THE PRISM WEALTH-BUILDING PROCESS

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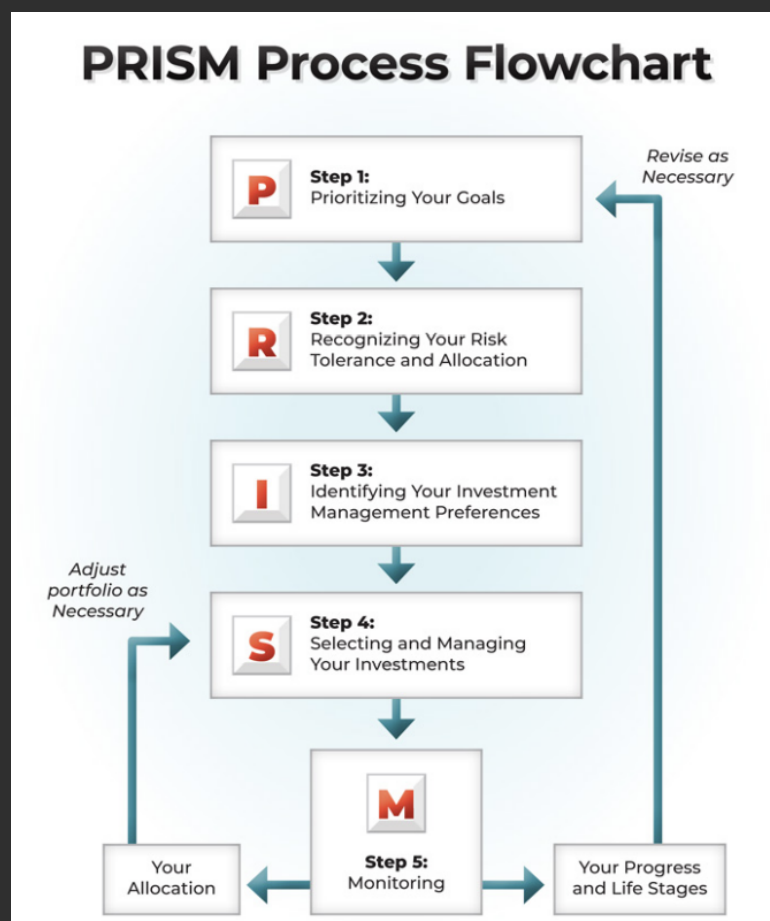
WHAT IS PRISM?

The PRISM Wealth-Building Process provides a framework for aligning your investment decisions with your goals. Following the five steps of PRISM empowers you to create a personalized investment plan and gives you the confidence to follow it. Each step is dependent on the others, meaning one step must be completed before moving onto the next and a change at the top or bottom can lead to a comprehensive review.

AAII founder James Cloonan had two simple rules for achieving investment success:

- Rule #1 was "develop a consistent, well-defined approach to investing."
- Rule #2 was "stick to rule #1."



ABOUT THE CREATOR

Charles Rotblut, CFA, is a vice president and financial analyst at AAII as well as creator of the PRISM Wealth-Building Process. He is the editor of the AAII Journal, created VMQ Stocks, co-created AAII Dividend Investing, helps to manage the Stock Superstars Report portfolio and authors the weekly AAII Investor Update email.

Rotblut holds the Chartered Financial Analyst designation and has analyzed both publicly traded and privately held companies.

AAII'S MISSION

AAII is an independent nonprofit corporation formed in 1978 to assist individuals in becoming effective managers of their own assets through programs of education, information and research.

Our founder, the late James B. Cloonan, Ph.D., started AAII in defense of the individual investor at a time when all investing publications, tools and focus went to professional financial managers and bankers.

AAII empowers the individual investor with the tools and resources they need to make informed investment decisions based on their individual needs. AAII believes in investing the right way, building a solid foundation of education, using tools to validate ideas and hunches, letting data and research guide decision-making and investing for the long term.

Learn more about AAII's mission at www.aaii.com/about

HOW TO USE THIS RESOURCE GUIDE

This guide offers a comprehensive look into the PRISM Wealth-Building Process as a whole. Articles and worksheets can be reviewed and used to complete the PRISM Academy online course at your own leisure.

Begin with the letter P, Prioritizing Your Goals, and progress through each step until you complete the letter M, Monitoring Your Allocation, Progress and Life Stages, which is the final portion of the PRISM Wealth-Building Process. Once you reach the end of the course, you can use the PRISM process whenever you need to adjust your goals or allocation during various life stages. This is a cyclical process that can be used time and time again.

THE PRISM ACADEMY

The PRISM Academy is an online, interactive course available to all AAII members. This course follows the PRISM Wealth-Building Process and its five steps through various material such as video lessons, webinars, engagement prompts, discussion and worksheets.

Visit **www.aaii.com/learnandplan** to get started and enroll in the PRISM Academy today.

PRISM WEALTH-BUILDING PROCESS

A Plan for Achieving the Financial Goal of Building Retirement Savings

We use the example of a hypothetical couple to illustrate how the PRISM process can get you to your retirement goal.

BY CHARLES ROTBLUT, CFA

***Charles Rotblut**, CFA, is a vice president at AAII and editor of the* AAII Journal. *Find out more at www.aaii.com/authors/charles-rotblut and follow him on Twitter at twitter.com/CharlesRAAII.*

Each new year brings about new resolutions. Unfortunately, many people fail to achieve their goals. One study cited by Psychology Today found that just 19% of people stick to their New Year's resolutions.

One of the best ways to achieve your goals is to have a written plan for achieving them. The PRISM Wealth-Building Process is designed to help you do this. It is a five-step process for creating a framework to achieve your financial goals.

Since many financial and investing goals are set in January, we show you here how the PRISM process can be used to establish a plan for reaching them. Specifically, we use a hypothetical couple, Jack and Cynthia. They are both age 50 and want to be more disciplined in building and managing their retirement savings—a common goal and common New Year's resolution many people have.

Reaching Goals Means Writing Down and Prioritizing Goals

A common first step for achieving a goal—be it a New Year's resolution or a longer-term goal—is to write it down. An oft-cited study by Gail Matthews, Ph.D., at Dominican University in California found that those who wrote down their goals were 42% more likely to achieve them.

Chances are you have more than one goal for what you want to do with money. Jack and Cynthia are no different. They want to retire comfortably, travel, help their children in the future and give to charity. In such situations, prioritization is important.

Using Step 1 of the PRISM process, they prioritize saving for retirement as their first goal. They set a target date for retiring at the year they turn 67. This will be the date both will be able to claim their full retirement benefits from Social Security. The date also sets the number of years they have to achieve their goal at 17.

To estimate the duration of retirement—the period over which they will spend on the goal—Jack and Cynthia take into consideration their current health, their parents' longevity and estimates from online life expectancy tables and calculators. Based on this, they assume that at least one of them will live to age 90 or longer. The couple choose a 30-year spending duration for retirement to err on the conservative side.

Jack and Cynthia set an estimated cost of retirement at $2.4 million. This number is based on what they think they will spend annually in retirement on their desired lifestyle multiplied by the number of years in retirement. Though the actual cost will rise with inflation, the couple assume their portfolio will grow at a faster rate.

Long-Term Goals Require the Ability to Accept Risk

Assigning a dollar value to a financial goal is just one part of reaching a financial goal; another big part is having that amount of wealth grow over time. Growing wealth to achieve a long-term financial goal requires maintaining an allocation to equities over a long period of time to benefit from compounded returns.

Step 2 of the PRISM process helps you recognize risk tolerance and allocation. Jack and Cynthia start with the first part of this step by filling out the risk questionnaire.

The questionnaire helps the couple realize that they have high a tolerance for risk from a timing standpoint. Retirement is nearly two decades away, which gives their portfolio plenty of time to recover from any shorter-term drops. They also hope to have a long and healthy retirement. This would be an extended period over which their portfolio can continue to benefit from the long-term compounding of returns.

Being AAII members, Jack and Cynthia understand the importance of moderating how much they will take out of retirement savings to spend each year. They agree to limit first-year withdrawals to just 4% of their savings once in retirement and then adjust this amount each year by inflation.

The inclusion of income from Social Security benefits lessens their financial risk by not making the couple solely reliant on their portfolio to fund their retirement.

Psychologically, they have reacted to the down markets differently. Jack has been more willing to endure downturns—viewing them as opportunities to buy stocks on the cheap. Cynthia is a bit more conservative, preferring to have some less volatile assets in the portfolio to lessen the dips. They both self-describe their knowledge of key investing concepts as moderate. The couple perceives themselves as having a good understanding while still realizing that there is more they can learn.

The risk questionnaire shows that Jack and Cynthia have the risk tolerance to follow an aggressive allocation. Recognizing Cynthia's desire to have a counterbalance to equities in the portfolio, the couple agree to include some exposure to bonds.

In reviewing the AAII Asset Allocation Models (www.aaii.com/asset-allocation), they opt for the transitions version of the aggressive investor model. This allocation calls for a 75% weighting in equities and a 25% weighting in fixed income. It still provides much growth but reduces the level of volatility relative to the full aggressive investor model's 90% allocation to equity.

With their allocation determined, Jack and Cynthia can now go about determining what investments to use to achieve their financial goal of saving for retirement.

Defining the Investment Management Preferences

An important bridge exists between recognizing the appropriate allocation to achieve financial goals and selecting the right investments to do so. That bridge is Step 3 of the PRISM process: Identifying Your Investment Management Preferences.

These preferences reflect two things. The first is how involved you want to be in the selection of the individual securities that will populate your portfolio. The second is acknowledging any constraints or restrictions you may face.

Both Jack and Cynthia have 401(k) plan accounts through their respective employers. Both plans only offer mutual funds as investment options. Jack holds index funds in his, while Cynthia's plan mostly offers actively managed funds. In their respective IRAs, Jack invests in individual stocks while Cynthia holds exchange-traded funds (ETFs).

Whenever spouses have separate accounts but common goals, some coordination must be used both in terms of allocation and selecting investments. Allowances must be made for differences in preferences (e.g., individual stocks versus ETFs) as well as any constraints. In this case, the couple must own mutual funds to get the benefits of their 401(k) plans.

The couple agree to have Jack hold stocks in his IRA, while Cynthia holds bond ETFs in her IRA. Mutual funds and ETFs will be used to allocate to international equities (developed and emerging markets) and bonds. Jack will target domestic companies with his stock picks.

They will combine their accounts into a single tracking portfolio using AAII's My Portfolio tool. Doing so gives them a higher-level view of everything they own. It also makes it easier for them to coordinate the choice of investments.

Selecting the Investments to Achieve Goals

The first three steps of the PRISM process lead an investor to Step 4: Selecting and Managing Your Investments.

An analogy would be starting a new fitness regimen at the start of the year. A person may set a goal of losing weight or achieving a certain level of fitness. Before exercising, they would be wise to consider any potential health risks and allocate time in their schedule to workout. They would then decide whether they prefer working out at home or at a gym, as well as determining whether to work with or without a trainer or class instructor (in-person or virtual).

Similarly, with the PRISM process, the investments selected to help achieve a financial goal reflect the first three steps. The PRISM process narrows down the field of potential investments to the most suitable ones based on an investor's allocation requirements and investment management preferences.

Jack and Cynthia start with their 401(k) plans. These are their largest accounts due to the higher contribution limits and employer contributions. The couple use the AAII Asset Allocation Model to determine which fund categories to look at—large-cap, mid-cap, small-cap, international and emerging market stocks as well as intermediate-term bonds. They purposely choose not to use target-date funds. The latter decision reflects their preference to manage their own portfolio allocation.

When choosing funds, they place an emphasis on funds with low expense ratios, given the drag on returns that high fund fees can have. Jack and Cynthia use the mutual fund evaluator on AAII.com to analyze individual fund returns over one-, three-, five- and 10-year periods. The couple establish a preference for funds with return grades of A or B for most periods, if available through their plans. For the actively managed funds in Cynthia's account, they keep an eye out for any manager changes.

In Cynthia's IRA, they target ETFs following broad, well-known indexes. The choice of ETFs is made with the same rules used for mutual funds, though with AAII's ETF grades. Should there be funds within Cynthia's 401(k) in one or more of the target allocation categories with lackluster relative performance and/or high expenses, Cynthia underweights them to the extent reasonably possible. The couple then use her IRA and Jack's 401(k) to bring their overall portfolio's allocation back to their target.

ETFs are selected using criteria similar to those used for mutual funds. Cynthia considers holding developed and emerging market stock ETFs in her IRA since Jack holds shares of domestically based companies in his IRA.

Jack and Cynthia's Investment Guidelines

Here is a copy of the guidelines Jack and Cynthia wrote down as part of Step 4 of the PRISM Wealth-Building Process, Selecting and Managing Your Investments. They are using their 401(k) plan accounts to hold low-cost mutual funds with return grades of A or B for most time periods. In Cynthia's IRA, they are holding ETFs with return grades of A or B for most time periods. Jack prefers to own individual stocks and holds them in his IRA. He uses the AAII stock screens to find stocks and monitors the A+ grades on the stocks he holds.

Portfolio Composition and Notes

Equities	Portfolio Allocation	Strategies, Types of Investments and Rules
Large-Cap Stocks	20 %	Low cost mutual funds, ETFs & stocks (Jack's IRA); Monitor A+ Grades; Use screens for stocks & watch fundamentals
Mid-Cap Stocks	20 %	Low cost mutual funds, ETFs & stocks (Jack's IRA); Monitor A+ Grades; Use screens for stocks & watch fundamentals
Small-Cap Stocks	15 %	Low cost mutual funds, ETFs & stocks (Jack's IRA); Monitor A+ Grades; Use screens for stocks & watch fundamentals
International Stocks	20 %	Low cost developed (15%) and Emerging (5%) mutual funds and ETFs; Monitor A+ Grades
Balanced/Target-Date Fund Portion	%	
Other: ____________	%	
Total Equity Allocation	75 %	Rebalance at start of new calendar year if more than five percentage points off target
Fixed-Income Allocation		
Short-Term	%	
Intermediate-Term	25 %	Mutual funds and ETFs; Monitor A+ Grades
Long-Term	%	
Balanced/Target-Date Fund Portion	%	
Other: ____________	%	
Total Fixed-Income Allocation	25 %	Rebalance at start of new calendar year if more than five percentage points off target
Other Assets		
	%	
	%	
	%	
Total Other Assets	0 %	
Cash Equivalents		
Checking/Savings	%	Excluded to separate short-term savings from long-term savings
Money Market	%	
CDs	%	
Total Cash Equivalents	0 %	
Total Allocation	100 %	

The couple check their mutual funds and ETFs once per quarter. They pay particular attention to the actively managed funds in Cynthia's 401(k) for any unexpected quarterly returns. They are less concerned with the performance of Jack's mutual funds and Cynthia's ETFs since both follow broad indexes. A change in the index followed would prompt them to reevaluate a mutual fund or ETF.

Jack has a preference for growth and uses the AAII stock screens to find ideas. He establishes written directives regarding his buy and sell rules. They include minimum levels of revenue and earnings growth and a cap on valuations, plus profitability and positive cash flow. Should any of his stocks no longer possess one or more of these criteria, he will sell them.

He opts to look at his individual stock holdings weekly, with a focus on any notable news that has come out. He also monitors the A+ grades on his stocks for any deterioration. He conducts a deeper dive into each stock following the release of their quarterly earnings. Any stocks that meet a sell rule are sold and replaced.

He adds all holdings to the My Portfolio tool on AAII.com, which makes tracking them easier.

Monitoring Progress Toward Goals

The final step of achieving any goal is monitoring one's progress toward it. Are you still on track to reach it? Has anything occurred that would cause you to change or alter the goal? Is there a need to lower the goal's priority relative to other goals?

Retirement is a big goal. Though the date at which it occurs can change from the intended target (either due to voluntary or involuntary reasons), there will be a time when most people do retire. As such, it is a top financial goal.

Near the end of each year, Jack and Cynthia's monitoring process starts with their savings contributions. They look at how much they saved for retirement relative to the goals they established during the previous year. In doing so, they take into consideration anything that might have caused them to miss their targets—unexpectedly large expenses, a change in employment status, etc. The couple take into consideration any change in their employer's policy for matching 401(k) contributions. If they fall short during any one year, they seek to boost their savings rates during the next year it is possible to do so.

Then at the start of each calendar year (e.g., January 1), Jack and Cynthia check the allocation of the combined accounts to ensure it is within a reasonable range of their target. They also look at the overall value of their portfolio relative to their target. Their goal is to ensure their retirement savings remain on track assuming a reasonable level of future savings contributions and portfolio returns.

The couple take the further step of reviewing their current life stage. In doing so, they consider their current health and as well as any change in their family. At the same time, Jack and Cynthia also take the time to review all of their beneficiary designations to ensure they are correct and up to date.

If no changes are necessary, they go back to their regular process. If a change in their life stage does occur—such as approaching retirement—they revisit their goals and determine if a change in their plan is needed by working through entire PRISM process again.

PRISM Helps You Reach Your Goals

The PRISM Wealth-Building Process gives Jack and Cynthia the structure for achieving their primary goal of being disciplined in building and managing their retirement savings. They now have a framework and set of self-defined rules they can use for making future investment decisions.

There is an added benefit. Research shows that those who write down and follow a plan are more successful at achieving their goals. PRISM helps you create a written plan based on your personal goals, risk tolerance and preferences.

Go to www.aaii.com/learnandplan to take advantage of the PRISM Wealth-Building Process, an AAII member benefit. If you would like us to demonstrate the PRISM process for people at other life stages, please let us know at the online version of this article (www.aaii.com/journal) in the comments section or by emailing us at journal@aaii.com. ■

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8 Factors That Influence Your Investing Management Preferences by Charles Rotblut, CFA, May 2021

Prioritizing Your Goals

The PRISM Wealth-Building Process

Prioritizing Your Goals

List of all of your financial goals below, ranked in the order of importance. Estimates can be used if there is uncertainty about the date of when the goal will be reached, its cost and/or its spending duration.

Goal	Number of Years Away	Spending Duration	Priority	Estimated Cost	Comments
			1		
			2		
			3		
			4		
			5		

Notes:

Goal is what you plan to do with money. Goals can include, but are not limited to, funding retirement, leaving an inheritance, donating to a charitable or religious organization, paying for a child's or grandchild's college, building emergency savings and paying off debt.

Number of Years Away is the amount of time between now and when the goal must be funded.

Spending Duration is the length of time you expect to spend cash on the goal.

Priority is the numerical ranking of how important each goal is.

Estimated Cost is the amount you expect you will need for the goal.

Comments are any notes about the goal you want to list.

WEALTH-BUILDING PROCESS

Why Your Goals Should Drive Your Investment Decisions

When your investment goals change, so should your strategy.

BY CHARLES ROTBLUT, CFA

When we first launched the Individual Investor Wealth-Building Process (Figure 1), I asked AAII members to consider: Why is money important? Put a different way, what is the rationale for building or maintaining wealth?

The obvious answer is "money buys things." But is the real reason you are investing to simply buy things? Chances are the real reasons go beyond what we consider material items such as a new Tesla or Mercedes.

You may want to ensure that you have a roof over your head and the ability to pay for food and medical care in retirement. You may be thinking about your children's or grandchildren's college educations. There may be a charity or other cause personal to you. Perhaps you want to leave a legacy for your heirs so they can live a better life.

Whatever your goals are, they should drive all of your investing decisions. How much you save, how much risk you take, what allocation you implement and when you start withdrawing money from your portfolio are determined by your goals. When your goals change, so should your strategy.

An analogy would be planning a trip. Say you intend to drive from Tampa Bay to Los Angeles and need to be there in a week. If this is your goal, you would start by focusing on the most direct route and where you might stay each night. You wouldn't spend time considering whether it's a good time to go to Niagara Falls because visiting it would interfere with reaching your goal.

Identifying and stating your goals brings clarity to the rest of the investment process. Once you've identified what you're investing for, it becomes easier to make other portfolio decisions. Goals allow you to know what to say yes to and what to say no to.

Goals Are Personal

Goals are personal decisions. No one can tell you what your goals are. They vary by person.

Just because someone you know is focused on leaving a large inheritance doesn't mean you should be. Perhaps you don't have kids. Maybe your children are financially independent. You could be concerned about high end-of-life expenses because Alzheimer's disease runs in your family. You may wish to give it all away to charity or spend as much as you can on travel while you are healthy enough to do so.

No one can tell you what your goals are. They vary by person.

If you're a young adult, you could also have different goals than your friends. You may be fortunate enough to have financial help from your family. You could have a high level of college debt. You might be in a high-paying field and thinking about becoming part of the Financial Independence, Retire Early (FIRE) movement. Alternatively, you could be struggling to save.

There are obviously more scenarios we could give than would fit into this article. The big takeaway in this section is that goals are personal. Because goals are personal, your investment strategy should be as well.

Consider the large amount of investment advice given. Often, it's focused on the short term. Strategists are asked how the financial markets will perform this year. Analysts are asked how a stock will perform over the next X number of months or what investors should expect from the upcoming earnings reports. Such information can give you ideas and help set expectations (rightfully or wrongfully), but the advice isn't given with your unique goals in mind.

What about the fund managers you see being interviewed? What are their timelines? They may talk about investing for the long term, but two things should be kept in mind. First, fund managers are judged on short-term results. Underperforming over just a small number of years can cause investors in a given fund to leave. Second, most funds are intended to last into perpetuity. In reality, they have far shorter actual life-spans but, suffice it to say, the investment horizon of the typical fund is different than yours.

Even target-date funds may not match up with the timing of your goal. These funds are designed to evolve their portfolio allocations from being aggressive early in

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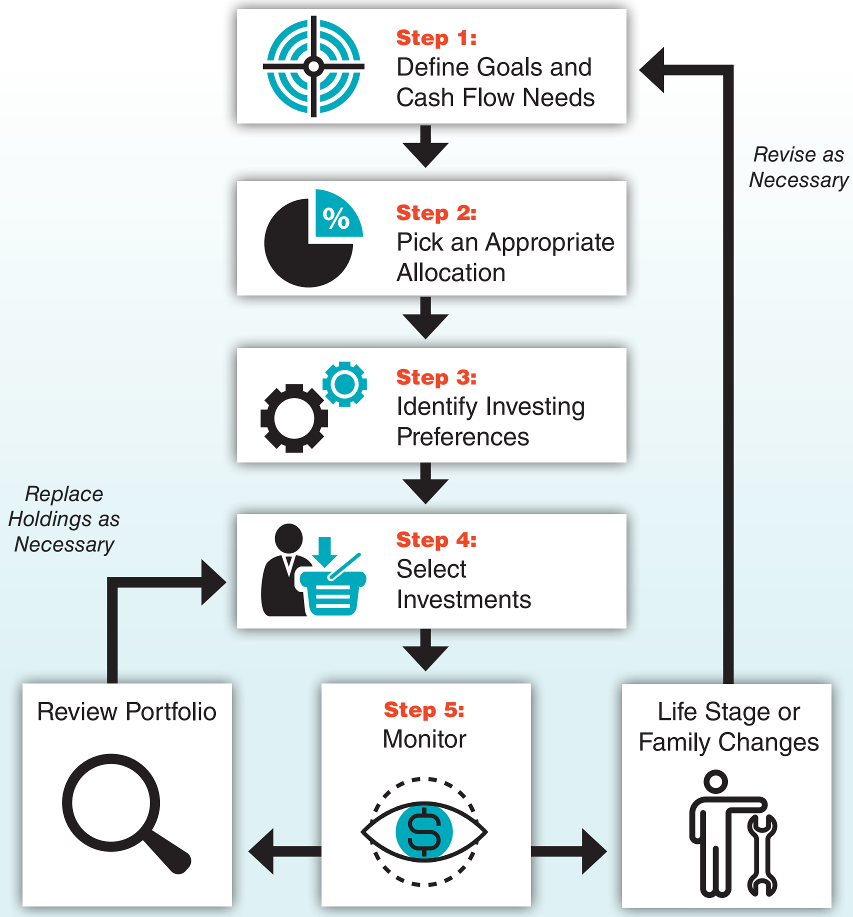
FIGURE 1

Wealth-Building Process Flowchart



an investor's career to being conservative as retirement approaches. Our research into these funds found that they differ from each other not only in their final allocations, but also in the length of time between the target (retirement) date and when they reach their final allocations. (See "A Second Look at How Target Date Funds Change Their Allocations" in the June 2016 *AAII Journal* for more information.)

None of this means you are on your own. Rather, it shows the importance of knowing what you will pull out of your investing toolbox to achieve your goals. Just as you wouldn't use a hammer to insert a screw, you shouldn't follow investment recommendations without first considering whether they are appropriate for your goals. The best strategy in the world isn't right for you if it doesn't keep you on the path to reach your goals.

When you are clear about your goals, you start viewing your investment choices through a different light. Your priorities become reaching those goals instead of trying to keep up with your neighbor or friend who likes to talk about the investments they are making. You begin to view new strategies through the lens of what you are trying to achieve. You ask, "How does this fit into my allocation?" and "Is it a good fit given what I'm trying to accomplish?" You start to worry less about what the market did today and focus more on whether you are on track given your timeline. You view your strategy in terms of the process needed to achieve your goals instead of what someone tells you it should be.

We made "Define Goals and Cash Flow Needs" the first of the five steps in the Wealth-Building Process because these decisions drive every other investing decision. When you are clear about your goals, executing the next four steps becomes easier. You have a clear purpose to consider every investing decision against.

Being clear about your goals can be empowering.

Timing: When and How Long?

The reason we place such a high emphasis on goals is their timelines. The timing of goals can be broken into two parts. The first is the amount of time until the goal is expected to be reached. The second is the duration over which you expect to spend money fulfilling the goal.

Combined, these two parts have significant influence over how you will invest (Figure 2). Setting aside money for a large one-time expense expected to be incurred within a few years requires a very conservative allocation. Saving for a goal not expected to be reached for a period of 20 years or longer requires a very aggressive allocation, especially if the goal will have a long spending duration once reached.

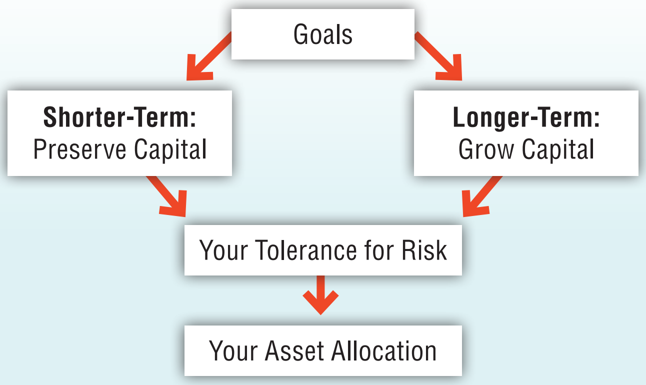
A way to think about this is the trade-off between the risk of losing capital and the risk of losing purchasing power. Consider a hypothetical millennial we used as an example when introducing our "Identify and Prioritize Your Financial Goals" worksheet (Figure 3). Elizabeth wants to both build emergency savings and start saving for retirement. Her emergency savings will cover things like deposits on a new apartment, replacing her phone or computer should they stop working and potential medical bills, among other things. This is money she should not put into the stock market because an ill-timed drop would prevent her from being able to pay for them.

The shorter the investment period, the greater the risk of a capital loss becomes. Since 1928, large-cap stocks have

FIGURE 2

The Influence of Goals on Investing Decisions

The timing of when goals will be reached and the duration over which you expect to spend money fulfilling each goal is significantly influenced by your risk tolerance, and thereby your asset allocation choices.



fallen in value once every four calendar years. The large-cap S&P 500 index has averaged a drop of at least 5% once every six months since the end of World War II. It has experienced a bear market—defined as a drop of 20% or more—approximately once every six years between 1946 and 2020.

Sequence of returns is a risk for anyone facing a short-term need for cash, like Elizabeth might with her emergency savings. Sequence of returns risk refers to the order in which returns occur. For a near-term goal with a short spending duration, a bad sequence of returns can force you to make unwanted choices. You may have to postpone your goal, cut back on your spending plans or completely abandon your goal. In the case of Elizabeth, she might have to rely on high-interest credit card debt.

The way to avoid incurring a bad sequence of returns is to invest conservatively. So-called safe assets such as savings accounts, certificates of deposit (CDs), money market funds and high-quality, short-term bond funds will protect your capital from the swings of the market.

Elizabeth's contributions to retirement savings should be fully allocated to stocks (or at least close to it, depending on her psychological tolerance for risk). Not doing so will significantly harm her future purchasing power. (Purchasing power is the ability to buy goods and services with the money you have.) A dollar saved today is not worth a dollar 10 years into the future because of the eroding effects of inflation.

Longer investment periods smooth out sequence of returns risk. The bouts of downside volatility in stocks are offset by bigger, and longer periods of, upside returns. Longer periods of time also give you the ability to benefit from compounded returns or gains upon your gains. This compounded growth is necessary to preserve your purchasing power. The further out the goal is, the more you will need to be concerned about the eroding effect inflation has.

A helpful way to think about this is the rule of 72. Dividing 72 by the projected rate of return provides an estimate of how long it will take to double your money. It can also be used to measure the impact of inflation. Say you think inflation will average 3% for an extended period of time. Such a rate of inflation will cause prices to double in less than 25 years. To offset this risk, you will need to earn at least this much just to maintain your purchasing power. If you need additional wealth to fund your goal, you'll have to earn a higher rate of return. A 7% annualized return will more than quintuple your savings over the same period.

You can change the assumptions as you please, but the big point does not change: the further out your goal is, the more important growth of capital becomes. The nearer your goal is, the more important preservation of capital becomes.

The further out your goal is, the more important growth of capital becomes.

Spending Duration

There is another timing aspect of goals: the spending duration. Spending duration is the length of time you expect to spend money on the goal. A large purchase has a very short spending duration. You may splurge on a once-in-a-lifetime vacation, like a world cruise. Retirement can have a long spending duration, especially if you are in good health and there is a history of longevity in your family. In between, there is a wide range of durations. College for a child or grandchild, for example, can be expected to last four years if graduate school isn't a consideration.

The duration of spending impacts your investing strategy because as you approach your goal, you will have to consider the timing of withdrawals. Elizabeth may need to withdraw from emergency savings without much advance notice to cover a one-time expense. For her retirement, she will be making withdrawals over a period of potentially three decades.

Those of you intending to help children or grandchildren with college costs may be looking at a four-year spending duration. This is the case for our hypothetical retired couple, Bob and Jane. They also would like to leave an inheritance. While the transfer of the couple's assets will occur on a single date (e.g., the settlement of the estate, the funding of a trust, etc.), their heirs may have a lengthy spending duration afterward. These differences influence the type of allocation needed.

FIGURE 3

Examples of Wealth-Building Process Worksheet for Identifying and Prioritizing Goal

Millennial: Elizabeth is her mid-20s, has college loans, some credit card debt and a little in savings.

Goal	Number of Years Away	Spending Duration	Priority	Estimated Cost	Comments
Build emergency savings	Now	18 months	1	$1,000	Set aside $1,000 to start
Pay off credit cards	Now	12 months	2	$1,500	Pay more than the minimum amount due
Pay down college debt	Now	15 years	3	$30,000	Increase payments after credit cards paid off
Retirement	40-45 years	30-35 years	4	$1 million	Set up 401(k); increase contributions with every raise

Retired Couple: Bob and Jane are recently retired and have children and grandchildren.

Goal	Number of Years Away	Spending Duration	Priority	Estimated Cost	Comments
Pay for retirement	Now	30 years	1	$2.5 million	Social Security and pension income should be sufficient
Help with older grandchild's college expenses	8 years	4 years	2	$50,000	Do first, but balance with younger grandchild
Help with younger grandchild's college expenses	12 years	4 years	3	$50,000	Try to proportionately match with first grandchild
Leave an inheritance	30-35 years	Zero	4	$1 million	Invest aggressively to grow for heirs

A large one-time withdrawal or a series of withdrawals over a short period of time mandates reaching the goal with a conservative allocation. A lengthy duration of spending requires striking a balance between the short-term needed to preserve capital and the long-term need to grow capital.

Prioritizing Goals

Chances are you have more than one goal. Elizabeth wants to build her emergency savings, pay off credit card debt, pay down college debt and save for retirement. Bob and Jane need to ensure their retirement expenses are covered, would like to help out with their grandchildren's college expenses and want to leave an inheritance.

Each goal has a different length of time before it is expected to be reached, as well as a different spending duration. A different sum of money will be required to fund each goal. In an ideal world, this wouldn't be an issue. The real world isn't so simple.

A good place to start is by prioritizing your goals. Which one of your goals is most important? What is second in terms of importance? What is third? Etc.

In the case of Elizabeth, building up emergency savings should take primary importance. Doing so will keep her from falling further into debt. Plus, she'll need the cash to cover things like the deposit on a new apartment.

Prioritizing one goal doesn't necessarily mean the other goals should be ignored. Elizabeth will need to pay down her credit card debt as quickly as her budget allows while also staying current with her student loan payments. It would also be wise to start saving for retirement—especially if there is an employer match—given her young age.

Each goal has a different length of time before it is expected to be reached, as well as a different spending duration.

For Bob and Jane, ensuring their retirement expenses are covered is their top priority. While helping their grandchildren may be desired, it's more important for them to ensure their own financial security. Their secondary goals can be covered by assets not needed. If the couple's expenses are covered by Social Security and pension benefits, they may be able to use their accumulated wealth to pay for their secondary goals.

When it is realistic to save for—and potentially fulfill—several goals, some complexity is added to the investment process. The approach followed will need to account for the different timelines of each goal.

A simple place to start is to use the goals worksheet to

(continued on page 36)

WEALTH-BUILDING PROCESS (CONTINUED FROM PAGE 31)

list out each goal, how far away it is, the spending duration and the estimated cost of the goal. (We've added the estimated cost of the goal to the original worksheet.) You then have two options.

The first is to allocate your overall portfolio based on the timing and duration of each goal. The larger the sum of money needed within the next few years, the more conservative your overall allocation should be. The less money needed over the next few years, the more aggressive your overall allocation can be.

The second is to use more of a bucket approach. Each goal would be assigned its own account. While this adds complexity in terms of managing accounts, it may mentally help you better manage each priority. It is akin to the envelopes approach some of you may have used for budgeting and saving.

Timing of Goals Drives Investment Decisions

As you can see, the timing of when goals will be reached and their spending durations have implications for how you will invest. Short-term goals require different allocations than long-term goals. Knowing this allows you to narrow your investment focus. Advice from pundits and friends can be filtered through the lens of "Does this fit with the decisions I need to make to achieve my goals?"

We'll come back to this inward-focusing concept as we move through each step of the Individual Investor Wealth-Building Process. It will help you to think about what your personalized investing plan should be. ■

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How Investors Can Overcome Emotional and Social Biases by H. Kent Baker, Ph.D., CFA, CMA, and Vesa Puttonen, Ph.D., May 2020

The Sequence in Which Returns Occur Affects Your Wealth by Charles Rotblut, CFA, May 2015

Target Wealth: A Better Bet for Achieving Wealth Goals by Peter A. Forsyth, Ph.D., Kenneth R. Vetzal, Ph.D., and Graham Westmacott, CFA, October 2017

Recognizing Your Risk Tolerance & Allocation

The PRISM Wealth-Building Process

Recognizing Your Risk Tolerance

Goal: ____

This worksheet will help you assess how much risk you should take to achieve a specific goal based on the timing of the goal (both when it will be reached and how long it will last) and your psychological and financial ability to withstand market volatility. Enter the number of points for each of the answers and total the scores for each section. Note: If investing for more than one goal, fill out a separate Risk Tolerance Worksheet for each goal.

Timing of Goal

How far out into the future is the goal?

Short-term — Five years or less 1 ___
Intermediate — Five to 10 years 3 ___
Long-term — More than 10 years 6 ___

Over what time period do you anticipate spending money on the goal?

Short-term — Five years or less 1 ___
Intermediate — Five to 10 years 3 ___
Long-term — More than 10 years 6 ___

Relative to your wealth, how large of a withdrawal will your goal require over a period of five years or less?

High — More than 25% of wealth 1 ___
Moderate — 10% to 25% of wealth 3 ___
Low — Less than 10% of wealth 6 ___

Timing Score (total of scores above) 0

Based on your score, your timing risk is:	
Short-term	3–5
Intermediate	6–11
Long-term	12–18

Financial and Psychological Risk

During drops in the stock market, have you:

Significantly reduced your exposure to stocks and stock funds 1 ___
Somewhat reduced your exposure to stocks and stock funds 3 ___
Maintained your allocation or bought more stocks 6 ___

How much of your spending needs are covered by non-portfolio income?

None 1 ___
Some 3 ___
All 6 ___

How would you describe your knowledge of key investing concepts?

Basic/Low 1 ___
Moderate 3 ___
High 6 ___

Financial/Psychological Tolerance Score (total of scores above) 0

Based on your score, your financial and psychological tolerance is:	
Low	3–5
Moderate	6–11
High	12–18

In the grid below, mark the box corresponding to both your timing risk score and your financial and psychological tolerance score. Then find the same box in the shaded grid to identify your risk tolerance.

Timing Risk

		Short-Term 3–5	Intermediate 6–11	Long-Term 12–18
Financial / Psychological Tolerance	Low 3–5			
	Moderate 6–11			
	High 12–18			

(Put an "X" in the box that best describes you)

Timing Risk

		Short-Term 3–5	Intermediate 6–11	Long-Term 12–18
Financial / Psychological Tolerance	Low 3–5	Very Conservative	Cons. to Mod.	Mod. to Aggr.
	Moderate 6–11	Conservative	Moderate	Aggressive
	High 12–18	Cons. to Moderate	Mod. to Aggr.	Aggressive

Risk Tolerance Definitions

Very Conservative: No ability to withstand market swings; will need to withdraw a significant amount of money from portfolio/savings in less than five years; spending on goal not covered by other sources of income; little to no understanding of key investing concepts

Conservative: Limited ability to withstand market drops of up to 15% without panic; limited sources of income beyond portfolio/savings to spend on goal; will need to withdraw money within five years to 10 years; basic understanding of key investing concepts

Moderate: Ability to withstand market drops of up to 20% to 25% without panic; will/may need to begin withdrawing money from portfolio/savings within 10 years; portfolio withdrawals relative to wealth are moderate; some sources of income outside of portfolio help cover spending on goal; generally understand key investing concepts

Aggressive: No need to take withdrawals in the short-term or shorter-term withdrawals are low relative to wealth; non-portfolio income can cover a significant portion of spending needs; ability to handle market swings without panic; possess understanding of key investing concepts

Note: If investing for more than one goal, fill out a separate Risk Tolerance Worksheet for each goal.
Goals should be listed on the Identifying and Prioritizing Your Financial Goals Worksheet

WEALTH-BUILDING PROCESS

How Much Risk Can You Handle and Still Meet Your Goals?

An investor's overall tolerance can be determined both by the timing of their goals and financial and psychological factors.

BY CHARLES ROTBLUT, CFA

What is risk?

From a financial standpoint, it could be simply defined as not having the money available to spend at the time you need to spend it. From an investing standpoint, AAII founder James Cloonan described it as "the likelihood that when we must withdraw assets from our portfolio, they will have a lower value than we could reasonably expect based on our investment strategy."

The definitions overlap. Both have implications for how you should invest.

The Risk of Not Having Enough Money

Not having the money that you need at the time you need it can be caused by several factors. A big one is simply not saving enough. If you have not adequately saved for your goal and lack enough wealth and/or cash flow from other sources to pay for it, you're not going to be able to afford it. Failing to build up and preserve adequate savings will require an adjustment to the timing of when the goal will be realized or a reassessment of the goal itself.

Beyond not making large enough contributions to savings over a long enough time period and avoiding unplanned withdrawals, there are other factors influencing the risk of not having enough when you need it.

An ill-timed correction or bear market near the time withdrawals are planned can potentially be damaging.

One is the sequence in which returns occur. An ill-timed correction or bear market near the time withdrawals are planned can potentially be damaging. Such a market event reduces your wealth at the very time you need to be at a certain level to fund the goal. It is possible to reduce the impact of sequence of return risk through portfolio allocation. One example would be to invest part of the portfolio in so-called "safe assets."

***Charles Rotblut**, CFA, is a vice president at AAII and editor of the* AAII Journal. *Find out more at www.aaii.com/authors/charles-rotblut and follow him on Twitter at twitter.com/CharlesRAAII.*

Following too conservative of an allocation for too long of a time period creates a different type of risk. Failure to adequately grow your portfolio's value could also leave you short of your goal, leaving you with less wealth than is needed.

Part of the reason being too conservative is a risk has to do with purchasing power. Purchasing power is the ability to buy goods and services with the dollars you have. Over time, inflation—even low levels of inflation—erodes your purchasing power. The longer the time between now and when your goal will be completely funded, the more important it becomes to realize a long-term return in excess of the rate of inflation. The annualized rate of return has to be high enough to grow your portfolio in both absolute size and above the rate of inflation.

An aggressive allocation is not the correct strategy in all situations. Dollars needed within a few years should be invested conservatively because of the sequence of returns risk. There simply is not enough time to recover from an ill-timed drop.

Behavior and the Risk of Having Less Than Reasonably Expected

Mismatching one's allocation relative to their goals is one type of psychological risk incurred by investors. Getting greedy by seeking out a higher return on dollars needed soon can leave you short-handed. Conversely, conservatively allocating dollars not needed for many years into the future based on shorter-term trends can have a damaging long-term impact on your wealth.

Often what deters investors from adhering to a long-term strategy is volatility. Volatility, as you know, is the fluctuation in prices and portfolio returns. Nobody minds when volatility sends the value of their portfolio upward. Downward volatility is often noticed and rarely welcomed.

Cloonan used the term "phantom risk" to describe volatility. In his book, "Investing at Level3," Cloonan observed that "for the long-term investor … it would seem that there is no concern with volatility." He also believed that volatility creates opportunities "because high volatility leads to greater long-term returns."

However, the threat of volatility wasn't ignored. Cloonan acknowledged the ability of downside volatility to cause investors to abandon their long-term investment strategies. "It increases the chances of sub-optimal behavior, primarily selling out at cycle lows," wrote Cloonan.

Morningstar and Dalbar have tracked the returns of mutual funds and the returns realized by investors who have invested in them (aka the behavior gap). Though the methodology used for calculating the behavior gap varies between the two firms, the conclusion is the same: The returns realized by many investors are often worse than the performance of the very funds they invest in. Figure 1 shows this data, along with notes about it.

Assessing Your Personal Risk Tolerance

To help AAII members determine their tolerance for risk, we created a simple worksheet of six questions as part of the Individual Investor Wealth-Building Process (Figure 2). It will help you determine how much risk you should take to achieve a specific goal based on the timing of the goal, your wealth and your investing persona.

There are two parts to the worksheet. The first focuses on the timing of your goal. The second focuses on your financial and psychological ability to tolerate risk. We separated them because they represent different aspects of risk. A person can be completely comfortable with turbulent market conditions from a psychological standpoint but if they need the money within a few years, then an aggressive allocation could put them at high risk of incurring a shortfall of wealth. Conversely, a person could have a very long investing time horizon, but also be very uncomfortable with market volatility. For such a person, a more moderate allocation may be more useful if it keeps them from panicking.

I discuss all six questions that make up the worksheet below. By sharing the rationale for including each question, I hope to give you have a better understanding of where investing risk may appear and how each of these components of risk may impact your allocation decisions.

I also include examples of hypothetical investors to demonstrate how these components of risk can impact the decisions and challenges that real investors face.

Timing of Goal

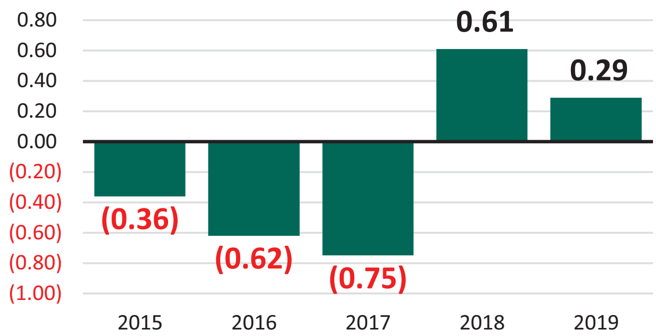
The following three questions about the timing of goals help to assess when you will need to spend money on your goals. Combined, they consider when the goal is expected to be reached, whether the goal is a one-time event or will last over several years and how much of your wealth you expect to spend on it.

FIGURE 1

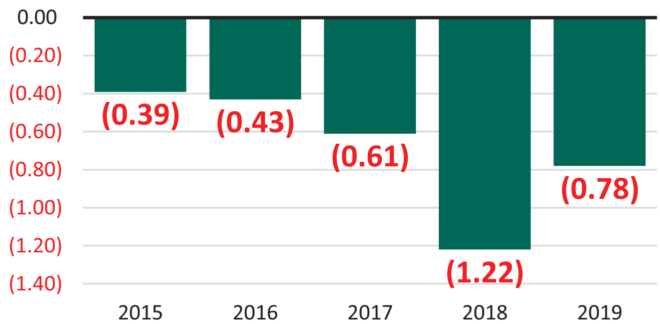
The Behavior Gap

These charts show the trend in the 10-year behavior gap for large-cap equity funds and taxable bond funds as calculated by Morningstar. The behavior gap is the difference in returns between what funds realize and the returns investors in those funds realized.

U.S. Equity Funds: 10-Year Behavior Gap



Taxable Bond Funds: 10-Year Behavior Gap



As you can see, for most periods the returns for investors were lower than the funds they invested in—a negative gap. The positive gaps in equity funds for 2018 and 2019 reflect a combination of 2008 dropping out of the data, a lengthy bull market and the sheer size of the group, which Morningstar says helped to "buffer the impact of any cash inflows or outflows."

Negative behavior gaps can be attributed to investor behavior. When investors fail to follow a long-term allocation, their actions often lead to lower returns. The impact of short-term trading is most evident in sector funds, which incurred a behavior gap of –1.35 percentage points in 2019.

Source: "Mind the Gap 2020: A Report on Investor Returns in the United States," Morningstar, August 18, 2020.

How many years away is the goal?

This first question is very simple: When do you expect your goal to be reached?

Some goals will have very clear dates. College is one such example. Consider Sue and Frank. Their second child was just born. They expect her to go to college right after high school. Based on this, they can plan on having to start paying for the goal 18 years into the future.

Others are not as certain. Bequests are one such goal. Bob and Jane, a recently retired couple, would like to leave an inheritance to their family. Obviously, they don't know when they'll die. They can make an approximate guess based on their health, family history and average life-span. At age 66, they may live for at least another 20 years, if not more. The number isn't exact, nor does it need to be. Bob and Jane can simply establish the expectation of their estate not being passed on to their heirs for a long time (assuming no planned gifting in between now and then).

We established three time periods on the worksheet to answer this question. The first is five years or less, including now. The short-term nature of this spending implies a very low tolerance for risk because there is no time to recover from sudden drops in the stock market.

The second is intermediate: five to 10 years from now. This time frame allows for some recovery from the stock market downturns but potentially not enough to fully recover savings lost to downside volatility. Since World War II, bear markets—defined as a drop of at least 20% in the S&P 500 index—have occurred once every six years on average. Excluding the unusually short coronavirus drop, bear markets have taken an average of 18 months to reach bottom. Though the actual length varies, short bear markets have averaged more than two years in total length while long bear markets have lasted more than three years on average, according to calculations by Sam Stovall at CFRA.

The third is long term. We define the long term as periods longer than 10 years. There is still a chance of losing money, but it is small. It is possible to extend this time frame.

Over what time period do you anticipate spending money on the goal?

Put another way, what is the duration of the goal? Whereas the first question asked when the goal will be reached, this second question asks over what time period you expect to spend money on the goal.

Bob and Jane's bequests will occur on a single date. Once the estate is settled or ownership or the assets are otherwise transferred, the goal will be fulfilled. Similar examples include the purchase of a vacation house, a dream vacation or splurging on a luxury car. These are either single transactions or ones that occur over a very short period of time.

Other goals will require years of spending. Let's consider Elizabeth. She is in her mid-20s and starting to save for retirement. She'd be prudent to assume retirement lasts 25 years or longer. Put another way, Elizabeth's goal of retiring one day comes with a long duration of spending. She'll have to balance her need for shorter-term withdrawals in retirement with the longer-term requirement of ensuring that her savings continue to grow at a rate faster than inflation.

The same time frames are used for spending duration as for reaching the goal: short (less than five years), intermediate (five to 10 years) and long (over 10 years).

Relative to your wealth, how large of a withdrawal will your goal require over a period of five years or less?

While timing matters, so does proportionate size. Needing $20,000 out of a $2 million portfolio is different than needing $20,000 out of a $50,000 portfolio. The withdrawal amount equates to 1% of the bigger portfolio but 40% of the smaller portfolio.

Two well-known life events will put this into additional perspective. At retirement, the withdrawals over the first few years will not be large relative to the total amount saved. College expenditures will consume everything saved over a short period for most families.

There is a rule at play here. Your ability to take risk is inversely related to the amount you need to withdraw relative to the size of your portfolio. The smaller the percentage of your total portfolio you need to withdraw, the more risk you can take. The larger the percentage of your total portfolio you need to withdraw, the less risk you can take.

One way to think about this is how much will be left in your portfolio to recover should the market drop near the time you need to take withdrawals? The more you need to withdraw, the less there will be left to benefit from the rebound in asset prices.

Financial and Psychological Factors

These three questions measure your ability to tolerate market fluctuations and changes in the value of your portfolio. They will help you assess how comfortable you are with volatility. They also provide feedback on whether you are more or less likely to panic when the next market downturn occurs.

During drops in the stock market, have you (reduced, maintained or increased your exposure to equities)?

This question prompts you to consider your past

FIGURE 2

Wealth-Building Process: Assessing Your Risk Tolerance

Goal: ____________________

This worksheet will help you assess how much risk you should take to achieve a specific goal based on the timing of the goal (both when it will be reached and how long it will last) and your psychological and financial ability to withstand market volatility. Enter the number of points for each of the answers and total the scores for each section. See the online article for an interactive spreadsheet. Note: If investing for more than one goal, fill out a separate Risk Tolerance Worksheet for each goal.

Timing of Goal

How far out into the future is the goal?
Short-term — Five years or less 1 ___
Intermediate — Five to 10 years 3 ___
Long-term — More than 10 years 6 ___

Over what time period do you anticipate spending money on the goal?
Short-term — Five years or less 1 ___
Intermediate — Five to 10 years 3 ___
Long-term — More than 10 years 6 ___

Relative to your wealth, how large of a withdrawal will your goal require over a period of five years or less?
High — More than 25% of wealth 1 ___
Moderate — 10% to 25% of wealth 3 ___
Low — Less than 10% of wealth 6 ___

Timing Score (total of scores above) ___

Based on your score, your timing risk is:
Short-term 3–5
Intermediate 6–11
Long-term 12–18

Financial and Psychological Risk

During drops in the stock market, have you:
Significantly reduced your exposure to stocks and stock funds 1 ___
Somewhat reduced your exposure to stocks and stock funds 3 ___
Maintained your allocation or bought more stocks 6 ___

How much of your spending needs are covered by non-portfolio income?
None 1 ___
Some 3 ___
All 6 ___

How would you describe your knowledge of key investing concepts?
Basic/Low 1 ___
Moderate 3 ___
High 6 ___

Financial/Psychological Tolerance Score (total of scores above) ___

Based on your score, your financial and psychological tolerance is:
Low 3–5
Moderate 6–11
High 12–18

In the grid below, mark the box corresponding to both your timing risk score and your financial and psychological tolerance score. Then find the same box in the shaded grid to identify your risk tolerance.

Timing Risk

Financial / Psychological Tolerance		Short-Term 3–5	Intermediate 6–11	Long-Term 12–18
	Low 3–5			
	Moderate 6–11			
	High 12–18			

(Put an "X" in the box that best describes you)

Timing Risk

Financial / Psychological Tolerance		Short-Term 3–5	Intermediate 6–11	Long-Term 12–18
	Low 3–5	Very Conservative	Cons. to Mod.	Mod. to Aggr.
	Moderate 6–11	Conservative	Moderate	Aggressive
	High 12–18	Cons. to Moderate	Mod. to Aggr.	Aggressive

behavior. Ideally, before answering it, you'll review your past brokerage records to see what you actually did during past downturns.

The question is a twist on what appears on risk questionnaires given by brokerage firms and advisers. These questionnaires ask how comfortable you would be if your portfolio fell by X% in value. Unfortunately, the answer you give will be heavily influenced by how comfortable or nervous you are about current market conditions.

Your past brokerage statements shed light on how you've previously behaved. Could your behavior have changed between then and now? Yes, but until the next downturn occurs, you won't know for sure. This is why it's important to consider actual behavior as opposed to predicted behavior.

Behavior is a risk because panicking could prompt you to sell at a market bottom, locking in losses. Past behavior can also be a sign of your ability to handle volatility. If you have been stoic in the face of market downturns or viewed them as an opportunity to buy stocks at discounted prices, you are better able to handle a more aggressive allocation.

How much of your spending needs for the goal are/will be covered by non-portfolio income?

Whereas the proportionate amount you need to withdraw is a timing risk, the amount of cash flow you have (or don't have) helps to determine your financial risk. The more reliant you are on savings to fund your goal, the less short-term volatility you will be able to withstand. Conversely, the greater your non-portfolio cash flow, the less volatility should matter.

Let's go back to our recently retired couple, Bob and Jane. If their pension and Social Security benefits are large enough to cover their living expenses, then fluctuations in the value of their retirement savings won't have a big impact. No matter what happens to the market, they have guaranteed sources of income to rely on.

Elizabeth is in a very different boat when it comes to her short-term savings. If she, like many her age, are balancing college loans and, potentially credit card debt, along with an early-career salary, she'll have very little ability to handle risk with her short-term savings. She will need to have these dollars available anytime there is a large expense, such as a medical bill or a deposit on a new apartment.

How would you describe your knowledge of key investing concepts?

Understanding how the financial markets act over time reduces the temptation to react to both upside and downside volatility. It also enables you to better set your expectations for how certain assets will perform.

If Elizabeth is new to investing, she might not understand what the funds she chooses are designed to do. For example, a drop in her target-date fund's value might catch her off guard because she doesn't realize that it's heavily allocated to stocks by design given her age. This lack of knowledge may cause her to be more reactive to market moves.

An educated investor who has taken the time to read market history will bring a different perspective. They will view corrections and bear markets as a normal part of the investing cycle. They'll understand how changes in interest rates can drive bond prices up or down. They'll naturally expect correlations between domestic and international stocks to increase during turbulent periods and decrease afterward. This knowledge can lead them to be less reactive to market conditions.

Your Personal Tolerance for Risk

As shown in Figure 2, the answers for each question are assigned point values of 1, 3 or 6. Higher scores imply greater tolerance while lower scores imply lower tolerance. An investor's overall tolerance is determined both by the timing of their goals and the financial and psychological factors. Depending on the combination of both, a suitable portfolio allocation can range from very conservative to aggressive.

You can see how we define risk tolerances at the bottom of Figure 2. Our allocation models (www.aaii.com/asset-allocation) provide examples of how to implement such strategies.

Risk Tolerance for Multiple Goals

If you have more than one goal, we suggest filling out a different risk worksheet for each goal. Doing so will allow you to align your allocation needs based on the timing and wealth needed for each goal.

This particularly works well if you segment your portfolio accordingly. An example would be a married couple who is saving for retirement via their 401(k) plans and IRAs while using a 529 savings plans to save for their children's college education. ■

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Why Your Goals Should Drive Your Investment Decisions by Charles Rotblut, CFA, January 2021

Stock Market Retreats and Recoveries by Sam Stovall, October 2017

How Investors Can Overcome Emotional and Social Biases by H. Kent Baker, Ph.D., CFA, CMA, and Vesa Puttonen, Ph.D., May 2020

Recognizing Your Allocation

Goal: ____

Risk Tolerance for Goal: ____

The goal you are attempting to achieve and your corresponding tolerance for risk for that goal should help you identify the appropriate allocation to use.

To help you determine what that allocation is, the AAII Asset Allocation Models are presented below. These models have long served as guidelines that individual investors can use to help construct appropriate portfolios.

You can select one of these models or, alternatively, enter in your preferred allocation manually in the form below.

	Aggressive Investor	**Moderate Investor**	**Conservative Investor**
	90% Diversified Stock	**60%** Diversified Stock	**40%** Diversified Stock
Time Horizon	**20+ Years:** Long Investment Horizon	**15+ Years:** Mid-Term Investment Horizon	**10+ Years:** Short-Term Investment Horizon
	For investors who are very risk tolerant	***For investors who can tolerate some risk***	***For investors who are not risk tolerant***
Characteristics			
Growth:	Substantial	Moderate	Low
Income:	Very Low	Low	Moderate
Risk:	Substantial Year-to-Year Volatility of Portfolio Value	Moderate Year-to-Year Volatility of Portfolio Value	Low Year-to-Year Volatility of Portfolio Value
Average Annual Growth in Value	**8%**	**7%**	**6%**
Bad Year	**-37%**	**-21%**	**-12%**
Allocations	**10%** Fixed Income **90%** Diversified Stock	**40%** Fixed Income **60%** Diversified Stock	**60%** Fixed Income **40%** Diversified Stock
	Select ☐	Select ☐	Select ☐

Your Customized Portfolio Allocation

Equities	**Portfolio Allocation**
Large-Cap Stocks	
Mid-Cap Stocks	
Small-Cap Stocks	
International Stocks	
Balanced/Target-Date Fund Portion	
Other:	
Total Equity Allocation	0 %

Fixed-Income Allocation	
Short-Term	
Intermediate-Term	
Long-Term	
Balanced/Target-Date Fund Portion	
Other:	
Total Fixed-Income Allocation	0 %

Other Assets	
Total Other Assets	0 %

Cash Equivalents	
Total Cash Equivalents	%

Buffer Assets	**Dollar Value**
Cash	
Reverse Mortgage	
Whole Life Insurance	

Rules for Using and Replenishing Buffer Assets

____

____

____

____

WEALTH-BUILDING PROCESS

The Building Blocks of a Successful Portfolio Allocation

The mix of assets held primarily determines the returns you will realize. The other keys are sticking to your strategy and making periodic adjustments to keep your allocations at the desired level.

BY CHARLES ROTBLUT, CFA

Allocation may be the most important decision an investor makes. The mix of assets held—and the percentage of the portfolio allocated to each asset class and categories within each asset class—primarily determines the returns you will realize. One study put the influence that allocation has on portfolio returns at 90%.

Though the actual magnitude of the influence has been debated, one thing remains clear: Your returns and your ability to fund goals are directly influenced by both your choice of and how consistently you stick with an allocation strategy. To grow wealth, greater exposure to equities and the tolerance to put up with their volatility is required. Shorter-term goals require a greater emphasis on preserving wealth. Such needs call for a greater exposure to less volatile assets. This is because an ill-timed drop in stocks can cause the goal to be missed.

Beyond time, your financial and psychological tolerance also play a role in determining the proper allocation.

Beyond time, your financial and psychological tolerance also play a role in determining the proper allocation. Where many investors fail is not following an allocation appropriate for their risk tolerance. Allocation strategies only work as well as your ability to stick with them. An allocation strategy with a somewhat lower expected rate of return can result in greater long-term wealth if you are able to consistently stick with it. More wealth will, of course, be realized by consistently following an aggressive allocation.

APRIL IS: Financial Capability Month

In this article, we discuss the role of three key building blocks to a successful allocation strategy: stocks, bonds and cash. Though other asset classes can be incorporated, it's important for most investors to focus first on getting the basic of mix of these three asset classes right over the long term. We also discuss the AAII Asset Allocation Models and offer suggestions on how to implement them in real-world portfolios using mutual funds, exchange-traded funds (ETFs) and individual securities.

Diversification Reduces the Odds of Being Wrong

A key component of allocation is diversification. Diversification is holding a mix of different investments. By diversifying, you limit your odds of being completely wrong in your investment decisions.

There are two major types of risk that diversification helps to mitigate.

The first is systematic risk. This is more commonly known as market risk. It is the risk all investors take by simply doing something with their money. Changes in the economy, adjustments to monetary policy, inflation trends, natural disasters, war and bear markets are among the many causes of systematic risk. It can't be avoided, though the types of systematic risk an investor is exposed to can be controlled through the choice of assets held. Stocks, for instance, will do well when the economy is growing. Bonds can rise when there is fear about the economy slowing.

Investors are compensated for systematic risk through higher returns. Stocks have historically outperformed bonds by a wide margin because they have more volatile returns. Similarly, bonds have outperformed cash because they require investors to part with their dollars for a longer period of time.

The second type of risk is idiosyncratic risk. This is the risk of a particular investment falling in value. An example would be shares of a company whose CEO makes bad business decisions. It can also be bonds of an issuer who defaults. At the portfolio level, it could be a choice to overweight an asset class group that goes out of favor.

Systematic risk can be reduced by diversifying across asset classes. Idiosyncratic risk can be reduced by holding a mix of different investments as well as by holding different asset class groups.

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FIGURE 1

Annual Returns for Each Asset Class Group (2007–2020)

The chart below shows the annual returns for each of the asset class groups used in the AAII Asset Allocation Models. The asset class groups are sorted in descending order of return (left to right) for each calendar year. As you can see, the best-performing asset class frequently changed from year to year, demonstrating the benefits of diversification.

2007	Emerging Markets Stocks 38.9%	International Stocks 13.1%	Intermediate Bonds 10.0%	Short-Term Bonds 7.9%	Mid-Cap Stocks 7.6%	Large-Cap Stocks 5.4%	Small-Cap Stocks 1.2%
2008	Intermediate Bonds 13.3%	Short-Term Bonds 6.7%	Small-Cap Stocks –36.1%	Mid-Cap Stocks –36.5%	Large-Cap Stocks –37.0%	International Stocks –42.0%	Emerging Markets Stocks –52.8%
2009	Emerging Markets Stocks 76.0%	Mid-Cap Stocks 37.0%	Small-Cap Stocks 36.1%	International Stocks 29.2%	Large-Cap Stocks 26.5%	Short-Term Bonds 1.4%	Intermediate Bonds –1.7%
2010	Small-Cap Stocks 27.7%	Mid-Cap Stocks 26.0%	Emerging Markets Stocks 18.9%	Large-Cap Stocks 14.9%	Intermediate Bonds 7.4%	International Stocks 6.6%	Short-Term Bonds 2.6%
2011	Intermediate Bonds 9.8%	Short-Term Bonds 2.3%	Large-Cap Stocks 2.0%	Mid-Cap Stocks –2.2%	Small-Cap Stocks –2.8%	International Stocks –11.7%	Emerging Markets Stocks –18.8%
2012	International Stocks 18.9%	Emerging Markets Stocks 18.6%	Small-Cap Stocks 18.0%	Mid-Cap Stocks 17.2%	Large-Cap Stocks 15.8%	Intermediate Bonds 2.7%	Short-Term Bonds 0.7%
2013	Small-Cap Stocks 37.6%	Mid-Cap Stocks 32.9%	Large-Cap Stocks 32.2%	International Stocks 21.6%	Short-Term Bonds –0.1%	Intermediate Bonds –3.1%	Emerging Markets Stocks –5.2%
2014	Large-Cap Stocks 13.5%	Mid-Cap Stocks 9.4%	Small-Cap Stocks 7.4%	Intermediate Bonds 4.3%	Short-Term Bonds 0.7%	Emerging Markets Stocks 0.4%	International Stocks –5.7%
2015	Intermediate Bonds 1.5%	Large-Cap Stocks 1.3%	Short-Term Bonds 0.5%	International Stocks –0.9%	Mid-Cap Stocks –2.6%	Small-Cap Stocks –3.8%	Emerging Markets Stocks –15.5%
2016	Mid-Cap Stocks 20.2%	Small-Cap Stocks 18.2%	Large-Cap Stocks 11.8%	Emerging Markets Stocks 11.5%	Intermediate Bonds 1.2%	International Stocks 1.1%	Short-Term Bonds 1.1%
2017	Emerging Markets Stocks 31.2%	International Stocks 25.3%	Large-Cap Stocks 21.7%	Small-Cap Stocks 16.1%	Mid-Cap Stocks 15.7%	Intermediate Bonds 1.6%	Short-Term Bonds 0.4%
2018	Short-Term Bonds 1.4%	Intermediate Bonds 1.0%	Large-Cap Stocks –4.5%	Small-Cap Stocks –9.4%	Mid-Cap Stocks –11.5%	International Stocks –13.3%	Emerging Markets Stocks –14.7%
2019	Large-Cap Stocks 31.3%	Small-Cap Stocks 27.2%	Mid-Cap Stocks 25.6%	International Stocks 21.9%	Emerging Markets Stocks 20.1%	Intermediate Bonds 6.3%	Short-Term Bonds 3.6%
2020	Small-Cap Stocks 19.0%	Large-Cap Stocks 18.3%	Emerging Markets Stocks 15.1%	Mid-Cap Stocks 13.1%	Intermediate Bonds 8.2%	International Stocks 8.1%	Short-Term Bonds 4.0%

Prior to December 2020, the following mutual funds were used as proxies for calculating historical performance: Vanguard 500 Index Investor Class (VFINX), BNY Melon Mid Cap Index Investor Class (PESPX), Vanguard Small Cap Index Investor Class (NAESX), Schwab International Index (SWISX), Vanguard Emerging Markets, Stock Index Investor Class (VEIEX), Vanguard Intermediate-Term Treasury Investor Class (VFITX) and Vanguard Short-Term Treasury Investor Class (VFISX).
As of December 2020, the following funds are used to calculate historical performance: Vanguard 500 Index Admiral Shares (VFIAX), Vanguard Admiral Mid-Cap Index Fund Admiral Shares (VIMAX), Vanguard Small Cap Index Admiral Shares (VSMAX), Vanguard Developed Markets Index Fund Admiral Shares (VTMGX), Vanguard Emerging Markets Stock Index Admiral Shares (VEMAX), Vanguard Intermediate-Term Treasury Investor Class (VSIGX) and Vanguard Short-Term Treasury Admiral Shares (VFISX).
Source: Morningstar, Inc.

Figure 1 demonstrates how diversification has helped an investor reduce both types of risk. Each asset class group is color-coded so that you can more easily track them from year to year.

As you look at the chart, one thing should jump out—the lack of a consistent leader. The top-performing asset class group (left-most column) frequently changed. Since crystal balls are always cracked, diversification reduces the risk of being wrong. The flip side of this coin is that by diversifying, you increase the odds of being exposed to the right asset class group at the right time.

The Role of Stocks

Stocks provide growth of wealth. More specifically, stocks provide growth of wealth in excess of the rate of inflation.

This is important to ward off the deteriorating effect inflation has on purchasing power. Purchasing power is our ability to buy goods and services with the dollars we have. If our savings grow at a rate slower than inflation, more and more money will need to be spent relative to our wealth to buy the same goods and services. Over the short term this may not be noticeable, but over the long term, purchasing power can be significantly compromised—even at low inflation rates.

Historically, stocks have been exceptional inflation fighters. Between the period of 1926 and 2019, large-cap stocks returned 10.2%. Small-cap stocks returned 11.9%. Inflation over the same period was 2.9% on an annualized basis.

The "price" of realizing this growth was higher volatility. Data from the Ibbotson Stocks, Bonds, Bills, and Inflation (SBBI) 2020 Yearbook shows the typical annualized volatility in monthly returns for large-cap stocks over the past five decades ranging from a low of 14.1% in the 2010s to a high of 19.4% in the 1980s. The volatility of returns was even higher for small-cap stocks. It ranged from 19.6% in the 2010s to 30.8% in the 1970s. Stock prices fluctuate … sometimes by significant amounts.

To achieve the higher long-term returns realized by stocks, investors need the wherewithal to put up with the volatility of stocks. This is why the Individual Investor Wealth-Building Process asks you to identify your goals and risk tolerance before deciding upon an allocation (www.aaii.com/learnandplan).

To achieve the higher long-term returns realized by stocks, investors need the wherewithal to put up with the volatility of stocks.

Holding different types of stocks can reduce some of the volatility. As Figure 1 shows, the category of stocks with the best and worst returns varies on a calendar-year basis. In addition, stock groups can experience serial returns—consecutive years when they outperform or underperform.

The AAII Asset Allocation Models use five different categories of stocks: domestic large-cap, mid-cap and small-cap as well as international and emerging markets.

» Large-cap stocks are large, well-established companies; are typically what people refer to when discussing "the market" (the S&P 500 index covers about the 80% of the U.S. market capitalization per S&P Dow Jones Indices); and may pay dividends (not all do).

» Mid-cap stocks have market capitalizations ranging between approximately $3 billion and $10 billion; tend to have achieved a certain level of stability and maturity; may have room to grow and expand; offer the possibility for higher returns than large-cap stocks, though with more volatility and generally less dividend income.

» Small-cap stocks have market capitalizations below $3 billion (stocks below $1 billion are classified as micro-cap); offer even greater long-term performance but with great volatility; and can be less established, have a narrower business focus or be more prone to economic swings than their larger peers.

» International developed stocks are from the more stable and established economies (Europe, Great Britain, Canada, Japan, etc.); may be affected by economic and market trends that differ from those of the U.S.; incur currency risks; and include well-known global and regional conglomerates.

» International emerging markets stocks are from younger and less developed economies; offer more opportunities for growth but also may be exposed to greater economic, political and currency risk; and tend to be more volatile.

The Role of Bonds

Bonds can provide preservation of wealth plus a stream of income.

Bonds are debt instruments. They represent a loan (typically $1,000 per bond, known as par value) with fixed interest payments (coupons) and a set date for repayment (maturity). These characteristics make it possible to calculate the return of a bond from purchase to its maturity. This certainty is a big part of what makes bonds less volatile than stocks.

Two primary factors influence a bond's price:

» Inflation: Anticipated changes—and thereby changes in interest rates—alter how much investors are willing to pay for a bond (more when interest rates are falling; less when interest rates are rising).

» Credit quality: Investment-grade bonds command comparatively higher prices because they are perceived to have a low risk of defaulting on their debt obligations. Non-investment-grade (aka, high-yield or junk) bonds trade at lower prices because they have a higher perceived risk of defaulting.

If the role of bonds in a portfolio is to reduce the overall level of volatility and risk, investment-grade bonds should be favored. Such bonds will be less affected by economic and business cycle downturns—two events that can also adversely impact stock prices.

Short-term and intermediate-term bonds are used by AAII's Asset Allocation Models. Short-term bonds are those maturing in three years or less. Intermediate-term bonds mature within three to 10 years. Relative to long-term government bonds, intermediate-term government bonds have realized a little less in annualized returns (5.1% versus 5.5%) but experienced even less volatility (5.2% versus 6.0%), according to the Ibbotson SBBI 2020 Yearbook.

Cash Equivalents Can Provide Liquidity

An alternative to holding short-term bonds would be to use so-called cash equivalents. These include money market funds, certificates of deposit (CDs) and high-yield savings accounts.

Cash holdings are not subject to changes in the bond market or the stock market. The interest you receive will change but not the absolute value of the dollars you deposited. On the other hand, the interest rates paid are often close to or below the rate of inflation. Over time, the value of your cash holdings will decrease in relative terms as the purchasing power of each dollar deteriorates. So while holding cash-like assets for shorter-term needs makes sense, cash is not a good asset for goals expected to be reached well into the future.

Three AAII Asset Allocation Models

The AAII Asset Allocation Models are displayed in Figure 2. They can also be accessed at www.aaii.com/asset-allocation.

Each model applies to investors with different levels of risk tolerance. Historically, investing time horizons of approximately 20, 15 and 10 years, respectively, have been presented as guidelines to avoid a chance of loss for the respective models. Investors willing to accept some risk of an extended period of bad returns can shorten those periods. For example, the moderate portfolio allocation has had a low—but not completely zero—chance of incurring a loss on a 10-year basis.

The moderate and conservative allocation models were

FIGURE 2

Breakdown of the Three AAII Asset Allocation Models

	Aggressive Investor	Moderate Investor	Conservative Investor
	90% Diversified Stock	**60%** Diversified Stock	**40%** Diversified Stock
Suggested Allocation Breakdowns			
Large-Cap Stocks	**20%**	**20%**	**20%**
Mid-Cap Stocks	**20%**	**15%**	**10%**
Small-Cap Stocks	**20%**	**10%**	**0%**
International Stocks	**20%**	**15%**	**10%**
Emerging Markets Stocks	**10%**	**0%**	**0%**
Intermediate Bonds	**10%**	**30%**	**40%**
Short-Term Bonds	**0%**	**10%**	**20%**
Allocations			
Fixed Income	**10%**	**40%**	**60%**
Diversified Stock	**90%**	**60%**	**40%**

Source: AAII.com, www.aaii.com/asset-allocation.

Sample Mutual Funds and ETFs for Implementing the Asset Allocation Models

As of December 2020, the following mutual funds used to track the models are:

- » Large-cap stocks: Vanguard 500 Index Admiral Shares (VFIAX)
- » Mid-cap stocks: Vanguard Admiral Mid-Cap Index Fund Admiral Shares (VIMAX)
- » Small-cap stocks: Vanguard Small Cap Index Admiral Shares (VSMAX)
- » International stocks: Vanguard Developed Markets Index Fund Admiral Shares (VTMGX)
- » Emerging market stocks: Vanguard Emerging Markets Stock Index Admiral Shares (VEMAX)
- » Intermediate-term bonds: Vanguard Intermediate-Term Treasury Investor Class (VSIGX)
- » Short-term bonds: Vanguard Short-Term Treasury Admiral Shares (VFISX)

Other mutual funds that can be used for implementing the allocation models can be found in AAII's mutual fund guide (February 2021 *AAII Journal*; online at www.aaii.com/guides/mfguide).

Exchange-traded funds (ETFs) that can serve as proxies for the allocation models include, but are not limited to:

- » Large-cap stocks: Vanguard S&P 500 (VOO)
- » Mid-cap stocks: Vanguard Mid-Cap ETF (VO)
- » Small-cap stocks: Vanguard Small Cap Index ETF (VB)
- » International stocks: Vanguard Developed Markets ETF (VEA)
- » Emerging market stocks: Vanguard Emerging Markets ETF (VWO)
- » Intermediate-term bonds: Vanguard Intermediate-Term Treasury ETF (VGIT)
- » Short-term bonds: Vanguard Short-Term Treasury ETF (VGSH)

Other ETFs that can be used for implementing the allocation models can be found in AAII's ETF guide (February 2021 *AAII Journal*; online at www.aaii.com/guides/etfguide).

revised in 2020. In both cases, the bond allocations were increased, reducing the models' volatility to make it easier for investors to continuously follow them. As previously stated, a lower-returning allocation can result in greater wealth if you are better able to stick with it over a long period of time.

Aggressive Allocation Model

The aggressive allocation uses a 90% stock weighting. It should realize the highest level of return but will also incur the greatest level of volatility. Investors intending to use it should have both a high level of tolerance of risk and a lengthy investment time horizon.

Large-cap, mid-cap, small-cap and international stocks are each assigned a 20% weight. An additional 10% is assigned to emerging market stocks. Just 10% is assigned to intermediate-term bonds.

The key to the model is to maintain a heavy allocation to stocks. The bond holdings can be substituted with cash equivalents. A retired investor who is using the Level3 withdrawal strategy may opt to hold up to four years' worth of planned withdrawals in short-term bonds or cash equivalents in lieu of the 10% allocation, for instance. Alternatively, the investor could allocate just enough to bonds or cash equivalents to provide a source of assets for shorter-term spending needs or to take advantage of temporary drops in stock prices.

Moderate Allocation Model

The moderate allocation uses a 60% stock weighting and 40% bond weighting. It is intended to provide long-term growth though with more income, less volatility and also lower returns than the aggressive allocation model.

This model is based on the traditional 60/40 allocation. The traditional 60/40 approach allocates 60% to large-cap stocks and 40% to bonds. It is a well-established and time-tested allocation model. It works well for investors with long time horizons but who do not have the tolerance to stick with an aggressive allocation as well as for retirees who are taking withdrawals.

The AAII moderate allocation uses a more diversified approach than the traditional 60/40 model. Mid-cap, small-cap and international stocks are held to provide exposure to a broader range of stocks. Intermediate- and short-term bonds are held but not long-term bonds.

Conservative Allocation Model

The conservative allocation uses a 40% stock weighting and a 60% bond weighting. It places a greater emphasis on preservation of capital and reduction of portfolio volatility. A sizable weighting to stocks is still included to provide growth in excess of the rate of inflation. The expected rate of return is lower than either the aggressive or moderate models.

This model excludes both small-cap and emerging market stocks. Though both offer the potential for higher long-term returns, they are also more volatile. Investors following this model may also wish to emphasize dividend-paying stocks for the equity portion of the portfolio. The higher short-term bond allocation is intended to provide a larger pool of assets that can be used to fund shorter-term goals.

Implementing the Allocations in a Real-World Portfolio

The returns shown on the asset allocation models page are based on hypothetical portfolios comprising mutual funds that represent each asset class. Funds, instead of indexes, are used to better represent the returns investors would realize in a tax-preferred account such as a traditional or Roth IRA account. The box on page 15 provides the funds used plus similar exchange-traded funds. Other options for fund investors can be found in our mutual fund and ETF guides.

Investors who prefer to hold stocks instead of mutual funds and ETFs can do so. One example would be to use a combination of stocks from AAII Dividend Investing, Stock Superstars Report, VMQ Stocks and the Model Shadow Stock Portfolio for the domestic allocation.

Investors with an aggressive risk tolerance could also use the Model Shadow Stock Portfolio as their primary exposure to equities. Alternatively, a variety of investing ideas can be found via the AAII stock screens on AAII.com.

Exposure to foreign stocks is often best done through mutual funds or ETFs.

For the bond portion, investors can opt for traditional bond mutual funds or ETFs. Those concerned about interest rates can alternatively consider using defined-maturity bond funds. Offered by Fidelity, Invesco and iShares, these mutual funds and ETFs mature like bonds. They can be laddered at different maturity dates.

Individual bonds are another option. Again, laddering—buying bonds with different maturity dates—can work here. Municipal bonds can be substituted by those who prefer their tax-free characteristics. Treasuries can be purchased directly from the U.S. Treasury department.

Tracking Your Allocation

AAII's My Portfolio (www.aaii.com/myportfolio) provides you with a breakdown of how much you have allocated to each investment. It also breaks out your bond and cash weightings.

A+ Investor subscribers have access to the Diversification Analyzer in My Portfolio. This tool provides a more detailed analysis of your allocation. It also shows how it compares to the appropriate allocation model for your stated risk tolerance.

Maintaining and Transitioning Your Allocation

There are two keys to successfully following any asset allocation strategy.

The first is to simply stick to your strategy no matter what happens with the financial markets. The benefits of allocation and diversification are realized over long periods. Over short periods, you may not notice these benefits. In fact, you may even think they are not working. This is because both different asset classes and groups within asset classes can become temporarily more correlated—particularly when there is a macro event such as a recession. Rest assured, diversification is still working even when it's not as noticeable. The second you abandon the allocation strategy is the second you stop benefiting from it.

The benefits of allocation and diversification are realized over long periods.

The other step is to periodically adjust (rebalance) your portfolio. When left completely unchanged, portfolio allocations will gradually tilt more toward the best-performing asset class. A portfolio following the moderate allocation can see its equity allocation drift from 60% to nearly 90% or higher if no periodic adjustments are made to maintain the desired allocation.

Should your tolerance for risk change, you can opt to gradually change your allocation. An investor switching from the aggressive to the moderate allocation model could target a 75% stocks/25% fixed-income allocation before fully changing the portfolio to 60/40. An investor switching from the moderate to the conservative allocation model could target a 50% stocks/50% fixed-income allocation before fully changing the portfolio to 40/60. Doing so would reduce the timing risk associated with a big portfolio change.

A one-time change could also be made. This not only may incur timing risks but could also expose the investor to higher taxes in the year the transition is made. By spreading out the timing of the change, the tax costs may be spread out into different tax years. ■

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I

Identifying Your Investment Management Preferences

The PRISM Wealth-Building Process

Identifying Your Investment Management Preferences

The following worksheet is intended to help you think through the various considerations about how your portfolio will be managed. You may view yourself as being a true DIYer, only to realize that your 401(k) requires you to cede some control to mutual fund managers. As such, this worksheet can serve as a prompt for you to include rules for buying and selling mutual funds in your personalized investing plan.

There are no right or wrong answers. Rather, the goal is to help you clarify the type of investor you are in terms of how portfolio decisions will be made.

1. How much control do you want in determining which investments are held in your portfolio?
   - ☐ Complete
   - ☐ A mix of self-directed and an adviser
   - ☐ Just keep me informed about my portfolio

2. Do you prefer an active approach to investing, a passive approach (indexing) or a blend of the two?
   - ☐ Active (try to beat the market)
   - ☐ A blend (a mix of active and passive strategies)
   - ☐ Passive (indexing/tracking the market)

3. Are there any constraints on your strategy?
   - ☐ Limitations on what you can own [e.g., 401(k) plans, job-related restrictions, etc.]
   - ☐ Trading restrictions
   - ☐ Trusts or partnerships
   - ☐ Social or religious beliefs
   - ☐ Other: ____
   - ☐ None

4. How comfortable are you in researching and following investments?
   - ☐ Enjoy researching and analyzing stocks
   - ☐ Enjoy researching and analyzing bonds
   - ☐ Content looking at mutual funds or exchange-traded funds (ETFs)
   - ☐ Not interested

5. How often would you like to review your holdings?
   - ☐ Daily
   - ☐ Weekly
   - ☐ Monthly
   - ☐ Quarterly
   - ☐ Annually

6. Based on your answer to Question 5, do you have the available time to stick to that schedule?
   - ☐ Yes
   - ☐ No

7. How would you describe your investing knowledge?
   - ☐ Good
   - ☐ Moderate
   - ☐ Low (but I'm learning)

8. What tasks do you need a professional to assist you with?
   - ☐ Taxes
   - ☐ Estate planning
   - ☐ Financial planning/portfolio review
   - ☐ Investment selection
   - ☐ Other: ____
   - ☐ None

As you review your answers, take a look at the following investor types below to see which one best fits with how you described yourself. You can then use the descriptions to write down how you will implement your allocation (e.g., by picking investments, using index funds, etc.). This exercise will help you develop management rules for your portfolio as we move forward with The AAII Way.

Fully hands-on investors seek a high level of control over their investing decisions. They have time and enjoy researching individual securities. They also have a moderate-to-high level of investing knowledge. They tend to hold individual stocks and individual bonds.

The **partially hands-on investor** combines holding individual securities with mutual funds, ETFs or closed-end funds. This investor owns both individual securities (most commonly individual stocks) and funds. They have a least a moderate level of knowledge but are comfortable ceding control over part of their portfolio to either a mutual fund or ETF manager. Active investors who lack enough time or interest to research every security of their portfolio may fall into this category.

Index investors prefer index mutual funds and ETFs over individual securities. While potentially having a high level of investing knowledge, they view passive strategies as advantageous and are happy to cede control of picking individual securities to keep costs low and avoid underperforming the market. Trading restrictions, or a lack of available time or knowledge to research individual securities, may lead someone to be an index investor.

The **fund investor** is similar to the index investor with the exception that they consider owning actively managed funds. This type of investor is hoping to outperform the market and/or takes comfort in knowing that a professional portfolio manager is choosing the investments and potentially the allocation.

The **combo hands-on/works with a planner investor** combines using a fee-only planner with personal control of investments. This type of investor hires a financial professional—such as a financial planner—to provide assistance with carrying out their investment strategy. The planner might be used on a periodic basis to assist with the portfolio review process to ensure that the allocation strategy chosen matches current goals, or to simply provide objective feedback and consultation. Alternatively, a portion of the portfolio might be given to a robo-adviser to be managed, while part of the portfolio is self-managed. This type of approach works best for those who want some personalized assistance while still making their own investing decisions.

A twist on this combo is a **bolt-on approach**. This involves working with specialists to address specific tasks. For instance, a life insurance agent could be contacted for the purchase and management of policies. Alternatively, a tax professional or estate attorney may be warranted. A good fee-only financial planner may be able to serve as a hub for providing recommendations to these types of specialists and, for those with complex financial and estate-planning needs, coordinating their recommendations. Even fully hands-on investors may find themselves needing to consult with a specialist.

The **adviser investor** hires a professional to carry out their allocation strategy. This investor outsources the process of implementing and managing their allocation and investment strategy. It can make sense for those who lack confidence, knowledge and/or the time to make their own investing decisions—including the selection of mutual funds or ETFs. As one ages, turning over management of investment decisions can be a prudent decision, though the selection of an adviser (or a trusted family member) should be done well before cognitive issues evolve. Robo-advisers would be a consideration for those with moderate levels of wealth and who don’t require much one-on-one communication. A traditional adviser is most suited to those who have complex financial and/or estate-planning needs requiring a higher level of personal service.

I am a ___________________________ investor. Based on my preferences and constraints, I will use the following types of investments (individual securities, mutual funds, ETFs, index funds, etc.):

____

____

____

If I'm going to use the services of a professional, I will seek their assistance with:

____

____

WEALTH-BUILDING PROCESS

8 Factors That Influence Your Investing Management Preferences

Knowing your preferences for carrying out your portfolio strategy allows you to focus only on what you will consider and ignore the investments that aren't a good fit for you.

BY CHARLES ROTBLUT, CFA

How involved should you be in the management of your portfolio?

This may seem like a simple question, but its answer has big implications. Answering the question should prompt you to consider what you can and cannot do. It determines how your portfolio should be managed. It even narrows the scope of suitable investments.

Think of an individual investor's preference for an investing management approach as existing on a spectrum. At the one end is the do-it-yourself investor who researches and selects each investment. At the other end of the spectrum is the adviser investor. An adviser recommends an asset allocation, selects investments and manages the portfolio. The investor meets with the adviser on a periodic basis to discuss the portfolio and any changes in their life.

In between these two opposites are preferences of varying degrees of involvement. An individual investor may utilize exchange-traded funds (ETFs) to fill in specific parts of their allocation. Another may hold mutual funds only because their workplace plan requires them to. Some individual investors have a strong preference for index funds. Others may hire an adviser or a financial planner solely for specific tasks such as to get periodic feedback.

There isn't a single best approach. Identifying one's investing management approach depends on their interest, ability and time. In this article, we walk you through the key factors to consider when deciding how involved you want to be.

Identifying one's investing management approach depends on their interest, ability and time.

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The 8 Factors

In creating a worksheet (Figure 1) to help you identify your investing management approach, we settled on eight specific factors to ask about. Each one addresses a different part of the investment process. All have implications for how you go about implementing the right allocation to achieve your goal.

1. Control

Who decides which specific investments will be held in your portfolio?

A diehard, do-it-yourself investor exerts full control over their portfolio. They choose each individual security, whether it's a stock, bond or other type of security (e.g., a real estate investment trust). This type of investor makes all buy and sell decisions.

Other investors strike a balance by using mutual funds and ETFs. They like deciding which funds are held in their portfolios but are comfortable letting the fund manager choose the actual securities held. In this approach, the investor makes higher level buy and sell decisions—whether to keep or part with a particular fund—while the fund manager makes the decisions of when to buy and sell the individual securities.

An adviser investor effectively outsources the buy and sell decisions. For instance, the investor selects which robo-adviser they use but then relies on the service to determine which ETFs are purchased and sold. In such an approach, a professional—in this specific case, a service and its algorithm—is hired to make the key decisions.

2. Active Versus Passive

Active investment approaches attempt to beat the market through the individual selection of securities. A do-it-yourself investor who rolls up their sleeves and makes their own stock picks may come to mind as an example, but they are not the only type of investor incorporating an active approach to investing. A fund investor may seek out mutual fund or ETF managers they believe are capable of outperforming. Another investor may believe their adviser has the ability to outperform.

Passive strategies are commonly known as indexing. Investors who favor passive strategies seek to earn the return of a major index. The S&P 500 index is the most commonly followed index, though passive investors may seek to track other indexes with their fund choices as well.

A key trait of passive investing is low cost. Index investors believe the minimal expenses charged by index funds as well as the tax efficiency of such funds provides a performance advantage over active strategies.

Many investors opt for a blend of the two approaches. Doing so takes advantage of the low-cost nature of index funds while still providing the opportunity to outperform.

3. Constraints

Constraints may limit an investor's ability to implement their preferences. This commonly occurs when a workplace retirement plan is involved. The offerings available through a 401(k) plan may force a do-it-yourself investor to adopt a partially hands-on approach by incorporating mutual funds into their portfolio. Another investor who prefers index funds may find that actively managed funds are the only option in their 401(k) plan.

Trading restrictions may exist. An investor may be restricted from investing directly in clients. Another investor may only be allowed to hold mutual funds or ETFs. Limits on how frequently trades can be made may make holding funds a more viable option than stocks.

Those with strong social or religious beliefs may seek to exclude certain types of investments. A person who is concerned about climate change might purposely exclude companies they perceive as harmful to the environment. A religious person might exclude any company perceived as being in conflict with their moral beliefs. Such constraints may make using mutual funds, ETFs or advisers who use

FIGURE 1

Questionnaire for Identifying Your Preferred Investing Management Approach

This questionnaire is intended to help you think through the various considerations about how your portfolio will be managed. There are no right or wrong answers. Rather, the purpose is to help you clarify the type of investor you are in terms of how portfolio decisions will be made. More than one answer can be selected for each question.

1. How much control do you want in determining which investments are held in your portfolio?
- ❑ Complete
- ❑ A mix of self-directed and an adviser
- ❑ Just keep me informed about my portfolio

2. Do you prefer an active approach to investing, a passive approach (indexing) or a blend of the two?
- ❑ Active (try to beat the market)
- ❑ A blend (a mix of active and passive strategies)
- ❑ Passive (indexing/tracking the market)

3. Are there any constraints on your strategy?
- ❑ Limitations on what you can own [e.g., 401(k) plans, job-related restrictions, etc.]
- ❑ Trading restrictions
- ❑ Trusts or partnerships
- ❑ Social or religious beliefs
- ❑ Other: ____________________
- ❑ None

4. How comfortable are you in researching and following investments?
- ❑ Enjoy researching and analyzing stocks
- ❑ Enjoy researching and analyzing bonds
- ❑ Content looking at mutual funds or exchange-traded funds (ETFs)
- ❑ Not interested

5. How often would you like to review your holdings?
- ❑ Daily
- ❑ Weekly
- ❑ Monthly
- ❑ Quarterly
- ❑ Annually

6. Based on your answer to Question 5, do you have the available time to stick to that schedule?
- ❑ Yes
- ❑ No

7. How would you describe your investing knowledge?
- ❑ Good
- ❑ Moderate
- ❑ Low (but I'm learning)

8. What tasks do you need a professional to assist you with?
- ❑ Taxes
- ❑ Estate planning
- ❑ Financial planning/portfolio review
- ❑ Investment selection
- ❑ Other: ____________________
- ❑ None

strategies in sync with such beliefs an easier way to carry out one's strategy.

4. Comfort Level With Researching Investments

Personal preferences come into play when it comes to researching investments.

Some investors truly enjoy researching individual stocks and bonds. They like figuring out what makes a company's business model special. They analyze the financial statements for signs of strength or weakness. They look at charts to analyze the trends. On the bond side, they read the prospectuses and look for changes in credit ratings.

Index, fund and partially hands-on investors research mutual fund and ETF candidates as well as track the funds they own. They will monitor performance, look at the fees and may even pay attention to the tax-cost ratio. Some will read the prospectus and/or investigate the fund's holdings.

Of course, other investors may find no joy in such activities. They may find such efforts boring or otherwise have little desire to do such research.

5. Preferred Frequency of Reviewing Holdings

Investments change over time and thus require periodic monitoring. While investors should not look at their portfolio holdings too often, the frequency at which they are willing to do a review has implications for their investment choices.

Publicly traded corporations report earnings quarterly. This cycle calls for reviewing holdings at least once every three months, which is the cycle followed by the AAII Model Shadow Stock Portfolio. More active investors may wish to review their stocks with greater frequency. Weekly overviews and more detailed monthly reviews can be used. The AAII Dividend Investing and Stock Superstars Report portfolios mostly limit announcing transactions to a monthly cycle if a change is necessary. Investors following a more short-term trading approach may, of course, look at their holdings with even greater frequency.

Mutual funds, ETFs and bonds can be reviewed on a much longer cycle. Quarterly or semiannual reviews may be sufficient. For long-term positions—such as index funds—annual reviews can work.

6. Available Time to Analyze Holdings

Even if the desire to analyze investments exists, the available time to do so may not. Work, family, volunteering with charitable organizations, involvement within one's congregation, travel or other activities can limit one's ability to set aside the time to look at their investments.

This is a consideration where being honest about your constraints is important.

Time constraints do not mean that individual securities need to be fully avoided. How one approaches such investments may need to be altered, however. Investment newsletters and model portfolios can reduce the research time needed. (Investors are still encouraged to do their own due diligence.) A long-term approach may also be warranted.

Alternatively, a blended approach could be used. This would involve holding a limited number of individual securities and supplementing those holdings with mutual funds and/or ETFs.

Of course, if the time available to research and track investments is limited, relying on index funds or actively managed funds (mutual funds or ETFs) can make sense. Using an adviser—either partially or fully—may also be a consideration.

7. Investing Knowledge

Being cognizant of the limits of your investing knowledge will reduce the number of mistakes you will make. Among those mistakes is holding investments you do not fully understand. If you cannot identify what might cause an investment to fall in value, you will not know when it is time to sell. The same applies to strategies. If you do not know what the strategy is designed to do, you will not understand what is causing it to underperform or experience a period of negative returns.

In investing, it is very easy to run before you learn to walk. You simply need enough money to open an account and buy an investment. This fact leads to an unfortunate cycle of investors having to learn from their mistakes at younger ages before finally realizing the importance of learning how to invest as they gain experience. This cycle can take place over a lengthy period of time.

A prudent strategy is to start as a fund or index investor and build up knowledge from there. A blended approach can work well, particularly if shares of a few companies that an investor is familiar with are held at first. Such an approach can help to spark interest without going too far beyond one's knowledge limitations.

Even experienced investors should be conscious of their limitations. An investor can be skilled at analysis, but if they lack access to information about, say, foreign investments or lack the background to understand research about emergent pharmaceutical treatments, a mutual fund or ETF may be the better option.

8. Tasks Requiring Help

Are there any tasks warranting the use of a professional?

Estate planning is one such scenario. An estate attorney can assist not only with wills but also with trusts and powers of attorney, among other things. A tax professional may provide suggestions for reducing one's tax exposure in addition to preparing returns for filing.

You may also require assistance with buying or

FIGURE 2

Types of Investors by Investing Management Preferences

Though no description matches every investor, we believe the following provides a good framework for classifying the type of investor you are from the standpoint of your preferences. The description for each type includes references to specific questions shown in Figure 1. Use the answers to those questions to determine the type of investor that best describes you.

Fully hands-on investors seek a high level of control (Question 1), tend to hold individual stocks and individual bonds (Question 4), have the interest and time to research individual securities (Questions 4 and 5) and have a moderate-to-high level of investing knowledge (Question 7).

Partially hands-on investors own both individual securities (most commonly individual stocks) and funds (Questions 2 and 4), have at least a moderate level of knowledge of investing (Question 7), are comfortable using mutual funds or ETFs (Question 4) and may lack the time or interest to research every security of their portfolio (Questions 5 and 6).

Index investors prefer index mutual funds and ETFs for their low cost and ability to consistently realize returns similar to that of broad indexes (Question 2), may not want to devote the time or effort to research individual securities (Questions 4 and 5) and/or may have trading restrictions or a lack of knowledge to research individual securities (Questions 3 and 7).

Fund investors are willing to own mutual funds and ETFs (Questions 1 and 4), consider owning both index and actively managed funds (Question 2), hope to outperform by using active strategies (Question 2), may not want to devote the time or effort to research individual securities (Questions 4 and 5), may have trading restrictions or a lack of knowledge to research individual securities (Questions 3 and 7) and/or take comfort in having a professional portfolio manager choose investments.

Combo hands-on/works with a planner investors combine using a fee-only planner with personal control of investments (Question 1). They may self-manage part of the portfolio and have an adviser or robo-adviser manage another part (Questions 1 and 2), hire a financial professional to provide assistance with the portfolio review process or to simply provide objective feedback and consultation (Question 8). This type of approach works best for those who want some personalized assistance while still making their own investing decisions.

Bolt-on approach investors are similar to combo investors but work with specialists to address specific tasks (Question 8). Examples of such specialists include a life insurance agent, a tax professional or an estate attorney. These investors may use a fee-only financial planner for providing recommendations to specialists.

Adviser investors outsource the process of implementing and managing their allocations and investment strategies (Question 1). They may lack the confidence, knowledge and/or the time to make their own investing decisions (Questions 4 and 7). Robo-advisers would be a consideration for those with moderate levels of wealth who don't require much one-on-one communication. A traditional adviser is most suited to those who have complex financial and/or estate-planning needs (Question 8).

managing a life insurance policy, a long-term care policy or an annuity. Older investors may eventually need assistance with their finances.

Matching the Factors With Investor Types

Combined, the factors give insight into the type of investor a person should consider themselves to be. Though no description matches every investor, we believe the descriptions in Figure 2 provide a good framework for classifying the type of investor you are from the standpoint of preferences for an investing management approach.

Some of you will quickly find a fit with one of the investor types. Others will find themselves matching more than one that type. In such cases, opt for one of the blended types such as partially hands-on or combo hands-on/works with a planner.

Once this determination is made, you can then begin to set rules for implementing your allocation strategy. Index investors need not spend time researching stocks. Do-it-yourself investors may not need to worry much about mutual funds. The big advantage to knowing your investment management preference is the ability to narrow your focus. By identifying what you will consider, you can ignore the investments that aren't a good fit for you. ■

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WEALTH-BUILDING PROCESS

Populating Your Portfolio Based on Your Allocation and Preferences

Broad guidelines and considerations can help you select investments appropriate for the type of investor you are.

BY CHARLES ROTBLUT, CFA

***Charles Rotblut**, CFA, is a vice president at AAII and editor of the* AAII Journal*. Find out more at www.aaii.com/authors/charles-rotblut and follow him on Twitter at twitter.com/CharlesRAAII.*

There is an overall flow to populating your portfolio with specific investments that is embedded into The Individual Investor Wealth-Building Process. It is the first three of the five steps of PRISM: prioritize your goals, recognize your risk tolerance and allocation and then identify your investment management preferences (see Figure 1). Combined, these steps narrow the field of potential investments and enable you to move to step four: selecting among just those investments most suitable for you.

In this article, we provide broad guidelines and considerations for selecting investments by the type of investor. We show how one's allocation and preferences follow through to the specific decisions about which investments to buy and hold. We also provide broad guidelines and considerations for selecting investments by the type of investor. In future articles, we will get more into the guidelines for selecting individual investments and determining when to remove them.

The Index Investor

We start with index investors because purely passive strategies are the easiest to implement. An index investor primarily seeks two things: returns similar to major indexes, and low expenses. Such strategies call for matching the index funds to one's asset allocation.

We use Elizabeth to demonstrate. She is early in her career and is saving for retirement. Her employer's 401(k) plan only offers index funds. This constraint makes her an index investor by default.

Elizabeth is following an aggressive allocation, given her lengthy time horizon until retirement. Growth of capital is her primary goal.

Her goal is to match funds with her allocation. A good starting point would be to look for index funds following recognizable indexes. These could be funds tracking the S&P 500 index, the S&P MidCap 400 index and the S&P SmallCap 600 index or the Russell 2000 index. For the international portion of her portfolio, she might look for a fund tracking a broad-based MSCI index. Her allocation to bonds will be very small but should she choose to allocate a little to it she might consider an investment-grade bond fund tracking a Bloomberg Barclays index.

The precise portfolio weightings will depend on the allocation model she follows. Should Elizabeth choose to follow AAII's aggressive allocation model, she would evenly split her contributions to the large-, mid- and small-cap funds as well as an international fund. It would be her option whether to include an emerging market fund. This may depend on the offerings in her 401(k) plan. For any investor using a 401(k) or similar type of account, the choices will depend on what precise funds are being offered. Were Elizabeth to also allocate to a bond fund, using our allocation model as an example, she would

FIGURE 1

PRISM: The Five Steps of the Individual Investor Wealth-Building Process

consider a weighting of approximately 10%.

Let's assume that instead of using a 401(k) plan, Elizabeth was using a brokerage account. This might be the case if she were saving through an IRA as opposed to through a workplace retirement plan. In such a case she would have the option of considering exchange-traded funds (ETFs) in addition to mutual funds. This would allow her to consider alternatives such as equally weighted index funds instead of market-cap-weighted funds. The choice between an ETF and a mutual fund is dependent not only on the type of account used but also the preference of the individual investor making the decisions.

In all cases, the index investor seeks low cost funds following traditional, broad indexes. Index investors avoid individual securities as well as funds and ETFs following more niche strategies or niche indexes.

The Fund Investor

Fund investors are similar to index investors. Both prefer to use mutual funds or ETFs instead of selecting individual securities. The difference is that fund investors are willing to consider active strategies. Fund investors may alternatively choose to invest in ETFs tracking lesser-known indexes, closed-end funds and/or perhaps even make tactical decisions involving sector funds.

An investor with a preference for index funds may find themselves being a fund investor simply because of the options offered through their workplace retirement plan. Suppose for instance that Elizabeth was offered a retirement plan with actively managed funds instead of index funds. In this case, she would become a fund investor. This is a case where a constraint alters her investment decisions.

The strategy for implementing her asset allocation does not change. She will continue to seek out funds matching the allocation model or strategy she chooses to follow. Each fund's expense ratio would especially be considered because actively managed funds typically come with higher expense ratios. Additional emphasis would have to be given to relative performance. She would want to look at how the individual funds have fared relative to their peers over various periods of time.

If Elizabeth was in a plan that offered both active and passive strategies, then her choices become a little more complicated. There could be certain asset class groups where a preference for index or active strategies may come into play. Perhaps she prefers index funds for large-cap stocks. For, say emerging market funds or for bonds, she could prefer active management. Such a choice should be predicated on identifying the asset class groups where she believes active managers have an advantage over index funds.

Index fund investors may find themselves in this situation if they have workplace retirement plans in addition to their IRAs and other brokerage accounts. In such a situation, they might be forced to use actively managed funds even though their preference is for pure index funds. Asset location strategies—which consider the tax treatment of each type of account—could come into play here, with the retirement plan used for less tax-efficient funds and the other accounts used for index funds.

A simple example would be where there is a taxable brokerage account and a 401(k) plan account. If such an investor believes there are certain advantages to active investing or wishes to avoid the higher tax costs associated with active strategies, they could use the 401(k) plan to hold the actively managed funds. More tax-efficient index funds would then go into the taxable account.

The asset allocation strategy followed would not change. Only its implementation will evolve. More rules regarding which investments will be selected for which account will be needed. It's an added level of complexity, but one that could be easily managed.

Of course, like Elizabeth, an investor might prefer combining active and passive strategies. Again, the asset allocation strategy would not change. The only thing that would change is where the investor intends to use active strategies and where they intend to use passive strategies.

Preferences and Constraints to Consider When Selecting Investments for Your Portfolio

Here's a brief list of factors that may determine the type of investments you consider for your portfolio.

- Do you and your spouse have different investment management preferences?
- Are there multiple accounts you hold investments in: IRAs, taxable brokerage accounts, 401(k) plans?
- Can you allocate the necessary amount of time to research and monitor specific investments?
- Are taxes an issue? Do you wish to minimize tax exposure as much as possible?
- Regarding bonds, do you have any preferences for the type or duration?
- How frequently do you intend to check your portfolio?

Partially Hands-On Investor

Partially hands-on investors hold both individual securities and funds. This type of investor may invest in individual stocks and fill the remaining part of their allocation with funds. An example would be an individual investor who uses stocks for their domestic equity allocation and uses funds for their international allocation and their bond allocation.

FIGURE 2

Types of Investors by Investing Management Preferences

Though no description matches every investor, we believe the following provides a good framework for classifying the type of investor you are from the standpoint of your management preferences.

Fully hands-on investors seek a high level of control, tend to hold individual stocks and individual bonds have the interest and time to research individual securities and have a moderate-to-high level of investing knowledge.

Partially hands-on investors own both individual securities (most commonly individual stocks) and funds, have at least a moderate level of knowledge of investing, are comfortable using mutual funds or ETFs and may lack the time or interest to research every security of their portfolio.

Index investors prefer index mutual funds and ETFs for their low cost and ability to consistently realize returns similar to that of broad indexes, may not want to devote the time or effort to research individual securities and/or may have trading restrictions or a lack of knowledge to research individual securities.

Fund investors are willing to own mutual funds and ETFs, consider owning both index and actively managed funds, hope to outperform by using active strategies, may not want to devote the time or effort to research individual securities, may have trading restrictions or a lack of knowledge to research individual securities and/or take comfort in having a professional portfolio manager choose investments.

Combo hands-on/works with a planner investors combine using a fee-only planner with personal control of investments. They may self-manage part of the portfolio and have an adviser or robo-adviser manage another part, hire a financial professional to provide assistance with the portfolio review process or to simply provide objective feedback and consultation. This type of approach works best for those who want some personalized assistance while still making their own investing decisions.

Bolt-on approach investors are similar to combo investors but work with specialists to address specific tasks. Examples of such specialists include a life insurance agent, a tax professional or an estate attorney. These investors may use a fee-only financial planner for providing recommendations to specialists.

Adviser investors outsource the process of implementing and managing their allocations and investment strategies. They may lack the confidence, knowledge and/or the time to make their own investing decisions. Robo-advisers would be a consideration for those with moderate levels of wealth who don't require much one-on-one communication. A traditional adviser is most suited to those who have complex financial and/or estate-planning needs.

A self-described do-it-yourself investor may find themselves being a partially hands-on investor due to constraints. This could include the presence of a workplace retirement plan or restrictions related to their job. Index funds could be required to avoid professional conflicts of interest. Alternatively, investors may choose to use funds for certain parts of their portfolio because they lack enough time to do the adequate research.

Couples with differing investment management preferences would be partially hands-on investors. One partner may be comfortable purchasing individual securities, while the other partner is more comfortable owning funds.

Consider Frank and Sue, a young couple who is saving for retirement as their joint primary goal. Frank likes to select stocks using the AAII stock screens, while Sue prefers to use funds. The process for selecting investments, again, starts with their asset allocation. They then decide together where they want to hold individual securities and where they want to use mutual funds or ETFs.

They would want to look at how their overall portfolio is distributed across accounts. In doing so, they should consider the proportionate size of each account, what investment options are available in each account and what constraints may exist.

If a workplace retirement plan is in the mix, they will need to factor in any related constraints. They might be limited to index funds for certain asset class groups, or they may have a choice between actively managed and passively managed funds.

It's a more complex approach to allocating the portfolio because there are more moving parts and potentially more constraints. Working through this exercise would prevent unnecessary overlap as well as address any potential gaps between the actual portfolios and the desired allocation that may occur.

When there is a choice between actively managed and passively managed funds, a decision will need to be made regarding preferences. How much of the portfolio should be actively managed and how much of the portfolio should be passively managed? Are there certain asset class groups the couple prefers for active or passive management?

For situations where either a couple agrees on investing preferences or a single person is managing their portfolio, the approach is a little simpler. It comes down to where individual security selection will be used and where funds will be used. An investor who feels very comfortable selecting stocks may use this for the equity portion of the portfolio. They could then use mutual funds or ETFs for asset class groups they either don't feel comfortable doing individual security selection for or have restrictions on doing.

An investor may want to implement the domestic portion of their equity allocation themselves. A lack of available research or knowledge about international securities may prompt them to use mutual funds or ETFs. Similarly, for bonds, they may be more comfortable using mutual funds or ETFs. This will be the case if they either feel they lack the ability to research bonds, lack enough wealth to buy bonds from a variety of issuers and/or lack the available time to build a diversified portfolio of bonds.

Fully Hands-On Investor

The fully hands-on investor is a true do-it-yourself investor. This investor enjoys selecting all the securities held in their portfolio and has the time and ability to do the necessary research.

A top-down approach to being a fully hands-on investor would mean using the desired asset allocation strategy or model to determine which asset class groups to look at. If there was a need to fill the small stock bucket, this investor will look at small-cap stocks. If there is a need to hold large-cap stocks, this investor would look at large-cap stocks. The same logic would apply to other asset class groups such as bonds. This investor is simply looking for the best securities matching their allocation needs.

We can use another hypothetical investor named Bill. Bill wants to pick the stocks for the equity portion of his allocation. He will determine what types of stocks to look at based on his allocation needs. This may mean that he would hold a combination of large-, mid- and small-sized stocks. If he desired international holdings as well, he would consider finding companies with American depositary receipts (ADRs) or American depositary shares (ADSs) listed on U.S. stock exchanges.

In doing so, Bill would consider how he's going to identify which stocks to hold. He could use stock screens, investment newsletters or perhaps recommendations from analysts or other people he trusts. He would also want to establish rules regarding the addition or deletion of stocks from his portfolio.

For the bond portion of his portfolio, Bill would want to think about what types of bonds he wants to hold. Does he prefer Treasury, corporate or municipal bonds? Credit quality and duration, which shows how sensitive a bond is to changes in interest rates, are also considerations. Depending on the size of Bill's portfolio and how much he has to allocate to fixed income, he would also have to consider which bonds are available for purchase. As is the case with stocks, he would need rules for buying and rules governing whether to hold the bonds until maturity or part with a bond before maturity is reached.

Combo Hands-On and Bolt-On

There are situations where an investor is managing part of their portfolio themselves but also works with a financial planner. A simple example is someone who uses a financial planner to provide feedback and general guidance about their portfolio and their progress toward their goals. Investors may also have part of their portfolio managed by an adviser while managing the remainder themselves.

An adviser or other financial professional might be hired for specific tasks. An investor might use a financial planner to assist with retirement planning, buying annuities and/or managing life insurance policies.

For these types of situations, it is important to clarify what the financial professional is being used for. Doing so will allow you to avoid having unnecessary overlap and more importantly ensure the portion of your portfolio that you are managing syncs up with the portion of the portfolio they are managing. Communication and coordination are key. It will avoid unnecessary overlap and potential mistakes.

Conclusion

Regardless of what your investment management preferences are, all portfolio strategies start with prioritizing your goals, recognizing your risk tolerance and allocation and identifying your investment preferences. Once you have done this, you can populate your portfolio using investments matching your investment management preferences and your allocation needs.

Future columns will provide suggestions for establishing both buy and sell rules. These vary depending on the type of investment held. Understanding what type of investments you will hold and what might prompt you to sell them will help you better establish portfolio management rules that best fit your personal needs and preferences. ■

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Selecting and Managing Your Investments

The PRISM Wealth-Building Process

S | Selecting Your Investments

Goal: ____

AAII founder James Cloonan encouraged investors to develop a consistent, well-defined approach to investing. The way to do so is have written rules governing your buy and sell decisions.

To provide you with a framework for creating rules, we've listed some of the major characteristics to consider for the major types of investments used by individual investors. You will notice the fields are blank. This was purposeful because AAII members follow a variety of investing strategies.

Here are some brief suggestions for what to consider in terms of creating rules for evaluating each type of investment:

- **Bonds**—Taxable or municipal (depending on type of account used); good credit quality; appropriate time to maturity; awareness that higher yields signal higher risk; aim to hold individual bonds until maturity unless credit quality deteriorates; note if intention is to rollover maturing bonds into new ones as part of an ongoing bond ladder

- **Mutual Funds/ETFs**—Lower cost; seek funds that have outperformed category peers over time (be sure to compare similar funds—such as small-cap value to small-cap value); funds should maintain stated objective and strategy; be on the alert for changes in the strategy if the manager changes; pay attention to tax cost ratio when determining what type of account to hold in

- **Stocks**—Use quantitative metrics for analyzing (see AAII model portfolios and stock screens for ideas); determine whether to seek a blend or a purposeful style tilt (value, growth, size, etc.); sell when a stock no longer possesses desired characteristics (sales stop increasing for a growth stock, a value stock's valuation becomes expensive, a dividend-paying stock cuts its dividend, etc.)

Enter the rules you will follow for buying and selling investments for your portfolio on the next page.

Stocks (Buy / Sell Rules)

Valuation:	
Growth:	
Quality:	
Momentum:	
EPS Revision:	
Dividend:	
Other:	

Bonds (Buy / Sell Rules)

Credit Quality:	
Maturity/Duration:	
Yield:	
Premium/Discount:	
Type:	
Other:	

Mutual Funds (Buy / Sell Rules)

Active or Passive:	
Asset Class Group:	
Relative Returns:	
Expense Ratio/Cost:	

Other:	____
	____

<u>ETFs</u> (Buy / Sell Rules)

Active or Passive:	____
	____
Asset Class Group:	____
	____
Relative Returns:	____
	____
Expense Ratio/Cost:	____
	____
Other:	____
	____

Other Investments

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PRISM WEALTH-BUILDING PROCESS

Guidelines for Selecting Mutual Funds and ETFs

PRISM leads you to consider funds appropriate for you and what you are trying to achieve.

BY CHARLES ROTBLUT, CFA

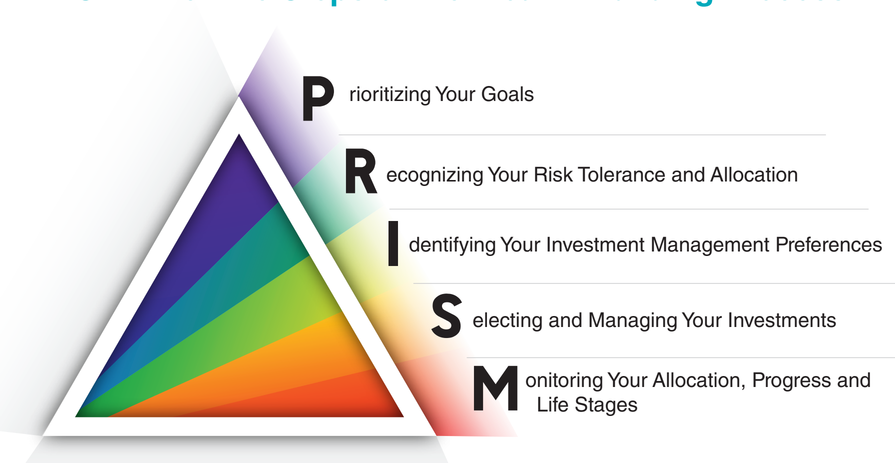
There are more than 24,000 mutual funds and more than 2,500 exchange-traded funds (ETFs) listed in AAII's Mutual Fund and ETF Guides. Choosing which ones should go in your portfolio can at first seem like a daunting task, given the large number of choices.

Step 4 of the PRISM Wealth-Building Process begins with selecting your investments, to help guide you to narrow down the large number of investments to a manageable list (Figure 1). In this article, we focus on mutual funds and ETFs. There are enough similarities to create general rules for determining which are attractive and which warrant selling (or avoiding). These same rules can be applied to closed-end funds, if appropriate.

The term "funds" is used here to refer to both mutual funds and ETFs. Both are open-ended types of funds. They can issue or reduce the number of shares depending on inflows (deposits) and outflows (withdrawals) of investor dollars.

FIGURE 1

PRISM: The Five Steps of the Wealth-Building Process



***Charles Rotblut**, CFA, is a vice president at AAII and editor of the AAII Journal. Find out more at www.aaii.com/authors/charles-rotblut and follow him on Twitter at twitter.com/CharlesRAAII.*

Start With Your Allocation Needs and Preferences

There are two broad approaches to selecting a fund.

One is a top-down approach. A top-down approach uses your asset allocation and investment management preferences to guide your choices.

The other is a bottom-up approach. A bottom-up approach calls for seeking out the best fund regardless of your allocation needs or preferences.

PRISM follows a top-down approach. We believe an investor's allocation should reflect their goals and risk tolerance. The choice of a fund—and even whether to use a fund instead of individual securities—should be reflective of each investor's investment management preferences. Put another way, the investor's choice of a fund is an extension of:

» What you are investing for,
» Your tolerance for risk,
» The appropriate allocation for you and
» Your investing preferences and constraints.

This top-down approach personalizes the process of selecting a fund. PRISM leads you to consider funds appropriate for you and what you are trying to achieve. One of the big advantages of PRISM is the clarity it provides. Rather than looking for a needle in a haystack, you are narrowing your search down to a particular bale of hay.

Example #1: A Young Investor With a 401(k) Plan

Elizabeth is early in her career and is starting to save for retirement through her employer's 401(k) plan. Given her young age and long investing time horizon, she is following AAII's aggressive portfolio allocation model. This model calls for mostly allocating to equities.

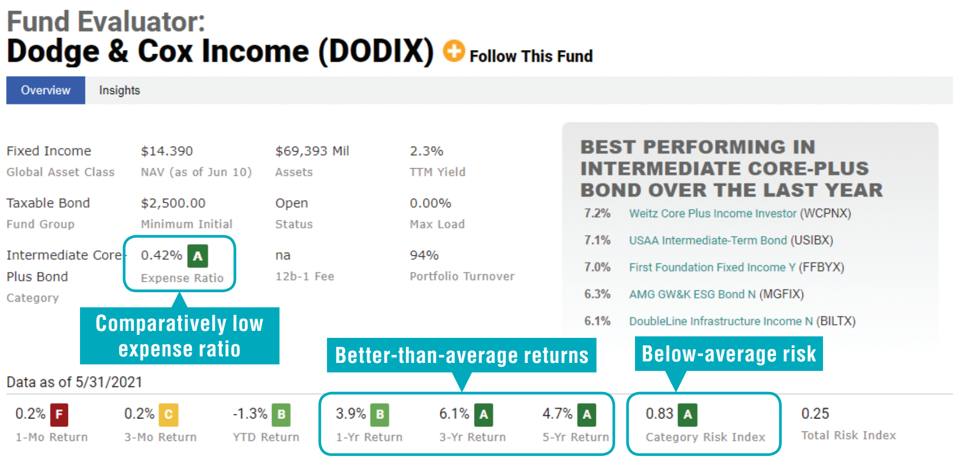
She uses this allocation to consider stock-focused funds. She targets specific categories: large-cap, mid-cap, small-cap and international. She ignores sector and industry funds—if included in her 401(k) plan—as she is seeking long-term investments, not funds better suited to tactical approaches.

Elizabeth might prefer index funds. If so, she would seek out passively managed funds in each specific category first. This would simplify the process by immediately narrowing down the list of funds to consider.

The offerings available in her 401(k) plan may place a constraint on her ability to do this. Depending on which fund family the plan is run through, actively managed funds may be her only choices. In this case, Elizabeth would have to be flexible on her preferences. Seeking out the fund with the lowest expense ratio in each category would be a workaround. It would help her to potentially identify those funds most similar to an index fund. (She should look closely at the fund to ensure that this is the case.)

Key Numbers on the AAII Fund Evaluator

Most of the statistics discussed in this article can be found in the Mutual Fund and ETF Evaluators. To access either, type in the mutual fund or ETF name or ticker symbol into the search box located at the top of most pages on AAII.com and select the name from the drop-down list.



Example #2: Retirees With Brokerage Accounts

Jane and Bob are married and retired. They are fortunate to have all of their living expenses covered by pension and Social Security benefits. This allows them to focus on their secondary goals of helping to pay college expenses for their two grandchildren.

To provide a contrast with Elizabeth, let's assume all of the couple's investment accounts are held with brokerage firms.

Bob and Jane's choice of allocation depends in part on the age of their grandchildren. When both grandchildren are young, an aggressive allocation would maximize growth of wealth. As each child approaches their college years, the allocation will need to evolve to include more bonds as preservation of wealth grows in importance.

Mutual funds and ETFs are both options. The couple's PRISM investment management preferences designate them as fund investors. They prefer having a professional manager make the selection of individual securities, and they like the diversification offered by funds. Bob and Jane are open to both actively and passively managed funds.

The couple's initial selection process involves selecting funds to match their allocation needs. Tax considerations may come into play as a constraint. If they have taxable brokerage accounts, it may lead them to favor ETFs or index mutual funds with very low tax-cost ratios. Taxes would not be a primary consideration for their individual retirement accounts (IRAs), since neither distributions nor capital gains realized within the accounts are taxed.

(Note: If Bob and Jane were to use a 529 college savings plan instead of a traditional brokerage account, they would be limited in their choice of investment options. The couple's approach to selecting a fund would be similar to Elizabeth's.)

The Role of Performance in Choosing a Fund

Under top-down approaches, such as PRISM, mutual fund and ETF performance is considered after the choice of investment candidates is narrowed down by asset allocation needs and investment management preferences. Once the pool of potential candidates is narrowed down, returns are used to help select a single fund.

It's important to compare a fund's performance against its peers. The returns of any mutual fund or ETF are primarily driven by the asset class group(s) they target. Performance of an intermediate-term bond fund is not comparable to that of a large-cap growth stock fund. Similarly, the returns of emerging market stock funds should not be measured against the returns of domestic small-cap value stock funds. Differences in each asset class and each asset class group lead to different return characteristics.

Annualized three-, five- and 10-year returns give you a sense of how a fund has performed over time. A trend of these being above their category averages (designated by grades of A or B in our fund guides) is a good sign.

Calendar-year returns provide context. Keep an eye out for one or two very strong years. If the returns for those years are well above the category average, they may be skewing the annualized returns. This would particularly be the case if the returns for most other years are below average. Below-average returns for a few years shouldn't be a concern if the returns for most calendar years are above average.

Active, Passive or Both?

If presented with a wide choice of funds and you don't have a strong personal preference for active or passive management, which should you choose? Let's look at the pros and cons of each.

Pros and Cons of Active Management

Managers of actively managed funds and their teams handpick the individual securities to hold. Their goal is to beat their respective benchmarks and peers though their analysis and investment methods. The allure of potentially higher returns is what attracts investors to actively managed funds.

Some active managers have enjoyed long-term success. Peter Lynch is among them. Lynch ran Fidelity's Magellan fund between 1977 and 1990 with great fanfare. During this period, his fund realized an average annual return of 29.2%.

Lynch's performance was an exception, not the norm. Data from S&P Dow Jones Indices has routinely shown a lack of persistent outperformance by mutual fund managers. The firm looked at how funds that outperformed during the first half of the last decade fared during the second half. Nearly 60% of all funds whose returns ranked in the top-half during the five-year period of 2011 through 2015 did not maintain their above-average returns during the subsequent five-year period of 2016 through 2020. About 11% of the former outperformers either merged with another fund or were liquidated.

Still, there are actively managed funds with a history of beating their peers. AAII's Fund First Cut screen for Consistent Category Winners (February 2020 *AAII Journal*; updated monthly for A+ Investor subscribers) seeks no-load mutual funds with both above-category-average returns for the past three-, five- and 10-year periods and below-category-average risk. Most of the passing mutual funds are actively managed.

One school of thought suggests that active management is the better option for certain asset classes and asset class categories. Bond indexes can be difficult to replicate. An active bond manager can use their flexibility to take on more credit risk in search of higher yields and returns or adjust their inflation risk within the parameters allowed by the fund's objective. Small-cap domestic stocks and smaller international markets are often less efficiently priced and thereby provide more opportunities for active managers.

The challenge with selecting an actively managed fund is finding one likely to outperform in the future. Beyond costs, this is one of the arguments against choosing active management. A fund manager who has been successful in the past may not continue to be so in the future.

There are some characteristics to favor when looking at an actively managed fund. One is a record of outperforming peers. Another is a lower expense ratio. R-squared can tell you how truly active a manager is. (Lower R-squared values are indicative of managers whose performance differs from the performance of the S&P 500 index.) Smaller size relative to category peers can give an active manager more flexibility in what they choose to invest in.

Tenure has traditionally been viewed as another useful characteristic. With more funds using two or more co-managers, it's become a harder metric to rely on. Still, stability at the top can be a good sign.

Most mutual funds are actively managed. Most closed-end funds are actively managed as well. Attempts to bring active management to ETFs has so far been met with a large level of apathy.

Pros and Cons of Passive Management

Proponents of passive funds point to their low costs and index-like returns.

Passive funds seek to mimic the returns of an index. This eliminates the need to hire a team of analysts to assess the operations of individual companies. Index fund managers seek to match their portfolios to the construction of an index.

Trading and, thereby, tax costs are frequently lower for index funds. Turnover is limited to the frequency at which the index is rebalanced or adjusted.

Passively managed funds following well-established indexes will not outperform the market. This is by design. These funds' objective is to deliver the return of the index less expenses. Shareholders holding them will never significantly underperform the stock or bond market, but they also will never beat them either. Proponents cite this as a benefit. The risks of selecting the wrong active manager are eliminated with index funds.

However, not all index funds are the same. It is very important for investors to look specifically at which index a passively managed fund is designed to follow.

Consider the S&P 500. This market-capitalization-weighted index tracks the 500 leading U.S. companies, with larger companies having proportionally greater weight. The S&P 500 Equal Weight index tracks the same companies but with equal weights for each holding. The difference leads to different returns.

There are also a variety of subset indexes. Some are factor-based such as the S&P 500 Pure Growth index or the S&P 500 Dividend Aristocrats index. Others follow thematic approaches, such as the S&P 500 ESG (environmental, social & governance) index and the S&P 500 Catholic Values index. Each deviation from the primary S&P 500 leads to different return characteristics.

Coinciding with the growth of ETFs has been a proliferation of indexes for these funds to track. Some of the indexes are broad in nature. The Dow Jones U.S. Index—launched in 2000—attempts to provide coverage of 95% of U.S. market capitalization. Many other indexes are highly specialized. The WisdomTree U.S. MidCap Dividend index is a dividend-weighted index tracked by a WisdomTree ETF.

Each index has its own return characteristics. While tracking an index is a passive approach to investing, the creation of indexes is not. The methodology for an index can often be found by typing the index name and "methodology" into a search engine such as Google.

Indexing primarily remains within the realm of ETFs, though there are many passively managed mutual funds. For most of the better-known indexes, investors can find both mutual funds and ETFs tracking them. Choosing between the two can often come down to preference. Mutual funds work better for dollar-cost averaging (although fractional-share purchases—offered by some brokerage firms—is changing that). Exchange-traded funds can be bought and sold throughout the trading day.

Other Factors When Choosing a Fund

Once the list of potential fund candidates is narrowed by the top-down approach, the primary factors to consider are returns relative to peers (higher is better) and expense ratios (lower is better). R-squared is a consideration when looking at actively managed funds—particularly domestic stock funds—to ensure the manager is truly active.

Three other ratios can help guide your choice of which fund to use.

The first is the category risk index, which indicates how volatile a fund's returns have been over the last three years relative to all other funds in its category. Higher ratios indicate greater volatility. Higher volatility is not a negative if a manager is targeting investments with higher potential returns. A high category risk would be a reason for caution if bigger swings in returns would prompt you to sell more frequently.

Interest rate sensitivity signals the likelihood of a bond fund's underlying holdings moving in price in reaction to changes in interest rates. Bond funds with extensive levels of sensitivity can be expected to experience larger swings in returns than bond funds with moderate or limited levels of sensitivity.

Turnover reveals the trading activity of a fund. A value of 100% indicates complete turnover of a portfolio within one year. Low turnover ratios reflect a long-term investing focus by the fund manager. High turnover rates reflect a shorter-term approach. High turnover rates can result in higher tax costs and higher fund expenses. ■

Key Characteristics to Look for in a Mutual Fund or ETF

Category Risk: Higher scores indicate more volatile returns. Higher risk can be justified if the fund manager is targeting investments with higher potential returns. It may not be desired if big swings in returns would make you more likely to sell.

Expenses: Is the fund's expense ratio below or above its category peers? High expense ratios raise the minimum return a fund has to realize just to match its lower-cost peers.

Fund Type: Does the fund match your allocation needs? A top-down approach to selecting funds uses your allocation and investment preferences (e.g., active or passive) to initially narrow down the list of mutual funds and/or ETFs you will consider.

Interest Rate Sensitivity: Bond funds with extensive levels of interest rate sensitivity are the most likely to react to interest rates. Combining this measure with the category risk index shows whether a manager is taking on more interest rate risk and potentially more credit risk in order to realize higher returns and/or yield.

R-Squared: This measure shows how much of a fund's return is attributable to movements in the S&P 500 index. Be aware of funds with above-average expense ratios and high R-squared numbers. They are providing index-like return characteristics at a much higher cost.

Returns: How has the fund performed relative to its category peers over various time periods? Comparing returns against similar funds is important because a fund's returns are primarily driven by the asset class group they invest in.

COMPARE FUNDS AT AAII'S FUND AND ETF GUIDES
www.aaii.com/guides/mfguide
www.aaii.com/guides/etfguide
Select a category under Expanded Fund Listings, sort on any column heading, then mark funds to check side-by-side using the Compare column.

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Comparing Funds That Track the Same Index by Wayne A. Thorp, CFA, October 2020
Top Considerations When Comparing Funds by John Bajkowski, June 2020
Understanding Mutual Fund Fees and Expenses by John Bajkowski, November 2020

PRISM WEALTH-BUILDING PROCESS

Guidelines for Selecting Bonds and Cash-Like Instruments

Key characteristics when analyzing bonds, choosing between bonds and bond funds and the role of laddering.

BY CHARLES ROTBLUT, CFA

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Rotblut is speaking at AAII's virtual conference this fall, see https://conference.aaii.com for details.

To describe the bond market as large is an understatement. The Securities Industry and Financial Markets Association (SIFMA) tabulates close to $52 trillion worth of outstanding fixed-income securities in the U.S. as of the end of first-quarter 2021.

Though comparatively smaller, allocations to cash-like instruments are also large at the aggregate level. SIFMA says there is more than $1.1 trillion of outstanding money market funds and very short-term securities.

Both bonds and cash-like instruments can play an important role in an investor's portfolio. In this article, we address both bonds and cash-like instruments [money market funds, certificates of deposit (CDs), etc.] from the standpoint of Step 4 of the PRISM Wealth-Building Process—selecting and managing your investments (Figure 1). We share some of the key characteristics to look at when analyzing bonds, discuss the choice between bonds and bond funds, explain the role of laddering and provide a basic framework for choosing among cash-like instruments.

Investors interested in a more detailed discussion about funds should read "Guidelines for Selecting Mutual Funds and ETFs" in the July 2021 *AAII Journal*. Stocks were covered in the August 2021 *AAII Journal* ("Guidelines for Selecting Stocks for Your Portfolio").

FIGURE 1

PRISM: The Five Steps of the Wealth-Building Process

Prioritizing Your Goals
Recognizing Your Risk Tolerance and Allocation
Identifying Your Investment Management Preferences
Selecting and Managing Your Investments
Monitoring Your Allocation, Progress and Life Stages

Allocation and Withdrawal Needs Determine the Role of Bonds and Cash

Bonds reduce the level of volatility of a portfolio's return. They also provide a stream of income. Cash preserves nominal wealth but does a poor job of protecting a portfolio against the eroding effects of inflation.

Beyond cash savings to cover emergencies—something every investor should have—the decision to hold bonds and cash-like instruments depends on your allocation and withdrawal needs. This viewpoint stems from the top-down approach used by PRISM. We believe an investor's allocation should reflect their goals and risk tolerance, not tactical choices such as expectations about where interest rates may be headed in the future.

Beyond cash savings to cover emergencies—something every investor should have—the decision to hold bonds and cash-like instruments depends on your allocation and withdrawal needs.

In addition, preferences, needs and constraints should be factored in. Some investors prefer to maintain a certain allocation to cash-like instruments to take advantage of downturns in the stock market or to provide a bucket from which portfolio withdrawals can be taken. A variety of personal situations can necessitate an allocation to cash-like instruments.

Example: Retired Couple With a Pension

Jane and Bob are married and recently retired. They are fortunate to have their living expenses covered by pension and Social Security benefits. This allows them to focus on their secondary goals of helping to pay college expenses for their two grandchildren, who are both young.

Because the couple's guaranteed sources of income are large enough to cover their spending needs, they can maintain an aggressive allocation. This means having a small allocation to bonds and cash-like instruments beyond what should be set aside for emergency spending and splurges (e.g., a very nice vacation).

Still, Bob and Jane face two potential constraints that could influence their allocation preferences.

The first is required minimum distributions (RMDs) from their traditional IRAs [and 401(k) plan account, were either to have one]. If their broker allows in-kind IRA distributions, they would be able to transfer shares of stock directly to a taxable account. (In-kind distributions from a traditional IRA are taxed at ordinary income rates like cash withdrawals are.) If either of them takes a cash distribution, they will have to decide whether to maintain a cash allocation to fund the withdrawals or to sell a portion of investments to fund each withdrawal.

In either case, maintaining some allocation to bonds would allow them to better withstand volatility in their equity holdings from a psychological perspective.

The second constraint is the grandchildren's college expenses. Planned annual contributions to 529 plans would necessitate the need to maintain an allocation to lower-risk investments. If the couple opted for lump-sum gifts at the time college expenses are incurred, a more aggressive allocation could be maintained. The potential impacts of financial aid should be a consideration when deciding which option to follow. Nonetheless, it shows that funding secondary goals can influence the decision of how much to allocate to bonds or cash-like instruments.

Key Characteristics of Bonds

There are three types of characteristics to consider when choosing bonds and bond funds. They are maturity, credit quality and bond type.

Bond Maturity Determines Interest Rate Sensitivity

One characteristic of bonds is maturity. Bonds are debt instruments with a set date for when the loan must be paid back to investors. The farther out into the future this maturity date is, the more sensitive the bond will be to changes in interest rates (Table 1).

Fixed interest rates are the reason why. The interest rate for traditional bonds is set at issuance. The longer the time until the bond's principal (the amount of the loan—typically $1,000 for a bond issued in the U.S.) is paid back, the longer an investor will be locked into the interest rate.

TABLE 1

Influence of Interest Rate Changes on Prices

	Sensitivity to Interest Rates		
Bond Maturity	**Less**	**Moderate**	**Greater**
Short-Term	X		
Intermediate-Term		X	
Long-Term			X

A bond paying a 4% coupon is more attractive during periods when prevailing rates on newly issued bonds with similar maturities have 3% coupons. Should interest rates rise to 5%, the 4% coupon bond will seem less attractive. Investors will not mind the difference as much if their 4% coupon bond was going to mature in a year or two as much as they would mind if the 4% coupon bond was not going to mature for another 15 or 20 years.

Interest rate changes alter a bond's price and yield. Yield is income received divided by the price paid for the bond. Since the level of income is fixed with bonds, bond prices are adjusted based on prevailing interest rates. Falling rates reduce yield (higher prices are paid for bonds with larger relative coupons) while rising rates raise yield (lower prices are paid for bonds with smaller relative coupons).

How sensitive a bond is to changes in interest rates can be determined by looking at its duration. Measured in years, duration shows how much a bond's price can be anticipated to move if interest rates move by 1%. A duration of five years means a 1% move in interest rates should lead to a 5% change in the bond's price. Bond funds report duration for their portfolios.

The relationship of each year of duration equaling a full-percentage-point increase in interest rate sensitivity is not an exact measure. Bond prices are convex, with falling interest rates leading to comparatively larger price increases and rising interest rates leading to comparatively smaller price decreases. Nonetheless, duration is a useful tool for setting expectations about future price volatility.

The AAII Asset Allocation Models (www.aaii.com/asset-allocation) use both short-term and intermediate-term bonds. Short-term bonds are generally those maturing in one to five years. Intermediate-term bonds mature in five to 10 years. Long-term bonds have longer maturities. Their extra yield may not be comparatively high enough to offset their higher interest rate risk, though laddering can be used to minimize some of these risks.

Credit Quality Adjusts Yield for the Risk of Default

Another big influencer on yield is credit quality. Credit quality is the perceived ability of a bond issuer to service their debt. The riskier a bond issuer is perceived as being, the higher the yield bond investors will demand in return.

Credit quality is of key importance because the return of a bond is fixed if it is held until maturity. At purchase, the interest rate, the yield and the maturity date are all known. This means bonds have limited upside for price appreciation while their downside is a potential complete loss if the issuer goes bankrupt.

Credit ratings fall into one of two broad categories:

Investment grade and non-investment grade (Table 2). Investment-grade bonds have a lower risk of default. They are rated between AAA/Aaa to BBB/Baa. Non-investment-grade bonds range between a high risk of default to being in default. Non-investment grades range from BB/Ba to D (C for Moody's).

TABLE 2
Relative Credit Risk

Rating	Credit Risk: Less	Credit Risk: Greater
Investment Grade	X	
Non-Investment Grade		X

Investors seeking to hold bonds in order to counterbalance the risk of equities and/or to provide a source of income would be prudent to consider investment-grade bonds. Similarly, mutual funds and exchange-traded funds (ETFs) that mostly allocate to investment-grade bonds are more suitable for these objectives.

Non-investment-grade bonds and funds are speculative and should be treated as such. Though their yields are higher, so are their price volatility and credit risk. Issuers of so-called high-yield bonds may struggle during economic downturns—the same time investors would want the bond portion of their portfolios to provide a ballast against corrections and bear markets in stocks.

Bond Types and Taxes

Beyond maturity and credit quality, bond investors must also choose a bond type. There are three key types: government, municipal and corporate.

Government Bonds

Government bonds are primarily those issued by a nation's government. In the U.S., these are most commonly Treasuries. U.S. Treasury bonds are considered to be the safest from the standpoint of credit risk. Yields are lower for these bonds as a result. Interest from Treasury bonds is taxable at the federal level but is exempt from state and local taxes (Table 3).

TABLE 3
Tax Treatment of Bonds

Bond Type	Taxable: Federal	Taxable: State and Local
Treasury	X	
Municipal*		
Corporate	X	X

**Can influence Medicare Part B premiums and the taxation of Social Security benefits.*

Bonds issued from government-backed agencies also fall under the government category. The tax treatment for other domestic government bonds can differ from Treasuries. Read the prospectus and consult a tax professional if you still have questions.

Foreign governments also issue their own bonds. Buying bonds issued by other countries incurs currency risk as well as potentially higher costs. Both can diminish returns.

Municipal Bonds

Municipal ("muni") bonds are issued by state, county and local governments and agencies. Their big allure is the favorable tax treatment. Interest from muni bonds is generally exempt from state, local and federal income taxes. (Read the prospectus to be sure.) The higher your tax rate, the bigger the tax benefit you will receive.

The favorable tax treatment has two implications. First, the yield of a muni bond needs to be compared against the taxable-equivalent yield (aka aftertax yield) of a taxable bond yield. The tax-equivalent yield is calculated by dividing the tax-exempt yield by 1.00 minus your marginal federal income tax rate (in decimal form). This calculation is necessary because muni bonds often have a comparatively lower quoted yield than bonds with less favorable tax treatment.

Secondly, muni bonds should be held in taxable accounts. The preferential tax treatment of the interest payments is lost when a tax-preferred account such as an IRA or a Roth IRA is used.

Retirees should take Social Security and Medicare into consideration when looking at muni bonds. Interest from muni bonds is included in provisional income, which determines how much of Social Security benefits are taxed, and in the calculation of modified adjusted gross income (MAGI), which determines what Medicare Part B premiums will be charged.

Corporate Bonds

Corporate bonds, as the name implies, are debt issued by businesses.

Interest on these bonds is taxable at the federal, state and local (if local taxes are assessed) levels. The interest is taxed at ordinary tax rates. This tax treatment can make corporate bonds and funds that invest in them more suitable for tax-preferred accounts like IRAs.

Credit quality varies widely and is a key consideration. Large, well-known corporations tend to have more favorable credit ratings, but this is not universally the case. Moody's assigns an Aa1 long-term rating to Apple Inc. (AAPL) but a Baa2 rating to Boeing Co. (BA). The latter rating is essentially at the bottom of Moody's investment-grade scale.

Economic disruptions and changes in industry conditions can cause corporations to see their credit quality deteriorate. On the other hand, corporate bonds do generally command higher yields and have generally realized higher returns—even among those with higher credit quality ratings.

Choosing Between Bonds and Bond Funds

Purchasing individual bonds is different than purchasing individual stocks. A single issuer can have many bonds issued, each with a different CUSIP. A CUSIP is the identifying number assigned to each bond issue. This means buyers have to not only decide which issuer's bonds they want to buy but also which specific bond they want to purchase.

A big advantage of buying individual bonds is the ability to create a bond ladder. A bond ladder reduces interest rate risk by holding bonds of different maturities. As shorter-term bonds mature, the proceeds can either be used as a source of cash flow or be reinvested into longer-dated bonds at prevailing interest rates. The increased certainty over cash flows can be helpful for those with projected spending needs at future intervals.

A big advantage of buying individual bonds is the ability to create a bond ladder.

Individual bonds are priced at par ($1,000) or at a premium or discount to par value. They can be sold in lots worth $100,000 or more. While it is very easy to buy a few shares of stock, it is harder to buy just a few bonds at a time. In addition, many bonds do not trade every day. Adding to the complexity is that the brokers embed their commission into the quoted bond price. These factors make it difficult for individual investors with smaller portfolios to hold individual bonds.

One option is TreasuryDirect.gov. Operated by the U.S. Department of the Treasury, it allows individuals to buy Treasuries directly from the government.

Bond mutual funds and exchange-traded funds provide easy access to diversified bond holdings. They can be an effective way for investors with smaller portfolios or smaller bond allocations to get exposure. The trade-offs are expenses, lack of control over the timing of taxable distributions and the reliance on a portfolio manager. In addition, bond ladders cannot be constructed by holding bond mutual funds and ETFs.

A compromise solution is defined-maturity bond funds. Issued by iShares (ETFs), Invesco (ETFs) and Fidelity (mutual funds), these funds mature on a predesignated date. At maturity, the funds' balances are returned to shareholders. Defined-maturity bond funds lack the customization afforded by purchasing individual bonds but give investors greater ability to diversify against interest rate risk than is possible with bond funds.

The PRISM Wealth-Building Process calls for embedding a preference for holding individual bonds, traditional bond funds or bond ladders into your rules governing investment selection. The same applies for the choice of bond type, maturity and credit quality. Doing so will provide clarity and allow you to only focus on those investments most suitable to your investing plan.

Cash-Like Investments

Cash-like investments include money market funds, Treasury bills (maturities of one year or less), CDs and savings accounts. Their role in a portfolio is to protect allocated dollars from fluctuations in the capital markets and to make it easy to quickly access those dollars. They do not provide the capital appreciation required to meet long-term goals.

Allocations to cash-like investments should be generally limited to anticipated withdrawals needed within the next approximately two to four years as well as emergency savings. Accounts insured by the Federal Deposit Insurance Corporation (FDIC) provide the most protection, though it is generally rare—but not impossible—for a money market fund issued by a well-established company to go under. Be wary of interest rates that seem too good to be true. They probably are.

Savings accounts, interest-bearing checking accounts and money market funds provide quick access to your money. CDs can offer higher yields and be laddered. The trade-off is a penalty for early redemption. Short-term T-bills can also be laddered, but access to portfolio dollars may not be immediate. The choice of which cash instrument to use comes down to comparative yields, account considerations and how quickly you want to access the dollars. There can be situations where it makes sense to sacrifice yield to keep all accounts with a single or very small number of institutions. ■

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A Fresh Look at Defined-Maturity Bond Funds by Charles Rotblut, CFA, September 2019

M

Monitoring Your Allocation, Progress & Life Stages

The PRISM Wealth-Building Process

M | Monitoring Your Allocation

Use this worksheet to compare your current portfolio's allocation against the target allocation you listed in Step 2 of the PRISM process, R - Recognizing Your Risk Tolerance and Allocation. If the difference between your current and target allocation is within your acceptable range of variability, no action is required. If your current allocation has strayed too far away from your target allocation, consider rebalancing (either directly or by via future contributions or withdrawals) to adjust your allocation back closer to your target.

Equities	**Current Portfolio Allocation (%)**	**Target Portfolio Allocation (%)**	**Difference**	**Acceptable Range of Variability**
Large-Cap Stocks	%	%	0 %	%
Mid-Cap Stocks	%	%	0 %	%
Small-Cap Stocks	%	%	0 %	%
International Stocks	%	%	0 %	%
Balanced/Target-Date Fund Portion	%	%	0 %	%
Other: ___________________________	%	%	0 %	%
Total Equity Allocation	0 %	0 %	0 %	%
Fixed Income				
Short-Term	%	%	0 %	%
Intermediate-Term	%	%	0 %	%
Long-Term	%	%	0 %	%
Intermediate	%	%	0 %	%
Balanced/Target-Date Fund Portion	%	%	0 %	%
Other: ___________________________	%	%	0 %	%
Total Fixed Income Allocation	0 %	0 %	0 %	%
Other Assets				
___________________________	%	%	0 %	%
___________________________	%	%	0 %	%
___________________________	%	%	0 %	%
Total Other Assets	0 %	0 %	0 %	%
Cash Equivalents				
Total Cash Equivalents	%	%	0 %	%

Monitoring Your Life Stages

Over the past year, have any of the following happened?

Family	Yes/No	Who	Does It Impact Your Goals?	Does It Impact Your Will, Life Insurance or Trusts?	Does It Change a Beneficiary?
Birth/Adoption					
Death					
Marriage					
Separation					
Divorce					
Start or Graduate From College					

Change in Health	Yes/No	Description	Does It Impact Your Goals?	Does It Impact Your Will, Life Insurance or Trusts?	Does It Change a Beneficiary?
You					
Spouse/Partner					
Dependent					
Other Close Relative					

Employment (You or Spouse/Partner)	Yes/No	Description	Does It Impact Your Goals?	Does It Impact Your Will, Life Insurance or Trusts?
New Job				
Change in Compensation				
Job Loss				
Retirement				

Housing	Yes/No	Description	Does It Impact Your Goals?	Does It Impact Your Will, Life Insurance or Trusts?
Bought/Sold Residence				
Reverse Mortgage (New/Borrowed From)				
Move Into Retirement Community				
Bought/Sold Vacation Home				

Change in Wealth	Yes/No	Description	Does It Impact Your Goals?	Does It Impact Your Will, Life Insurance or Trusts?
Inheritance				
Portfolio Returns				
Bought/Sold Business				
Other Big Influx/Outflow				

Inventory of Key Estate Planning Information

Beneficiaries*

Account	Names

**Check against the Investment Account Inventory List:*
https://www.aaii.com/latest/article/12932-a-worksheet-for-listing-all-of-your-investment-accounts

Financial and Estate Planning Professionals

Type	Name	Phone Number and Email

Doctors**

Type	Name	Phone Number and Email

Life Insurance Policies

Type	Company	Policy Number	Phone Number and Website

Pensions and Annuities

Type	Company	Pension/Contract Number	Phone Number and Website

Wills and Trust Documents

Type	Location	Date of Last Update

Funeral Arrangements**

Type	Funeral Home/Cemetery	Phone Number and Website

Digital Accounts

Type	Username/Password	URL

Other Documents**

Type	Location
Military ID/Discharge Papers	
Personal Contacts	
Final Wishes	
House Title	
Vehicle Titles	
Other	

***Though not tied to your investments, heirs may appreciate having this information included.*

PRISM WEALTH-BUILDING PROCESS

Effectively Monitoring Your Portfolio

The PRISM Wealth-Building Process helps you establish metrics to analyze your portfolio and make changes in line with your long-term allocation.

BY CHARLES ROTBLUT, CFA

Charles ("Charley") Ellis once described the secret to successful investing as "simply not making big mistakes." Many big mistakes occur when investors look at or review their portfolio. Emotions, biases, failing to consider the timing and duration of goals and an overall sense of needing to do something commonly leads to mistakes.

We see the impact of these mistakes in studies on investors' returns. Morningstar's "Mind the Gap 2021" report found the returns realized by investors were 1.7 percentage points below the returns realized by the very funds they invest in (Figure 1). This was an annual return gap (aka behavior gap), meaning investors forfeited 1.7 percentage points in return each year due to their buy and sell decisions. This is a huge amount to have left on the table.

Step 5 of the PRISM Wealth-Building Process—monitoring your allocation, progress and life stages—is designed to limit the mistakes leading to such large return gaps (Figure 2). It helps you to create a disciplined process for interacting with your portfolio. What you look at, how frequently you look and the decisions you make are all based on your goals, desired allocation, buy and sell rules and changes in your life.

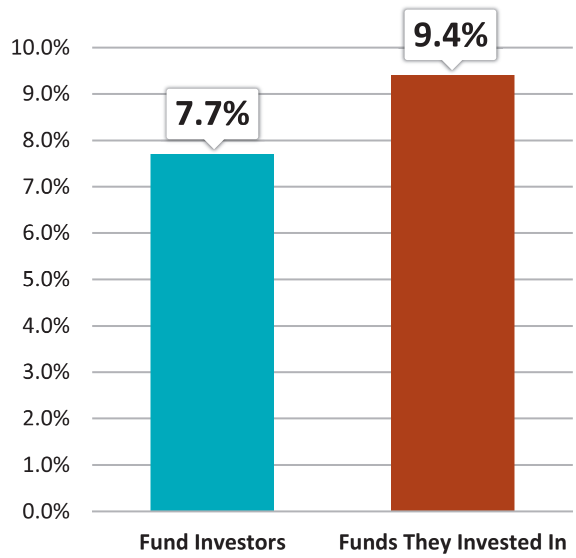
The advantage of this process is that it reduces the noise that so often affects investors' decisions. Your choice of whether to sit still or to make modifications is governed by your own wealth-building process, not the headlines or the "advice" you hear from the various outlets of investing commentary. PRISM provides you with much needed clarity.

There are three key parts to the portfolio monitoring process. The first is monitoring your allocation. The second is monitoring the progress toward your goals. The third part is monitoring your personal situation for any changes in your life or family status. In this article, we address the first part. In a forthcoming article, we'll discuss monitoring your progress toward goals and life stage changes.

FIGURE 1

Investors Underperformed the Funds They Invested In

During the 10-year period ended December 31, 2020, fund investors realized annual returns that were 1.7 percentage points less than the returns realized by the funds they invested in. This return gap is attributed to the timing of purchases and sales by investors. Using a consistent, well-defined approach like the PRISM Wealth-Building Process will help to avoid such large gaps in performance.



Source: "Mind the Gap 2021: A Report on Investor Returns in the United States," by Amy C. Arnott, Morningstar, August 31, 2021.

What About Monitoring the Investments Held in the Portfolio?

You might notice nothing was mentioned about reviewing the individual investments constituting the portfolio as part of Step 5. This is because such reviews are part of Step 4 of the PRISM Wealth-Building Process—selecting

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Rotblut is speaking at AAII's virtual Investor Conference this fall; go to https://www.aaii.com/investorconference for details on purchasing video recordings.

FIGURE 2

PRISM: The Five Steps of the Wealth-Building Process

and managing your investments.

Step 5: Monitoring Your Allocation, Progress and Life Stages is a higher-level review of your portfolio. Its intention is to determine if your portfolio continues to be properly allocated relative to your goals and tolerance for risk. Step 5 prompts you to consider whether your allocation is what it should be, if you are still on track to achieve your goals and whether your goals themselves are still valid.

Consider Elizabeth. She is early in her career and has started to save for retirement through her employer's 401(k) plan. She is following AAII's aggressive portfolio allocation model and is fully invested in equity funds. At the same time, she is building up short-term savings in cash to cover unanticipated expenses to pay for things like the security deposit on a new apartment.

Elizabeth uses Step 5 each year to determine if the mix of large-cap, mid-cap, small-cap and international funds held in her portfolio remain reasonably close to her target weightings. She reviews how much she has contributed to her retirement account relative to her salary as well as her contributions to her short-term savings account to ensure both remain on track. Were Elizabeth to become involved in a serious relationship or have another significant change in her life, she would review her goals to see if any needed revising.

Elizabeth could choose to review the funds she invests in at the same time. In doing so, she would use the rules she established in Step 4 of the PRISM process. She'd consider the funds' performance relative to their peers, expense ratios and whether anything has changed in the funds' objectives.

If her parents or grandparents were to help her save for retirement by gifting her money to invest in individual stocks, Elizabeth may opt to review them on a different schedule. She would use the rules she added to Step 4 for individual stocks to determine whether any are meeting a sell rule.

The decision to sell a specific fund or stock does not alter her choice of allocation. Rather, it is a tactical extension of her allocation. If either type of investment were to meet a sell rule, Elizabeth would seek a similar type of fund or stock as a replacement. A sold international stock fund would be replaced by a new international stock fund. A sold stock would be replaced by a new stock.

Could a needed adjustment to your allocation lead to the selling of an individual fund or stock? Absolutely. The need to adjust the allocation is a higher-level decision than the decision as too which investment to sell, pare, reinvest in or buy. These latter choices reflect the tactical execution of the allocation strategy. The allocation itself is determined in Step 2 of the PRISM Wealth-Building Process—recognizing your risk tolerance and allocation.

How Often Should You Monitor Your Allocation?

Portfolio allocations are rarely stable. As soon as a portfolio's weightings among different asset classes and asset class groups are established, they will begin to shift. Typically, significant changes in allocations develop over time. During periods with sharp market moves, allocations can change quickly.

The coronavirus bear market of 2020 was one such event when allocations rapidly changed by large amounts. Yet, an investor who looked at their allocation on January 1, 2020, and then again on January 1, 2021, noticed a far smaller change in their portfolio's allocation than those who looked in March 2020.

Monitoring portfolio allocations less frequently is advantageous. Volatility is reduced over time as up and down moves are smoothed out. Plus, neither your goals nor their timing or duration change quickly. And we believe your allocation should be reflective of your goals.

Looking less often has another benefit: It reduces the temptation to act. Making adjustments to one's allocation leads to transaction costs and potentially capital gains taxes. It also increases the odds of incurring the return gap. A key reason why many investors underperform the very funds they invest in is because they buy and sell versus simply holding onto the fund.

Most importantly, transacting less often gives your winners more time to run. If, say, small-cap stocks are outperforming, refraining from frequently checking your allocations allows them to benefit from their upward momentum.

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Looking less frequently should not be confused with not looking at all. The PRISM process calls for regularly monitoring your allocation. The frequency is a personal choice, but most investors can get by with an annual review of their allocations. Semiannual reviews are an option for those who want to monitor their allocations more frequently. Shorter intervals for monitoring allocations are only appropriate when a tactical allocation strategy is purposely being used.

Use Bands of Acceptable Allocation Ranges

Investing is messy. Trying to hold allocations to specific percentages (e.g., 90% stocks and 10% intermediate bonds or safe assets—AAII's aggressive allocation model) will lead to high transaction costs and will generally drive an investor crazy.

Allocation bands are a helpful solution: Rather than acting every time a portfolio's allocation appears to have strayed from its targeted allocation, set an allocation range to determine when to act and when not to act. Vanguard has found that allowing portfolio allocations to move within a band of five or 10 percentage points strikes a good balance.

Rather than acting every time a portfolio's allocation appears to have strayed from its targeted allocation, set an allocation range to determine when to act and when not to act.

Bands like these will lead to fewer transactions. When a change is warranted, the dollar size of those changes will be bigger too, however. This can be an issue for those who are concerned about the tax implications of rebalancing or otherwise prefer gradual over large changes.

There are three workarounds.

The first is to redirect portfolio income. Proceeds from dividends, interest payments and fund distributions can be allocated to the underweighted asset classes (e.g., stocks) or asset class groups (e.g., international stocks). In the current low-interest-rate and dividend yield environment, there may not be enough portfolio income generated to adequately rebalance, however.

The second is to use planned contributions or withdrawals to rebalance the portfolio. New contributions could be directed to the underweighted asset classes or asset class groups. Withdrawals can be taken from the overweighted asset classes or asset class groups. This uses transactions that would have occurred otherwise to rebalance the portfolio. The effectiveness of this approach is dependent on the proportionate size of contributions and withdrawals relative to the dollar value of the rebalancing required. Such approaches may work better when an annual rebalancing strategy is desired.

A third approach is to use the proceeds from the sale of portfolio holdings to fund withdrawals. Say large-cap stocks are overweighted and bonds are underweighted, and a large-cap holding meets the sell rules specified in Step 4 of the PRISM process. The proceeds from the sale of this stock could be used to buy additional shares of a bond fund to reduce the large-cap stock exposure and increase the portfolio weighting in bonds. The advantage of this approach is that it makes dual use of a transaction. Lower turnover strategies, such as holding index funds, may not lead to enough transactions, however.

The three approaches are not exclusive to each other. Any three can be used in conjunction with each other. And if additional rebalancing is still needed, it can be done.

Level3 and Market Performance

AAII founder James Cloonan's Level3 withdrawal approach uses the stock market to adjust a portfolio's allocation.

The base allocation is a twist on AAII's aggressive allocation. The Level3 approach calls for an equity allocation mixed with four years' worth of planned withdrawals allocated to short-term (defensive) assets. These are safe assets like cash, money market funds, short-term Treasuries and certificates of deposit (CDs). The defensive allocation is built up over a period of four years before the planned retirement date.

Monitoring of the portfolio's allocation is done annually (e.g., on January 1). On the monitoring date, the level of the S&P 500 index is compared to the all-time highest level of the index. If the current level is more than 5% below the all-time high of the S&P 500, the portfolio is put into defensive mode. Your withdrawals in the year you determine to be a down year will come out of the safe investment part of your portfolio.

Withdrawals will continue to be taken from the safe portion each year until the S&P 500 is above the level used to choose the defensive mode on a portfolio monitoring day. At this point, annual withdrawals are resumed from the equity portion of the portfolio. In addition, the safe investment segment will start to be replenished. Cloonan recommended replenishing the safe assets over a two-year period, restoring half of the deficit (the amount below four years of withdrawal) each year. Any restoration would stop if a new down year occurred, and withdrawals would revert to the safe portion. Table 1 shows a hypothetical example.

Investors following a more traditional bucket approach could use a similar strategy, assuming the safe bucket holds an adequate amount of assets to fund withdrawals. In this case, the short-term bucket and intermediate-term bucket (if used) would only be replenished from the long-term bucket when the S&P 500 is near its high.

Though the AAII Asset Allocation Models do not incorporate traditional bucket approaches, buckets can be easily substituted into the PRISM Wealth-Building Process. The number of buckets and the allocation among them would be determined by an investor's risk tolerance as defined in Step 2 of the PRISM process.

TABLE 1

Establishing Defensive Funds

Date	Condition	Amount	Transfer	Safe Portion
Pre-Retirement Stage				
1/1/2022	OK	$50,000	transfer from Equity to Defensive	$50,000
1/1/2023	DOWN	$0	wait to transfer Equity to Defensive	$50,000
1/1/2024	OK	$75,000	transfer from Equity to Defensive	$125,000
1/1/2025	OK	$75,000	transfer from Equity to Defensive	$200,000
Start of Retirement				
1/1/2026	OK	$50,000	withdraw from Equity for expenses	$200,000
1/1/2027	DOWN	$50,000	withdraw from Defensive for expenses	$150,000
1/1/2028	DOWN	$50,000	withdraw from Defensive for expenses	$100,000
1/1/2029	DOWN	$50,000	withdraw from Defensive for expenses	$50,000
1/1/2030	UP	$50,000	withdraw from Equity for expenses	$50,000
		$75,000	transfer from Equity to Defensive	$125,000
1/1/2031	UP	$50,000	withdraw from Equity for expenses	$125,000
		$75,000	transfer from Equity to Defensive	$200,000

Source: "Investing at Level3: Higher Returns With Minimal Risk for the Long-Term Individual Investor" by James B. Cloonan (AAII, 2017), www.level3investing.com.

Transitioning to a Different Allocation

During the portfolio monitoring process, you may realize that your target allocation weightings need to be revised. There may have been a large change in your wealth, you may be transitioning to retirement, one of your goals may be approaching or one or more of your goals may have changed.

We suggest going through all five steps of the PRISM process before making a change to your allocation weightings. The change requiring a different allocation should stem from your goals and your tolerance for risk. Since PRISM follows a top-down process, it is helpful to reassess your goals—including their timing and duration—as well as your tolerance for risk.

Once this is done, then you can begin adjusting your portfolio to reflect your new desired allocation. The same strategies previously mentioned for rebalancing—using contributions, withdrawals, portfolio income and proceeds from the sale of specific investments—can be used. Chances are that you will also need to pare down or outright sell certain investments to complete the reallocation.

The shift does not need to be done at all once. A two-year transition can work. AAII's Allocation Models include a suggested transition midpoint of 75% diversified stocks/25% bonds when moving from the aggressive model to the moderate model. A midpoint of 50% stocks/50% bonds is suggested for those transitioning from the moderate to the conservative model. These midpoints could be used for the first year of the transition, with the new allocation being fully implemented in year two.

If taxes are not an issue and a more aggressive allocation is being switched to, a shorter time frame is an option. Lump-sum investments in stocks can lead to higher returns than dollar-cost averaging. Psychologically, a rapid change may be harder to stomach especially if the asset class taking a bigger weighting in the portfolio dips soon after the transition has occurred.

Look Less, but Be More Diligent When You Do

If there is one underlying theme here, it is to check your portfolio's allocation less frequently but be more diligent when you do. The PRISM Wealth-Building Process helps you establish metrics to analyze your portfolio. When those metrics suggest no change is needed, don't act. When a change is needed, act in a way that keeps your portfolio in line with your long-term allocation. ■

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PRISM WEALTH-BUILDING PROCESS

Portfolio Monitoring for Progress of Goals and Life Stage Changes

Checking your portfolio at regular intervals tells you if you are on or off track to achieve your goals and whether they are still valid.

BY CHARLES ROTBLUT, CFA

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In last month's *AAII Journal*, I discussed the importance of monitoring your portfolio's allocation along with suggestions about when to make adjustments ("Effectively Monitoring Your Portfolio," October 2021). Monitoring your portfolio is just one of the components of Step 5 of the PRISM Wealth-Building Process. The other two components are monitoring your progress and life stages. I address monitoring both in this article.

Before doing so, let me explain why. Monitoring progress tells you if you are on track or off track to achieve your goals. Identifying whether you are ahead, you are where you should be or you are behind can alert you as to whether changes are needed. Monitoring your life stages provides a reminder to revisit your goals to determine whether they are still valid. A positive change (e.g., a new child or grandchild) or a negative change (e.g., an unexpected job loss, a deterioration in health, etc.) in your life may require a change in your goals—and thereby a revision to your wealth-building plan.

We created PRISM to be an ongoing process. The plan you create by using the PRISM process should evolve over time as your financial, personal and family situation changes. While much of the wealth-building process focuses on investing, factors outside the realm of portfolio management play an important role too. Just because your goals may require a certain amount of money doesn't mean the goals themselves are financial in nature. Houses can be bought as investments; homes are made by the people living there.

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Progress Toward Goals

Progress toward goals from a financial standpoint can be defined by asking, "How much do I have saved right now relative to what I should have saved?" It's a simple question with what may appear to be a simple answer: yes or no.

The simplicity or complexity of getting to the "yes" or "no" answer can vary. A 55-year-old person with no pension who has just $10,000 set aside for retirement does not have enough saved. A 40-year-old with a six-year-old child for whom they've saved $10,000 toward college could find themselves being on track. This would be the case if they've just paid off their own student loans, are on a fast-track career path in a well-paying field or have received some other type of financial windfall (e.g., stock options, an inheritance, etc.).

There is also the timing component of goals. Goals with a short spending duration—such as a dream vacation—must be fully funded at the time the cost is incurred. Goals with a long spending duration—such as retirement—do not need to be fully funded at the time they start.

In either case, there is a certain amount of money that will be needed at the time the goal is first reached. This amount should be determined at the time the goals are prioritized. In the PRISM Wealth-Building Process Academy, we provide a spreadsheet to help estimate the cost of a goal based on your assumptions. There are also various calculators online. Once you arrive at an estimate, then it is a question of whether savings are increasing at a fast enough pace to reach the number.

Determining If Your Savings Are on Track to Fund Your Goals

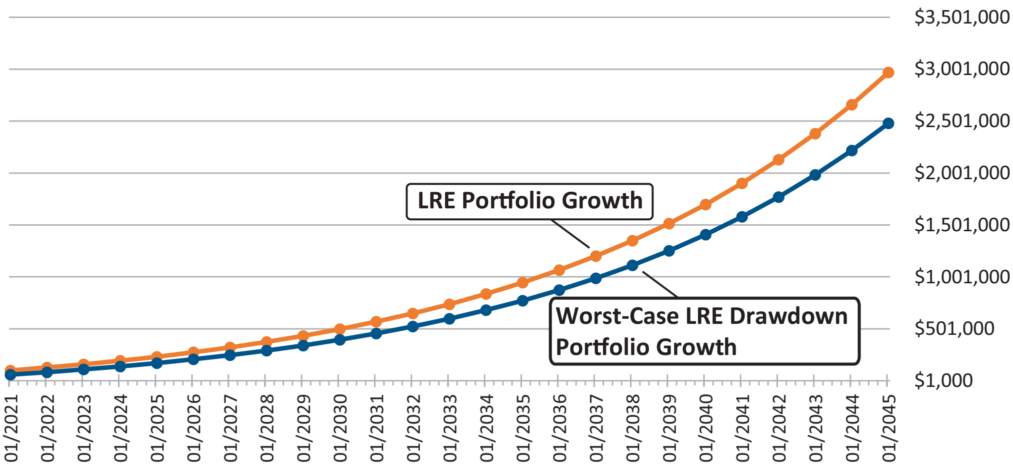
In his book, "Investing at Level3" (AAII, 2016), AAII founder James Cloonan introduced the line of reasonable expectations (LRE). The LRE shows how much your portfolio will grow given a certain annualized return. Contributions or withdrawals can be added so that the LRE shows how much your portfolio should be worth factoring them in.

The beauty of the LRE is that it can show you where you should be wealth-wise at any given point in time. Your portfolio will rarely be exactly on the line. At certain points in time, your portfolio's value will be above the line as your wealth grows faster than the LRE's projection. During other periods, your portfolio's value will be below the

FIGURE 1

Expected and Worst-Case Returns

In his book, "Investing at Level3," AAII founder James Cloonan introduced the line of reasonable expectations (LRE). The worst-case LRE tracks the possible drop in portfolio wealth should a mega-bear market occur. Based on historical drawdowns, it illustrates how much downside your portfolio could potentially incur. The two lines are based on a Level3 (high equity allocation) portfolio realizing an annualized return of 11% with a worst-case drawdown potential of 40%. A worksheet with this chart will be made available in the PRISM Wealth-Building Academy.



line as returns are below expectations. Cloonan referred to these scenarios as the "you owe the market" (wealth above the LRE) and "the market owes you" (wealth below the line).

Investing is messy. A margin of acceptable error should be factored into your plan. This is where an understanding of the historical volatility of your asset allocation strategy comes into play. If the separation between the LRE and your portfolio is within the normal volatility, you may not need to make any adjustments. If it is outside of the range, you may need to make adjustments. These adjustments could include changing how much you save, how much you withdraw, the timing of your goal or the cost of the goal itself. If you find your portfolio is farther above the LRE than you anticipated, you could even consider allocating some of those excess dollars to funding lower-priority goals.

The Worst-Case Line of Expected Returns

Cloonan also calculated a worst-case LRE. This line showed what a portfolio would be worth at a point in time if a mega-bear market occurred. Cloonan assumed a 40% drop in the market with a portfolio realizing an 11% annualized return (see Figure 1). The assumptions can be changed based on your allocation strategy and either historical or projected returns.

The timing of when your portfolio falls to the worst-case LRE matters significantly. It has taken, on average, slightly more than two years for the S&P 500 index to fully recover from a bear market according to data provided by Sam Stovall, the chief investment strategist at CFRA Research. Mega-meltdown drops of at least 40% have taken an average of nearly six years to fully recover.

The length of time it has historically taken for the stock market to recover is why shifting toward a comparatively more conservative allocation while nearing a goal is a prudent strategy. Reducing risk is not necessarily the same thing as dramatically de-risking. Retirees, for instance, can incorporate a bucket of safe assets alongside a significant allocation to equities. Under the Level3 withdrawal approach, the bucket of safe assets would be used to fund withdrawals whenever the market is more than 5% below its highs. The safe bucket's role is to prevent the need to sell equities during a downturn.

The length of time it has historically taken for the stock market to recover is why shifting toward a comparatively more conservative allocation while nearing a goal is a prudent strategy.

If your portfolio falls to the worst-case LRE and there is enough time for the portfolio to recover before you need to sell equities to fund your goals, then you can maintain your allocation without shifting toward a more conservative allocation. If you can increase your savings rate when a bear market occurs, you will get an extra boost of wealth once the recovery occurs. This is particularly the case when the goal will not be reached for many years.

For goals with a one-time or a very short spending duration, reducing risk as the date of those goals nears is important. An ill-timed bear market that sends your portfolio down toward the worst-case LRE could cause you to miss your goals—especially if you are unable to postpone the timing of the goal. The risk questionnaire in Step 2 will help you determine when it makes sense to adopt a more conservative allocation.

Monitoring Portfolio Withdrawals

As previously noted, portfolio withdrawals can be incorporated into the LRE. Projected withdrawals can be used at first, though those projections should be replaced with actual withdrawal amounts each year to provide better monitoring.

Doing so allows you to incorporate a floor-and-ceiling approach. If your portfolio is significantly above the LRE, you can take a larger withdrawal—but not so large that it drops your portfolio to or below the LRE. If your portfolio is below the LRE, you can reduce the size of your withdrawals to allow your portfolio time to recover.

Even if you limit withdrawals to required minimum distributions (RMDs), this approach works. During periods when the portfolio is above the LRE, you can spend more of your RMD amount as opposed to saving it. During periods when the portfolio is below the LRE, you reduce how much of the RMD amount is spent with the remainder potentially reinvested into a taxable account to help your portfolio recover.

What If You're Behind in Funding Your Goal?

If your analysis shows that you are behind in terms of having enough saved to eventually fund your goal, you have three options.

The first is to save more. As your goal approaches, saving more can have a bigger impact than attempting to boost your portfolio returns because of the uncertain sequence of good and bad market conditions and the longer period of time it takes to benefit from the power of compounding. Saving more during a market downturn is also beneficial because it allows you to buy stocks when they are on sale.

The second is to invest more aggressively. This has the biggest benefit when your goal is 10 or more years into the future. Over shorter periods (especially less than five years), the upside of realizing a higher return can be more than offset by the risk of increased downside volatility. Your psychological ability to withstand greater fluctuations in your portfolio's value also matters. If the increased volatility makes it too difficult to stick with the portfolio allocation, then it's not the right strategy for you.

The third is to delay, reduce or kill your goal. Delaying the goal gives you more time to both save and grow your portfolio. In the case of retirement, delaying has the added benefit of increasing Social Security benefits (if you also postpone claiming them) and shortening the time you will be relying on your savings. Reducing means opting for a lower-cost version of your goal. An example would be having a child start at a lower-cost community college before transferring to a university or opting for a state school instead of a private college.

If neither of the first two is a viable option, then you may have to let the goal go unfulfilled. The reason why Step 1 of the PRISM process asks you to prioritize your goals is because it may not be possible to fulfill every goal. Some goals are critical while others can be let go if push comes to shove. While it may not be an easy decision to let a goal go, sometimes it is the best decision.

What If You Are Ahead in Funding Your Goal?

Step 1 of the PRISM process asks you to estimate the cost of your goal. This is your target. It should be periodically updated to account for changes in inflation. You should also incorporate some room for error in case your actual spending on the goal is greater than anticipated (as anyone who has done a home renovation project knows is possible).

Once you exceed this projected amount, the concept of target wealth comes into play. Target wealth approaches call for de-risking, meaning adopting a more conservative allocation once the targeted amount of wealth is reached. The idea is that preserving wealth is more important than continuing to grow wealth. This approach only applies to the dollars meant for a specific goal, not all goals.

If your primary goals are met, then you can focus on secondary goals. These may be goals that are nice to fulfill (e.g., leaving an inheritance or a sizeable donation to charity) or ones that are more aspirational (a second home or taking a dream vacation). Depending on the specific goal, you may wish to maintain an aggressive allocation to achieve it.

Life Stage Changes

Life stage changes are any big event that would potentially alter your goals and/or tolerance for risk. These include family changes, employment changes and health changes. When any life stage change happens, it's essential to go back to Step 1 and review the entire PRISM process. Doing this ensures your wealth-building plan properly reflects the changes that have occurred.

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Family Changes

Family changes can not only alter your goals but also your finances. The birth or adoption of a child will lead to new goals (e.g., college education) and also changes in how much you can save. Marriage increases the amount required to fund retirement (two people instead of one) and potentially adds a new stream of income (or new debt). It can also introduce new goals (e.g., a house, children, etc.). Divorce reduces wealth and leads to a reevaluation of goals. The death of a spouse can reduce income (e.g., one person receiving Social Security benefits instead of two) and also leads to a reevaluation of goals.

Any time there is a change in your family, it is important to review all beneficiary information and estate plans. Update them as necessary.

Employment Changes

Changes in employment directly impact your income and ability to save—two significant influences on any financial plan.

Starting a job brings income and potentially access to an employer-sponsored retirement plan. A raise or cut in pay alters how much you can save, and thereby the progress you will be able to make toward your goals as well which goals are realistic and which ones will have to be viewed as aspirational. A loss of a job, such as a layoff, will disrupt the ability to save for goals. A prolonged period of unemployment or underemployment may require adopting a more conservative allocation to preserve wealth and a reevaluation of goals.

Transitioning to retirement should be a prompt to allocate a portion of the portfolio more conservatively as insurance against a drop in the stock market soon after you start taking withdrawals. Retirement will shift a high-priority goal for many from the building savings phase to the spending savings phase—and require appropriate adjustments to the allocation strategy used.

Health Changes

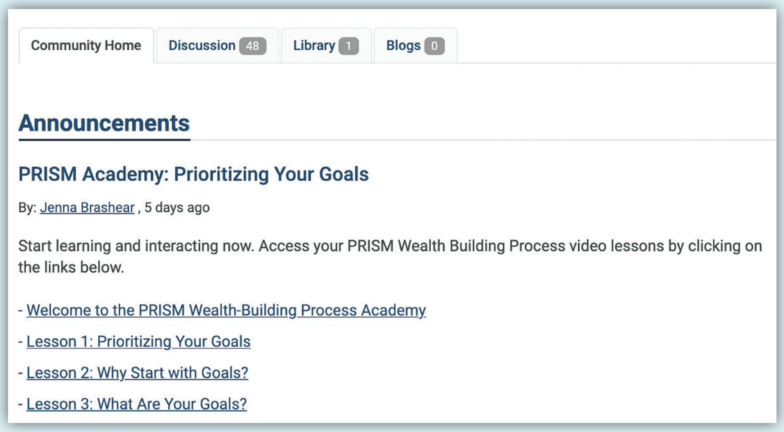
A negative change in health can have several impacts on your wealth-building plan. Cognitive declines will mean altering your investment preferences to include professional help—or at least assistance from someone close you can trust (e.g., a member of your family). A deterioration in your, your spouse's or close family member's health will lead to a reevaluation of goals and tolerance for risk. The same would apply to your spouse's or a close family member's death. Your death would impact your spouse's and potentially your children's or other heirs' wealth-buildng plans.

Other Significant Life Events

There are many other life events that could create the need to go back through all five steps of the PRISM process.

A significant change in wealth alters what goals you will be able to reach and your tolerance for risk. You could experience a large, positive change in wealth (proceeds from selling a business, employee stock options, a large inheritance, etc.) or a significantly negative impact (a prolonged period of unemployment, high medical bills, a business failure, etc.).

New Member Benefits: PRISM Wealth-Building Academy and AAII Community



Last month we added two new AAII member benefits: the PRISM Wealth-Building Academy (www.aaii.com/learnand plan) and AAII Community (https://community.aaii.com).

The PRISM Wealth-Building Academy is an interactive, multi-media self-directed course. It will help you get the most out of the PRISM process. Included in the PRISM Academy are videos covering the key aspects of each step, challenges to learn and apply the concepts and forums to share ideas with other AAII members. I am also holding "office hours" where you can ask me questions and provide feedback about PRISM. Most importantly, when you complete all five courses, you will have created your own personalized wealth-building plan.

The PRISM Academy is integrated into our new AAII Community. The AAII Community is a secure, interactive discussion platform. It connects you with other AAII members. On the Community platform, we have groups about asset allocation, mutual funds and exchange-traded funds (ETFs), retirement withdrawals and more.

We launched Community because we are passionate about connecting our members so you can take advantage of a "collective investor brain." Sharing investment wisdom and experiences can help you become a better investor as well as take control of your financial freedom.

Both the PRISM Wealth-Building Academy and AAII Community are available to all members. We've already seen many AAII members take advantage of these new benefits and hope you will too.

Housing changes alter your wealth and expenditures. The purchase of your first house incurs a large outflow of wealth and new expenses. Downsizing by selling a larger house and buying a smaller one untaps wealth and reduces expenses. Paying off a mortgage frees up cash that can be used to boost savings or spend on other goals. Taking out a reverse mortgage can increase a retiree's tolerance for risk by providing an additional source of income for use during down markets. Moving to a retirement community may introduce new expenditures—potentially costly ones if assisted living or memory care is needed.

Monitoring Is an Ongoing Process

Monitoring your progress and life stage changes should be scheduled at regular intervals. Once per year is appropriate. Should something happen between the scheduled reviews, it is appropriate to accelerate the timing of the review. Life stage changes would be the most common reason to accelerate a review of the portfolio.

While you could monitor your progress toward your goals more often than once per year, it is important not to compare your portfolio to the LRE too frequently. The portfolio will rarely be on the line; rather it will move above and below it. As long as those movements are within the typical range expected for the allocation strategy followed, you should allow your portfolio room to fluctuate. The PRISM Wealth-Building Process is designed to help you create a plan that gives you the confidence to focus on your goals and not the shorter-term fluctuations of the financial markets. ■

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PRISM WEALTH-BUILDING PROCESS

Guidelines for Selecting Stocks for Your Portfolio

The choice of a stock—and even whether to hold individual stocks instead of mutual funds or ETFs—should be reflective of each investor's investment management preferences.

BY CHARLES ROTBLUT, CFA

There are more than 6,500 publicly traded stocks included in AAII's *Stock Investor Pro* database. Choosing which one to invest in requires consideration of your portfolio needs and your preferences and constraints, as well the characteristics of the stock itself.

In this article, we address Step 4 of the PRISM Wealth-Building Process—selecting and managing your investments—as it relates to stocks. As is the case with mutual funds and exchange-traded funds (ETFs), discussed in the July *AAII Journal* ("Guidelines for Selecting Mutual Funds and ETFs"), the PRISM process helps you narrow down the large number of stocks to a manageable list. We'll also provide guidelines from academic research and industry practitioners for selecting stocks based on widely followed investing styles.

Start With Your Allocation Needs and Preferences

Suggestions for which stock to buy are most commonly given from a bottom-up point of view. A bottom-up approach to investing calls for seeking out the best stock regardless of your allocation needs or preferences. These suggestions for stocks perceived as attractive investment candidates can come from analysts, portfolio managers, newsletter writers, pundits and even friends.

When your personal wealth-building process is not taken into consideration, a mismatch between the stock and your long-term strategy can emerge. A recommendation for an emergent, small-cap biotechnology stock does you little good if what you really need for your portfolio is a large-cap dividend-paying stock. Yes, the biotech stock may do well, but you will end up with more volatility and less portfolio income than you had been planning on.

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PRISM follows a top-down approach. We believe an investor's allocation should reflect their goals and risk tolerance. The choice of a stock—and even whether to hold individual stocks instead of mutual funds or ETFs—should be reflective of each investor's investment management preferences. Put another way, your choice of a stock is an extension of:

» What you are investing for,
» Your tolerance for risk,
» The appropriate allocation for you and
» Your investing preferences and constraints.

This top-down approach personalizes the process of selecting a stock. PRISM leads you to consider only those stocks that are appropriate for you. One of the big advantages of PRISM is the clarity it provides. Rather than looking for a needle in a giant haystack, you are narrowing your search down to one small bale of hay.

This top-down approach personalizes the process of selecting a stock.

Using Allocation to Narrow Down the Universe of Stocks

The starting point for selecting a stock is your allocation needs. Specifically, what part of your allocation are you trying to fill?

At a very high level, we can divide stocks into two broad groups: domestic and international. Domestic stocks—shares of companies domiciled in the U.S.—are the ones most likely to be found in individual investor's portfolios. (A bias toward companies domiciled in an investor's home country has been documented around the world.) International stocks represent companies domiciled in other countries. (From the standpoint of allocation, we can divide international into developed countries and emerging market countries.) While foreign-country companies can seek a listing in the U.S. either directly or through American depositary receipts/shares (ADRs or ADSs), many are listed on foreign exchanges.

Both groups can be divided into size-defined categories: large-cap, mid-cap and small-cap stocks. Micro-cap stocks can arguably be added as a fourth category.

Most allocation models split equities into these groups and categories. Portfolio weightings are assigned to domestic large-cap, mid-cap and small-cap stocks as well as international developed and emerging market stocks. Simply using this framework narrows down the list of potential stocks to consider.

Example: A Young Couple Using a Blended Portfolio

Hypothetical couple Frank and Sue supplement the funds held in their 401(k) plans and IRAs with individual stocks. Taking a bird's eye view of the couple's portfolio across accounts, Frank determines they are underweighted to small-cap stocks relative to their targeted allocation.

Frank uses this information to purposely focus on small caps when researching individual stocks. He deliberately ignores other stocks because they are mismatched to his portfolio's needs. Frank is making the conscious choice to narrow his scope of focus in order to adhere to the couple's long-term wealth-building plan.

If Frank and Sue only held individual stocks, the process for narrowing down stocks wouldn't change much. They would still use their allocation needs as a guide for which category of stocks to look at.

Overlaying Preferred Investment Styles

It is not uncommon for investors to look at stocks through the lens of style instead of size. Investment styles include—but are not limited to—growth, value, income and momentum. Studies have linked a preference for a particular investment style to personality traits, biology, life experiences and investment knowledge.

Having a strong preference for a particular investment style fits well within the PRISM Wealth-Building Process. As part of Step 4 of the PRISM Wealth-Building Process—selecting and managing your investments—it's important to clearly state such preferences. Doing so will help to narrow down both the types of stocks you will consider and the rules you will establish for determining when to buy or sell.

Investing preferences are a filter to be used after allocation needs are determined. You first narrow the universe of stocks down to the asset class group matching your allocation needs and then you apply your style preferences.

Example: Matching a Preference for Value With Allocation Needs

Our hypothetical couple Frank and Sue have developed a preference for the value investment style. This preference is based on the long-term outperformance of value stocks.

In searching for small-cap stocks to fill the couple's allocation needs, Frank looks specifically at small-cap value stocks. This combines their allocation need (small-cap stocks) with their style preference (value).

The Value Style and Stock Selection

Value investors seek stocks trading at discounted valuations. The premise of value investing is to pay less than a dollar for something worth a dollar.

Several metrics are now used to determine a stock's valuation. They include the price-to-book, price-to-sales, price-earnings, price-to-cash flow and enterprise-value-to-EBITDA (earnings before interest, taxes, depreciation and amortization) ratios.

Value investors utilize these metrics either on an absolute or relative basis.

An absolute basis sets a firm number above which the stock will not be bought, and a second level at which it will be sold. AAII's Model Shadow Stock Portfolio uses a form of absolute ratios. Micro-cap stocks must have a price-to-book ratio no higher than 1.10 and a price-to-sales ratio no higher than 1.20 to be considered as candidates.

Absolute valuation ratios do not have to be set in stone. They can evolve over time if set to a measurable quantitative metric. The current price-to-book ratio ceiling of 1.10 for the Model Shadow Stock Portfolio is based on the valuation of the "cheapest" 10% of domestic companies listed on the New York Stock Exchange (NYSE). This ratio is periodically revised up or down to reflect prevailing market conditions. (The portfolio's valuation sell rule is simply three times the maximum price-to-book ratio for purchasing stocks.)

Relative valuations compare a stock's current valuation to another metric. The metric can be the valuations of other stocks, the market's valuation or the valuation range that a stock has previously traded within. The Model Shadow Stock Portfolio's valuation rules are based on a relative indicator (the cheapest 10% of NYSE-listed stocks).

Many AAII stock screens use relative valuation metrics. The Joseph Piotroski screen seeks out stocks with price-to-book ratios ranking in the cheapest 20% of all stocks. Industry metrics are used for the AAII Josef Lakonishok screen. A stock must have a price-earnings ratio, price-to-book-value ratio, price-to-cash-flow ratio, or a price-to-sales ratio lower than the respective industry median value to qualify.

It is possible to combine relative and absolute metrics. AAII's David Dreman screen uses a relative valuation metric for price-earnings ratios of the cheapest 40% of all stocks and an absolute valuation metric of a dividend yield greater than 1.5%.

The valuation ratios listed below show the breakpoints for what is cheap and what is expensive as of the time of publication.

Valuation Ratio	Bottom 20%	40%	60%	Top 80%
Price-Earnings (P/E)	10.5	16.5	26.3	49.6
Price-to-Book (P/B)	1.2	1.8	3.2	6.7
Price-to-Cash Flow per Share (P/CFPS)	4.3	11.8	28.4	79.7
Price-to-Sales (P/S)	1.0	2.2	4.1	10.0

Source: AAII Stock Investor Pro. *Data as of 7/12/21.*

In all cases, the rules for selling are the opposite of the rules for buying. Sell a low-value stock when it is either no longer heavily discounted (if favoring deep value) or expensive (if favoring value).

The Growth Style and Stock Selection

Growth investors seek stocks primarily with rising sales and/or earnings. Higher sales and earnings can justify higher valuations and therefore higher share prices.

Growth metrics can be backward- or forward-looking. Backward-looking metrics include historical sales and historical earnings. Projected earnings are the forward-looking metric most widely available to individual investors.

Just like value, growth metrics can be used on an absolute or a relative basis.

Absolute growth metrics require a minimum rate of increases. AAII's John Neff screen requires companies to have a five-year sales growth rate of between 7% and 20%. (Neff's logic for using an upper limit is to exclude those companies whose rate of growth is too high to be sustainable.)

Relative growth is what AAII's William O'Neil CAN SLIM screen uses. The CAN SLIM Revised 3rd Edition screen seeks a trend of quarter-over-quarter and year-over-year growth in historical earnings. Notably, it also includes an absolute component by requiring a three-year annualized growth rate of 25% in earnings.

The growth rate of one company can also be compared to the growth rates of other companies. Relative year-over-year and five-year growth rates for sales, earnings and operating cash flow can tell you if growth is strong or weak.

Growth stocks are candidates to be sold if sales or earnings are falling instead of growing. They may also be candidates for selling if growth falls below a certain level. An investor desiring strong growth may consider parting with a stock if its current or projected growth rate falls to a mid- or low-single-digit percentage, for instance. Those wishing to reduce the number of transactions may want to add allowances for business and economic cyclicality—such as considering both short-term and long-term growth rates.

Current growth rates—from low to high as of the time of publication—are listed below.

Growth Rate	Bottom 20%	40%	60%	Top 80%
EPS Growth 12-Month (%)	(56)	1	38	92
EPS Growth 5-Year (%)	(23)	(1)	12	27
Sales Growth 12-Month (%)	(17)	(4)	6	24
Sales Growth 5-Year (%)	(4)	2	8	18

Source: AAII Stock Investor Pro. *Data as of 7/12/21.*

Some investors combine growth and value metrics, a concept known as growth at a reasonable price, or GARP. The AAII Stock Market Winners screen requires a low price-to-book ratio and two quarters of earnings growth.

The Income Style and Stock Selection

Dividends are favored by many investors as a source of portfolio income or a sign of underlying fundamental strength.

There are two primary camps of dividend investors. One prefers higher yields. The other prefers growth. In both cases, absolute and relative measures can be used.

Higher yields signal a larger dividend being paid relative to the price of the stock. Investors can also use higher yields to seek out stocks with cheaper valuations. The Dogs of the Dow screen seeks out the 10 stocks that have the highest yield within the 30 stocks of the Dow Jones industrial average (a relative measure).

Dividend growth strategies, on the other hand, seek a pattern of rising dividends. These are companies that are expected to continue growing their dividend in the future. AAII's High Relative Dividend Yield screen requires companies to have increased their dividends over each of the past six fiscal years (an absolute measure).

A relatively higher yield can be combined with dividend growth. AAII's Geraldine Weiss Blue Chip Dividend Yield screen requires that a stock's current yield be within 10% of its seven-year average high. It also requires the dividend to have been raised at least three times over the past seven years.

Here are metrics for dividend growth and yield as of the time of publication. The numbers are skewed because only one-third of publicly traded companies pay a dividend.

Dividend Growth and Yield	Bottom 20%	40%	60%	Top 80%
Dividend Growth 12-Month (%)	(76)	0	2	9
Dividend Growth 5-Year (%)	(14)	0	6	11
Current Yield (%)	0	0	0	2

Source: AAII Stock Investor Pro. *Data as of 7/12/21.*

A common rule is to sell a stock when its dividend has been cut or suspended. A drop in a stock's yield below its historical average low or a certain percentage below the market's yield are other sell rules that can be used.

The Momentum Style and Stock Selection

Momentum investors seek outperforming stocks.

Relative momentum strategies seek stocks that have outperformed over a certain period. AAII's Value on Move—PEG With Estimated Growth screen requires passing stocks to have outperformed at least 70% of stocks over the past 26 weeks.

Absolute momentum screens look at a stock's individual price performance. The Driehaus Revised screen requires passing stocks to have risen in price over the past four weeks. The O'Neil CAN SLIM Revised 3rd Edition screen seeks stocks trading within 90% of their 52-week highs.

Momentum strategies sell stocks when their relative price strength has weakened. Because momentum is likely to change quicker than value or growth, allowances should be made by those who desire to reduce the number of transactions. Where you set the number depends on your preference for fewer versus more transactions. Price performance tends to weaken the most for stocks with the weakest levels of relative strength. O'Neil—whose CAN SLIM system is associated with more frequent transactions—has suggested a much higher relative strength rank. Essentially, any stock whose relative strength is nearing average levels (60% or lower) should be removed.

Absolute levels of price return do not translate into a specific level of relative price strength that an investor can consistently seek out because of varying market conditions. (This is why no table is shown here.) Rather, momentum investors should consider relative price strength rankings of 60% or higher as a buy rule. Portfolios composed of stocks with relative price strength rankings in the bottom third—and particularly the bottom 20%—have historically continued to underperform.

Momentum indicators can be combined with other styles. Momentum has been shown to work particularly well with value. (See the discussion with Jack Vogel about factors on page 7 in this issue for more on combining momentum and value.)

Other Preferences and Constraints

Beyond the aforementioned styles, there are other preferences and constraints an investor may have.

Trading activity is one. Investors who prefer to transact less often should consider strategies with less frequent turnover. These are often tied more to a company's underlying fundamentals, such as value and income approaches. Strategies incorporating momentum or technical analysis (charting) are associated with comparatively higher levels of turnover.

Taxes are a related consideration. A higher number of transactions increases the odds of realizing a short-term capital gain in a taxable account. Such gains are taxed at ordinary income rates. Long-term capital gains and qualified dividend income both qualify for reduced tax rates.

A stock's liquidity—the ability to buy or sell easily at quoted prices—can be a concern for investors with large portfolios or the desire to execute trades in a quick fashion. Such investors may consider opting for larger companies. Small-cap value stocks can provide more potential upside for those investors who are comfortable purchasing stocks with comparatively much lower levels of volume.

Sustainable investing strategies—including environmental, social and governance (ESG)—will reduce the universe of stocks to choose from. So will other values-based approaches, such as those based on religious values. If such approaches matter to you, be sure include them in your rules.

Know Who You Are as an Investor

Preferences for styles, strategies and types of stocks vary by investor. There is no single strategy that makes sense for every investor. When writing down your approach for buying and selling stocks, think about your personal preferences. Doing so will help you narrow down the large universe of stocks to those most likely to be appealing to you. ■

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