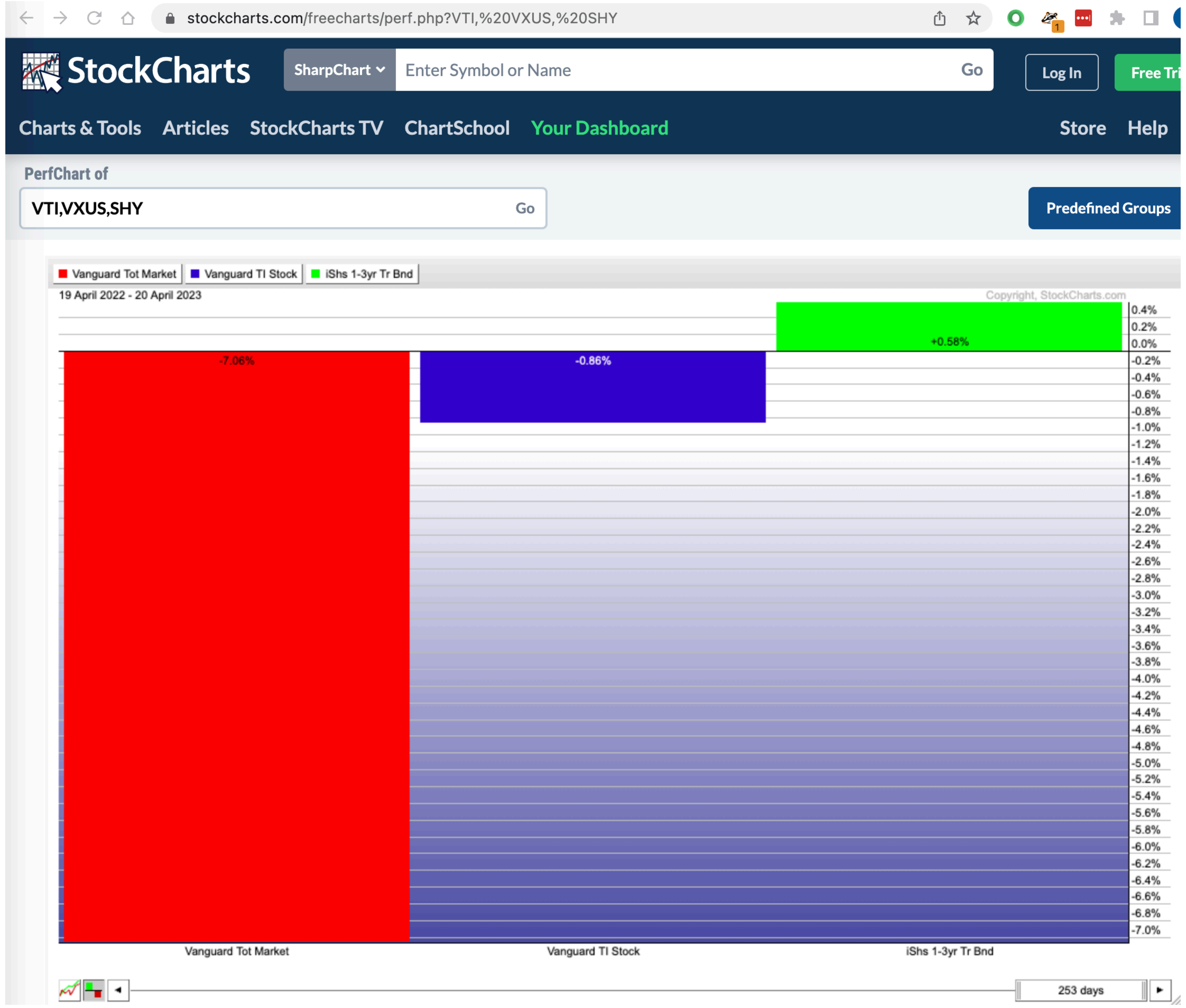
Dual Momentum: Step2 with stockcharts.com



- This is what you get after you click "Go" from previous slide.
- Double click "200 days" in lower right corner and enter "253". (There are roughly 253 trading days in 12 months.)
- Click the symbol in the lower left corner that looks like this:



Dual Momentum: Step3 with stockcharts.com



- The red is VTI. The purple is VXUS. Both have negative returns. The green is SHY. It is positive. SHY has the best return for the last 12 months prior to April 20, 2023.
- Select SHY for the following month.

Muscular Portfolios (Livingston)

Three portfolios are described:

- Baby Bear - For portfolios of less than $10K. Put 50% into a bond fund and 50% into an equity fund. Rebalance once a year. This is not a momentum portfolio.
- Mama Bear - For investors willing to sacrifice a small amount of return to get reduced volatility.
- Papa Bear - For investors seeking high return at the cost of higher volatility.
- Both Mama Bear and Papa Bear are momentum portfolios.
- Check momentum once a month and update your portfolio.

Muscular Portfolios - Mama Bear and Papa Bear

- Mama Bear tracks 9 ETFs. Papa Bear tracks 13 ETFs.
- In both cases, once a month identify which 3 ETFs have the best momentum.
- Momentum rules are different for the 2 portfolios. Mama Bear looks at the previous 5 months (105 trading days). Papa bear averages the previous 3 months, 6 months, and 12 months.
- Invest in the top 3 ETFs each month.
- You can find out the top 3 by looking them up at muscularportfolios.com
- If you mess with the ETFs being tracked, you can use stockcharts.com or etfscreen.com to look up the top 3. Etfscreen does a better job of averaging needed by Papa Bear. (Also, stockcharts can handle only 10 items at a time.)

Part Two: Momentum

Moving Averages

Simple Moving Average (SMA): $\mathbf{A_k} = \left(\sum_{j=k+1-N}^{k} V_j \right)/N$

V_j= Closing value on Day j
N = Number of days in the moving average
k = Identification of day for which average is being calculated

Advantage: Easy to calculate
Disadvantage: Distorted by the value of the entry dropping off

Moving Averages

Exponential Moving Average (EMA): $A_{k+1} = A_k*(1-f) + V_{k+1}*f$

$f = 2/(N+1)$, notice that $f < 1$ and $(1-f) < 1$
N = Number of Days in Moving Average

Advantage: Free of distortions caused by old values
Disadvantage: Hard to establish initial value

Moving Averages

Suppose you have an erroneous estimate of the EMA.

Let $A_k = C_k + e_k$

Then $A_{k+1} = (1\text{-}f)*C_k + (1\text{-}f)*e_k + f*V_{k+1}$

A_k = Assumed value on day k that is erroneous

C_k = Correct value on day k

e_k = Error in the assumed value on day k

f = 2/(N+1), N=Number of Days in Moving Average

V_k = Index Value on day k

Junk Bond Index

ICE BofA US High Yield Index Total Return

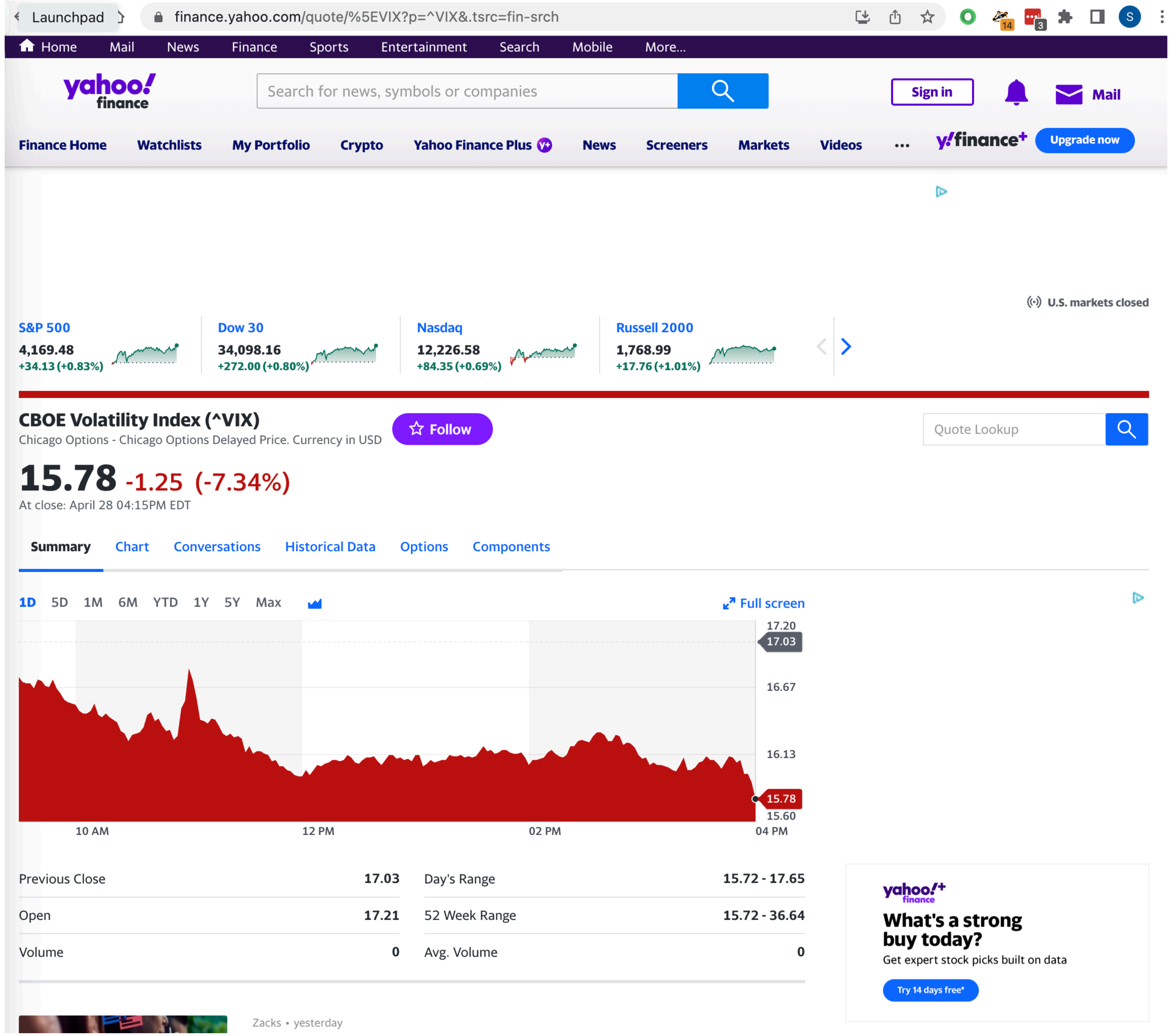
Junk Bonds are also known as High Yield Bonds. They tend to move in the same direction as stocks because the prospect of default is higher when stocks are in a bear market. Our Chapter President, Rob Bernstein, has noticed that junk bonds have a smaller standard deviation than stocks.

https://fred.stlouisfed.org/data/BAMLHYH0A0HYM2TRIV.txt

https://indices.theice.com/ (Look for “US High Yield”, “H0A0” in the right column)

Part Two: Momentum

Volatility Index (^VIX)



Volatility Index (^VIX)

The Volatility Index is based on the Implied Volatility aggregated from all the options that are traded. Options are Calls (option to buy stock) and Puts (option to sell stock). Models exist to calculate a “fair trading price” for options:

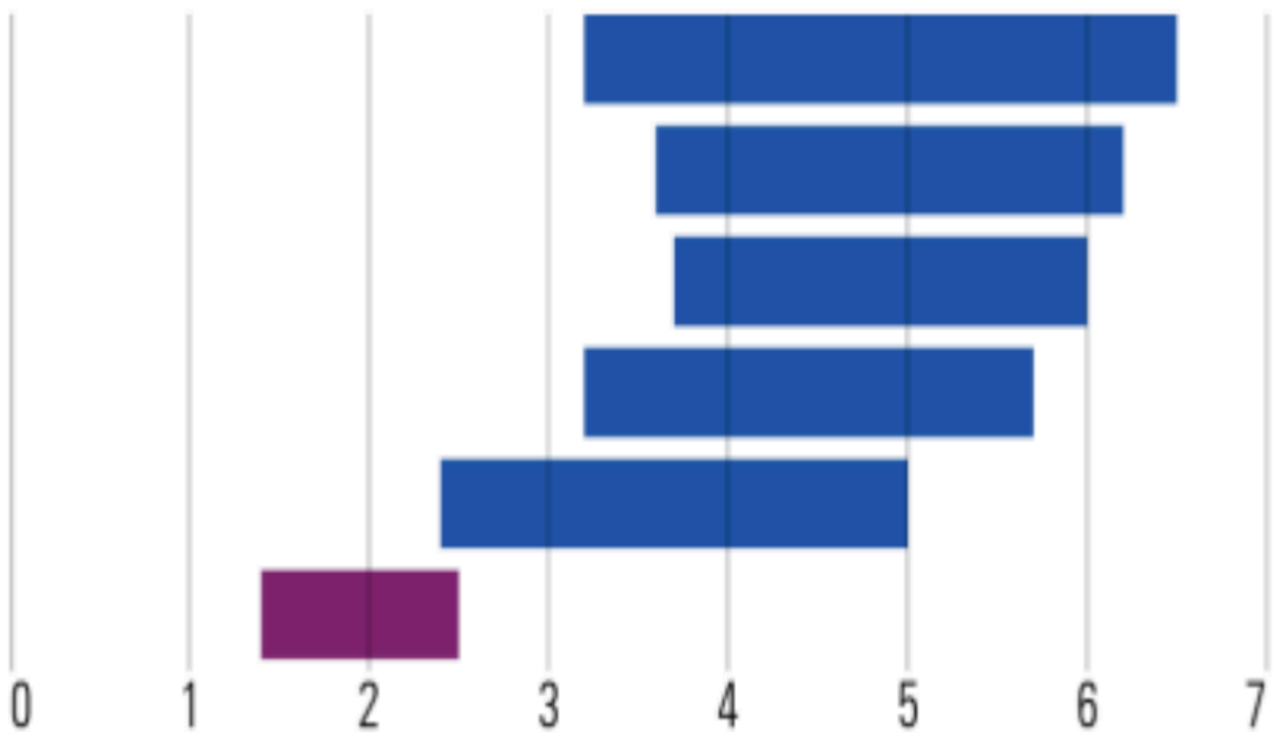
OTP = f(USP, SP, T, IV)
OTP = Option Trading Price
USP = Underlying Security Trading Price
SP = Strike Price
T = Time to expiration
IV = Implied Volatility

High volatility suggests a bear market in the future. A popular model is Black-Scholes.

Lesson 2: Maintain a balanced portfolio.

Exhibit 3 Highest and Lowest Starting Safe Withdrawal Rates, by Asset Allocation
(Rolling 30-Year Time Horizon, Starting From 1930 Through 1990, 90% Success Rate)

	Safe Withdrawal Rates	
Asset Allocation	Lowest	Highest
100% Stocks	3.2	6.5
75% Stocks, 25% Bonds	3.6	6.2
50% Stocks, 50% Bonds	3.7	6.0
25% Stocks, 75% Bonds	3.2	5.7
100% Bonds	2.4	5.0
Mattress	**1.4**	**2.5**



Source: Morningstar Direct. Data as of 12/31/2019.

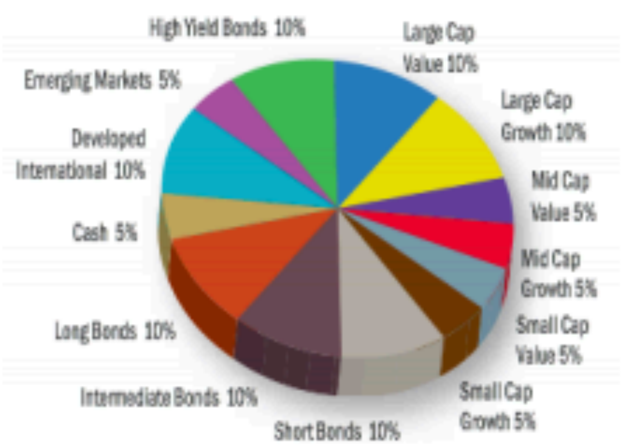
Asset Allocation

Classic rules of thumb:
70% equity, 30% bonds for young people
65% equity, 35% bonds for slightly older people
60% equity, 40% bonds for people in their 50's
50% equity, 50% bonds for retired people
Subtract age from 100

There is a lack of systematic thinking in coming up with these guidelines.

Part Three: Bucket Investing

Traditional Risk Management



60/40 Stock/Bond Portfolio
10-Year Average Annual Return: **4.01%**
Maximum Drawdown: **-41%**
60/40 Stock/Bond Composite Index (MSCI/Citi)
No deduction of fees, expenses, or taxes
Through 12/31/2017

Vs.

S&P 500 Index
10-Year Average Annual Return: **8.13%**
Maximum Drawdown: **-55%**
No deduction for fees, expenses or taxes
Through 12/31/2017

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DELTA
INVESTMENT
MANAGEMENT

Another problem highlighted in a presentation of February, 2020

Part Three: Bucket Investing

Asset Allocation

These old rules are breaking down

- Most of us are living longer than our parents did and are healthier than our parents were when they were our age
- It is no longer fashionable to smoke (well, except maybe for smoking pot)
- Many people of the same age have much different circumstances
- Christine Benz has come up with a systematic way of approaching this issue in The Bucket Investor's Guide to Setting Asset Allocation for Retirement and For Bucket Portfolios, the Devil is in the Details

Bucket Investing

- Determine spending needs requiring withdrawals from portfolio
- Check if your spending needs are sustainable
- Bucket 1: Spending needs for first 2 years plus emergency fund needs. Funds to cover this go into cash or safe money market funds
- Bucket 2: Spending needs for years 3-10. Funds to cover this go into high-quality bond or high-quality bond funds.
- Bucket 3: Spending needs beyond year 10. Funds to cover this go into equities.
- You can vary the number of years covered by each bucket depending on your temperament.

Aligning Buckets with Your Accounts

- You may have taxable accounts, tax-deferred accounts, and Roth accounts.
- The taxable accounts are best used for bucket 1. You can withdraw from these accounts without incurring tax liability. Cash accounts don't provide much income; hence little tax liability generated. You can move funds into taxable accounts, but there are obstacles to moving funds into tax-deferred and Roth accounts.
- Tax-deferred accounts are good for bucket 2. Bonds and fixed income instruments produce taxable income which is tax-deferred. You incur a tax liability withdrawing from tax-deferred accounts and young people incur a penalty.
- Roth accounts are best for bucket 3. You want to generate your highest growth in nontaxable accounts. But young people should beware tax ramifications.
- Depending on how much you have in your different accounts, you may have one group of accounts spanning the desired bucket and an adjacent bucket.
- As Christine Benz says, the devil is in the details.

Part Three: Bucket Investing

Rebalancing Among Buckets

- Steve recommends rebalancing every year as long as there is not a drawdown in progress. Rebalance so that each bucket has the amount as described in a Slide 27.
- When there is a drawdown in progress, do not rebalance. Draw your cash down and give your equities a chance to recover. If you run out of cash, draw from your bond investments.
- Select an indicator to tell you when there is a drawdown. Steve recommends the S&P 500 index crossing below its 50 day SMA. Declare the drawdown over when the index has gone back up to the place it was when it crossed over the 50 day SMA.

Part Three: Bucket Investing

Rebalancing

- Don’t confuse rebalancing among the buckets with rebalancing within the buckets.
- You will have strategies for managing your bond portfolio in Bucket 2 and your stock portfolio in Bucket 3. Those strategies may entail rebalancing that has nothing to do with rebalancing among buckets.

Bonus Part: The Bud Light Scandal

- Do not let your emotions affect your investment decisions, but emotions are OK in other contexts.
- Buy when there is blood on the streets (but it does not always work).

- People often are emotional when they choose alcoholic beverages.
- Sales of Bud Light dropped 17% after April 1 while sales of Coors and Miller went up.
- Stock price of BUD dropped from 66.73 on 3/31 to 63.38 on 4/12 and then went up.
- According to a former Anheuser-Busch executive, the company has gone “woke” (i.e., adopted ESG and DEI) under pressure from Larry Fink of Blackrock. Hiring Dylan Mulvaney is consistent with these principles.
- Alissa Heinerscheid said, “Bud Light has been kind of a brand that was fratty and kind of out-of-touch humor and it was important that we had another approach.”

- If Anheuser-Busch InBev SA (BUD) sticks with ESG and DEI and is satisfied with terminating Alissa Heinerscheid’s employment, what does that mean for the future of the company?
- If Anheuser-Busch InBev SA tells Larry Fink that they have decided that his advice was bad and discontinues ESG and DEI, what does that mean for the future of the company?
- Are there other scenarios for the future of the company?

Future Classes

Class 4: Managing Investment in Retirement

- Tom Jones will present
- Mahendra Agrawal will talk about Long Term Care
- Good retirement information was in last week's Chapter Event
- Buckets are useful in managing investments in retirement
- See you on June 17

Class 5: Stock Selection

- Tom Jones will present
- See you on July 15