Smart Investing: Reducing Risk While Seeking Reward

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Two Key Concepts

- Investing Is Messy
- Smart Investors Create Their Own Luck

How Do You Create Luck?

Focus On:

- Diversification and Rebalancing
- Behavior and Portfolio Management
- Security and Fund Selection

Diversification

- Helped Harry Markowitz win a Nobel Prize.
- There is always an optimum level of risk and reward.
- 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

- Small-Cap Stocks: 0.72
- Equity REITs: 0.57
- Long-Term Corporate Bonds: 0.29
- Long-Term Government Bonds: 0.06
- Treasury Bills: 0.11

*Data for period of 1972-2011, Ibbotson SBBI 2012 Classic Yearbook

To Diversify Further, Consider…

- Master Limited Partnerships (MLPs)
- Micro-Cap Stocks (Shadow Stock Portfolio)
- Preferred Stocks
- Treasury Inflation-Protected Securities (TIPS)
- High-Yield Bonds (Junk Bonds)
- Gold

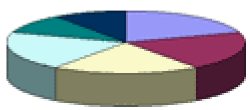
Diversify Across All of Your Accounts

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

AAII Has Allocation Models

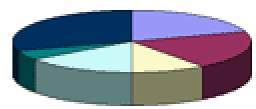
Suggested Allocation Breakdowns

Aggressive



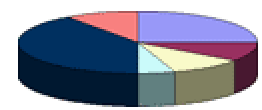
- 20% Large-Cap Stocks
- 20% Mid-Cap Stocks
- 20% Small-Cap Stocks
- 20% International Stocks
- 10% Emerging Markets Stocks
- 10% Intermediate Bonds
- 0% Short-Term Bonds

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

The proper portfolio allocation for you is dependent on your financial goals and your tolerance for risk.

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.)

Portfolio Rebalancing Is Important

- 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*

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

Long-Term Portfolio Performance

Portfolio	Annual Return	Standard Deviation	Ending Stock Allocation
50% Stocks / 50% Bonds			
Never Rebalance	8.9%	15.8%	**96.3%**
Rebalance Annually	8.3%	11.3%	50.0%
70% Stocks / 30% Bonds			
Never Rebalance	9.3%	17.5%	**98.4%**
Rebalance Annually	9.0%	14.5%	70.0%

*1926-2011; Large-cap stocks and long-term bonds, Ibbotson SBBI 2012 Classic Yearbook

Rebalancing and Withdrawals

- $100k portfolio based on AAII's moderate allocation model
- 4% annual withdrawals were assumed
- 5% threshold used for rebalancing
- Performance calculated from 1988 – 2011
- Vanguard index funds used to avoid impact of active management

Rebalancing and Withdrawals

- Rebalancing produced a higher ending balance than not rebalancing ($304,712 vs. $300,709)
- Total withdrawals were slightly lower with rebalancing ($3,525 difference over 24 years)
- Volatility was reduced by nearly 11%
- The rebalanced portfolio lost 18% less in 2008 than the non-rebalanced portfolio

Rebalancing Is a Long-Term Strategy

- Rebalancing and diversification provide the most benefits over the long term
- Will cause a portfolio to underperform during bull markets for its largest asset class (e.g., stocks)—a compromise for reduced volatility
- Losses will be smaller during bear markets, but they will not be avoided

Rebalancing Is Better Than Panicking

- Many investors panic during a bear market, sell stocks and lock in losses
- The same investors wait too long to get back into stocks, missing out on big gains
- Relative to panicking and selling stocks, rebalancing results in higher returns

Rebalancing Alternatives

- Correctly time the market on a consistent basis over the long term
- Ignore the market's volatility, especially during bear markets

In 2011, the average equity mutual fund investor lost 5.7%.

The average large-cap equity mutual fund declined by just 0.9%.

*"Investor Fear Leads to Losses in 2011," Dalbar; *AAII Journal*, February 2012

Portfolio Management

- Active Versus Passive
- Limit Behavioral Errors
- Regularly Review Your Portfolio

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 an 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 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.

Limiting Behavioral Errors

- Realize that overconfidence has led many people to trail the market's performance
- Understand that tomorrow's market conditions may be very different than today's
- Buy fear and sell greed (even though you will be tempted to do the opposite)

Limiting Behavioral Errors

- Don’t invest in a security or a fund that keeps you up at night
- But realize that if you want to beat inflation, you have to accept some volatility and down markets
- If you are scared by the markets, admit it, take a deep breath and wait a day before making changes to your portfolio

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
- Updated news and fundamental data about the investments I own and monitor
- Research notes about what I’ve looked at

AAII Dividend Investing Log

1	Wisconsin Energy Corp.	WEC	
13	4/19/2012	Announced dividend on 30 cents per share payable on payable June 1, 2012, to stockholders of record on May 14, 2012. This marks the 279th consecutive quarter - dating back to 1942 - that the company will have paid a dividend to its stockholders. The dividend was last raised in Jan 2012.	http://phx.corporate-ir.net/phoenix.zhtml?c=114170&p=irol-newsArticle&ID=168
14	4/24/2012	WEC will announce first quarter 2012 earnings news release before the stock market opens on Tuesday, May 1, 2012.	http://finance.yahoo. energy-announces-2012-first-170000428.html
15	5/1/2012	Q1 EPS: Earned $0.74 per share, topping expectations by a penny and up from $0.72 a year prior. Net income was $172.1 million versus $170.9 million. Revenues fell to $1.19 billion from $1.33 billion. "The warmest first quarter in at least 122 years led to a sharp decline in customer demand for natural gas." Decline in revenues offset by "stronger recovery of fuel costs for power generation, lower operation and maintenance costs, and the impact of the company's share repurchase program." Reaffirmed EPS guidance of $2.24 to $2.29 a share; consensus is $2.27	http://www.marketw energy-posts-first-quarter-results-2012-05-01
16		Q1 EPS Details: Consumption of electricity by large commercial and industrial customers grew by 3.0 percent - while electricity use by small commercial and industrial customers was down by 2.1 percent. Residential use of electricity -	

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.

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

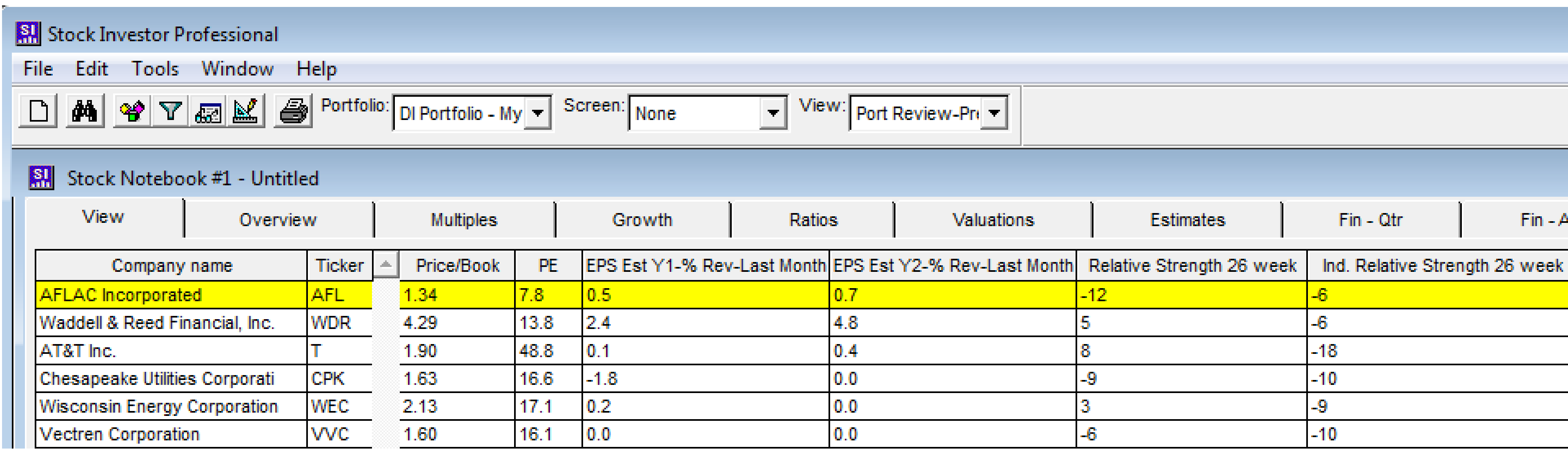
Be a Proactive Investor

- 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

What to Watch: Stocks

- Weekly: News, valuation, earnings estimates and relative strength
- Quarterly: Earnings release, conference call transcript, 10-Q
- Annually: 10-K, CEO’s letter to shareholders, proxy statement

My Weekly Review Report



Company name	Ticker	Price/Book	PE	EPS Est Y1-% Rev-Last Month	EPS Est Y2-% Rev-Last Month	Relative Strength 26 week	Ind. Relative Strength 26 week
AFLAC Incorporated	AFL	1.34	7.8	0.5	0.7	-12	-6
Waddell & Reed Financial, Inc.	WDR	4.29	13.8	2.4	4.8	5	-6
AT&T Inc.	T	1.90	48.8	0.1	0.4	8	-18
Chesapeake Utilities Corporati	CPK	1.63	16.6	-1.8	0.0	-9	-10
Wisconsin Energy Corporation	WEC	2.13	17.1	0.2	0.0	3	-9
Vectren Corporation	VVC	1.60	16.1	0.0	0.0	-6	-10

What to Watch: Bonds

- Weekly: News (especially corporate bonds)
- Quarterly: 10-Q for corporate bonds, credit ratings changes for all
- Semi-Annually: Interest payment
- Annually: 10-K or other financial data

What to Watch: Funds

- Weekly: News for sector and industry funds
- Quarterly: News for the funds, performance for actively managed funds
- Annually: Prospectus (any changes in the investment objective?)

Security and Fund Selection

- Stocks
- Bonds
- Funds

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

Dividends Matter

- Dividend-paying stocks have rewarded shareholders with annualized total returns of 8.61% over past 40 years
- In contrast, non-dividend payers have annualized total returns of just 1.35%
- Companies that raised or initiated dividends delivered the strongest returns

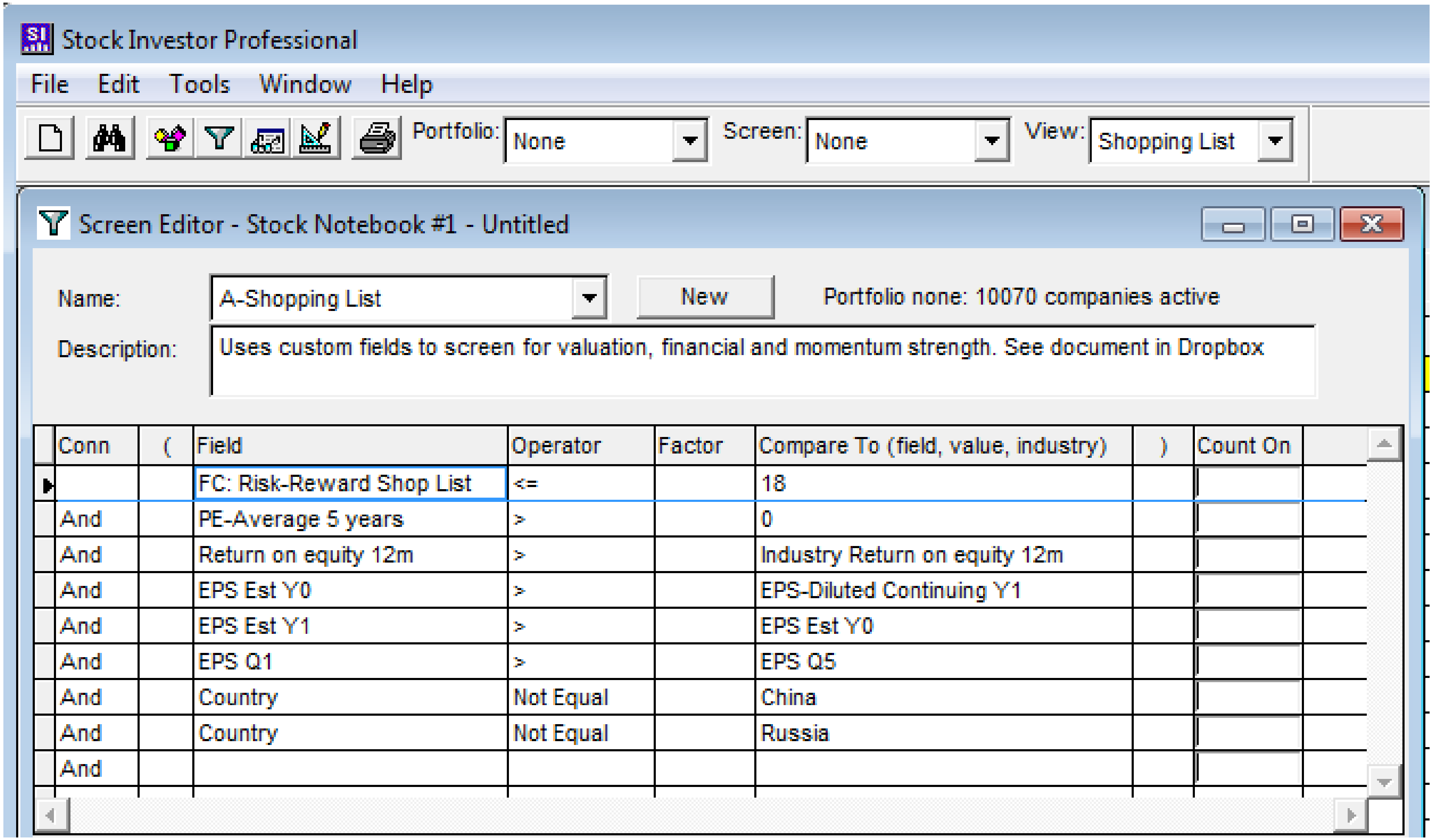
*OppenheimerFunds and Ned Davis Research; data for period of February 1972 through December 2011

My Stock Screening Criteria

Price to Book < 3
Price to Earnings < 20
Return on Equity > Ind Avg.
Current Ratio > 1.0
Debt to Equity < .50
Intangibles < 50% of Equity
Sales Growth = 3+ Years
EPS Growth = 3+ Years

Free Cash Flow = 3+ Years
Earnings Estimates Revised Up
Dividend Yield > 0.5%
Shares Outstanding Declining
26-Week RSI Rank > 60%
EPS Up Year-over-Year
EPS Up Qtr-over-Qtr

My Stock Screening Criteria



Stocks Passing My Screen

Stock Investor Professional

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Portfolio: None Screen: A-Shopping Lis View: Presentation-Sh

Stock Notebook #1 - Untitled

View | Overview | Multiples | Growth | Ratios | Valuation

Company name	Ticker	FC: Risk-Reward Shop List	Price/Book	PE	Yield	Yield-1 year ago	GW/Equity
Telecom Argentina S.A. (ADR)	TEO	13.00	1.38	4.4	7.6	4.6	0.00
Fluor Corporation (NEW)	FLR	13.00	2.37	14.1	1.3	0.8	0.00
Hormel Foods Corporation	HRL	14.00	2.83	17.2	2.0	1.9	0.27
Cummins Inc.	CMI	15.00	3.13	9.7	1.6	1.2	0.10
Family Dollar Stores, Inc.	FDO	15.00	6.51	19.9	1.2	1.4	0.00
Norfolk Southern Corp.	NSC	15.00	2.22	11.5	2.8	2.3	0.00
Williams-Sonoma, Inc.	WSM	15.00	2.97	16.0	2.4	1.8	0.00
Stryker Corporation	SYK	15.50	2.46	14.4	1.6	1.3	0.44
TransMontaigne Partners L.P.	TLP	15.50	1.55	11.0	7.9	6.9	0.03
Cintas Corporation	CTAS	16.00	2.20	17.3	1.4	1.7	0.72
Walt Disney Company, The	DIS	16.00	2.10	15.9	1.3	1.4	0.92
Zimmer Holdings, Inc.	ZMH	16.00	1.95	15.1	1.2	0.0	0.61
CA, Inc.	CA	16.50	2.17	13.2	4.0	1.6	1.34
Target Corporation	TGT	16.50	2.42	13.3	2.1	2.4	0.00
Applied Industrial Technologie	AIT	17.00	2.33	15.2	2.3	2.2	0.26
CSX Corporation	CSX	17.00	2.64	12.2	2.6	1.8	0.00
Cubic Corporation	CUB	17.00	1.93	12.9	0.5	0.4	0.32
Eaton Corporation	ETN	17.00	1.83	10.7	3.5	2.6	0.98

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–active funds should have better long-term returns than their 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

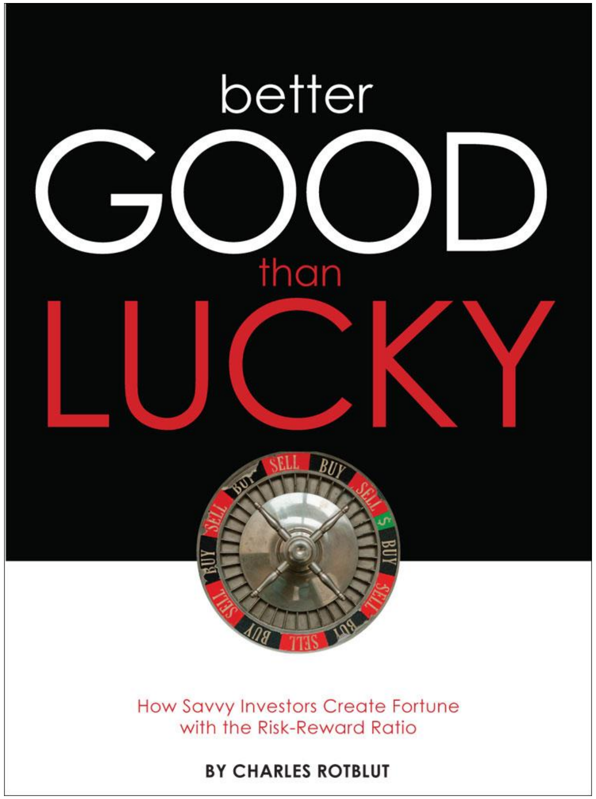
I Use Funds For

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

AAII Resources

- Financial Planning: http://www.aaii.com/financial-planning
- Investor Guides: http://www.aaii.com/guides
- Model Portfolios: http://www.aaii.com/model-portfolios
- Stock Investor Pro ($198 per year): http://www.aaii.com/stock-investor-pro
- AAII Dividend Investing ($149 per year): http://www.aaiidividendinvesting.com

My Book



(W&A Publishing / Traders Press)

You Can Reduce Risk and Create Luck By Focusing On:

- Diversification and Rebalancing
- Behavior and Portfolio Management
- Security and Fund Selection

Morning Break