Long-term Investment Strategy

Crystal Cove – the land of happy dreams.

... a summary overview of what we have learned

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To be included here ...

1. Decision time – your level of involvement
2. The impact of fees and returns in the long-run
3. Portfolio management with mutual funds and ETFs
4. Holistic investing
5. Summary lessons from stocks, bonds, and real estate
Decision time – 4 possible levels of involvement

1. **Uninvolved** – hire someone to do it (issues: competence and fees).
2. **Passive** – develop a “seldom look or decide strategy.”
3. **Active** – quarterly portfolio review with rebalance
4. **Aggressive** – fully involved with markets including derivatives all the time

How much should I be saving???

Frankly, as much as you can possibly afford.

Estimates based upon income and lifestyle surveys (offered by financial advisors in early interviews) are not really worth the time it takes to fill them out unless you are 55+, and then it may be too late for the survey to do any good. There are too many unknowns (your career path, inheritances, kids’ college expenses, status of government support programs, amount of your home equity in 25 years, status of medical care, impact of economic events).

As a general rule, you should

1. Make maximum contributions to any employer-subsidized retirement plan,
2. Try to contribute amounts beyond that to Roth and Spousal IRAs (or equiv), and even beyond the tax-break limits in later years as your income rises.
3. Develop a personal culture (life-attitude) of parsimony and involved attention to financial health (like you may already do to physical and emotional health)
... ok, so you want a formula

The formula is complicated, but if you plan to live for 30 years after your retirement, and anticipate earning 3% real after retirement begins, you will need **20** times your annual budget. *(6%, 14.5).*

<table>
<thead>
<tr>
<th>Annual estimated budget including taxes*</th>
<th>minus</th>
<th>Non-investment income (like SS)</th>
<th>times</th>
<th>equals</th>
<th>Required Investment</th>
</tr>
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Required Investment:

Note: All in current $.

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**So what does it take to get to $1,000,000?**

... all in real terms

**The value of your portfolio over 40 years**

Implication: Target 10% and invest to get 5% real. Remember, you need $1 million to get to $50K real annually.

<table>
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<tr>
<th>8% income invested earning 3% real</th>
<th>10% income invested earning 5% real</th>
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Let us assume a family income of **$70K**, an annualized inflation-adjusted *increase* in that income of 1%, an investment rate of **8%** earning **3%*** or **10%** earning **5%**, over **40** years. The more aggressive nearly doubles us up!

*meaning that you invest 8% of your income and earn 3% **real** (after inflation) return.
How high fees will affect this …

This is what high front-end loads (sales commissions) and expense fees will cost you.

Decision Option 1 – Uninvolved is ruled out!!

… and this is why you will want to do it yourself!

Holistic Investing

- Managing personal finances should be an integral component of personal and family life
  - like exercise, spiritual or religious strength, diet.
- Time should be scheduled for family consideration of financial and investment matters.
- Investment decisions should be long-sighted, as though managing wealth for you grandkids (even if only for your retirement)

... investment shown is the blue investment option shown from the previous page.
Decisions that you must make

- Should I do it all myself, dump it on someone else’s lap entirely, or hire a professional?
- If I build a mutual fund or ETF portfolio, should I build a managed portfolio or passive portfolio of mutual funds?
- If managed, should I include stocks, sector funds, international funds, and leveraged ETFs?
- How much risk am I willing to take?
- Should I supplement my savings with a Roth or Spousal IRA?
- How am I going to respond to bad markets like the current market? (Hint: Don’t panic, and try to see trouble before it arrives).

Portfolio and Risk/Diversity Management

... balancing and rebalancing Mutual Fund and ETF portfolios to minimize risk and improve returns
Deciding between YBFAs and Equities

- The more risk-adverse, the lower the equity component.
- The older the age of the investor, the lower the equity component.
- Higher risk will probably offer higher yield over one generation, but not necessarily, and certainly only if you do it right.
- Must decide between passive, active, or aggressive managed fund approach.
- **Do it yourself!!** Avoid low competence and high fees

Vanguard VFINX (S&P 500) 5 year Monte Carlo Simulation based upon:

- Weekly data for five years.
- Data converted to ln growth rate.
- Geom mean growth rate: 1.00189
- Standard deviation: 0.01669

These next four slides are “teaser slides” from Econ 136. They use Monte Carlo simulations to simulate the effects of portfolio diversity. They use real data (2010) to set the simulation range parameters.
Vanguard VFITX (Int Term Treas) 5 year Monte Carlo Simulation

Weekly data for five years.
Data converted to ln growth rate.
Geom mean growth rate: 1.00092
Standard deviation: 0.00592

DWBH: I won’t ask you directly about these MC simulations – I just want you to understand the point.

An 80/20 vs. 50/50 Portfolio

Warning: This 80/20 Monte Carlo simulation does not take into account either the occasional “six sigma” stock event, nor the possibility of a growth of volatility, as happened in 2008.
Low Risk Portfolio

Suitable for someone who is retired or approaching retirement, especially if elderly with adequate wealth and reliant upon this portfolio for covering expenses. **Note:** This is a “healthy-times” low-risk portfolio. True risk aversion may require a 70/30 mix or even 80/20 mix. [In Fall 2011 when this version of the show was prepared, your teacher had a 90/10 portfolio (aggressive investor). It would be hard to find a profession financial advisor who would ever advise 90/10].

Mid Risk Portfolio

This fairly conservative mix is for someone who is fairly risk adverse, normally suitable for 50+ retirement portfolio, especially if portfolio is already sizeable and likely to be adequate over two to four decades for retirement assuming reasonable growth and returns.
High Risk Portfolio

Suitable for informed, involved, younger investor who has an investment horizon long enough to ride out the cycles. Be prepared, though, to crank the equity component down in times of trouble. Even **80/20** or **90/10** may be acceptable for the smart, involved investor who is willing to manage the portfolio. However, the higher the first number the greater the necessity for the investor to be an **active investor** at a minimum and advisably an **aggressive investor**.

Rebalancing Active/Aggressive Managed Portfolios

- Requires frequent monitoring and adjustment for economic conditions (quarterly minimum, monthly advised).
- Change proportions between Equities and YBFAs at a minimum.
- Leave Index Funds constant (advised) or be the last to change.
- Use MMMF or UST as a buffer
- Move in and out of sectors or fund classes
- As a successful category grows (like gold) balance it back down.
Example: Index Diversified Portfolio (60/40)

Interest-earning assets shown in blue.

Example: Sector-based Managed Portfolio
The long view: what you should always remember about these major investment categories!

You want to have rainbows in your life ...

... and you want to remember who this is for (not you so much).

What to remember about stocks

- Have historically (with real estate) the highest yields on average in the very long run.
- Considerable volatility and long periods of poor performance.
  - Always the danger of a substantial and lasting crash.
- As goes earnings growth, so goes the market
  - which implies that as goes economic growth, so goes ...
- Performs poorly with inflation and rising interest rates.
- For long-term investments, dividends can matter
What to remember about bonds and notes

- Market values move in the opposite direction of interest rates.
  - the longer the maturity, the greater the sensitivity
  - even Treasuries have market risk
- Non-treasuries also reflect default and other risks
  - and therefore should not be a large part of a low-risk portfolio
- The yield you earn in interest is determined at the time you buy the asset.
- A diversified portfolio should include Treasuries but
  - buy bonds when interest rates are high, notes or bills when rates are low.
  - inflation will devalue bonds, bills will follow inflation at zero real yield or slightly higher

What to remember about Real Estate

- Real estate is typically leveraged, which compounds yields (both ways).
- The real estate buyer must be a sophisticated, intelligent, informed buyer.
- Real estate is a necessary hedge against inflation.
- Real estate can be dangerous. .. most failures in real estate are due to cashflow failures .. not having sufficient cash to service amortized debt.
- There are times when not to buy real estate.
- Real estate offers tremendous tax advantages
What to remember about mutual funds and ETPs

- Your investment portfolio will likely be here.
- You must do your research and understand investment objectives.
  - fees, fees, fees
  - investment objectives (dividends, index, growth, intl. etc.).
- You should strive for portfolio balance and you should consider rebalancing periodically.
- ETPs can be a viable liquid and marketable substitute for mutual funds BUT
  - beware futures-based ETNs and know why
  - ETFs have suffered liquidity events (flash crash)

What to remember about derivatives

- If you are good at this, then playing puts, calls, and/or futures can possibly supplement compounded rates of return on your portfolio by a few percentage points.
- This requires an active, aggressive investment attitude and dedicated attention when you in position.
- Writing covered calls on stock positions can be a good way to supplement yields on a portfolio.
- These investment categories should be done in Roth or traditional IRA or similar accounts
  - because if you hit it big-time it will be here.
- Duh!! These are risky!!