
Smart Investing: Seeking Reward While Reducing Risk

Charles Rotblut, CFA

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American Association of Individual Investors

“As in driving, the secret to success is not making big mistakes.”

Source: Charles Ellis, “My Investment Letter: Words of Advice for My Grandchildren,”
AAII Journal, October 2013



The optimal strategy is not one that maximizes return, but rather one that helps you stick to your long-term investing plan and achieve your goals.

Our Brain's Two Systems



SYSTEM 1:
Quick, Intuitive



SYSTEM 2:
Slow, Deliberate

Source: "Thinking, Fast and Slow," Daniel Kahneman (Farrar, Straus and Giroux, 2011)

Our Brains Rationalize

Overconfidence



We humans are likely to believe our decisions are correct

Our Brains Rationalize

Confirmation Bias



We look for information confirming our beliefs

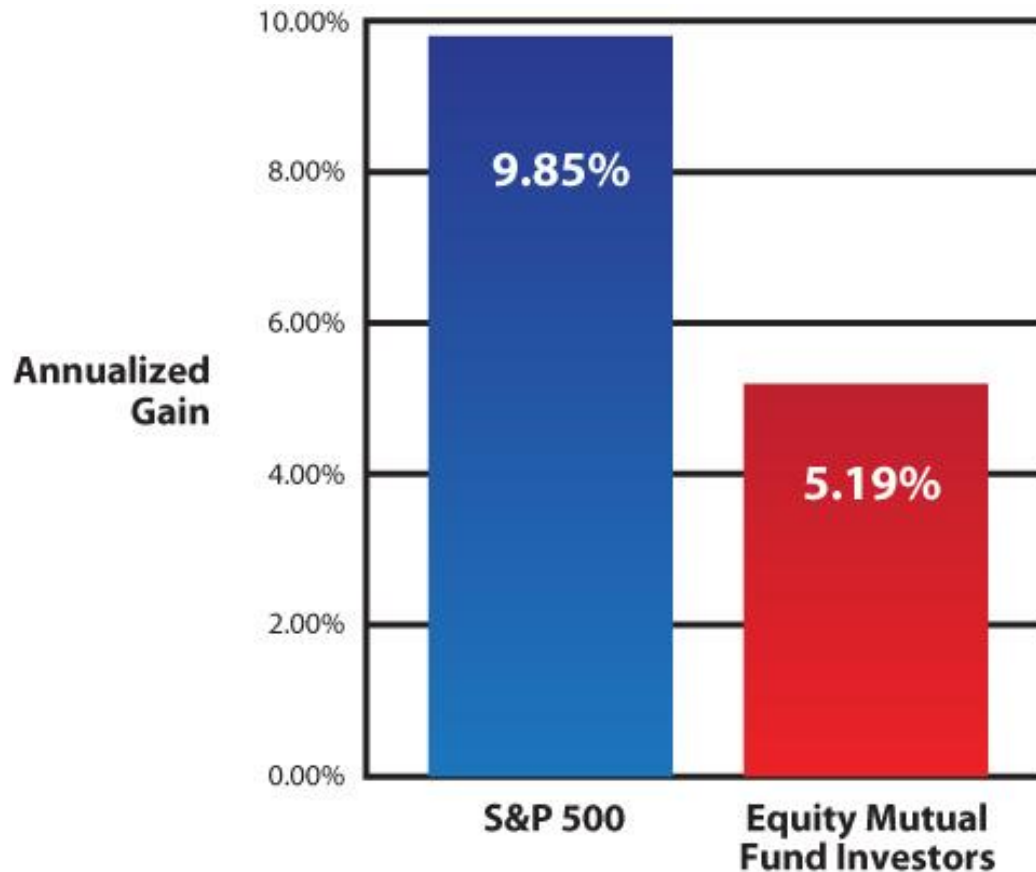
Our Brains Rationalize

Recency Bias



We assume present conditions will continue into the future

The Impact of Behavioral Errors



Source: "2015 Dalbar QAIB Highlights Futility of Investor Education," Dalbar, data from 1995 to 2014

Economic and financial theory assumes
humans act in rational ways.

Behavioral scientists have evidence
suggesting otherwise.

Was This Rational?



Share 358,790



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Remind me

I'm making potato salad.

Basically I'm just making potato salad. I haven't decided what kind yet.

5,879

backers

\$47,446

pledged of \$10 goal

20

days to go

Back This Project
\$1 minimum pledge

This project will be funded on Sat, Aug 2
2014 8:47 AM CDT.



Project by

Zack Danger
Brown

Columbus, OH

First created - 4 backed

Zack Brown 688 friends

See full bio

Contact me

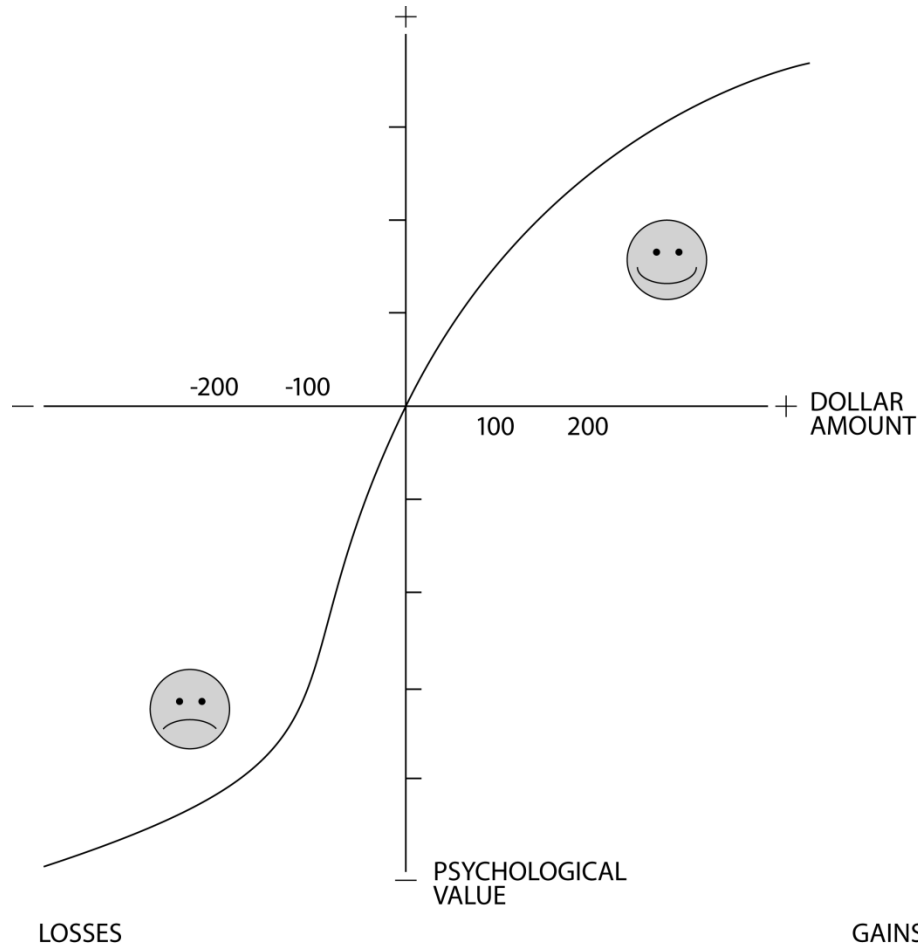
Source: Kickstarter, July 12, 2014; \$55,492 pledged in total

We Do Not Consider Expected Outcomes



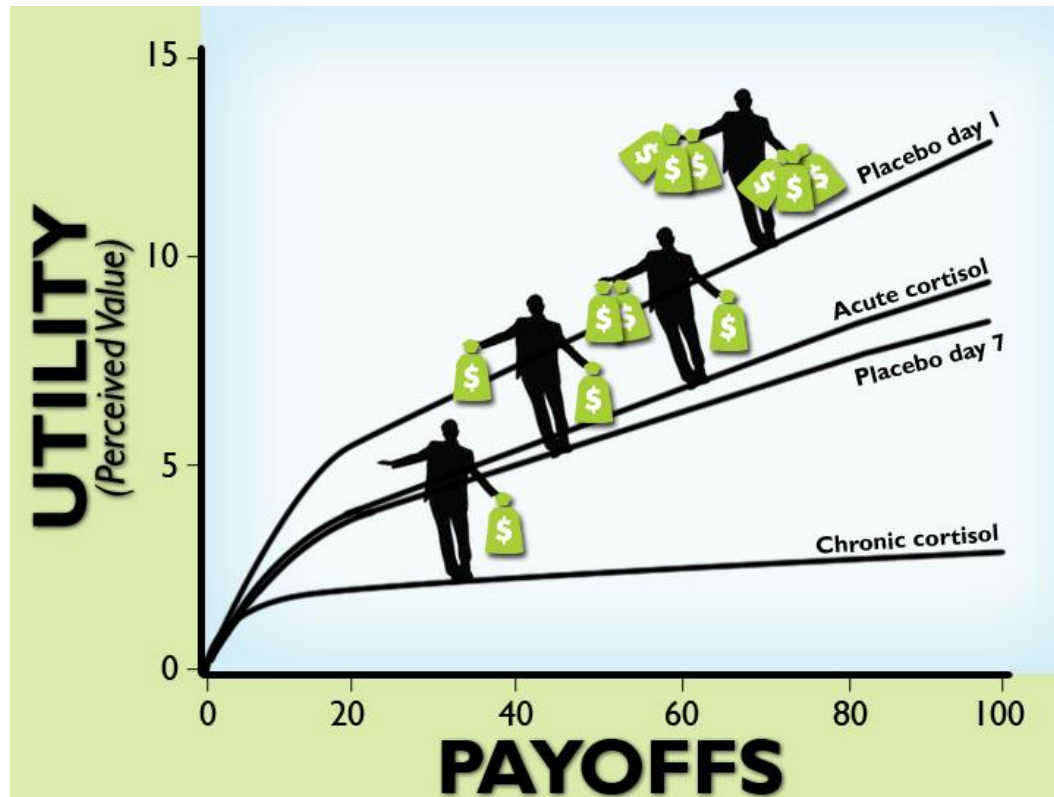
Source: Illinois Lottery, February 8, 2015; Overall odds of winning are 1:32 (3%)

We Are Risk-Averse



Source: "Prospect Theory: An Analysis of Decision under Risk," Daniel Kahneman and Amos Tversky, *Econometrica*, March 1979

Biology Makes Us Risk-Adverse



Source: "Cortisol Shifts Financial Risk Preferences," Narayanan Kandasamy et al., Proceedings of the National Academy of Sciences of the United States of America, March 4, 2014.

We Experience Bounded Rationality



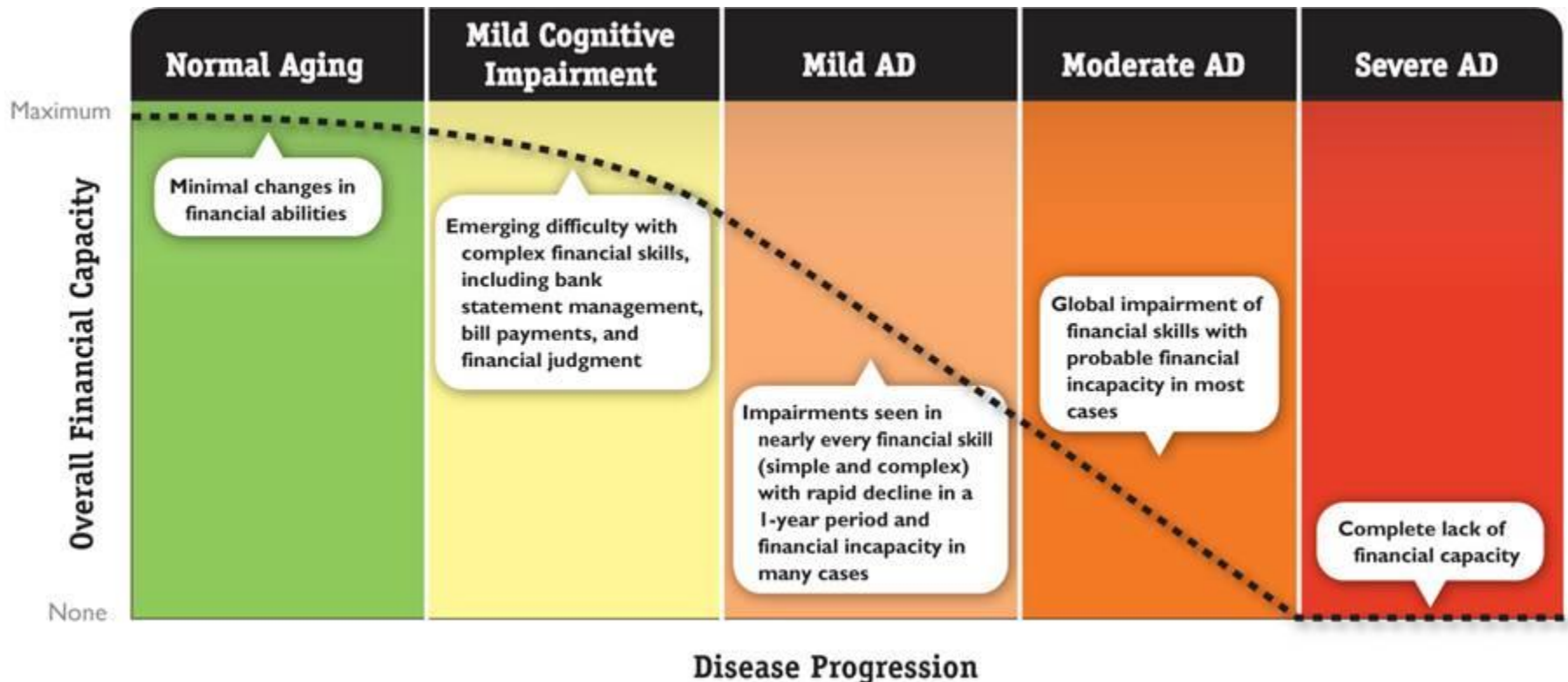
What If You Are Nervous?

- Admit you are scared by the markets, take a deep breath and wait a day before making changes to your portfolio
- Sell investments that keep you up at night
- But realize that if you want to beat inflation, you have to accept some volatility and down markets

Cognitive Decline

- The ability to make sophisticated decisions peaks at age 53
- Approximately 1 in 9 Americans age 65 or older have Alzheimer's disease according to the Alzheimer's Association

Cognitive Impairment Affects Financial Skills



Source: "Finances in the Older Patient With Cognitive Impairment," Eric Widera, Veronika Steenpass, Daniel Marson, and Rebecca Sudore, JAMA, February 16, 2011.

Simplify your strategy and be cautious
about making big changes as you age

Use the Power of the Written Word to Your Advantage

Write and maintain emergency instructions
on how to manage your portfolio.

Need another reason for writing down instructions for managing your portfolio?

Psychologists say people make more rational decisions when they are not in a crisis situation.

All AAI Portfolios Have Written Buy and Sell Rules

Shadow Stock Portfolio Rules

- > [PURCHASE & SALES RULES](#)
- > [STOCK ORDER RULES](#)
- > [MANAGEMENT RULES](#)

Purchase & Sales Rules

Stock purchases must meet these criteria:

- No bulletin board or pink sheet stocks will be purchased.
- Price-to-book-value ratio must be less than or equal to 1.00. (This figure will change gradually with changes in overall market values.)
- Market capitalization must be between \$30 million and \$300 million. (This figure will change gradually with changes in overall market values.)
- The firm's last quarter and last 12 months' earnings from continuing operations must be positive and, if there are earnings estimates, the estimates must be positive for the current quarter and year.

Model Shadow Stock rules located at <http://www.aai.com/model-portfolios/stock-rules>

My Favorite Investing Tool



(It's a spiral notebook)

AAII Dividend Investing Log

Date	News/Research Notes	Link
8/12/2015	New, post-DirectTV merger guidance: This year, the company anticipates adjusted earnings to range between \$2.62 and \$2.68 per share. This is above the I/B/E/S consensus estimate of \$2.60. Consolidated revenues should rise by double-digits and free cash flow should be about \$13 billion or better. Over the next three years (2016 through 2018), AT&T anticipates revenue growth to be in line with GDP growth or better. Adjusted earnings per share should rise at mid-single digit rate or better aided by a projected \$2.5 billion in cost savings by 2018 related to the DirectTV merger. Cash flow should improve with the company targeting a free cash flow dividend payout ratio in the 70s percent range or better.	http://about.att.com/
9/1/2015	AT&T (T) recommends shareholders reject the unsolicited "mini-tender" offer made by TRC Capital Corp. The offer is to purchase up to three million of outstanding AT&T shares at a price of \$31.30 per share, which is below the stock's current price.	http://www.sec.gov/
9/9/2015	Apple announced iPhone Upgrade Program with allows users to get unlocked phones on installment, upgrade every 12 months and not be tied to any carrier. Prices are same as AT&T Next plus the cost of Apple Care	http://www.apple.com
9/10/2015	CFO Stephens upbeat on Apple Upgrade Program, thinks it could provide a bigger inventory of used phones and shifts cost of financing to Apple; adds that most phones are sold thru AT&T stores	http://seekingalpha.c
9/16/2015	CFO John Stephens: there is a \$17 difference in content costs between DirectTV & U-verse; sees opportunity in cross-selling products; customers are holding onto cell phones "longer than we expected;" Next plan billings to balance outlays in 2016; Mexico to EBITDA positive in 2017, profitable in 2017	http://seekingalpha.c
9/17/2015	Verizon CEO warns that 2016 earnings "may plateau at 2015 levels;" the warning seems to be more related to Verizon-issues than industry headwinds	http://www.verizon.c

What I Write Down

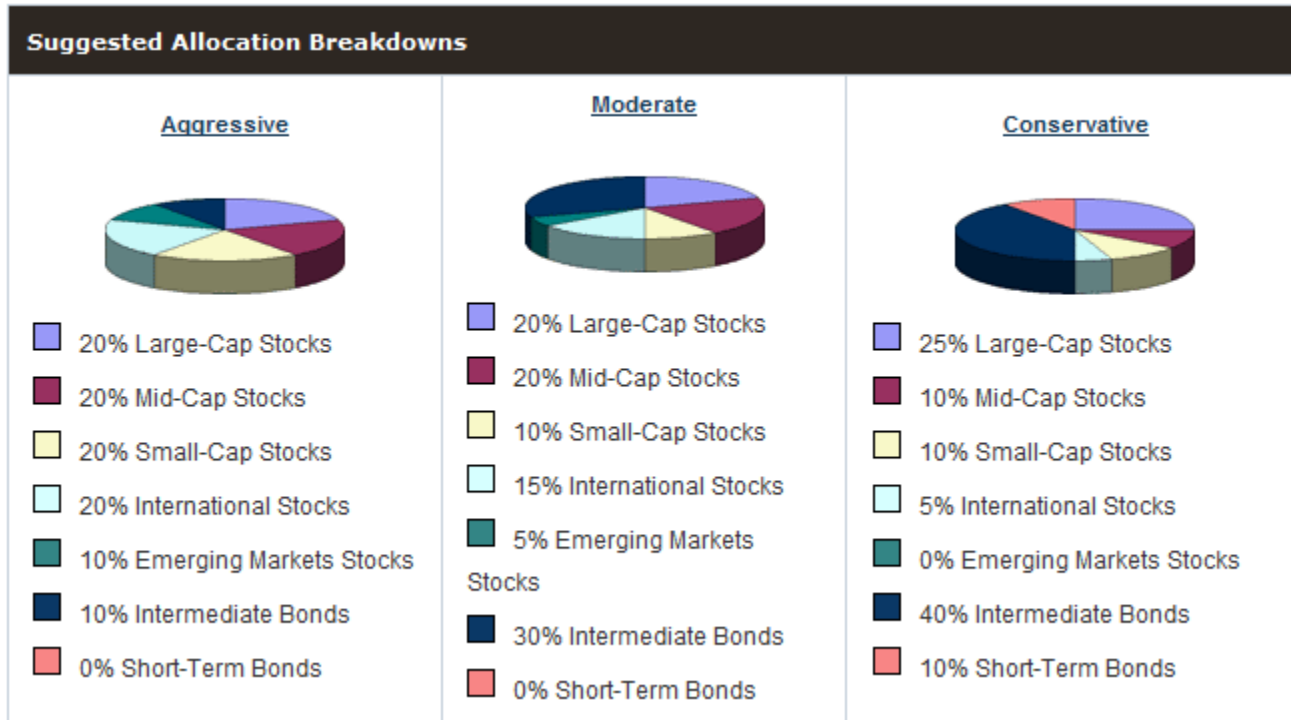
- The reasons why I bought an investment
- The reasons why I would sell an investment
- Updated news and fundamental data about the investments I own and monitor
- Research notes about what I've looked at

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.

Among the things to write down is your
long-term allocation strategy

AAII Allocation Models



AAII Asset Allocation Models located at <http://www.aaii.com/asset-allocation>

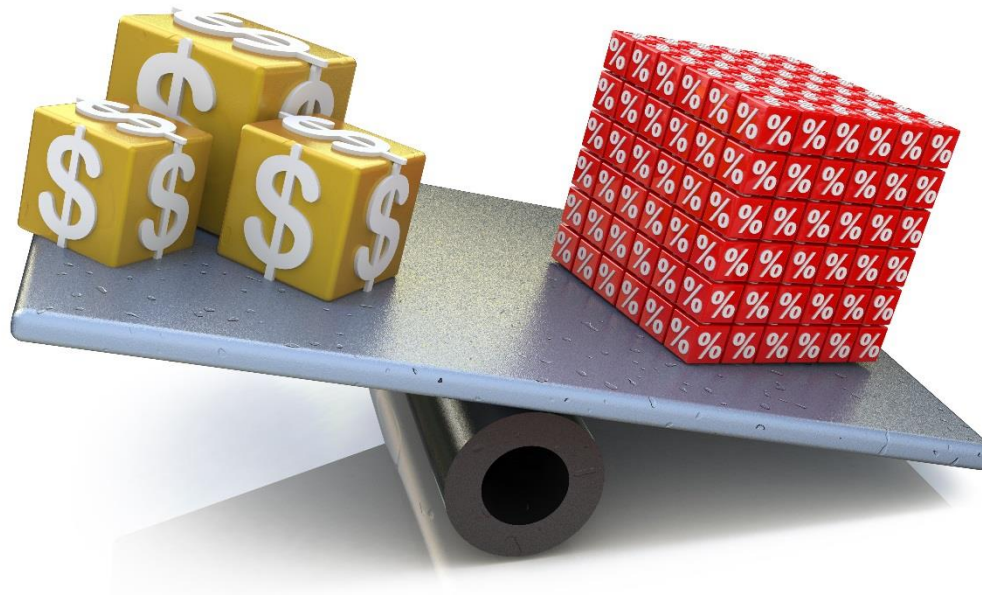
My 403(b) Allocation

- 20% Vanguard 500 (VFINX)
- 20% Vanguard Small-Cap Value (VISVX)
- 20% Vanguard REIT (VGSIX)
- 20% Vanguard FTSE All-World ex-U.S. Small-Cap (VFSVX)
- 20% Vanguard Intermediate-Term Investment-Grade (VFICX)

Key Points About Diversification

- The mix of stocks, bonds and cash will have the biggest impact on your returns
- Nobody knows how much inflation or interest rates will rise in the future

Diversify, Then Rebalance



Benefits of Rebalancing

- 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*

Source: "Best Practices for Portfolio Rebalancing," *AII Journal*, May 2011

Rebalancing and Returns

- A \$100K portfolio based on AAI's moderate allocation model
- No retirement withdrawals taken
- 5% threshold used for rebalancing
- Performance calculated from 1988 – 2014
- Vanguard index funds used to avoid impact of active management

Results From 27 Years of Data

Non-Withdrawal Portfolio		
Portfolio Strategy	Rebalance at 5% Thresholds	No Rebalancing
Ending Portfolio Value	\$1,164,373	\$1,218,211
Total Return	1,064.4%	1,118.2%
Standard Deviation	12.3%	15.9%
Annualized Return	9.5%	9.7%
Largest Drawdown	(\$204,880)	(\$253,424)
Largest Annual Loss	(26.9%)	(32.8%)
Ending Equity Allocation	70.4%	86.2%
Ending Fixed-Income Allocation	29.6%	13.8%

Source: "Rebalancing Update: Retirement Adjustments Necessary," by Charles Rotblut, *AAIL Journal*, April 2015

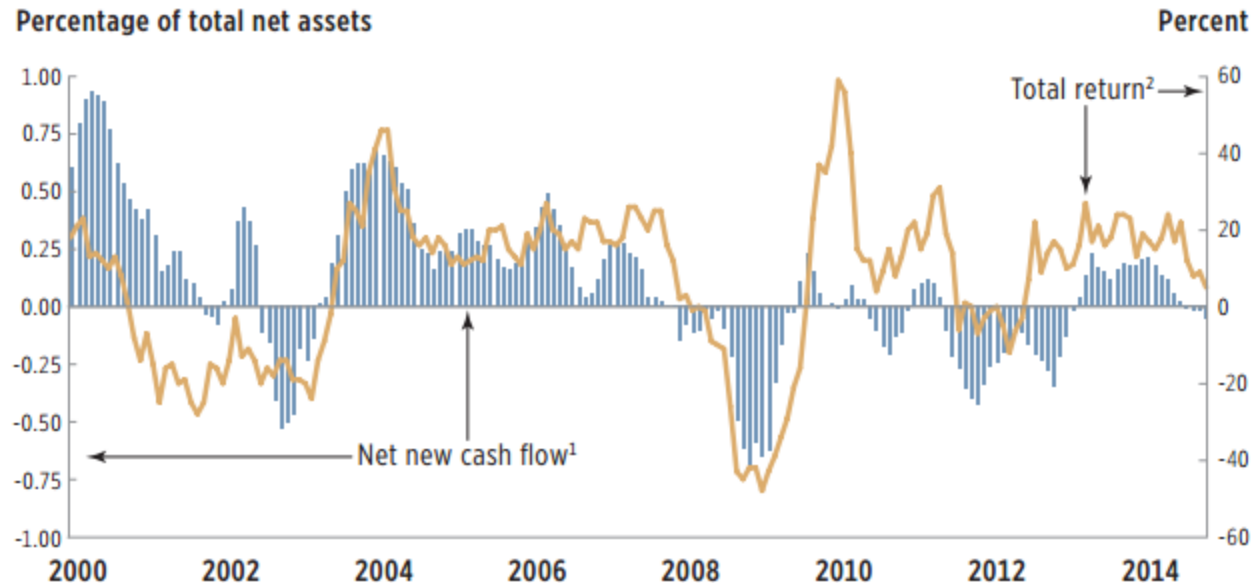
Other Allocation Approaches

- Allocate solely to one asset class
- Set allocation and (mostly) do nothing
- Rebalance to a glide path
- Segment portfolio (bucket, by goal, core and satellite, etc.)
- Tactical strategies

Source: "Choosing the Right Portfolio Allocation Approach for You," by Charles Rotblut,
AAII Journal, October 2014

Don't Buy High and Sell Low

Net New Cash Flow to Equity Funds Is Related to World Equity Returns
Monthly, 2000–2014



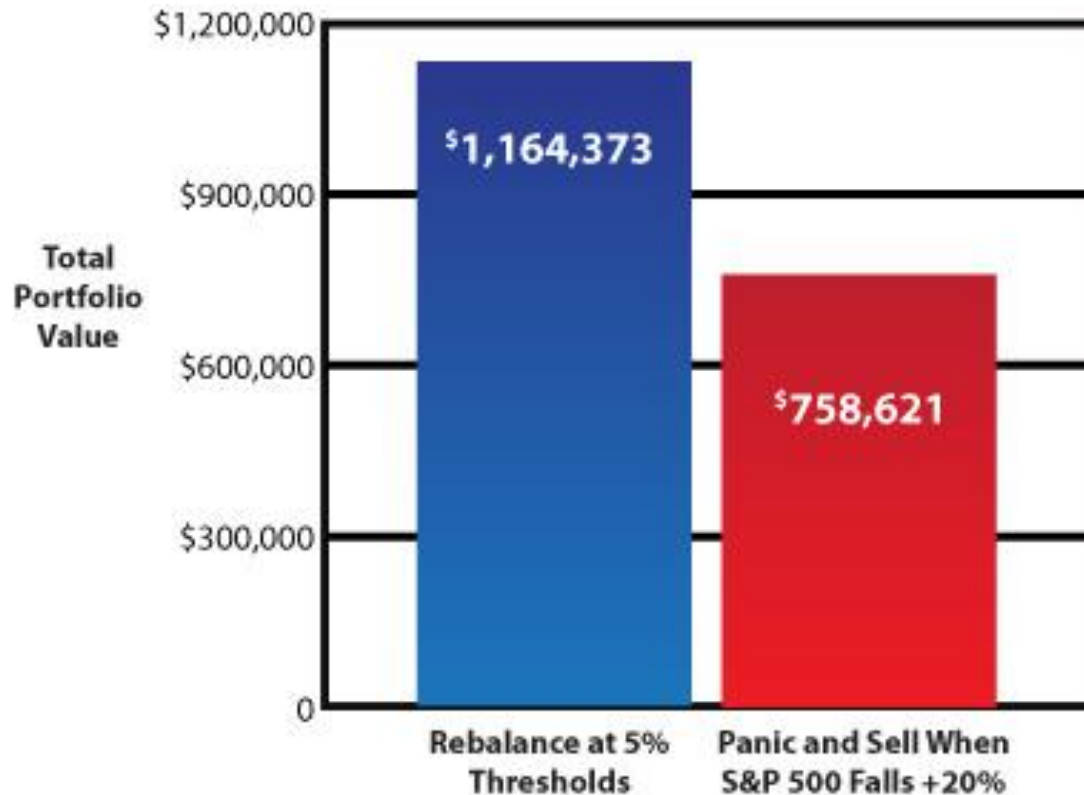
¹ Net new cash flow is the percentage of previous month-end equity fund assets, plotted as a six-month moving average.

² The total return on equities is measured as the year-over-year percent change in the MSCI All Country World Daily Total Return Index.

Sources: Investment Company Institute and Morgan Stanley Capital International

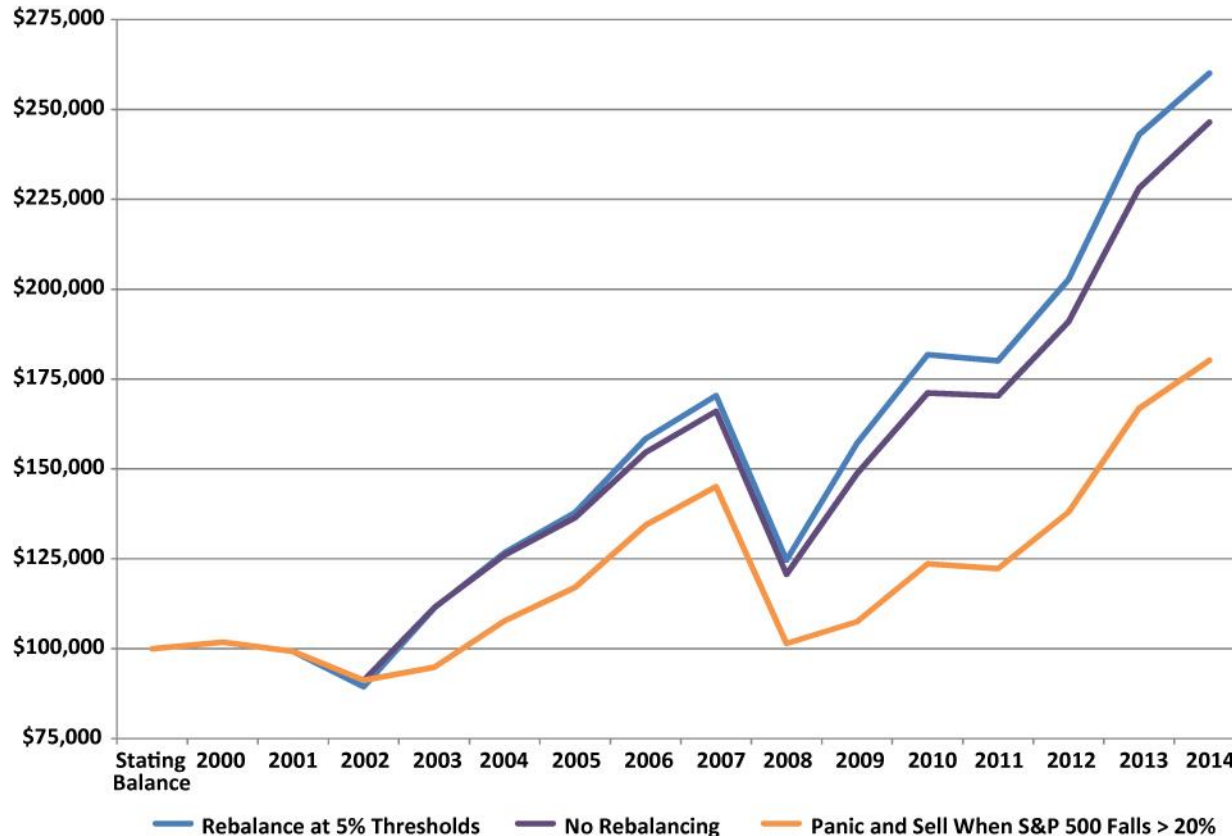
Source: 2015 Investment Company Fact Book, Investment Company Institute

Panicking Is Very Costly



*Allocation shifted to all bonds in 2003 and 2009 and back to target allocation in 2004 and 2010; Source: *AAIL Journal*, May 2014; Updated February 1, 2015

What If Your Timing Is Bad?



*Allocation shifted to all bonds in 2003 and 2009 and back to target allocation in 2004 and 2010; Source: *AII Journal*, May 2014; Updated February 1, 2015

Good investment practices only work if
you select good securities and funds

The first decision in security selection is not determining what to buy, but choosing whether to use a passive or an active strategy.

Passive vs. Active

- Passive—Gives you the index's returns, easy diversification, lower tax and transaction costs, requires less time and effort
- Active—More control, can beat the market or reduce volatility, requires more time and effort

How Do You Choose?

- Do you have the time to research individual securities and funds?
- How good have your previous stock and bond picks been relative to the broad market?

Choose Both Passive and Active

- 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.

Source: "Dishonesty, Choices and Investing," Dan Ariely, *AAII Journal*, June 2012



My Risk-Reward Criteria

Price to Book < 3

Price to Earnings < 20

Cash From Operations = 3+ Years

Sales Growth = 3+ Years

Net Income Growth = 3+ Years

EPS Growth = 3+ Years

Earnings Estimates Revised Up

Good Business Model

Current Ratio > 1.0

Debt to Equity < 0.50

Return on Equity > Peers

Adds Portfolio Diversification

Revised Risk-Reward Criteria

Price to Book < 3

Price to Earnings < 20

Dividend Growth = 1+ Years

Earnings Estimates Revised Up

26-Week RSI Rank > 60%

Market Cap < \$1 Bil Preferred

Operating Margin Rank > 60%

Return on Equity Rank > 60%

Intangibles < 50% of Equity

Current Ratio > 1.0

Debt to Equity < 0.50

Times Interest Earned > 2

Sales Growth = 3+ Years

EPS Growth = 3+ Years

Free Cash Flow = 3+ Years

EPS Up Year-Over-Year

EPS Up Quarter-Over-Quarter

There are many stocks whose potential rewards outweigh their risks. They may not be perfect, but they are capable of building wealth.

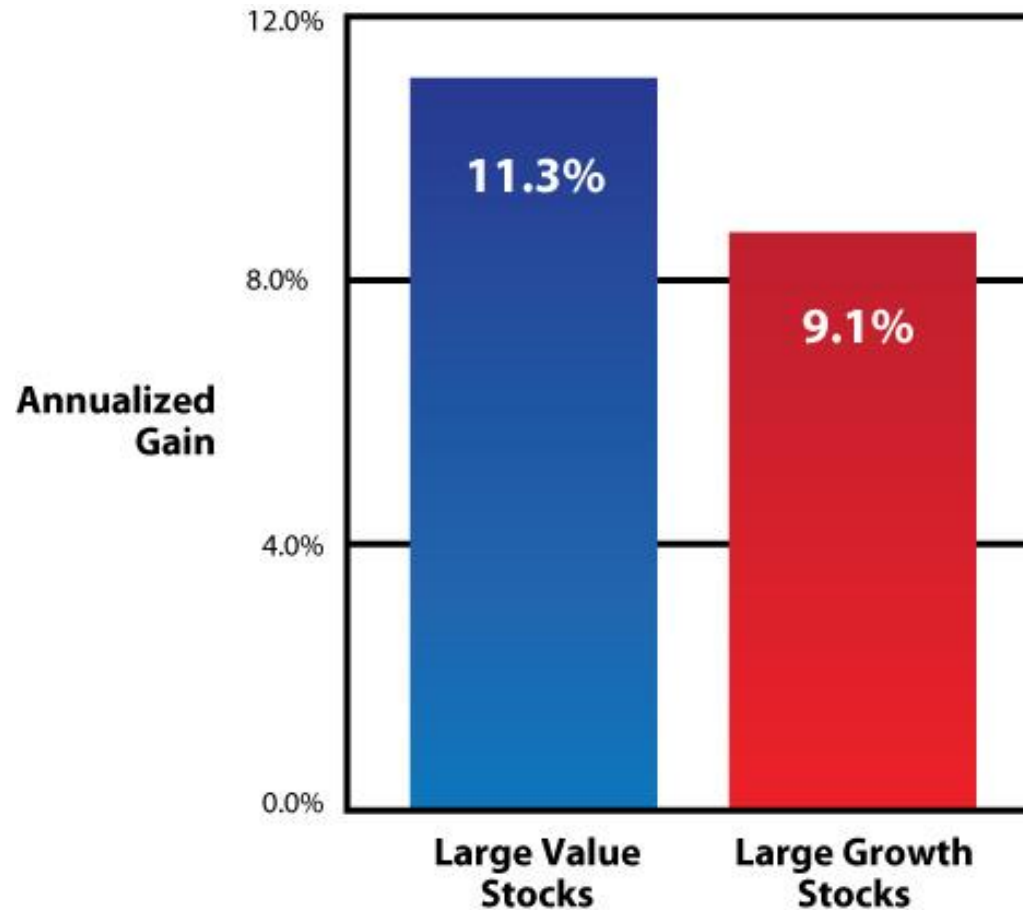
Source: "Better Good than Lucky," Charles Rotblut, *W&A Publishing*, 2010



A New Strategy



Value Beats Growth



Source: "2015 Ibbotson Classic Year Book," Morningstar, data from 1928 to 2015

High Valuations
=
High Expectations
=
More Room for Disappointment

Valuation Considerations

- Relative or absolute (e.g., cheapest 40% or below a certain number)?
- Combine valuation measures (e.g., price-to-book with price-to-sales or price-to-earnings)
- Some stocks are cheap for a reason

Ask What You're Paying For

Investors take big bite of Potbelly IPO

CNNMoney

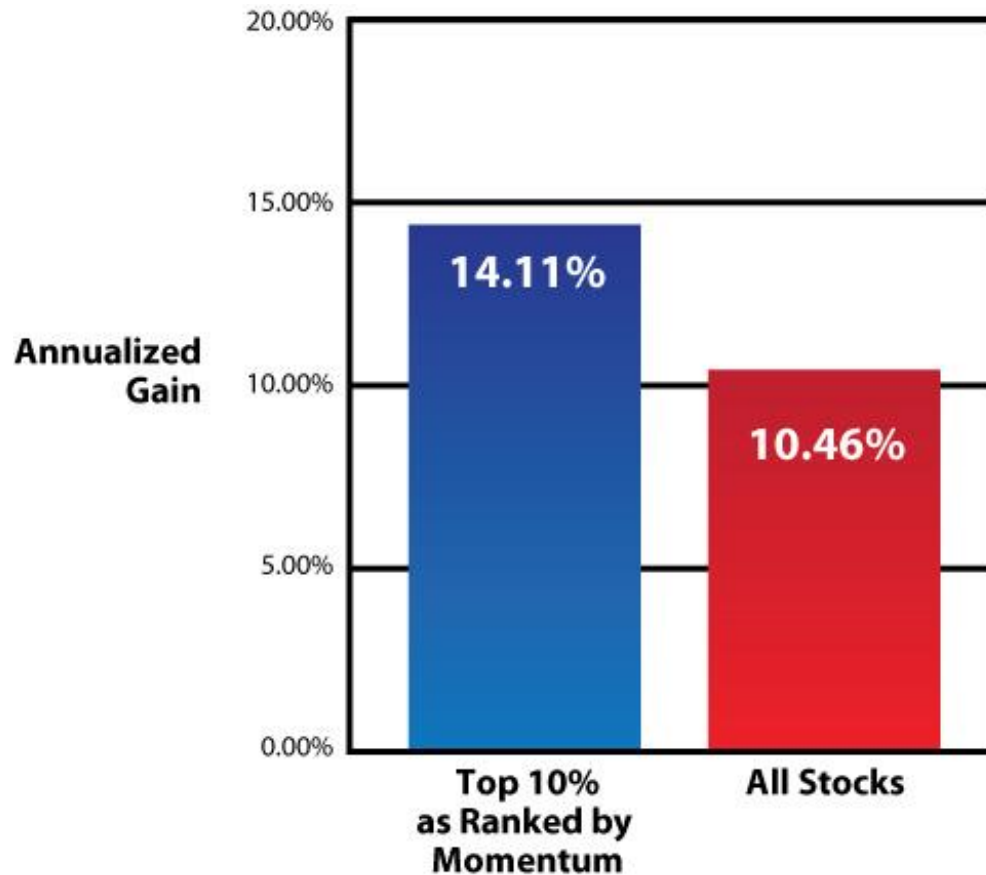
By Hibah Yousuf @CNMoneyInvest October 4, 2013: 4:23 PM ET

f Recommend 119



Source: CNN Money, October 4, 2013; estimated 2015 P/E is 41.7 and trailing 12-month operating margin is 3.5% as of September 18, 2015

Momentum



Source: "What Works on Wall Street," James P. O'Shaughnessy, McGraw-Hill, 2011, data from 1927 to 2009

Momentum Considerations

- Stocks with 26-week relative strength rankings of 60% or higher tend to outperform
- Earnings estimate revisions also impact price movement
- Tends to be uncorrelated with valuation
- Momentum strategies have more turnover, and therefore are more costly

Additional Qualifying Criteria

- Positive free cash flow
- Manageable level of debt; adequate interest coverage
- Current ratio above 1.0
- Above-average asset turnover
- Above-average operating margin
- Friendly to shareholders (pays a dividend and/or buys back shares)

Negative Cash Flow

RadioShack Files for Chapter 11 Bankruptcy After Striking Deal to Sell Some Stores

By REBECCA R. RUIZ and MICHAEL J. DE LA MERCED FEBRUARY 5, 2015 5:47 PM 14 Comments

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A sign indicating a "Clearance Blowout" at a RadioShack store in Miami. The retailer had not turned a profit since 2011. Joe Raedle/Getty Images

Source: New York Times, February 5, 2015

J.C. Penney's Poor Cash Flows

		Current	01/31/2015	02/01/2014	02/02/2013	01/28/2012
Update Type						Reclassified
CASH FLOW STATEMENT						
Total Cash from Operations	\$M	189.0	239.0	-1814.0	-10.0	820.0
Total Cash from Investing	\$M	-160.0	-142.0	-789.0	-293.0	-870.0
Total Cash from Financing	\$M	-92.0	-294.0	3188.0	-274.0	-1065.0
Net Change in Cash	\$M	-63.0	-197.0	585.0	-577.0	-1115.0
Depreciation and Amortization	\$M	620.0	631.0	601.0	543.0	518.0
Capital Expenditures	\$M	252.0	252.0	951.0	810.0	634.0
Common Dividends Paid	\$M	0.0	0.0	0.0	-86.0	-178.0
Exchange Rate Effects	\$M	0.0	0.0	0.0	0.0	0.0
Cash Flow per Share	\$/Shr	-0.20	-0.65	2.35	-2.63	-5.13
Free Cash Flow per Share	\$/Shr	-0.21	-0.04	-11.09	-4.13	0.04

Source: Stock Investor Pro, September 18, 2015

Consider the Business Model

Fitbit shares tumble but sales and profit beat

Published: Aug 5, 2015 4:46 p.m. ET



By
**CAITLIN
HUSTON**

Fitbit reported \$400 million in sales in its first report as a public company.

Shares of Fitbit Inc. **FIT**, **+2.11%** initially rose 5%, but then fell 12% in after-hours trade Wednesday, after the company reported second-quarter profit and sales that blew past estimates.

Source: MarketWatch, August 5, 2015

Excluded Companies

- Financial companies
- Price below \$4
- Not followed by analysts
- Non-exchanged listed (OTC)
- Russia- and China-based

Stocks: When to Sell

- The reason you bought the stock no longer applies (follow your sell rules)
- The valuation becomes excessive
- Business conditions, the fundamentals or the outlook deteriorates
- The dividend is cut or suspended
- You need to rebalance

A Few Final Words of Investing Advice

“If you don’t know what is going to happen,
don’t structure your portfolio
as though you do!”

Source: “The Purgatory of Low Returns,” James Montier, GMO Quarterly Newsletter, July 2013

Be a Proactive Investor

- No one cares more about your wealth than you do, so treat investing like a business
- Track your investments for any changes that make them less attractive
- Ensure that your asset allocations remain on track to meet your financial goals
- Read the annual reports and prospectuses

2 Rules for Investing Success

- Rule #1: Develop a consistent, well-defined approach to investing
- Rule #2: Stick to Rule #1

Source: James Cloonan, "Adherence to Rules Helps Model Shadow Stock Portfolio's Performance," *AAll Journal*, October 2012

AAII Resources

AAII Email Updates

One Positive Step to Take Right Now: Focus on Your Process

Thursday, August 27, 2015



Charles Rotblut, CFA
AAII Journal Editor

Given the volatility we've seen over the past several days, I want to talk about keeping your focus on the process of investing instead of what impact the daily and intraday gyrations of stock prices are having on your net worth. I realize that any time stocks incur a significant drop like they did late last week and early this week, an unrealized financial loss occurs. But focusing on what is happening to your wealth on a daily basis doesn't help you stay on track to achieve your long-term financial goals. What does help is to focus on your investing process, including the actions you take to prevent personal behavioral tendencies from harming your portfolio.

To convey my point, I'm going to focus on weight loss and fitness. I realize that this may seem odd, particularly right now, but there is a significant amount of overlap between wellness (which encompasses weight loss and exercise) and investing. Achieving and maintaining good physical and financial health is dependent on a person's behavior, including whether he or she has strategies to deal with emotions, setbacks and obstacles.

A large number of books have been written about investing and weight loss. An even larger number of people are constantly seeking the magic formula for reaching their targeted weight or desired wealth. Yet there is no secret to either. Weight loss is a matter of making smart choices about what and how much you eat and being physically active. Successful investing is a matter of selecting good investments and sticking to a well-thought-out strategy regardless of what the market is doing. However, simply telling someone to "eat better and exercise more" is often about as useful as telling someone to "buy broad-market, low-cost index funds and just ignore the market downturns." Good advice, but advice that often does not result in the desired change in behavior. If you truly want to achieve your goals, you have to have a process to do so—and the discipline to stick to the process.

(www.aaii.com/email/signup)

Stock Investor Pro

Stock Investor Professional

File Edit Tools Window Update Stock Investor Help

Portfolio: None Screen: None View: Standard Ticker Search:

Stock Notebook #1 - Untitled

View Overview Multiples Growth Ratios Valuations Estimates Fin - Qtr Fin - Ann'l Custom Charts

Company name	Ticker	Exchange	Sector	Industry	ADR/ADS Stock	Dow stock	Standard and Poor stock
1-800-Flowers.Com Inc	FLWS	Nasdaq	Services	Retail (Specialty Non-Apparel)	No	None	None
1347 Capital Corp	TFSCU	Nasdaq	Financial	Misc. Financial Services	No	None	None
1347 Property Insurance Holdin	PIH	Nasdaq	Financial	Insurance (Property & Casualty)	No	None	None
1st Century Bancshares, Inc.	FCTY	Nasdaq	Financial	Regional Banks	No	None	None
1st Constitution Bancorp	FCCY	Nasdaq	Financial	Regional Banks	No	None	None
1st Source Corporation	SRCE	Nasdaq	Financial	Regional Banks	No	None	None
2050 Motors Inc	ETFM	Over the counter	Consumer Cyclical	Auto & Truck Manufacturers	No	None	None
21Vianet Group Inc	VNET	Nasdaq	Technology	Computer Services	Yes	None	None
22nd Century Group Inc	XXII	American	Consumer Non-Cyclical	Tobacco	No	None	None
24Holdings Inc.	TWFFH	Over the counter	Financial	Misc. Financial Services	No	None	None
2U Inc	TWOU	Nasdaq	Technology	Software & Programming	No	None	None
30dc Inc	TDCH	Over the counter	Technology	Computer Services	No	None	None
3D Pioneer Systems Inc	DPSM	Over the counter	Technology	Software & Programming	No	None	None
3D Systems Corporation	DDD	New York	Technology	Computer Peripherals	No	None	MidCap 400
3dicon Corp	TDCP	Over the counter	Technology	Communications Equipment	No	None	None
3DX Industries Inc	DDDX	Over the counter	Technology	Scientific & Technical Instruments	No	None	None
3M Co	MMM	New York	Capital Goods	Construction - Supplies and Fixtures	No	Industrial	500

7013 stocks selected - ranked by Company name, ascending

NUM

(www.aaii.com/stock-investor-pro, \$198 per year)



AAII Dividend Investing

D AAI DIVIDEND INVESTING™

September 2015
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AT&T Inc. (T)	8
<i>A series of mergers have transformed this telephone company into an international conglomerate.</i>	
Eaton Corporation (ETN)	10
<i>Industrial manufacturing company focusing on cost control and cash generation.</i>	

Heightened Volatility Takes a Hold in August

August was a volatile month for global stock markets. Turbulence was aggravated by concerns over China's economy and its impact on the global economy as well as the timing of a U.S. interest rate increase by the Federal Reserve. All of the major benchmarks sank into pullback territory (dropping 5% or more from their most recent highs) and many flirted with correction territory (a decline of 10% from recent highs).

According to U.S. equity strategist Sam Stovall from S&P Capital IQ, it took 92 calendar days for the S&P 500 index to fall through the 5% decline threshold, which is the longest it has taken the S&P 500 to decline 5% since World War II. He said, "For those 16 times that the S&P 500 took its sweet time (40 days or more) to fall 5%, the [index] slid into correction mode only once, and never became a bear market." In this context, a bear market is a decline of 20% or more since its most recent high. He continued, "The rationale is that a drawn-out decline gives investors time to evaluate the concerns and dissipate the impact."

The S&P 500's 6.26% decline in August reflects investors' evaluation of current market conditions, but it does not mean that the U.S. stock market is sliding into bearish territory. Ever since the bull market turned six years old earlier this year,

(www.aaiidividendinvesting.com, \$149 per year)

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