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# Smart Investing: Seeking Reward While Reducing Risk

Charles Rotblut, CFA

Vice President & *AAII Journal* Editor

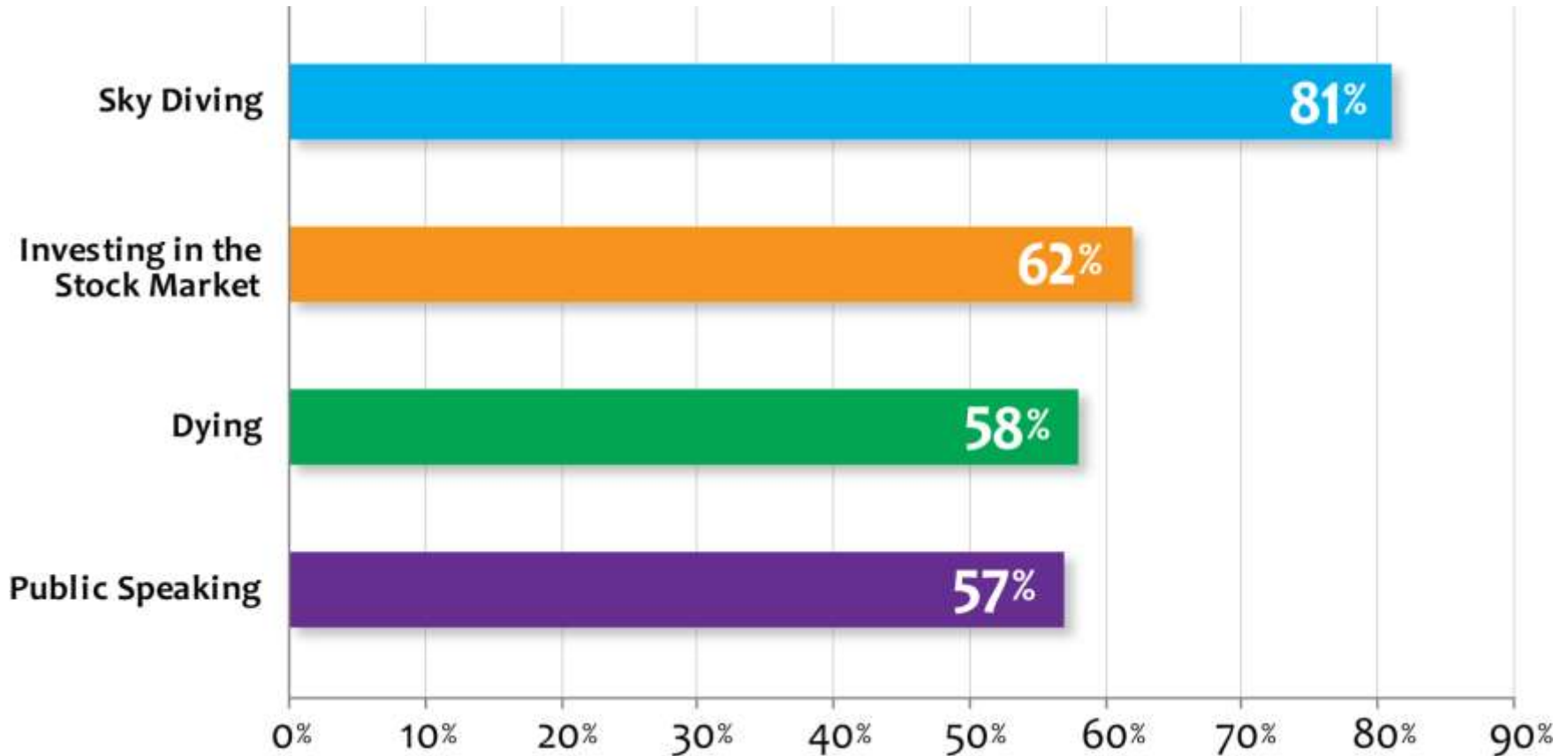
American Association of Individual Investors



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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.

# What Scares People



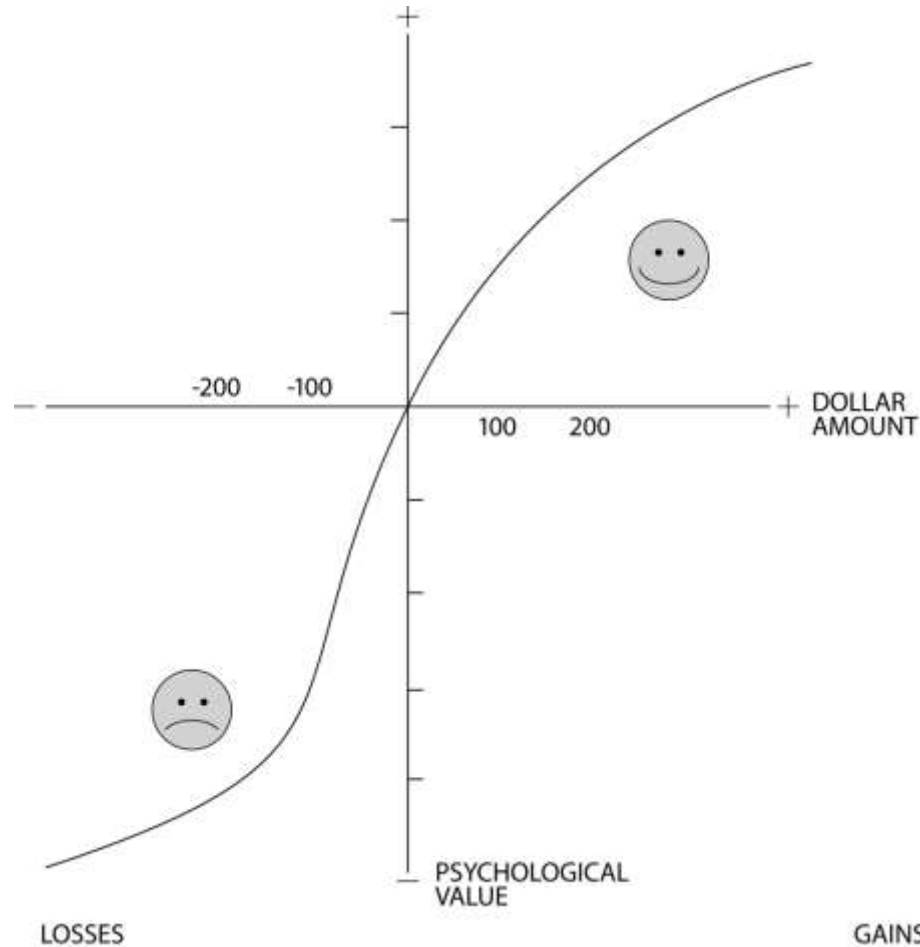
Source: "Fear of Financial Planning Consumer Study," Nationwide Financial, July 2013

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Economic and financial theory assumes humans act in rational ways.

Behavioral scientists have evidence suggesting otherwise.

# We Humans Are Risk-Averse



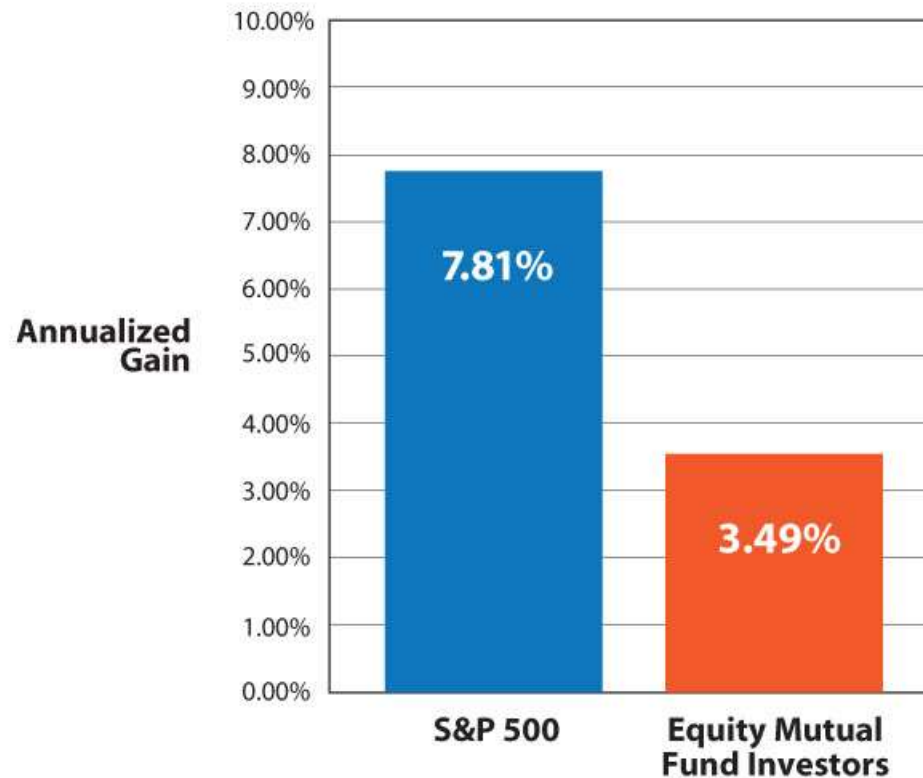
Source: "Thinking, Fast and Slow," Daniel Kahneman (Farrar, Straus and Giroux, 2011)

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# We're Also Overconfident

- We humans are likely to believe our decisions are correct
- We look for information confirming our beliefs (“confirmation bias”)
- We assume present conditions will continue into the future (“recency bias”)

# The Impact of Overconfidence



Source: "How Investors Miss Big Profits," Louis Harvey, *AAII Journal*, October 2012, data from 1988 to 2011



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# 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

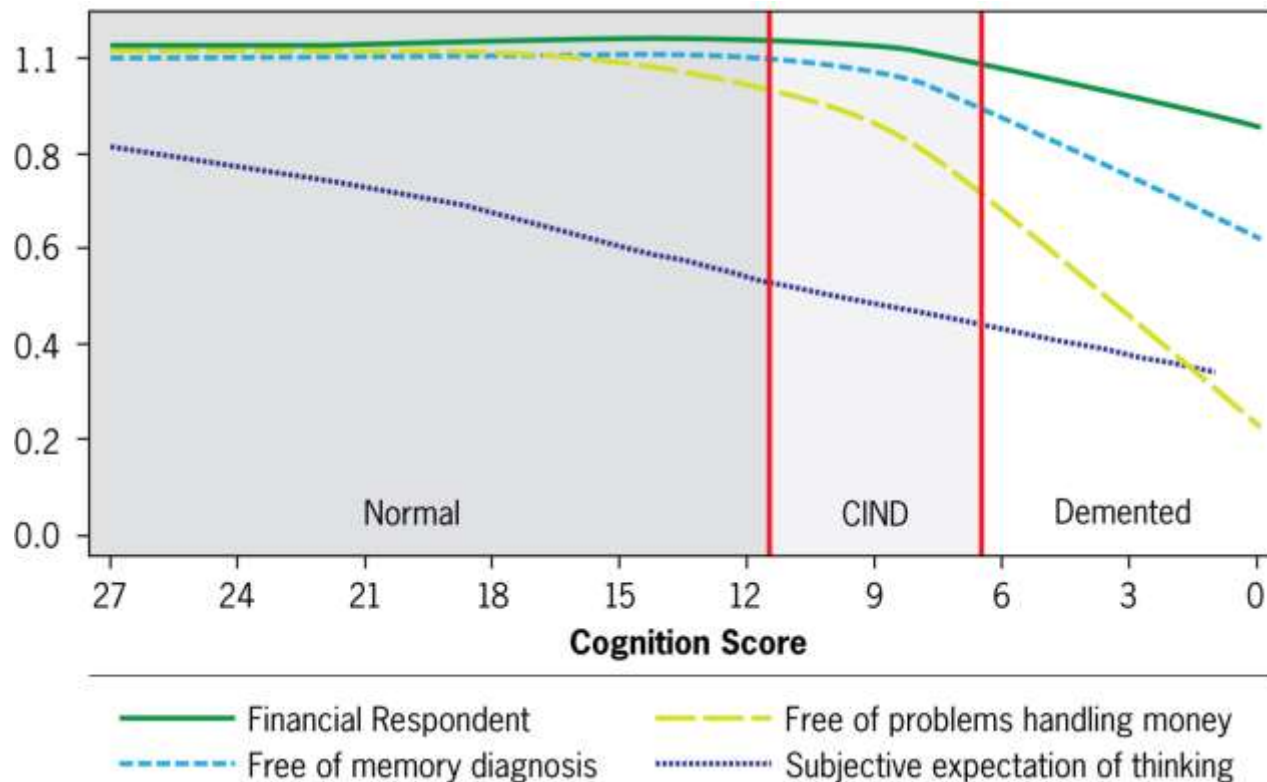


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# Cognitive Decline

- The ability to make sophisticated decisions peaks at age 53
- Approximately 1 in 7 Americans age 71 or older have dementia according to the Alzheimer's Association

# Many Manage Their Finances While Cognitively Impaired



Source: "Dementia Risk and Financial Decision Making by Older Households: The Impact of Information," Joanne W. Hsu and Robert J. Willis, Federal Reserve Board Working Paper, 2013-45

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

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# Use the Power of the Written Word to Your Advantage

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

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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 0.80. (This figure will change gradually with changes in overall market values.)
- Market capitalization must be between \$30 million and \$240 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.

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

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# My Favorite Investing Tool



(It's a spiral notebook)



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# 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

AT&T	T	
8/7/2013	The growth of the resale market is perhaps forcing carriers to shorten upgrade times and provide various incentives and deals to cellular subscribers to trade in their phones, as has been seen in recent plan changes from T-Mobile USA (TMUS), Sprint (S), AT&T (T), and Verizon Communications (VZ)	<a href="http://blogs.barrons.com/resale-market-to-clip-growth-says-bernstein/">http://blogs.barrons.com/resale-market-to-clip-growth-says-bernstein/</a>
8/27/2013	The Federal Communications Commission has delayed approving AT&T's January purchase of Atlantic Tele-Network's (ATNI) Alltel retail operations. The problem, it says, is that it hasn't received details about how AT&T will help Alltel's prepaid customers move onto a new network,	<a href="http://www.theverge.com/delays-att-alltel-buy-approval-over-prepaid-customer-roadmap">http://www.theverge.com/delays-att-alltel-buy-approval-over-prepaid-customer-roadmap</a>
8/30/2013	AT&T Inc., which has scoured Europe for potential acquisitions this year, would examine assets that remain after Vodafone sells its 45 percent stake in Verizon Wireless, people familiar with the matter said.	<a href="http://www.bloomberg.com/news/2013-08-29/vodafone-seen-as-at-t-prey-after-130-billion-verizon-deal-tech.html">http://www.bloomberg.com/news/2013-08-29/vodafone-seen-as-at-t-prey-after-130-billion-verizon-deal-tech.html</a>
8/30/2013	Verizon Communications Inc.'s push to take full control of its U.S. wireless business could spark a new round of mergers across the telecom industry.	<a href="http://online.wsj.com/mod=Wsj_hpsMID">http://online.wsj.com/mod=Wsj_hpsMID</a>
9/2/2013	Vodafone agrees to sell stake in Verizon Wireless to Verizon; proceeds to mostly be given back to VOD shareholders instead of being used for new acquisitions; deal expected to close in Q1	<a href="http://www.vodafone.com">http://www.vodafone.com</a>

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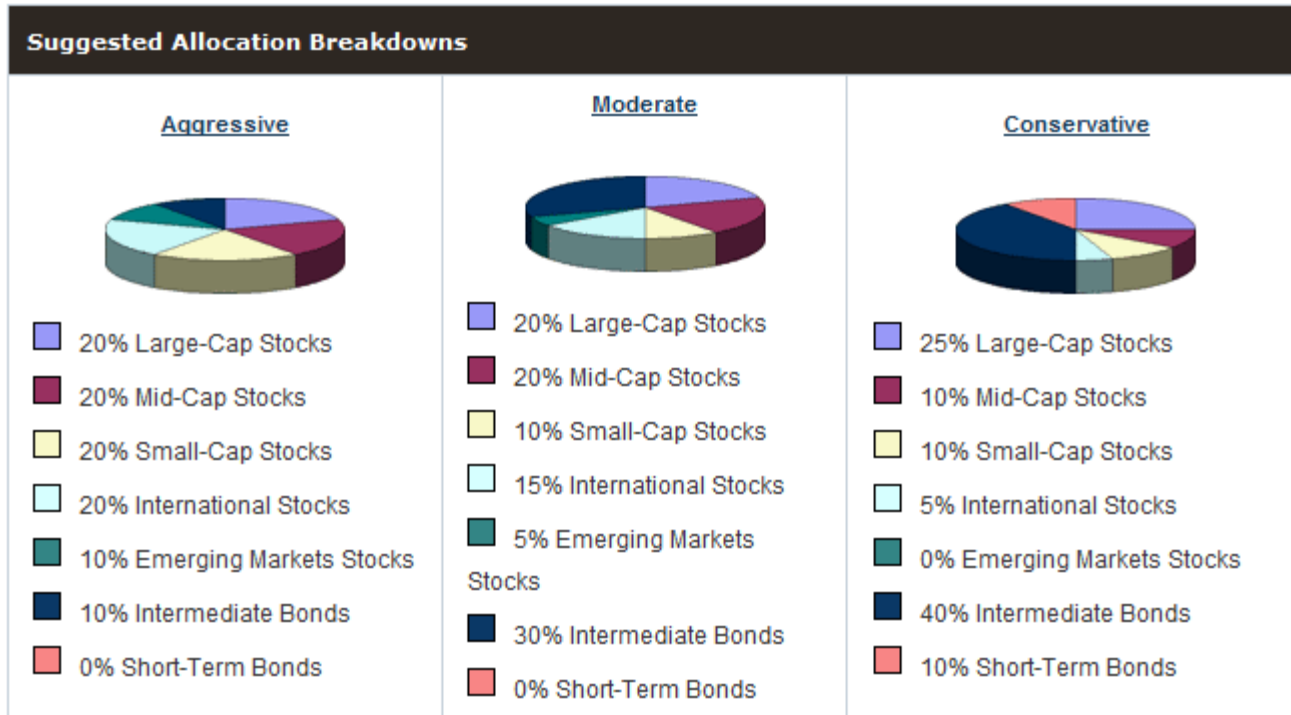
Write down everything that matters to your portfolio, rather than keeping it in your head.

It's more important to remember birthdays and anniversaries than the details of your portfolio.

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You can also create luck by sticking to  
a good, long-term allocation

# AAII Allocation Models



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

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# 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

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# Diversify, Then Rebalance

- 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



# Why You Need to Rebalance

Portfolio	Annual Return	Standard Deviation	Ending Stock Allocation
50% Stocks / 50% Bonds			
Never Rebalance	9.0%	15.7%	<b>96.5%</b>
Rebalance Annually	8.3%	11.3%	50.0%
70% Stocks / 30% Bonds			
Never Rebalance	9.4%	17.4%	<b>98.5%</b>
Rebalance Annually	9.0%	14.5%	70.0%

Source: Large-cap stocks and long-term bonds, Ibbotson SBBI 2013 Classic Yearbook, Data from 1926-2012





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# 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 – 2012
- Vanguard index funds used to avoid impact of active management

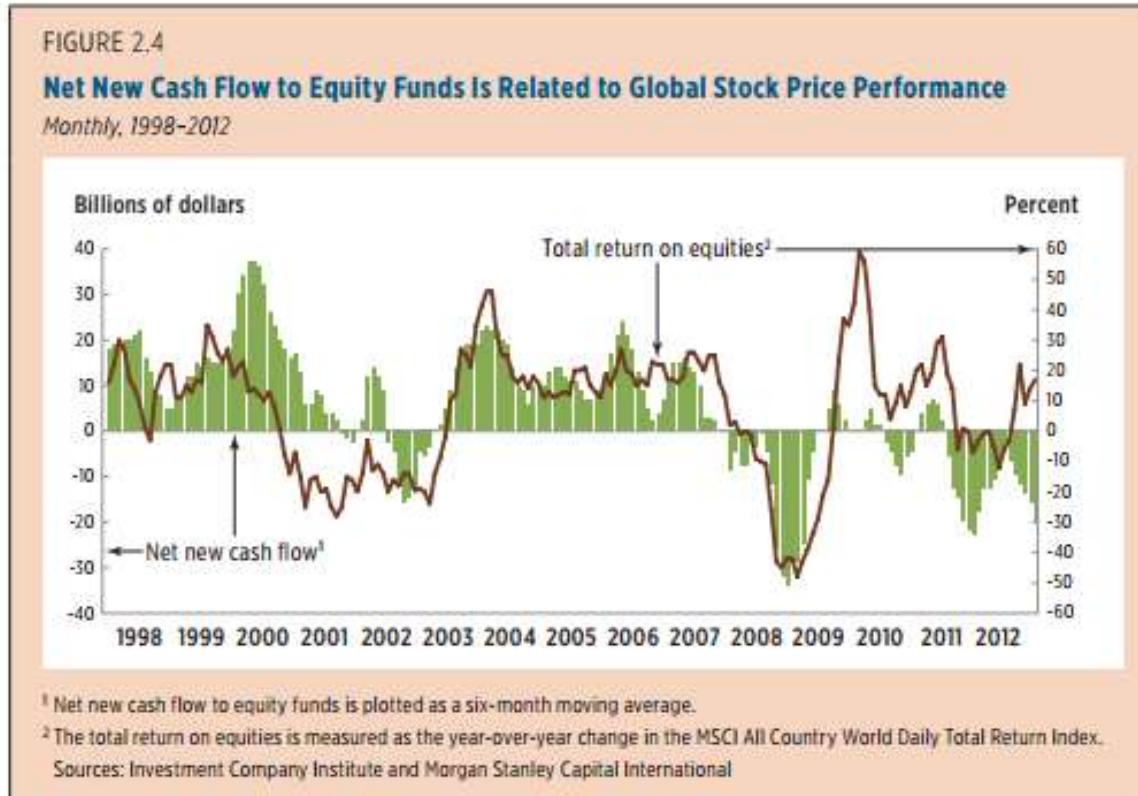
# Results From 25 Years of Data

<b>Non-Withdrawal Portfolio</b>		
Portfolio Strategy	No Rebalance	Rebalance at 5% Thresholds
Ending Portfolio Value	\$882,268	\$907,694
Total Return	782.3%	807.7%
Standard Deviation	14.1%	12.7%
Annualized Return	9.1%	9.2%
Largest Drawdown	(\$253,424)	(\$204,880)
Largest Annual Loss	(32.8%)	(26.9%)

*All numbers are rounded.*

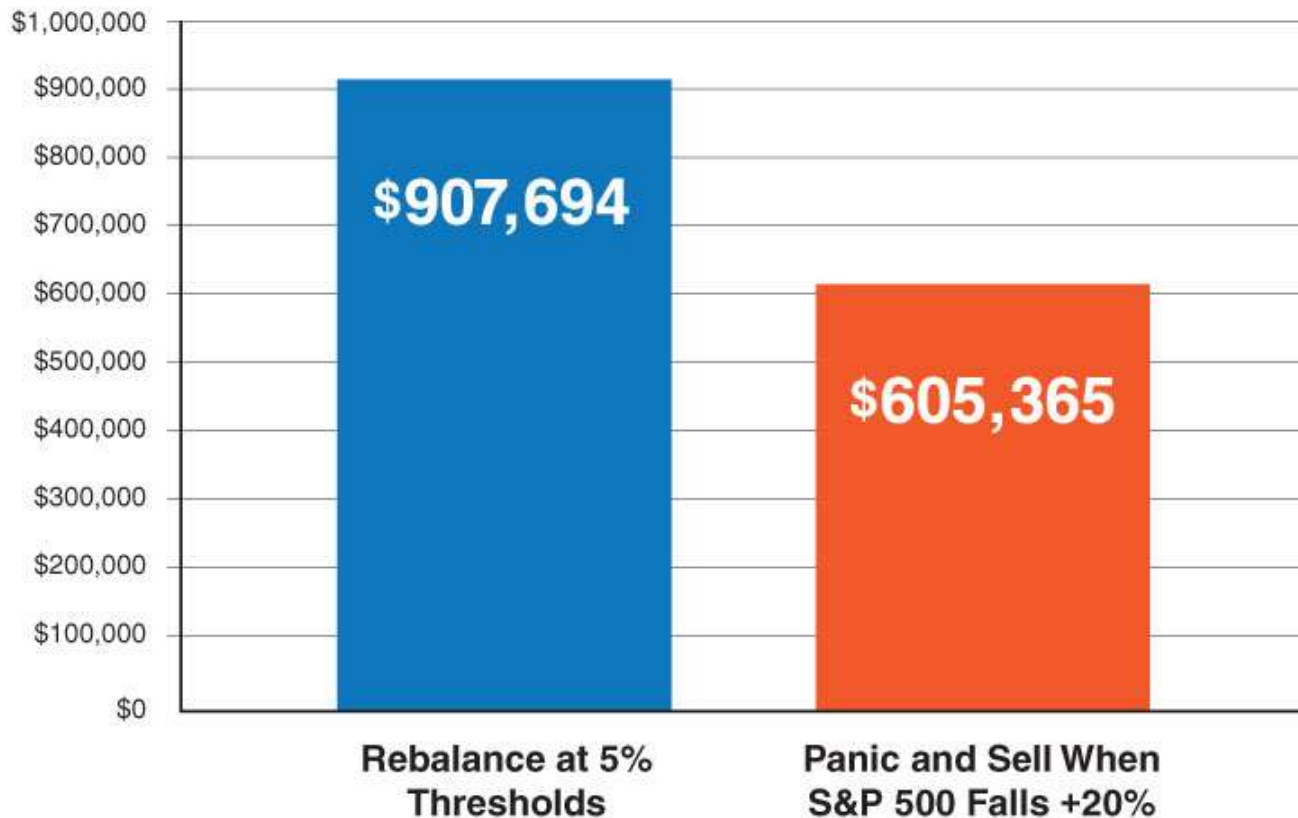
Source: "Portfolio Rebalancing: Observations From 25 Years of Data," by Charles Rotblut, *AII Journal*, April 2013

# Instead of Rebalancing, Many Buy High and Sell Low



Source: 2013 Investment Company Fact Book, Investment Company Institute

# Rebalancing Is Better Than Panicking



\*Allocation shifted to all bonds in 2003 and 2009 and back to target allocation in 2004 and 2010

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# 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

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

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

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# Active vs. Passive

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



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# 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?

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# 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

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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

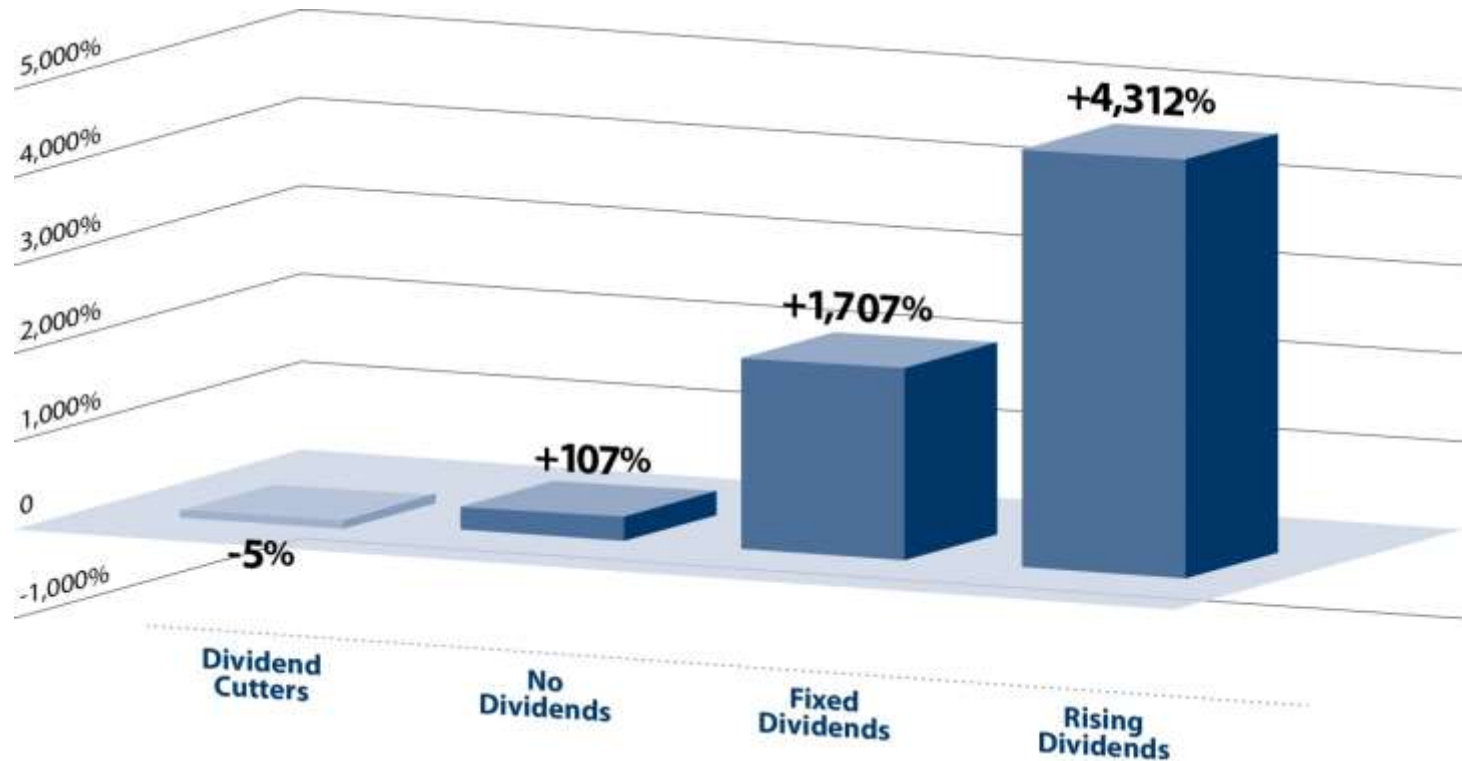


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# Stocks: Key Traits to Look For

- 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 Boost Returns



Source: Ned Davis Research, data for period of February 1972 through January 2013

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# Momentum Helps Too

- Stocks with 26-week relative strength rankings of 60% or higher tend to outperform
- Combine momentum with valuation measures such as the price-earnings ratio
- Momentum strategies have more turnover, and therefore are more costly

Source: James O'Shaughnessy, "What Works on Wall Street", Fourth Edition" (McGraw-Hill, 2011); Richard Tortoriello, "Quantitative Strategies for Achieving Alpha" (McGraw-Hill, 2008)

# Liquidity: An Overlooked Style

		Liquidity				Liquidity Premium	
		Low	→		High		
			1	2	3	4	Q 1 - Q4
Size	Small	1	16.17%	17.26%	10.83%	2.56%	13.61%
		2	15.81%	14.24%	12.20%	6.46%	9.35%
		3	13.94%	13.14%	12.38%	8.40%	5.55%
	Large	4	11.58%	11.31%	11.04%	9.03%	2.54%
Size Premium		Q 1 - Q4	4.59%	5.95%	-0.21%	-6.48%	

Source: Ibbotson, Chen, Kim & Hu, "Liquidity as an Investment Style" forthcoming Financial Analysts. Also see April 2013 *AAII Journal*



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# My Stock Screening Criteria

Price to Book < 3

Price to Earnings < 20

Dividend Growth = 1+ Years

Share Turnover < 192%

Market Cap < \$1 Bil Better

Earnings Estimates Revised Up

26-Week RSI Rank > 60%

Operating Margin Rank > 60%

EPS Up Year-over-Year

Current Ratio > 1.0

Debt to Equity < 0.50

Times Interest Earned > 2

Intangibles < 50% of Equity

Sales Growth = 3+ Years

EPS Growth = 3+ Years

Free Cash Flow = 3+ Years

Return on Equity Rank > 60%

EPS Up Quarter-over-Quarter



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# Seven Reward Criteria

- Price-to-Book
- Price-to-Earnings
- Dividend Growth
- Liquidity (Share Turnover)
- Market Cap
- Positive Estimate Revisions
- Momentum (Relative Strength)

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# Seven Risk Criteria

- Balance Sheet Liquidity (Current Ratio)
- Level of Debt
- Intangibles as a Percentage of Book Value
- Sales and Earnings Growth
- Free Cash Flow
- Return on Equity
- Operating Margin

# My Stock Screening Criteria

Stock Investor Professional

File Edit Tools Window Update Stock Investor Help

Portfolio: None Screen: Revised Risk-R View: Risk

Screen Editor - Stock Notebook #1 - Untitled

Name: Revised Risk-Reward Screen New Portfolio none: 7519 companies active

Description:

Conn	(	Field	Operator	Factor	Compare To (field, value, industry)	)	Count On
▶		RR: Reward Score	<=		12		
	And	RR: Risk Score	<=		10		
	And	EPS Est Y0	>		EPS-Diluted Continuing Y1		
	And	EPS Est Y1	>		EPS Est Y0		
	And	EPS-Diluted Continuing Q1	>		EPS-Diluted Continuing Q5		
	And	Country	Not Equal		China		
	And	Country	Not Equal		Russia		

Source: AAI's Stock Investor Pro (<http://www.aai.com/stock-investor-pro/>)



# Stocks Passing My Screen

Stock Investor Professional

File Edit Tools Window Update Stock Investor Help

Portfolio: None Screen: Revised Risk-R View: Presentation - F Ticker Search:

Stock Notebook #1 - Untitled

View	Overview	Multiples	Growth	Ratios	Valuations	Estimates	Fin - Qtr	
Company name	Ticker	RR: Reward Score	RR: Risk Score	Yield	Price/Book	PE	Liquidity-Share Turnover	% Rank-Rel Strength 26 week
AFLAC Incorporated	AFL	8.00	8.50	2.4	1.98	8.1	97.39	71
Torchmark Corporation	TMK	9.00	9.00	1.0	1.70	12.5	88.53	75
UFP Technologies, Inc.	UFPT	10.00	7.00	0.0	1.82	13.7	77.52	64
United Fire Group, Inc.	UFCS	11.00	10.00	2.6	0.94	15.7	42.69	61
Allianz SE (ADR)	AZSEY	11.00	9.00	4.0	1.04	8.7	0.88	49
<b>Amdocs Limited</b>	<b>DOX</b>	<b>12.00</b>	<b>9.00</b>	<b>1.4</b>	<b>1.84</b>	<b>14.3</b>	<b>106.61</b>	<b>51</b>
Johnson & Johnson	JNJ	12.00	10.00	3.0	3.52	19.4	70.68	65
Cooper Companies, Inc., The	COO	13.00	10.00	0.0	2.74	20.9	113.44	75
Gentex Corporation	GNTX	13.00	8.00	2.2	2.96	19.9	134.41	80
3M Co	MMM	13.00	10.00	2.2	4.43	18.0	69.94	61
SEI Investments Company	SEIC	13.00	8.50	1.3	4.57	19.9	95.29	53
TJX Companies, Inc., The	TJX	13.00	7.00	1.1	10.02	19.8	90.66	75
UniFirst Corp	UNF	13.00	7.50	0.2	1.92	17.7	56.34	66
Credit Acceptance Corp.	CACC	13.00	10.00	0.0	3.94	11.2	36.04	25
Sasol Limited (ADR)	SSL	13.00	8.50	4.0	2.30	13.4	6.39	62

Source: AAI's Stock Investor Pro, data as of August 30, 2013

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# 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

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# A Few Final Words of Investing Advice

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# 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

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“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



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

Source: “My Important and Only Investment Newsletter,” Charles Ellis, *AAII Journal*, October 2013

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# 2 Rules for Investing Success

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

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



# AAII Email Updates

A Weekly Email From the American Association of Individual Investors

**AAII**  
INVESTOR UPDATE



Thursday, April 11, 2013

Dear Member,

One consequence of the market's ongoing rally has been shrinking dividend yields. The Dow Jones U.S. Index (IYY), an exchange-traded fund that tracks the largest 1,200 domestic stocks, yielded just 1.9% at the end of last week. Within the slightly broader S&P Supercomposite 1500 index, just 263 members traded with yields above 3.0%.

I'll admit that 263 sounds like a number that would still give income-hungry investors plenty of choices, but adding two key filters quickly narrows this list. The first filter is a requirement for dividend growth. Research from Ned Davis Research shows that shares of companies that raise or initiate dividends greatly

## AAII Resources

### Dividend Safety and Warning Signs

These indicators determine how safe the dividend is.

[See them »](#)

### Chasing Yield for Income

There is good reason to be wary of chasing yield.

[Learn why »](#)

### AAII Discussion Boards

When is a stock's yield too

([www.aaii.com/email/signup](http://www.aaii.com/email/signup))

# AAII Dividend Investing

## **D** AAI DIVIDEND INVESTING™

April 2013  
Volume II Issue 4  
[www.AAIIDividendInvesting.com](http://www.AAIIDividendInvesting.com)

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#### In-Depth Stock Reports

Eaton Corporation (ETN)	8
<i>Global industrial powerhouse continues to expand into growing markets while rewarding shareholders with strong dividend growth.</i>	

### We're Adding Growth, Plus a Great First Quarter

We are replacing Vectren Corp. (VVC) with Texas Instruments Inc. (TXN) in the DI portfolio. We are making this change to seek a higher level of dividend growth as well as on the basis of relative yields.

Vectren's yield is 24% below its five-year average, making its dividend valuation rich. We also have concerns that the dividend growth rate will remain low in the foreseeable future. Though Vectren has a long history of annually raising its dividend, the growth rate has slowed to a mere 1.5% over the past three years.

In contrast, Texas Instruments' current yield of 3.2% is more than 50% above its five-year average yield of 2.0%. Furthermore, the company has hiked its dividend at annualized pace of 19.1% over the past five years. Though Texas Instruments does have a lower current yield than Vectren (3.2% versus 4.0%), future dividend hikes should close the gap in the amount of cash paid. We further think Texas Instruments offers a better potential for future total return.

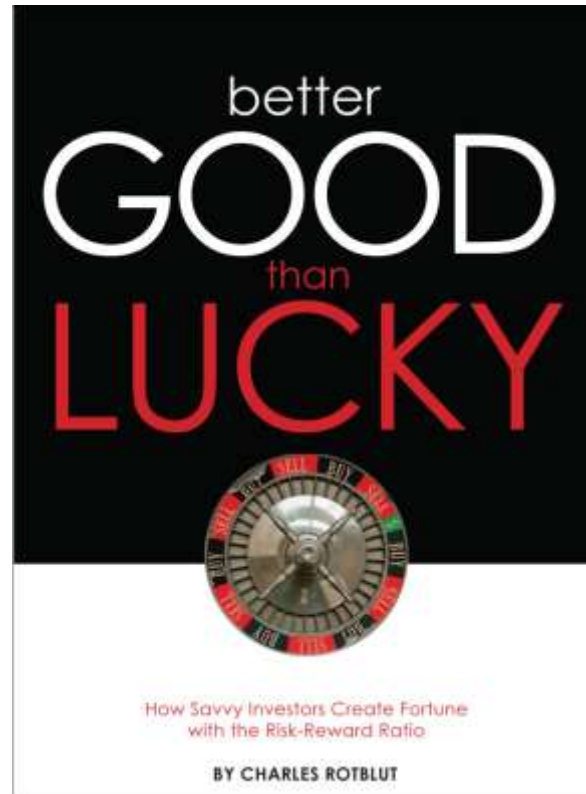
### Can Stocks Continue First-Quarter Rally?

The market continues to show strength, with several domestic stock indexes rising to record highs. The DI tracking portfolio has benefited from the upward

([www.aaividividendinvesting.com](http://www.aaividividendinvesting.com), \$149 per year)

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# My Book



(W&A Publishing / Traders Press)

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# Smart Investing: Reducing Risk While Seeking Reward

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Vice President & *AAII Journal* Editor

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