

A Lifetime Strategy for Investing In Common Stocks

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Perhaps the most common phrase in management thought today is "strategic planning". While not everyone defines strategic planning in the same way, strategy (as opposed to tactics) deals with the overall, long term guidelines that will attempt to insure the success of an individual or institution. Tactics are the specific methods for implementing strategies and are generally of shorter duration. This article is concerned with the lifetime strategic decisions of the individual investor in the management of a common stock portfolio.

There are two basic require-

ments for any business decision. First, there must be a clearly defined objective. Second, there must be a specified time horizon over which success is measured. Sometimes individuals attempt to make decisions with vague objectives such as "do well" or "succeed" but such fuzzy objectives make it impossible to successfully choose from the variety of decision alternatives facing them.

An even more common mistake is failure to specify the time period over which success is to be measured. In business it is frequently true that what is best for the short term is not best for the long term. That is not to say that the long term is better. A new venture struggling to get by might have to concentrate on short term cash flow, even at the expense of long term profits, or there might not be a long term. Sometimes there are both long term and short term considerations. The time period on which the decision maker should focus will vary with the situation, but effective decisions cannot be made without knowing our objectives and over what time period we wish to measure our success.

In our overview of a strategy for investing in the stock market we will assume a "wealth maximization" objective. This is not the objective generally used in investment theory for reasons we will discuss shortly. We will also assume a very long or infinite time frame for investment decision making. We are not so naive as to assume that anyone is going to live forever, but we feel that investment in the stock market for most investors goes through two stages (which may overlap somewhat). The first stage is accumulation — when earnings exceed expenditures and individuals are building wealth. The second stage is when the accumulated wealth begins to be used. We will call this the "withdrawal" stage. Our strategic approach is to use long term wealth maximization as an objective during the accumulation stage and then switch our approach as the withdrawal stage approaches. Some points should be

emphasized:

1. We will stress strategy during the accumulation stage in this article along with guidelines for adjusting holdings as the withdrawal stage approaches.

2. As we will discuss later, all of an individual's wealth should not be in stocks. This is important in our willingness to take a long term view because unexpected events may require that we use savings even though we felt we were still accumulating wealth. There should be liquid assets in other investments for emergencies so that the stock portfolio can be managed on a long term basis.

3. Some investors are always in the withdrawal stage — those living on a trust fund for example — and our strategic approach does not apply to them. Other investors will never have to withdraw accumulated wealth and will leave it to their heirs. They may use an accumulation strategy all of their lives.

4. We do not feel that anyone should embark on a long term investment strategy if the assets are going to be needed in less than five years. A more traditional risk dominated approach which is similar to a withdrawal stage strategy should be taken for shorter time frames.

BACKGROUND CONCEPTS

We feel it is important not only to develop a long term stock investment strategy but to show the rationale of such a strategy relative to current stock market investment research and theory. To support our discussion it is necessary to review some of the concepts of modern investment and portfolio theory. We will begin with some definitions.

Risk — Almost all approaches to investment are concerned with risk. Investment decision making requires concern with risk, but the concept of risk is viewed in a variety of ways. In this article we will refer to risk in two frameworks. The first is a simple and practical approach and the second is a more theoretical definition which is

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November 1981

important when using mathematical decision models.

Our practical and somewhat simplified definition of risk: the likelihood that our investment will be worth less at the end of our holding period than it was at the time of investment. This definition could be modified to take inflation (deflation) into account by saying "worth less in real dollars". Another refinement would be to compare our holdings with what they would have been if we had been put in a zero risk investment. These modifications are really not essential in our general discussion.

The theoretical definition of risk involves an understanding of statistics and particularly the meaning of variance or standard deviation. These are measures of volatility or how much our yield could vary around the expected or average yield. We will use a simple example. Suppose we have an investment opportunity (A) which is absolutely guaranteed to pay us a 10% yield over the holding period. Our "expected yield" is 10% and since it is guaranteed there is no other possible result and no volatility. The variance, the standard deviation and the analytic risk is 0.

Now let us examine a second potential investment (B). Let us say that there is a 50% chance that B will yield 40% and a 50% chance that we will lose 10% over the holding period.

Expected yield is $(50\% \times 40\% + 50\% \times -10\%)$ or 15%. Since the actual yield can be different from the expected yield there is volatility in returns which is risk. Without going into the statistics, the standard deviation of returns, the most common scientific measure of risk, is 25%. This measure, in itself, is meaningless but it can be used either to compare the riskiness of different investments or to make judgements about the best investments if the risk preference or ability to accept risk of the investor is known. As a point of reference the standard deviation of returns for the stock market as a whole is 22.2% for a one year holding

period. There are several important observations.

1. If we compare Investment A (10% yield, no risk) to Investment B (15% yield, 25% risk) we do not get an answer to the question of which is the best investment. B has a higher yield, but also a higher risk. The investment choice depends on the trade off the investor is willing to make. Objectives, which we said were critical to decision making, must be stated in terms of both yield and risk.

2. It is true in any efficient system that yields will be higher for higher risk — if the risk is necessary. We will talk about necessary risk in the next section.

3. We also emphasized that a time frame was essential to decision making. The yield and risk for one holding period (one year, for example) will likely be different for a different holding period (five years, for example). Analytic and practical risk will generally go down as the holding period lengthens.

4. In Investment B there was a 50% chance of losing 10% of capital — a very real risk in the ordinary sense of risk. Note very well that the effect of this risk was included in the Expected Yield of 15%. Expected Yield already factors in the potential loss due to unfavorable circumstances. Analytic measures of risk deal only with the variation of potential returns around the Expected Yield. A risk neutral decision maker would always choose the highest expected yield. Only those adverse to risk will trade off yield for risk reduction.

Diversification and Risk

The more often we assume a risk, provided each time is unrelated, the more we reduce our overall risk. If we agree to flip a fair coin once for a given amount, we have a 50% chance of losing (the standard deviation of returns is 100% which is extremely high). If we agree to flip the coin 10,000 times the overall risk virtually disappears (the standard deviation of returns becomes 1%). The same is true for diversification in investments but

there are limitations because not all risk is diversifiable.

The risk of investing in common stocks can generally be divided into two components — systematic risk and unsystematic risk. Systematic risk is the risk inherent in the stock market itself because there are factors that influence all stocks simultaneously. Since all stocks are effected this risk cannot be eliminated by diversification among different stocks. Systematic risk accounts for about 30% of the risk in a common stock. Not all stocks however are effected equally by general market movements. Beta is a measure of how any individual stock is impacted by general market movements or systematic risk. A stock with a beta of 2.00 tends to move twice as much as the market (up or down) and a stock with a beta of .50 tends to move half as much as the market as a whole. Beta then is a measure of a stock's systematic risk relative to the market which has a standard deviation of returns over the past 50 years of 22.2% for a one year holding period.

Unsystematic risk is the risk associated with the unique characteristics of any one stock. This risk, which accounts for about 70% of total risk, can be largely diversified away. Read the last sentence again. It means that the purchaser of a single stock is taking three times the risk necessary as compared to having a diversified portfolio. Another way of putting it is — investors who consider themselves conservative and invest in one low risk stock probably have more risk than the investor with a portfolio of 10 go-go stocks — and the conservative investor is getting lower expected yield. We mentioned that an efficient market pays higher yields for higher risks but only necessary risk. Systematic risk is largely unnecessary. No matter what investment objectives you have, no matter what your holding period, no matter what kind of stock analysis you perform; if you do not have a diversified portfolio, you are either throwing away yield or assuming unnecessary risk or both.

Throughout this discussion we are always talking about a diversified portfolio when we are talking about stock investment.

To make a point about diversification more dramatic, consider the stock of General Public Utilities before "Three Mile Island". This stock had one of the lowest betas and lowest overall risk measures of any stock available. The severe losses taken by investors who had large portions of their wealth in this stock were unnecessary. In a 10 stock portfolio the overall loss caused by GPU would have been small and fate is such that one of the other stocks may well have had better than expected earnings and offset the loss completely. For approaches to effective diversification see "Diversification Tactics" in the last section.

Naive Buy and Hold — Excess Yields

We will often refer to a naive buy and hold strategy. It is the benchmark against which any approach to the market should be measured. A naive buy and hold strategy is buying a random selection (a large enough selection to be well diversified) of common stocks and holding them forever. The naive buy and hold strategy provides the returns you would get from throwing darts at the Wall Street Journal and investing an equal amount in each stock hit by a dart. No analytic approach is valid unless it can outperform a dart thrower over the long run. A yield in excess of the yield from a naive buy and hold strategy is called an "excess yield" because it is in excess of what would be expected in an "efficient market". (We will expand this concept later.)

Fundamental vs Technical Analysis

Fundamental analysis is an approach to determining the value of a stock by examining factors that determine its expected future earnings and the volatility (risk) of the expected earnings.

Technical analysis is an approach

that tries to predict the future price of a stock or market based on past price and volume changes. The underlying assumption is that stock prices follow discernible patterns and if the beginning of a pattern can be identified the balance of the pattern can be predicted well enough to yield excess profits. The technical analyst keeps charts to discern patterns.

Transaction Costs

In considering the returns on different approaches to investing, the impact of transactions is significant. Most investors consider commission costs but there are other significant factors. Suppose we have 100 shares of ABC, selling at \$25.00 and we wish to switch into XYZ, also selling at \$25.00. The following factors will influence the overall cost of such a switch.

First there will be the commission charges for selling ABC and buying XYZ. The total cost would be between \$50 (Discount Broker) to \$125 (average full service). This totals from 2% to 5%. It will be less for larger transactions, but will be in the 2-4% range.

Second, the bid-ask spread will likely be 24-7/8 - 25-1/8. This means you will receive 24-7/8 for the stock sold and pay 25-1/8 for the stock purchased. This is another 1%.

Third, if you sell a stock with a gain, as opposed to holding it, you must pay taxes. Taxes will have to be paid eventually, but if they are deferred you are earning income in the interim on the eventual liability. If we compare a one year (long term) versus a ten year holding period, the tax deferral could be worth another 1/2 of 1%. This figure would be substantially higher if comparing short term gains versus long term.

In total then you are paying 3% - 6% of equity to switch holdings. This is not to say that it shouldn't be done, just that the new stock must do sufficiently better to overcome its handicap. Those who turn portfolios several times a year must outperform the market by 10% or more just to stay even.

MARKET EFFICIENCY

The approach to investment decision making will be greatly influenced by an investors attitude towards market efficiency. We divide the attitudes about market efficiency into three categories, but each of the categories includes a range of relative efficiency. Market efficiency is the degree to which the price of a stock reflects its "true" value based on all information available.

1. **Highly efficient market.** A highly efficient market hypothesis includes what theoreticians would call semi-strong and strongly efficient markets. The semi strong hypothesis says that stock prices reflect all publicity available information and thus are extremely close to the true value of the stock. This theory allows that there may be some insiders who have additional information and could do better than a naive buy and hold strategy. The strongly efficient market hypothesis denies the insider advantage but there is too much evidence against the strongly efficient market and those who believe in highly efficient markets generally take the semi strong viewpoint. Those who believe in highly efficient markets would deny the value of either fundamental or technical analysis in outperforming a naive buy and hold strategy. Analysts who adhere to a highly efficient market concentrate their efforts on finding efficient portfolios — those that have maximum yield for a given risk level or, put another way, have minimized unsystematic risk.

Weakly efficient market. Adherents of a weakly efficient market still believe, to varying degrees, in market efficiency. They believe that variations in information interpretation, lags in the time of information transfer and lack of proper evaluation of information allow prices of some stocks to deviate from true value and thus there is the opportunity for diligent analysts to find under the overpriced stocks and do better than a naive buy and hold strategy. There

would be disagreement as to the degree of inefficiency and thus the degree to which a fundamental analyst could outperform a naive buy and hold yield. Our own opinion is that the market is weakly efficient, that there are opportunities for excess profits — particularly in the stocks of smaller companies — but that the excess yield over a naive buy and hold strategy is no more than 2-3% a year. Over a lifetime of investing, however, even such a small additional return can lead to a doubling of wealth. The weakly efficient market hypothesis, while allowing some excess returns from fundamental analysis, states that there is no usable information in historic price and volume data that can help an investor outperform a naive buy and hold strategy. The weakly efficient market hypothesis denies the usefulness of technical analysis.

Inefficient Market. No one believes that the market is totally inefficient, but some believe that it is inefficient enough for there to be either large excess profits from fundamental analysis and/or large excess profits from technical analysis. Believers in technical analysis emphasize the inefficiency that comes from psychological aberrations of investors (bandwagon effects, mob hysteria, overreaction, vascillation, etc). They believe such psychological behavior has patterns and thus future behavior of stock prices can be predicted from past price and volume behavior.

How efficient is the market? There obviously is disagreement. Our personal opinion is that it is weakly efficient. This opinion is based on what we feel is sufficient research evidence to question the highly efficient market hypothesis as well as observed variations in rational information interpretation in other areas of the economy. On the other hand, we see no evidence to support an inefficient market hypothesis and much evidence to refute it. Study after study has shown that technical analysis doesn't work and we have never known anyone or even seen a docu-

mented case of anyone earning excess profits over an extended period of time from technical analysis.

MARKET EFFICIENCY AND INDIVIDUAL STRATEGY

While we personally believe in some market inefficiency and that fundamental analysis, particularly in stocks of non-giant companies, can yield excess returns, specific stock selection is really a tactic. The strategic decision is whether an investor should bother with individual stock selection or simply buy an efficiently diversified portfolio of the market — the index approach.

Let us assume that the market is highly efficient — either strong or semi strong. Those researchers and portfolio managers who hold this view conclude that since all stock prices are exactly where they should be in terms of the yield/risk of the stock, the analysis effort should concentrate only on creating efficient portfolios — portfolios where diversification has eliminated all the unnecessary (mostly systematic) risk. We feel that this jump from an assumption of market efficiency to a strategy of selecting stocks only on the basis of portfolio efficiency is incorrect for the individual investor although it may (or may not) be correct for institutions.

This is our greatest area of disagreement (it is only a disagreement about assumptions not about analysis) with contemporary portfolio management theory. This disagreement is critical to our long term approach to the market and we feel it is necessary to expand on it. What does it mean when we assume the market is highly efficient? The general interpretation is that the price of every stock reflects its "true value" based on all information about it. But wait! When discussing decision making we pointed out that the selection of the best alternatives depended on the decision makers objectives and time frame. This means that to the

extent different individuals have different objectives and time frames, the true value of a stock even under a highly efficient market hypothesis is only the mean of all the true values. Carrying this one step forward: Even if the market is strongly efficient, stocks will be over or undervalued for most individual investors. There is then the opportunity for excess profits to individual investors whose objectives and time frames are different from the average objectives and time frames. Further, since the average objectives and time frames are dominated by institutions, it is highly likely that the individual could outperform the market even if it is strongly efficient.

Not all individuals will have objectives and time frames different from the average. This recognition is the reason for our statement earlier that the long term investors (the accumulator) strategy should not be the same as that of those with shorter term considerations (withdrawers). By and large, the individual who will need capital or income from the market in the shorter term is similar to institutions and thus should follow traditional yield/risk analysis. The long term investor, however, faces a completely different set of circumstances and can select stocks with a wealth maximizing objective. Wealth maximizers will consistently find stocks that are undervalued because prices are forced down by those who are short term risk adverse.

SHORT VS. LONG TERM

Let us look at the difference in risk as a function of our time frame or holding period. For this purpose we will define risk in a practical way — the likelihood that our invested wealth will diminish from the time of our investment to the end of our holding period time frame. Some examples of risk differences follow. Our figures are from the monumental work of R. Ibbotson and R. Sinquefeld: *Stocks Bonds Bills and*

Inflation — Updates, which analyzes the market from 1928 to 1978. Portfolio gains and losses include dividends (reinvested) and transaction costs are ignored. The S&P 500 is used as the market measure.

1. If you told your broker to buy a stock at 10:00 AM each day and sell it at 10:00 the next day you would find that you had a loss a little less than 50% of the time.

2. If you told your broker to buy stock at the close of the last day of the year and sell it the end of the next year, you would have had a loss 18 years out of 53 or about a third of the time.

3. If you bought stock the last day of every year and sold it five years later you would have had a loss 6 times in 49 times or about one eighth of the time.

4. If you bought stock as before and sold it ten years later you would have had a loss 2 times in 44 or less than 5% of the time.

5. If you sold the stock after fifteen years you would never have had a loss.

While there would have been variation in the yield from period to period (which is a measure of risk), this variation becomes smaller as the holding period gets longer. One dollar invested in the diversified S&P portfolio at the end of 1925 would have, with dividends reinvested, been worth \$90 at the end of 1978. This period includes the tremendous stock market decline of the early 1930's.

We mentioned previously that the long term investor has an advantage in the market because the market is dominated by short term investors and stock prices, through market efficiency, are valued based on a short term risk dominated approach. Why should institutions, many of which have perpetual existence, be short term oriented? Because their performance is evaluated on a daily, monthly, quarterly or annual basis and the managers must conform to performance standards in the short run. In addition, institutions, particularly pension funds which are a

giant part of institutional activity, have short term demands on their earnings.

Betas, standard deviations of returns and the other analytical measures of risk used by contemporary institutional portfolio managers are almost always calculated on monthly or quarterly data. In addition, individual investors who are dependent on withdrawals have a short term view and while they may not be using theoretical approaches themselves, they are influenced by the conventional wisdom of investing in stocks that have low short term risk. Such an approach may be proper for them, but they help to create a market where price efficiency is based on short term objectives.

To round out our discussion of contemporary portfolio management concepts we should at least mention "random stock price movements" or "random walk". If one believes in a highly efficient market then a stock should stay at its fully valued price until there is additional information. Clearly, stock prices move minute by minute even in the absence of information. An efficient market theorist says that stocks tend towards or have an average price that is efficient but there are variations about this price. They maintain, however, that these variations are unpredictable, sometimes positive and other times negative, and cannot be used to obtain excess profits. These variations are caused by random forces in the environment. An analogy can be drawn with a commission salesman who averages \$100 a day. Given his skill level and a constancy of other factors, he will average this over any long period of time. We would not suppose, however, that he would earn \$100 each day. He frequently would earn as low as \$75 and as much as \$125 and, less frequently, he might have \$0 and \$200 days. These variations are caused by the combination of many chance factors and each day's variation cannot be predicted. He would make a grievous error, if the first time he had a lucky \$200 a day he assumed

that from now on he would be earning twice as much and immediately doubled his budget. Random walk is the explanation of observed short term price fluctuations seemingly without cause even in an efficient market.

THE STOCK MARKET

Since we are talking about the stock market over the long haul, let us compare the results with other investments. We use the geometric mean return because it adjusts for the detrimental effect that yield volatility has on wealth accumulation. One dollar invested at the end of 1925 was worth at the end of 1978 (with dividends and interest reinvested):

\$89.59 if in common stocks.
Geometric mean yield 8.9%
5.34 if in Government Bonds.
Geometric mean yield 3.2%
7.81 if in Corporate Bonds.
Geometric mean yield 4.0%
3.73 if in T-Bills.
Geometric mean yield 2.5%

The consumer price index in that period went from 1.00 to 3.78 with a geometric mean increase of 2.5%.

Historically it is evident that common stocks provide exceptionally high yields compared to "safer" investments and as the holding period gets longer the risk, in a practical sense, becomes unimportant.

In addition to the historical record there is an intuitive argument for the safety of the stock market for long term investors. While there are certainly business cycles and stock market cycles, the long term investors can outlast them. The longest sustained down market was three years and the investor putting away dollars on a regular basis would have bought only a fraction of holdings just prior to a severe downturn. What then is the real risk of long term market investment? It can only be a sustained collapse of private enterprise. If such a collapse occurred there would be no employment, no corporate or individual income tax payments, no banking system and no solvent government. What

would be a safe investment?

If the stock market is not as risky as generally supposed why do we all know people who have lost money in the market? First, the market is risky for the short term investor. As we saw, the one year investor would lose a portion of wealth about a third of the time (more often if transaction costs are included). The attitude of the short term investor must be different. Second, there are a great number of investors "playing the market" or speculating. They try to make large short term profits by trading their portfolios regularly. With transaction costs and without an overall strategy considerably over half of such speculators will lose even with the overall up trend of the market. Third, as we previously indicated, many investors don't diversify. Thus they take more risk and more losses than the market as a whole.

(To be continued next month)

ing number of trades in such instruments and the continual introduction of contracts on new financial instruments. By mid 1982 there will likely be options trading on futures contracts as well as on the actual instruments themselves. Speculators and hedgers, institutions and individuals, former farm commodity investors and those without interest in conventional commodities; all have aided the rapid growth of these markets.

With such growth potential investors are in need of detailed guidance and background material on the subject and we have just read two fairly new books on the subject. The Powers and Vogel book was written about nine months after the Loosigian book and includes some developments that occurred in the interim. Powers and Vogel have a more extensive treatment of taxes which unfortunately has been made obsolete by the 1981 tax changes.

While both books describe the financial instruments and the specifications of futures contracts traded on them, they have somewhat different orientation. Almost a third of the Powers and Vogel book is devoted to a general description of futures and the contents of the first seven chapters are an introduction to futures on either farm commodities or financial futures. Eliminating these chapters and skipping the now obsolete tax chapter results in a book that has only about half as much content on underlying forces, market structure and investment strategy as is found in the Loosigian book.

The individual with no knowledge of any kind of futures market will find Powers and Vogel easier going in the beginning and the general introduction to futures trading, likely based on Powers earlier introductory book on commodities, is very lucid. When Powers and Vogel get into the description of financial instruments and their futures, however, the coverage gets quite compressed and is sometimes difficult to follow. Perhaps the greatest weakness is the coverage of forces that shape

present and future interest rates, but in defense of the authors the orientation of the book is not towards interest rate market analysis but rather towards relationships between futures contracts and various instruments. The basic description of the various contracts is quite clear and the book provides reference tables for the various adjustment factors used by the exchanges in equating deliverable instruments. For some reason, perhaps because they are more lightly traded, commercial paper contracts are almost ignored.

Loosigian gets into the meat of financial futures more rapidly and his book has a more even pace. Much more space is given to analyzing interest rate market determinants and he goes much further into investment strategies. Currency futures are ignored, he is planning another book, but this is consistent with the book's title.

The individual with no prior knowledge of any kind of futures contract may find the need to comprehend the nature of futures trading and the specific aspects of financial futures at the same time a bit difficult. For the neophyte we would suggest introductory reading on the nature of futures trading before the Loosigian book.

Since there is so much overlap between the two books, particularly in their description of actual contracts and various relationships, we would not recommend reading both books. For the individual who wants a more complex description of market forces and investment strategies we would suggest Loosigian with the caution that those with no prior knowledge of futures should do some preliminary reading. For the individual with little prior knowledge of futures, who is more interested in the mechanisms of financial futures trading than in underlying forces and strategy, the Powers and Vogel book should be useful. On balance, since Powers and Vogel cover the first two-thirds of what an investor might like to know and Loosigian covers the second two-thirds, we would opt for Loosigian and pick up



INSIDE THE FINANCIAL FUTURES MARKETS, Mark J. Powers and David J. Vogel, (John Wiley & Sons, Inc. 1981), \$19.95, 320 pages.

INTEREST RATE FUTURES Allan M. Loosigian, (Dow Jones Books 1980), \$24.95, 431 pages.

A growing interest in financial futures is evidenced by the increas-

A Lifetime Strategy for Investing In Common Stocks (Part II)

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In the introduction to our lifetime strategy we have stressed our feeling that for the long term portion of invested wealth common stocks offer an outstanding opportunity for wealth accumulation and that the risk is extremely low. We wish to emphasize that the stock market is risky for short term holding periods but as our decision time frame goes beyond five years this risk is greatly diminished. We should also emphasize that an expected holding period can change due to unforeseen circumstances and this possibility leaves an element of risk. For that reason we

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feel that even individuals who don't plan on needing their assets for many years, should not commit all of their wealth to their long term stock portfolio.

STAGE ONE

Stage One begins with the first dollars available for long term investing. Exactly when any individual has money that is free from short term emergency demands depends on individual circumstances. We have heard it suggested that when income exceeds expenditures and when capital equivalent to 3-6 months income need is set aside in low risk liquid assets — then the long term investment program can begin. On average this seems reasonable but individual circumstances may cause variation. While we feel that basically the long term stock portfolio should not be used for short term needs, it is liquid enough to stand short term emergencies because it can be borrowed against without forced liquidations which might occur when the market is down. The same is true of the investment in a home. Under short term emergency conditions a second mortgage can be obtained without having to sell the home to retrieve the capital for an emergency. Whatever the "comfort level" of low risk short term liquid assets that an individual requires before embarking on a long term plan, the time comes when that amount is exceeded and Stage One begins.

Because diversification is so essential, it is our belief that the first dollars to be put into a long term common stock program, and succeeding dollars until capital is in the \$10,000 — \$15,000 range, should be put into no-load common stock mutual funds. While we firmly believe that the diligent individual can outperform mutual funds, the advantage of diversification more than offsets the investment disadvantage and mutual funds are better initially.

We suggest no-loads because: first, there is no evidence that load funds can perform sufficiently bet-

ter to offset the load; and second, our strategy will lead to the removal of capital from mutual funds as the long term portfolio value exceeds \$10,000. This eventual withdrawal would mean the loan (commission) would be distributed over a very short period.

Our basic criteria of "long term wealth maximization" applies even in Stage One and thus aggressive mutual funds, probably those specializing in the stocks of emerging companies, should be chosen. The method for choosing the best fund is a tactic which will not be treated in depth but will be discussed later. Since funds are themselves diversified it is not necessary to split initial capital, but in the case of no load funds there is no penalty for using two or three different funds. If you feel intrigued by a fund that specializes in one industry and wish to invest in it, then you should split your holdings and have other fund holdings that are not specialized.

STAGE TWO

When the value of your long term portfolio (up to now in mutual funds) grows above \$10,000 it is time to develop your own portfolio. We will discuss diversification tactics later, but at a minimum you want seven different stocks with about equal dollar amounts in each. Because 100 share lots involve less transaction costs, it may be a little difficult to come up with exactly equal dollar amounts with a minimum \$10,000 portfolio. While slight variations are not significant you may prefer waiting until you have over \$15,000 to begin Stage Two.

It is not essential to invest all the money in stocks of your own choosing at one time. Since the balance of your assets are in a mutual fund which is diversified you can substitute individual stocks one at a time. Simply limit yourself to about one seventh of your total portfolio for each purchase until you have closed out your mutual fund, at which time you will have seven stocks.

AAIL Journal

The methods you use to choose stocks are not part of our discussion of strategy (we will mention tactics later) but the overall objective is important. The strategy is to choose those stocks which appear to offer the greatest chance of future earnings expansion.

While all factors that may effect a company's future growth should be taken into account in estimating expected future earnings, you should not be concerned with short term or unsystematic risk. Conventional wisdom emphasizes short term variability, dividend protection, and characteristics relating to unsystematic risk. Basically, debt holders should be concerned about short term cash flow and balance sheet items. Stockholders should be concerned with the expected long term growth of profits.

In almost every long term diversified portfolio, time will bear out that the overall yield is supported by one or two stocks that did extremely well. Long term success will come from providing an opportunity for your portfolio to have in it at least one stock of a company that will go from being a medium company to a successful giant. If you buy stock in a large company you eliminate the chance for that kind of growth. We are convinced that the stock of large companies should not be purchased by long term individual investors. First, because while these companies may continue to grow, they are beyond the super growth stage. Second, because these companies are observed closely by so many analysts, there will rarely be an opportunity to find an underpriced stock even in a weakly efficient market.

In our cursory discussion of tactics it is important to mention that not only should the long term investor be looking for stocks with future growth potential, but for those which are underpriced. While most medium companies may be underpriced for the long term investor because of the markets concern with short run characteristics, there will be significant differences in the price you will

have to pay for future earnings. While analytic evaluation tactics are not our concern here, we will emphasize that "just discovered" companies or industries with high investor speculative interest will not generally be underpriced. While not always true, it seems that companies or industries whose stock has received much attention in the financial press are not good candidates. On the other hand the highly publicized offerings of a few years ago may be good buys after the short term speculators have abandoned them and the price has retreated.

In summary, the long term strategy is to buy stock in companies that have outstanding future growth potential and purchase the stock at reasonable prices. In a diversified portfolio don't be too concerned about risk — particularly short term risk factors.

STAGE THREE

Stage Three begins about four years before there will be significant dependence on invested capital for current expenditures. We use four years because that period will generally include an entire business cycle. The situation that is to be avoided is having to sell a stock portfolio at the bottom of an intermediate term cycle. Individual needs will be different. In some cases the accumulated wealth will be needed all at once as in the case of accumulation for a down payment on a house or a child's education. In other cases, such as retirement, the need will be stretched out but there is a dependence on at least part of the capital in less than four years.

In the case of the individual needing all of the wealth or much of it on a specific date, we suggest liquidating one-fourth of the stock portfolio in each of the four years preceeding the need. The liquidation proceeds should be put into shorter term, low risk investments which will mature prior to the date the capital is needed.

For individuals becoming dependent on the capital or income at a certain time, but not needing it all at once (the retirement case) there are two possible approaches. The first approach is to gradually switch the portfolio from stocks selected under Stage Two criteria to stocks appropriate for a short term risk adverse investor. The tactics involved here are the conventional tactics of investment theory: select a suitable risk level and choose a diversified portfolio of stocks with the given risk level that has the best potential yield. Dividend considerations may become more important, but remember that selling off shares of stocks that are appreciating is not different than receiving dividends on stocks that are not appreciating. In fact, the former alternative may have better tax consequences than the latter.

A second approach, and one that we favor, is to maintain the higher risk (short term risk) stocks selected in Stage Two, but control the overall portfolio risk by shifting a substantial portion of capital into low risk interest paying investments. For a given equal overall portfolio risk level, we feel that the portfolio made up of growth stocks and short term interest rate instruments will outperform the portfolio consisting of low risk stocks. We feel this is true because there is an overpayment for the risk of the growth stocks of small and medium companies and, in addition, short term money market instruments will often give extremely high yields when the stock market is weak.

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

Overall the difference between Stage Two and Stage Three is one of time frame. In Stage Two you live through market downturns for ultimate maximum return. In Stage Three short term market downturns can be harmful and

short term risk becomes a significant consideration. Stage One is similar to Stage Two but requires recognition that diversification is essential. Unsystematic risk is unnecessary and unrewarded.

TACTICS

This article has concentrated on the overall lifetime strategy of investment, but it is clear that to implement such a strategy specific tactical approaches are necessary. The major tactical areas of interest are:

1. Tactics for selecting the no-load funds for Stage One.
2. Tactics for effective diversification.
3. Tactics for selecting stocks with the highest long term growth potential for Stage Two.
4. Tactics for selection of a short term risk-adverse portfolio for Stage Three.
5. Tactics for timing of investment in-flows and variations.
6. Tactics for minimizing tax impact.

While complete discussion of these tactics would take several volumes, we will at least give you a general overview of them.

No-Load Fund Selection

Stage One, while needing the diversification of a mutual fund, involves a long term wealth maximizing approach. Interest should be in aggressive funds concentrating on smaller (smaller than the giants) firms. Long term results published in *Forbes Annual Mutual Fund Review* is easily accessible. Addresses for No Load Funds can be obtained from the No-Load Mutual Fund Association, Valley Forge, PA 19481. Funds in the categories of interest will send prospectuses upon request.

Diversification

Random diversification over 10 - 15 stocks gives very close to optimum diversification, but the investor selecting stocks with

specific criteria runs the risk of selecting a number of stocks whose risk is similar — same industry, same markets, same interest rate sensitivity, etc. The ideal approach is to use the formulas developed for minimizing unsystematic risk, but the correlation coefficients will be difficult to obtain particularly for second tier stocks. For the investor with the time, programs for home computers exist to solve this problem. A simpler approach, with a portfolio of less than 15 stocks, is to avoid any two companies in the same or related industry. With over 15 stocks diversification will be fairly efficient regardless of approach.

Growth Stock Selection Tactics

This is the most exhaustive area and cannot be treated here. The long term investor looking for growth stocks will have an advantage because stocks with short term systematic risk will be bid down by those with short term risk adverse attitudes. Since the dominant part of the market uses short term approaches, most stocks with high betas will provide an excess yield to the long term investor.

In addition to this advantage, however, there is a growing body of evidence that the market is only weakly efficient and thus there are opportunities for increased excess yield from effective analysis. Some of the characteristics that have been shown to identify stocks with excess yield opportunities are:

1. Strong capital position (cash position or book value over stock price).
2. Low priced stocks (under \$10/share).
3. Smaller companies.
4. Low price-earnings ratios.
5. High recent profit increases.

The above are numerical indicators that are easily screened. In addition there is the possibility that thorough analysis of market opportunities, new product development, management capability, merger potential and other potential profit considerations can also lead to stocks with excess profit oppor-

tunities.

There are almost an infinite number of books and theories about methods for selecting common stocks. The AAI reprint booklet, "Fundamental Stock Selection", covers some of them and the AAI Journal will continue to publish articles on this topic, but individuals can also experiment with their own methods. The basic objective is to select stocks whose companies have high expected growth rates without concern about short term systematic risk.

Risk-Adverse Selection Tactics

Selecting stocks when the investor becomes sensitive to short term market moves can be handled by the well developed approaches used by institutions. Basically, a suitable level of risk is determined and a diversified portfolio of stocks are selected which have the appropriate portfolio beta. Within the risk constraint it may also be possible to identify undervalued stocks if the market is only weakly efficient.

An alternative approach, and one we favor, is to continue selecting stocks as under the long term guidelines, but adjust for risk by reducing the percentage of total wealth that is invested in common stocks to an appropriate level.

Timing Tactics

There are two separate aspects of timing. The first is for individuals that will remain fully invested through time and the second relates to investors who may wish to vary the percentage of wealth committed to stocks based on economic conditions.

In the first case the only concern about timing is that a large portion of wealth not be put into the market at a single point in time. Doing so will lead to the risk of having invested at a market peak and such an occurrence would have a long term negative effect on yield. Dollar cost averaging has been amply discussed and we won't pursue it here. Our basic advice is that if a large amount of capital is available

at a single point in time (inheritance, home sale, business sale), the funds should be invested in the stock market gradually. We would suggest spreading purchase over at least a two year period.

The second aspect of timing has to do with the possibility of being out of the market during downturns and reinvesting at the end of the downturn. The ability to predict such turns would lead to higher yields. We will not even discuss the predicting of short term market changes because we have never seen satisfactory evidence that it can be done with enough precision to offset the increased transaction costs not to mention the adverse tax consequences. We have seen evidence that it won't increase yield at all but will generate costs that might run as high as 10% of portfolio value a year. Too much trading stands with lack of patience or a major reason for lack of investment success.

There is some evidence, however, that the business cycle (3 - 5 years) and the election cycle (4 years) can be tied to cycles in the stock market. Since the timing, duration and amplitude of this cycle varies considerably, the excess profit from such a strategy is limited but may be significant. If individuals feel they can predict such turns, they can vary their commitment to stocks over time. One very important consideration, often overlooked in the discussion of such tactics, is what are the alternative investment yields for funds when they are not in stocks? If low risk yields are low and dividends are foregone the relative advantage of intermediate term timing is reduced.

For the investor wishing to use intermediate term timing some study of cycle theory and the history of stock market movement is advisable. The most commonly discussed cycle phenomenon is the election cycle. Proponents of this approach move out of stocks the December after a presidential election and move back in from 1 - 2 years later. This approach has frequently led to additional yields but

has also failed on several occasions where large upturns were missed.

Tax Tactics

Tactics to minimize tax impact on accumulated wealth will vary over time depending on current tax regulation. We will not go into specifics but will point out that "after tax" return is all we will wind up with and any tactics that reduce the tax level or defer the tax are desirable if they do not make any substantial change in our investment strategy. A long term approach to investing will insure that a large portion of yield is taxed at the long term capital gains rate and will be deferred for a substantial period of time. Since this is the lowest rate available for taxed income, our long term approach is tax efficient. There are, and most likely will always be, plans to defer tax liability within an overall strategy through various forms of pension plans and these should be utilized to the extent possible. From time to time there will also be special programs such as the exemption of utility dividends under a qualified reinvestment program. The investor must always consider the potential yield loss versus the tax impact savings.

Summary

Our purpose of this series was to create an overview of a lifetime strategy for stock market investment. Implementation of this strategy will involve various kinds of tactics which we did not discuss in depth but which are important. Investigation of specific tactics should be carried out by individuals and such tactics will always be an important topic in the AAI Journal and other AAI programs. While such tactics, particularly the selection of stocks during Stage Two, are important, the game is biased in favor of the long term investor. Even if your tactics for selecting stocks with the greatest growth potential are imperfect, your long term diversified portfolio will likely outperform most professionally managed portfolios and the Dow Jones Average, over the long run.

INVESTMENT NEWS & VIEWS

Government spending will top \$1 trillion in 1981 for the first time in U.S. history according to Tax Foundation projections. All units of government — federal, state, and local — will spend an estimated \$1.07 trillion in the current fiscal year, say Foundation economists, up from \$942 billion in fiscal 1980. That means that government will be spending \$4,678 for each man, woman, and child in the United States. Long-term trends show a relentless escalation of government spending at all levels.

National Taxpayers Union

Unless there are some major changes in the developing cycles, expect the Winter of '82 to be a real BEARCAT over the eastern two-thirds of the nation.

The Reaper

As the prices of original art have increased, investors have looked more favorably on prints and photographs. But evaluating these "multiple" types of art poses special risks, according to Gustave Harrow, New York State assistant attorney general.

At a seminar presented in Atlanta at the meeting of the American Society of Appraisers (ASA), Mr. Harrow pointed out that "authenticating these items is a very sensitive area." For example, he said, an edition may be listed as having 250 multiples, but the artist may have taken 50 artist's proofs, then later pulled a few copies for friends. These eventually may start circulating, diluting the value of the print. Mr. Harrow noted that Dali, for example, often printed a separate series of a single work for distribution in each of several countries. This is one reason that it can be difficult to determine how many copies actually exist of a Dali print, regardless of the notation on the print.

The Collector Investor