



# A LIFETIME STRATEGY FOR INVESTING *By James B. Cloonan*

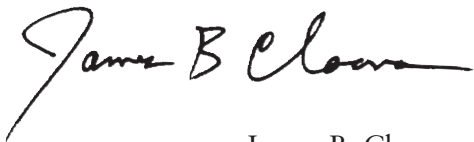


“The American Association of Individual Investors is an independent nonprofit corporation formed in 1978 for the purpose of assisting individuals in becoming effective managers of their own assets through programs of education, information, and research.”

## PREFACE

While individuals invest more money in Treasury bills, bank accounts, bonds and real estate than in equities, there has always been a mystique and allure about the stock market. To many investors, it offers an irresistible challenge. While the historical returns are high, the volatility of the stock market creates risk.

Sometimes, this risk makes itself very apparent; other times it is more subtle. However, some risk is always present because it is the reason for the higher returns. Those who wish to earn more than the Treasury bill rate must assume risk. This booklet is designed to help you understand risk and its relationship to return. It will also provide guidelines for the long-term successful management of your stock portfolio.

A handwritten signature in black ink that reads "James B. Cloonan". The signature is fluid and cursive, with a long, sweeping underline that extends to the right.

James B. Cloonan

Chairman, AAIL

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Strategic planning has become a common phrase these days. While everyone may not define strategic planning in exactly the same way, “strategy” deals with the overall, long-term guidelines that are set up in an attempt to ensure the success of an individual or institution. Tactics are used to implement a strategy, and they relate to activities of shorter duration. The focus of this brochure is strategy—lifetime strategic decisions made by the individual investor in the course of managing a common stock portfolio.

There are two basic requirements for any strategic planning decision:

- There must be a clearly defined objective; and
- There must be a specified time horizon.

Sometimes individuals attempt to make decisions while pursuing vague objectives such as “to do well” or “to succeed.” However, such fuzzy objectives make it impossible for investors to successfully choose from the investment alternatives facing them.

An even more common mistake is the failure to specify the time period that the planning will cover. This is critical because what is best for the short term may not be best for the long term. That’s not to say that emphasis should only be placed on long-term results. A young family struggling to

get by might have to concentrate on short-term cash generation, even at the expense of long-term investment profits. Frequently, decisions must be made with a view to both the long and short term. The point is that time horizons will vary depending upon both the investor and the situation.

In this overview of a strategy for investing in the stock market, a “wealth maximization” objective and a very long time horizon are assumed. These assumptions are used because they apply to the situation a large number of investors face when investing in the stock market.

Actually, investment in the stock market for most investors goes through two stages, although these may overlap. The first stage is “accumulation”—the period when earnings exceed expenditures and individuals are building wealth. The second stage occurs when the accumulated wealth begins to be consumed; this is the “withdrawal” stage.

This booklet stresses strategy during the accumulation stage and also presents guidelines for adjusting holdings as the withdrawal stage approaches. Some points, however, should be emphasized:

- *A long-term strategy means a time horizon of at least five years.* No one should embark on a long-term investment strategy if they are going to need their investable assets in less than five years. Instead, a traditional approach similar to that used in the withdrawal stage should be taken for shorter time frames.

- *Individuals should not invest all of their wealth in common stocks.* This is important because unexpected events may require that savings be used, even if the investor is still accumulating wealth. Taking money out of the stock market at the wrong time can seriously impair an investor's long-term strategy. Thus, the investor should possess a sufficient amount of liquid assets and other investments that can be used for consumption in emergencies. In this way, decisions regarding the common stock portion of an investor's wealth can be made with a view toward the long term. An investor can expect that—even with a well-diversified stock portfolio—at least once in an investing lifetime there will be a pullback of 30% to 50%. An investor completely in common stocks might panic at that kind of portfolio performance. The latest example occurred in 2008, but such pullbacks occurred in 2001–2002, 1973–1974 and the notorious crash of 1929.
- *Some investors are always in the withdrawal stage—those living on a trust fund, for example—and the strategic approach outlined here does not apply to them.* Other investors will never have to withdraw accumulated wealth and will leave it to their heirs. They may use an accumulation strategy all of their lives.

It is important not only to develop a long-term stock investment strategy, but to



understand the rationale of such a strategy relative to current stock market investment research and theory. With this in mind, this booklet reviews some of the basic concepts of investment theory.

# PART ONE

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## BACKGROUND CONCEPTS



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## ◆ RISK

Almost all approaches to investing are concerned with risk. But what is risk?

A practical and somewhat simplified definition of risk is that it is the likelihood that your investment will be worth less at the end of your holding period than it was at the time it was originally invested. This definition could be modified to take inflation into account, by stating that risk is the likelihood that your investment will be worth less in “real dollars” at the end of your holding period. Another refinement would be to state that risk is the likelihood that your investment will be worth less than if it had been put into a zero-risk investment, such as U.S. T-bills.

Many investors prefer to turn to a more measurable definition of risk. This definition involves the use of statistics; it measures variability—the amount by which an investor’s return could vary around the expected average return. Consider the following example. Suppose an investment opportunity is absolutely guaranteed to have a 10% return over your holding period. Your “expected return” is 10%. Since the 10% return is guaranteed, there is no other possible realized return and hence there is no variability. The risk is zero.

Now consider a second potential investment. Suppose that there is a 50% chance that this investment will return 40% and a 50% chance that a loss of 10% will be realized over the holding period.

The expected return on this second investment is  $(50\% \times 40\% + 50\% \times -10\%)$ , or 15%. However, the actual return may be different than the expected return of 15%—in other words, the return will vary. This implies the existence of risk—the more the potential variability, the greater the risk. Potential variability can be used to compare the riskiness of different investments, or to make judgments about the suitability of an investment when an investor’s risk preference is known. In statistical terms, variability or volatility is measured by standard deviation.

There are several important observations that can be drawn from these two examples.

First, if we compare the first investment (10% return, no risk) to the second investment (15% return, some level of risk), we do not get an answer to the question of which is the best investment. The second investment has a higher *expected return* (if you made such an investment 1,000 times you would average 15%), but it also has a higher risk. The investment choice depends on the trade-off between risk and return that the investor is willing to make. Objectives, which are critical for making investment decisions, must be stated in terms of both return and risk.

Second, in any efficient market, expected investment returns will be higher for investments that have higher degrees of risk—but only if the risk is unavoidable. The concept of “unavoidable” risk will be discussed in the next section.

Third, the risk and return trade-off will change depending on the time frame used. For instance, the risk and return trade-off for a one-year holding period will be different than the trade-off for a five-year holding period; in general, stock market risk declines as the holding period lengthens. This helps explain why setting a proper time frame is essential when making investment decisions.

### *Reducing Risk: Diversification*

We have defined risk in this booklet as variations in return. But what causes these variations? In the stock market, two factors will cause a stock's return to vary: changes in the firm or the way investors perceive the firm, and movements in the overall stock market. Thus, there are two components to the risk that an investor faces: market risk, which is inherent in the stock market itself; and firm risk, which is associated with the unique characteristics of any one stock or the industry in which it operates.

Firm risk accounts for up to 70% of the total risk that stock investors face. Yet, this risk can be almost eliminated by diversifying among different stocks—investing in, for instance, 10 different stocks rather than just one. Market risk, on the other hand, accounts for about 30% of total risk and cannot be avoided by diversification, since all stocks are affected to some degree by the overall market.

Think carefully about that last paragraph. An investor with a single stock in his portfolio is taking on 100% of the risk

associated with stock investing, compared with only a 30% risk that an investor with a diversified portfolio would take on—in other words, the single-stock investor is taking on three times more risk. Investors who consider themselves “conservative” but invest in one low-risk stock may actually incur more risk than investors with a portfolio of 10 aggressive growth stocks—and the “conservative” investors are getting a lower expected return since they are in lower-risk, lower-return stocks.

This illustrates an important concept. The stock market provides higher returns for higher risks, but it only provides those higher returns for *unavoidable* risk. Firm risk is largely *avoidable*. No matter what investment objectives investors may have, no matter what the intended holding periods are, no matter what kind of stock analysis is performed: *If investors do not have diversified portfolios, they are either throwing away return or assuming risk that could be avoided—or both.* The discussion here assumes a diversified portfolio when talking about common stock investment.

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## ◆ INVESTMENT APPROACHES

There are many different strategies that can be used to invest in the stock market. But most strategies fall under three broad categories:

- Technical analysis,
- Fundamental analysis,
- Buy and hold the market.

Let's start with the third category, since that may seem to many investors a strange approach to investing.

This approach will be referred to often in this booklet, because it is the benchmark against which any other approach to the market should be measured. This strategy provides the returns that would be obtained by buying and holding the stock market, generally defined as the Standard & Poor's 500 index. Of course, no investor would buy all 500 stocks. However, by investing in a large number of well-diversified stocks, investors can build a portfolio that closely resembles the S&P 500, or they can buy an index mutual fund that mirrors the S&P 500.

The **buy-and-hold-the-market** approach is used as a benchmark because no analytic investment approach is valid unless it can outperform the market over the long run. If an investment approach does produce a return above the market return with the same risk, the difference between the two returns is called an "excess return," and it represents the added value of that investment approach. It is often called "alpha."

**Fundamental analysis** is an approach to investing that is primarily concerned with value. This approach examines factors that determine a firm's expected future earnings and/or dividends and the variability of those earnings and dividends, and it attempts to put a value on the stock accordingly. The approach then seeks stocks that are a good value—in other words, stocks that are priced low relative to their perceived

value. Fundamental analysis assumes that the stock market will later recognize the value of the stock and bid up its stock price accordingly.

**Technical analysis** is an approach that tries to predict the future price of a stock or the future direction of the stock market based on past price and volume changes. The underlying assumption is that stock prices and the stock market follow discernible patterns, and if the beginning of a pattern can be identified, the balance of the pattern can be predicted well enough to yield excess returns.

Most academic studies indicate that investing using purely technical analysis does not work. This booklet does not cover the technical approach.

Instead, the Lifetime Strategy focuses on the two remaining—the fundamental analysis approach and the buy-and-hold-the-market approach. The choice between these two will be greatly influenced by your attitude toward market efficiency—how well stock prices reflect all available information.

### *Is the Market Efficient?*

According to investment theory, stock prices in an efficient market reflect all publicly available information concerning that stock, and thus are extremely close to the true value of the stock. This does not mean that stock prices at all times reflect the stock's true value. The theory assumes that stock prices on *average* reflect the true value, but it also assumes that variations about this



average price may exist. These variations, however, are unpredictable—sometimes they are positive and other times negative. And because they are unpredictable, they cannot be used to obtain excess returns. This theory concerning random variation in stock prices, known as the “random walk” theory, is the explanation for short-term price fluctuations that occur seemingly without cause.

So much for theory. What about reality: Is the stock market an “efficient” market?

Those who believe that it is would deny the value of a fundamental approach that seeks to find stocks selling significantly above or below their value, since they argue that stock prices vary randomly around their “true” value. Investors who believe the stock market is efficient would not concentrate on specific stock selection but rather on finding the most “efficient” portfolio. An efficient portfolio is one that provides returns closest to the market’s return at a given level of market risk (remember, firm risk is eliminated through diversification). The level of market risk depends on the investor’s own risk/return trade-off decision. In other words, the investor determines the amount of market risk he is willing to take on and then builds a portfolio accordingly.

Adherents of the view that markets are inefficient believe that variations in the way people receive and evaluate information cause the prices of some stocks to deviate significantly from their true value. In addition, psychological factors impact perceptions of data, thus compromising an essen-

tial ingredient of efficient market theory—a rational decision-maker. This psychological distortion can relate to institutional as well as individual decision-making. The developing field of “behavioral finance” is devoted to studying such factors. With any market inefficiency comes an opportunity for diligent analysts to find underpriced and overpriced stocks, allowing them to outperform a buy-and-hold-the-market strategy.

There is obviously considerable disagreement over the market’s efficiency. Our own opinion, as well as the opinion of most practitioners and a growing number of theoreticians, is that the market is often inefficient—that there are opportunities for outperforming a buy-and-hold-the-market strategy. We believe, however, that the market is reasonably efficient and there are limits to how much excess return can come from exploiting the market inefficiencies. But over an investing lifetime, even an additional return of 2%–3% a year could double an investor’s wealth at retirement.

### *Opportunities in an Efficient Market*

There are special opportunities for individual investors, even in an efficient market. When discussing investment planning, it was pointed out that the selection of the best alternatives depends on the investor’s objectives and time frame. This means that, to the extent that investors have different objectives and time frames, the true value of a stock—even in an efficient market—will be the average of all of the various individual values. If you carry this one step further, it

means that even if the market is efficient, stocks will be overvalued or undervalued for many investors whose objectives and time frames are different from the average objective and time frame.

What is the average objective and time frame? A look at the composition of stock market investors can provide a clue.

The stock market is dominated by institutional investors, and it is their objectives and time frames that will tend to dominate. By and large, institutions have objectives that stress low risk, and they have time frames that are very short. Why? Because their performance is evaluated on a daily, monthly, quarterly or annual basis, and the institutional managers must conform to performance standards in the short run. They are often more concerned with not doing worse compared to their competitors than with optimizing returns. Also, institutions, which account for a large percentage of trading activity, sometimes have short-term demands on their assets. In addition, large institutions cannot invest in the stocks of smaller companies or in less liquid issues, and these are the stocks that perform best over the long run.

Some individuals will have objectives and time frames that are similar to those of institutions, but many will not. This is the reason for making a distinction between the accumulation stage and the withdrawal stage of individual investors, as mentioned earlier in the discussion. By and large, individuals who will need capital or income from the market in the

shorter term—such as individuals in the withdrawal stage—will have objectives and time frames similar to those of institutions. Long-term individual investors—those in the accumulation stage—face a completely different set of objectives and time frames. And they will be able to find stocks that are undervalued because prices are forced down by short-term, highly risk-averse investors.

### *Transaction Costs*

When comparing the different approaches to investing, the impact of transaction costs should not be ignored. Transaction costs include brokerage commissions and the bid-ask spread, which is the difference between the price at which an individual can buy a stock and the price at which he can sell the same stock. [Taxes are also part of the transaction cost because a sale has an immediate tax consequence while holding defers the tax consequence, but we will consider taxes separately at the end of this booklet.]

Fortunately for the individual investor, commission rates have been steadily dropping. With online discount brokers, commissions can be less than \$10 per transaction. With a transaction size of \$5,000, this comes to 0.2%, and even with a more expensive online broker and smaller transaction size the cost would be less than 1%—much lower than in the past.

Due to decimalization and innovations by the exchanges, the bid-ask spread has also been reduced. For a high-priced liquid stock, the spread becomes almost trivial,

but for lower-priced smaller-cap companies, where we believe more opportunities lie, the spread is still significant.

Suppose you have 100 shares of ABC that recently sold for \$25 a share and wish to switch into XYZ, which also recently sold for \$25 a share. The following factors determine the transaction cost:

- 1) The average commission from an online broker might be \$12 for each side or a total of \$24, about 1% of the investment.
- 2) Next, the bid-ask spread will increase the cost of switching. In the example of ABC and XYZ, which last sold for \$25, you may find that the current spread is \$24.85 to \$25.10: You would receive \$2,485 for the stock sold and pay \$2,510 for the stock purchased. This is another 1% “charge.”

In total, then, you are paying 2% of your investment to switch holdings. This is not to say that it shouldn't be done, just that the new stock must perform sufficiently better to overcome this handicap.

Investors who use investment approaches that require them to turn over their portfolios several times a year must outperform the market by 5% or more just to stay even with a buy-and-hold-the-market approach.

Transaction costs can vary widely. Looking at my own portfolio, I have a stock trading at \$400 with a bid-ask spread of one cent. Trading 100 shares of this and a similar stock

would involve a cost of \$25 on \$40,000 or 0.06%—hardly noticeable. At the other extreme, I have a stock showing a bid of \$2.80 and an asked of \$3.00. Trading 100 shares of this and a similar stock would cost a total of \$44 on \$300 or 15%. The transaction size and bid-ask spread make a big difference. In AAI's model portfolio of small-cap stocks (the Model Shadow Stock Portfolio), transaction costs average 2%. Fortunately we have been able to absorb this cost and still have excess returns.

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## ◆ SETTING OBJECTIVES & TIME FRAMES

The importance of setting an objective and determining a time frame should be clear by now. How can investors do this?

The most useful approach is to look at the historical record: What kinds of risk and returns can investors expect, based on what has already occurred? The one important caveat, of course, is that history may not repeat itself. The historical record can, however, provide you with some idea of what you can reasonably expect.

### *Time Frame: Short-Term vs. Long-Term*

Let's look at the difference in risk as a function of our time frame, or holding period. For this purpose, risk will be defined in a practical way—the likelihood that invested wealth will diminish from the time of the initial investment to the end of the holding period time frame.

Examples of risk differences appear in Table 1. The table assumes that an individual is invested in a portfolio of the indicated asset category, and remains invested for the holding period indicated; the table indicates the percentage of times the individual would have suffered a loss if he had invested in this fashion from 1926 through 2011. The statistics from which the figures are derived include dividends and interest payments, but transaction costs and taxes are ignored.

Clearly, though, the percentage of losses declines as the holding period is increased for all of the asset categories.

**TABLE 1.**  
**TIME FRAME AND LOSSES**  
**(1926–2011)**

Holding Period (Years)	Percentage of Holding Periods That Resulted in Losses				
	S&P 500	Small Stocks	Corporate Bonds	U.S. Gov't. Bonds	T-Bills
1	28%	31%	20%	26%	0%
3	18	19	10	11	0
5	15	15	4	7	0
10	5	3	0	1	0

The table includes all possible holding periods for the time periods indicated over the past 86 years. For instance, the 3-year holding period includes 1926 through 1928, 1927-1929, 1928-1930, etc. Purchases are made at the beginning of the year and held through the time period indicated. The table indicates the percentage of times the holding period return would have been negative.

*Source: Roger G. Ibbotson and Rex A. Sinquefeld, "Stocks, Bonds, Bills and Inflation," 1982 ed., Institute of Chartered Financial Analysts, Charlottesville, Va.; updated by Ibbotson Associates, "Stocks, Bonds, Bills and Inflation 2012 Yearbook," Chicago.*

What does the historical record tell us about the stock market, as defined by the S&P 500?

- If you told your broker to buy a portfolio that matched the S&P 500 at the beginning of the year and to sell at the end of the year, you would have had a loss 24 times over the last 86 years, or about 28% of the time.
- If you told your broker to buy at the beginning of the year and sell after three years, you would have had a loss 15 times since 1926, or 18% of the time.
- If you told your broker to buy at the beginning of the year and sell after five years, you would have had a loss 12 times since 1926, or about 15% of the time.
- If you bought and held the portfolio for any 10 years, you would have had a loss only 5% of the time.

If we had adjusted for inflation (used real dollars), there would have been a few more losses for each holding period, but that would be true for all other investments as well. The point is, the variability of returns—risk as measured by the chance of loss—goes down as the holding period gets longer.

### *Setting Objectives: Returns and Risk*

Table 2 presents the returns provided by common stocks, corporate bonds, government bonds and Treasury bills over the past 50 years. Common stocks are broken down



**TABLE 2. LONG-TERM RETURNS (THROUGH YEAR-END 2011)**

Average Annual Compound Rates of Return (%)

	S&P 500	Small Stocks	Long-Term Corporate Bonds	Long-Term Government Bonds	Treasury Bills	Inflation (CPI)
Last 10 Years	2.9%	7.0%	8.3%	8.9%	1.8%	2.5%
Last 20 Years	7.8	11.2	8.2	8.8	3.2	2.5
Last 30 Years	11.0	11.5	10.8	11.0	4.6	3.0
Last 40 Years	9.8	12.9	8.8	8.9	5.4	4.4
Last 50 Years	9.3	12.8	7.6	7.6	5.2	4.1

Growth: What \$1 Invested Would Have Grown To

Last 10 Years	\$1.33	\$1.97	\$2.22	\$2.35	\$1.20	\$1.28
Last 20 Years	4.49	8.36	4.84	5.40	1.88	1.64
Last 30 Years	22.89	26.20	21.69	22.89	3.85	2.43
Last 40 Years	42.08	128.16	29.18	30.28	8.20	5.60
Last 50 Years	85.31	412.53	38.96	38.96	12.61	7.46

*Annual returns and growth figures include dividends and/or interest, but exclude taxes and transaction costs.*

*Source: Roger G. Ibbotson and Rex A. Sinquefeld, "Stocks, Bonds, Bills and Inflation," 1982 ed., Institute of Chartered Financial Analysts, Charlottesville, Va.; updated by Ibbotson Associates, "Stocks, Bonds, Bills and Inflation 2012 Yearbook," Chicago.*

into stocks in the S&P 500 and stocks of smaller firms, which are generally considered riskier investments.

In general, riskier investments provide higher returns. For instance, small stocks have tended to outperform the S&P 500. However, the table shows that different market segments do well over different time periods. For instance, long-term government bonds have outpaced large-cap stocks over certain time periods. In addition, while Treasury bills are considered riskless, they have provided returns that are only modestly above the rate of inflation over the long run.

Historically, it is evident that common stocks provide exceptionally high long-term returns compared to "safer" investments. And, as noted above, the risk in a practical sense becomes unimportant as the holding period is lengthened.

Historical records provide a strong argument for long-term investors to use the stock market as a base for setting their objectives. But there is also an intuitive argument for the safety of the stock market for long-term investors. While there certainly are business and stock market cycles, long-term investors can outlast them.

What, then, is the real risk of long-term

stock market investment? It can only be a sustained collapse of private enterprise. If such a collapse occurred, there would be no employment, no corporate or individual income tax payments, no banking system and no solvent government. What would be a safe investment?

If the stock market is not as risky as generally supposed, why do we all know people who have lost money in the market? First, the market is risky for the short-term investor. As we saw, the one-year investor on average would lose a portion of wealth about a third of the time—more often if transaction costs and taxes are considered. Second, there are a great number of investors “playing the market,” or speculating. They try to make large, short-term profits by trading their portfolios regularly or by trying to predict short-term market swings (market timing). Given the transaction costs and the lack of overall strategies, considerably more than half of these speculators will lose even with the overall upward trend of the market. Third, as we previously indicated, many investors do not diversify. Thus, they take on more risk and incur more losses than the market as a whole.

### *Conclusions*

Part One of this Lifetime Strategy stressed that for the long-term portion of invested wealth, common stock investing offers an outstanding opportunity for wealth accumulation through growth at relatively low risk. It should be emphasized that the stock market is risky for short-term holding periods, but as an investor’s time frame

goes beyond five years, this risk is greatly diminished. It should also be emphasized that an expected holding period can change due to unforeseen circumstances, and this possibility leaves an element of risk. For that reason, even individuals who do not plan on using their assets for many years should not commit all of their wealth to stocks.



# PART TWO

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## THE LIFETIME STRATEGY



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## ◆ STAGE ONE

Stage One of our Lifetime Strategy begins with the first dollars available for long-term investing.

Exactly when any individual has money that is free from short-term emergency demands depends on individual circumstances. A common rule of thumb is that a long-term investment program can begin when income exceeds expenditures and after having set aside in low-risk liquid assets (such as money market funds) enough capital to equal three to six months' income. For the average investor, this seems reasonable, but individual circumstances may dictate a somewhat different approach. While the long-term stock portfolio should not be used for short-term needs, individuals should realize that it will be liquid enough to withstand short-term emergencies because an investor can borrow against it rather than being forced to liquidate it and this interest is generally tax deductible. The same is true of an investment in a home: Under short-term emergency conditions, a second mortgage can be obtained without having to sell the home to retrieve the capital.

Determine the "comfort level" of low-risk, short-term liquid assets you require before embarking on a long-term plan. When your savings exceed that amount, Stage One begins.

Because diversification is so essential, the first dollars to be put into a long-term common stock program should be put into no-load or low-load common stock mutual

funds. These dollars should be invested there until capital is at least in the \$15,000 to \$20,000 range. While the diligent individual can outperform mutual funds, the advantage of diversification more than offsets the investment disadvantage, and thus mutual fund investment should provide a better risk/reward structure initially. After that level has been reached, an individual may still prefer the mutual fund route, or a combination of mutual funds and individual stock selection—that is fine. However, individuals should not start investing in individual stocks until they reach at least that level of investment capital.

No-load funds and low-load funds are suggested because a load is simply a sales commission, and does not go toward better investment management. There is no evidence that load funds can perform sufficiently better to offset the load, and when the load is taken into consideration, the average load fund tends to underperform the average no-load fund by at least the amount of the load.

The basic criterion of “long-term wealth maximization” applies even in Stage One, and thus aggressive-growth-oriented and growth-oriented stock mutual funds should be considered. The method for choosing the best fund is a tactic that will not be treated in depth, but it will be discussed later.

At this point it is necessary to look at the meaning of the term “growth” when related to stocks and stock mutual funds. In general we think of a growth stock as being one with a better-than-average chance

to increase in value. We will use “growth oriented” to describe this kind of stock or mutual funds investing in these stocks. When the term “growth stock” is used to differentiate between growth and value stocks, it has a different meaning. This is also true of so-called growth mutual funds. All existing stocks are ordered by

some value measure—usually the ratio of stock price to book value (P/B). Stocks in the lower half of the list are called value stocks. The upper half, instead of being properly called “low value” stocks, are called growth stocks on the assumption that their high price relative to their current book value must mean that growth is

**TABLE 3. THE LIFETIME STRATEGY**

	Goal	Time Horizon	Risk Tolerance	Strategy	Type of Investments
<b>Pre-Stage 1:</b> Income begins to exceed expenses	Establish a cushion for emergencies	Short-term	Low	Accumulate short-term low-risk investments equal to at least 3 to 6 months of income	Money market funds
<b>Stage 1:</b> Savings above your cushion: \$0 to \$20,000	Wealth accumulation	Long-term	Moderate	Build a diversified, growth-oriented portfolio	At this stage, stick with mutual funds or exchange-traded funds to assure adequate diversification; emphasize no-load and low-load mutual funds
<b>Stage 2:</b> Savings above cushion: \$20,000 and up	Wealth accumulation	Long-term	High	Add individual stocks to your mutual fund portfolio (if desired)*	If adding individual stocks, focus on these characteristics: <ul style="list-style-type: none"> <li>• Outstanding earnings growth potential</li> <li>• Undervalued, especially low price-to-book value</li> <li>• Small market capitalization</li> </ul>
<b>Stage 3:</b> Begins 5 years prior to retirement, and continues through retirement	Live off accumulated wealth for significant portion of expenditures	Short-term, long-term blend	Moderate to low	Gradually shift a portion of your portfolio to low-risk, short-term investments	Portfolio consists of: <ul style="list-style-type: none"> <li>• Money market funds and/or short-term bond funds, and</li> <li>• Growth-oriented stock mutual funds and individual stocks</li> </ul>

\* While individual stocks should not be added to your portfolio before this stage, some individuals may prefer to stay solely with mutual funds or exchange-traded funds at all stages.



ahead. In fact, history has shown that value stocks are more likely to increase in price than growth stocks as defined this way, and diversifying between that type of growth stock and value stocks is of little value in risk reduction.

Since mutual funds are themselves diversified, it is not necessary to split your initial capital among a large number of funds if they are general stock funds. However, there is no penalty for using as many funds as you wish if no-load or low-load funds are used.

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## ◆ STAGE TWO

When the value of the long-term portfolio, which up until now has been exclusively in mutual funds, grows to about \$20,000, individuals who want to invest in individual stocks can begin developing a stock portfolio. Diversification tactics will be discussed later, but you want to eventually have at least 10 different stocks that are not highly correlated (we will discuss correlation later), with approximately equal dollar amounts invested in each, included in your portfolio. Because of flat-rate commissions, transaction costs go down as the amount invested in each stock goes up. So you may prefer waiting until you have significantly over \$20,000 to begin Stage Two, particularly if you do not intend to liquidate your mutual fund holdings.

It is not essential to invest in stocks of your own choosing all at one time. Since the balance of your assets is in mutual funds

that are diversified, you can accumulate individually selected stocks one at a time. Individual stocks can be purchased using funds withdrawn from the mutual fund portfolio, or using additional funds. Of course, constructing a portfolio of individual common stocks over time does not preclude holding mutual funds in addition to the individual stocks.

The methods you use to choose stocks are not part of this discussion of strategy, but the overall selection strategy is important.

The basic strategy should be to choose the stocks of firms that appear to offer the greatest chance for future earnings expansion. While all factors that may affect a company's future growth should be taken into account in estimating expected future earnings, you should not be concerned with factors that only affect the firm over the short run. Short-term investors, particularly the institutions, spend considerable time worrying about short-term variability, dividend protection and other characteristics relating to firm risk. As a long-term and diversified investor, most of this risk is avoided, as was explained earlier.

Stock investors also should be concerned about the price of a stock relative to its prospects. An undervalued stock—one whose price does not fully reflect its growth potential—has a greater price appreciation potential than a fairly valued stock or an overvalued stock.

One of the more promising areas for finding long-term growth potential is

among the stocks of smaller firms. In fact, long-term success will come from providing an opportunity for your portfolio to include at least one stock of a company that will go from being a small company to a successful giant. If you buy stock in only large companies, you eliminate the chance for that kind of growth. While large companies may continue to grow, they are beyond the super-growth stage. These firms are also observed closely by many analysts, and there will rarely be an opportunity to find an undervalued stock.

Research also indicates a high return potential associated with smaller firms whose stocks are trading at low price-to-book-value ratios. Price divided by book value (common stockholder's equity) has long been used by value investors as one measure of a stock's potential; the research found this ratio to be a better indicator of high return potential than other value indicators, such as low price-earnings ratios. And as mentioned earlier, value stocks, on average, are the true growth stocks.

Individuals in most cases should avoid development-stage stocks or those with high speculative interest. Many times, companies or industries that have received much attention in the financial press are not good investment candidates, at least not at the time of the coverage.

Investors should also keep in mind that it is not necessary for every single stock in their portfolio to do well. In almost every long-term diversified portfolio, time will bear out that the overall return is supported

by one or two stocks that did extremely well.

In summary, the long-term strategy is to buy stocks in companies that have outstanding future growth potential and to make purchases at reasonable prices. This will mean investing a substantial portion in the stocks of smaller firms, which have higher short-term risk. Remember—in a diversified portfolio, long-term investors need not be too concerned about short-term risk factors.

Diversification is the effort to choose portfolio elements that are not highly correlated, which means they will not all go up or down at the same time to the same extent. Diversifying between primary investment areas (equities, real estate, bonds, cash) is usually referred to as asset allocation and is a critical step in investment decision-making. Diversification is also important within each primary area. Within the equity area, diversification can be carried out using the popular approaches for choosing stocks or mutual funds so they are not highly correlated. The usual rules include: choose stocks in different industries, choose some value stocks and some growth stocks, choose some large-cap, some mid-cap and some small-cap stocks (cap refers to the capitalization value of the corporation, or share price times number of shares), and choose some stocks of foreign companies. All of these approaches should lead to better diversification, but they are rather vague. Today there are tools available to measure the correlation between different stocks and approach diversification in a more scientific

way. These tools are generally available, as are historical stock prices for those more statistically inclined.

I cannot emphasize the importance of diversification enough. As an example, AAI's Model Shadow Stock Portfolio consists of about 30 stocks, each one of which is extremely risky. The average stock in the portfolio is over three times as risky as the market in general, but the portfolio is less risky than the S&P 500 index. Diversification eliminated 75% of the individual stock risk.

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### ◆ STAGE THREE

Stage Three begins about five years before an individual will become significantly dependent upon invested capital for current expenditures. Five years is used because that period will generally include an entire business cycle. The situation that an investor must avoid is having to sell an entire stock portfolio at the bottom of the economic cycle.

Of course, individual needs will vary. In some cases, accumulated wealth will be needed all at once, as in the case of accumulation for a down payment on a house or a child's education. In other cases, such as retirement, the need will be stretched out, although there may be a need for at least part of the capital in less than four years.

The individual who needs all of the wealth on a specific date should consider liquidating one-fifth of the stock portfo-

lio in each of the five years preceding the time of the need. The liquidation proceeds should be reinvested in shorter-term, low-risk investments (such as money market instruments) that will mature prior to the date that the capital is needed.

For individuals who perceive a future need for capital or income at a certain time, but who do not need it all at once, there are two possible approaches. The first approach is to gradually switch the portfolio from the growth-oriented stocks of small and medium firms selected under Stage Two criteria, to less risky (short-term risk) stocks—primarily those that pay significant dividends. One thing to keep in mind, however, is that although dividend considerations may become more important, selling off shares of stocks that are appreciating in value is no different than receiving dividends on stocks that are not appreciating. While this approach is often recommended, I have problems with it because so-called “extra safe” stocks often turn out to be just as risky as growth-oriented stocks.

A second approach—and one favored by this strategy—is to maintain a portion of capital in the higher-short-term-risk stocks selected in Stage Two, but control the overall portfolio risk by shifting a substantial portion of capital into low-risk, short-term interest-paying investments. Given equal overall portfolio risk, the portfolio made up of growth-oriented stocks and short-term, interest-paying investments (such as money market funds or short-term bond

mutual funds) will most likely outperform the portfolio consisting of only low-risk stocks. This is because there are excess returns for the risk of the growth stocks of small and medium-sized companies and because short-term money market instruments will often yield high returns when the stock market is weak.

It is also possible to create a portfolio that is a compromise between the two approaches described. And it is possible to vary the time frame of the conversion from Stage Two to Stage Three based on individual circumstances, such as retirement in stages.

Overall, the difference between Stage Two and Stage Three is the investor's time horizon. In Stage Two, the investor's outlook is long term: You will live through market downturns (when your invested capital may decline in value), and you will live through market upturns. Over the long term, however, the trend will be up, and you should receive a return based on your level of market risk. In Stage Three, short-term market downturns can be harmful, and short-term risk becomes a significant consideration. Stage One is similar to Stage Two, but requires immediate recognition that diversification is essential and that firm risk is avoidable and unrewarded.

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## ◆ TACTICS

This booklet concentrates on the overall Lifetime Strategy of investment. However, the implementation of such a strategy

requires certain tactical approaches. The major tactical areas of concern in the Lifetime Strategy are:

- Tactics for selecting the no-load and low-load mutual funds and exchange-traded funds for Stage One;
- Tactics for effective diversification in Stage Two;
- Tactics for selecting stocks with the best long-term appreciation potential for Stage Two;
- Tactics for timing investment inflows and variations in asset mix; and
- Tactics for minimizing taxes.

While complete discussion of these tactics would take several volumes and is the ongoing mission of AAI, the following section gives a general overview of the major tactics and possible follow-up sources for further information.

### *Mutual Fund Selection*

Stage One involves a long-term wealth maximizing approach. Individuals in this stage should concentrate on selecting growth-oriented no-load or low-load mutual funds and/or exchange-traded funds.

A very comprehensive review and evaluation of no-load and low-load funds, *The Individual Investor's Guide to the Top Mutual Funds*, is sent free to AAI members each February and can be purchased by non-members.



In the Model Portfolios column in the *AII Journal*, I maintain a model portfolio of equity mutual funds that have performed well and also have an excellent risk profile. These funds should provide an excellent start for the new investor.

Funds in the categories of interest will send prospectuses upon request (most are now available online from the fund family's website). Make sure you read the prospectus before investing.

Now that there are a variety of exchange-traded funds (ETFs) available, they can be used instead of conventional mutual funds. Most exchange-traded funds track traditional indexes, but some track specially created indexes that follow specific strategies and are similar to some managed mutual funds. The *AII Journal* publishes a complete guide to ETFs each year in the August issue. In addition, in my Model Portfolios column in the *AII Journal*, I maintain a Model Fund Portfolio, which I report on four times a year, that includes ETFs and mutual funds.

### *Effective Diversification*

It was stated earlier that adequate diversification can be achieved by purchasing 10 to 15 stocks, randomly selected. Most investors, however, don't randomly select stocks for their portfolios, but rather use specific criteria for stock selection. This method introduces the possibility that the investor will select a number of stocks whose risk is similar—they are in the same industry, same markets, have the same interest rate

sensitivity, etc. In other words, this investor's portfolio would not be adequately diversified even though it contains 10 or more stocks.

As discussed earlier, this problem can be overcome by using the mathematical formulas developed for minimizing firm risk. For the investor with the time, programs for home computers exist to apply these formulas. However, the data requirements may be so great as to be prohibitive, given the time the average individual has to devote to investment management.

For portfolios that contain a minimum of 15 stocks, however, diversification may be fairly efficient if a variety of selection approaches are used.

### *Stock Selection Tactics*

This is an extremely complex area and cannot be treated in-depth here; the following, however, are some brief thoughts.

It was noted that long-term investors should concentrate on stocks with potential for high returns. Often these stocks have considerable short-term risks, and thus their prices are bid down by the institutions and others with short-term risk-averse attitudes; but with effective diversification, the long-term investor can reduce this risk. In addition, there may be opportunities for increased excess returns from effective fundamental analysis.

In terms of fundamental analysis, a complete analysis should include a qualitative evaluation of a company's market opportunities, product development,

management capability, merger potential and other considerations that indicate the potential for future profit, as well as possible undervaluation of its stock. Major emphasis, however, should be given to the more easily obtained quantitative measures such as company size, past earnings and revenue growth rates, cash flow, balance sheet debt and liquidity, price-earnings ratio, and price relative to book value.

There are an almost infinite number of investment books and theories regarding methods for selecting common stocks. The *AII Journal* continues to publish articles on this topic, and AII.com investigates various strategies on an ongoing basis. We also maintain a model portfolio of micro-cap value stocks, the Model Shadow Stock Portfolio.

### *Timing Tactics*

There are two primary reasons for timing the market. The first relates to individuals who expect to remain fully invested through time; the second relates to investors who wish to vary the percentage of wealth committed to stocks based on economic conditions.

In the first case, individuals are concerned with timing only when investing or withdrawing significant amounts of money. The concern is to avoid putting in or taking out a large portion of wealth at a single point in time, since long-term investors want to avoid the risk of investing at a market peak or withdrawing at a market bottom. Basic advice is that an adequate period of

time be chosen for the percentage invested or withdrawn—for instance, spreading the purchase or withdrawal over at least a two-year period.

The second reason for timing has to do with a strategy of attempting to leave the market during downturns and reinvesting when the market begins to head back up. If investors could actually accomplish this, it would lead to higher returns. However, there is no satisfactory evidence that market upturns and downturns can be predicted with enough precision to offset the increased transaction costs, not to mention the adverse tax consequences. In fact, most evidence points to the opposite. Timing the market may generate costs as high as 10% of portfolio value a year. Too much trading stands with a lack of patience as a major reason for lack of investment success.

There is some evidence, however, that the stock market cycle, which generally runs from three to five years, can be tied to business cycles. Stocks are, in fact, leading indicators of the economy. If individuals feel they can predict such turns in the economy, they can vary their commitment to stocks over time. One very important consideration, often overlooked in the discussion of such tactics, is the alternative investment returns for funds when they are not in stocks. If returns for low-risk investments, such as bonds, are competitive with returns on stocks (including dividends), then the relative advantage of committing funds to these other areas is enhanced; if returns for alternative low-risk investments are lower,

the advantages are reduced. For the investor wishing to use timing, some study of cycle theory and the history of stock market movements is advisable.

### *Tax Tactics*

Tactics to minimize the tax impact on accumulated wealth will vary over time, depending on current tax regulation. This booklet will not go into specifics but will point out that “aftertax” return is all that any investor will wind up with, and any tactics that reduce or defer the tax are desirable—as long as there is no substantial change in the investment strategy. A long-term approach to investing will ensure that taxes on a large portion of return are deferred for a substantial period of time and taxed at the lowest rate. There should always be plans to defer tax liability within an overall strategy through various forms of retirement plans, and these should be utilized to the greatest extent possible. Which investments should be in any retirement plan will vary with the tax laws, and these can be counted on to change periodically—which may require repositioning of investments in different accounts. When making investment decisions, the investor must always weigh any tax savings against any potential loss of return that may be due to the tax strategy.

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#### ◆ SUMMARY

The purpose of this booklet is to create an overview of a Lifetime Strategy for stock market investment. Implementation of this

strategy involves various tactics. Individual investors should carefully investigate the various tactics and understand them before they invest. Such tactics will always be an important topic in the *AII Journal* and other AII programs.

Although tactics are important, remember that the game is biased in favor of the long-term investor. Even if your tactics for selecting stocks with the greatest growth potential are imperfect, your long-term diversified portfolio will likely outperform most professionally managed portfolios and the market over the long run.

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