Introducing the AAII Way for Creating a Wealth Plan

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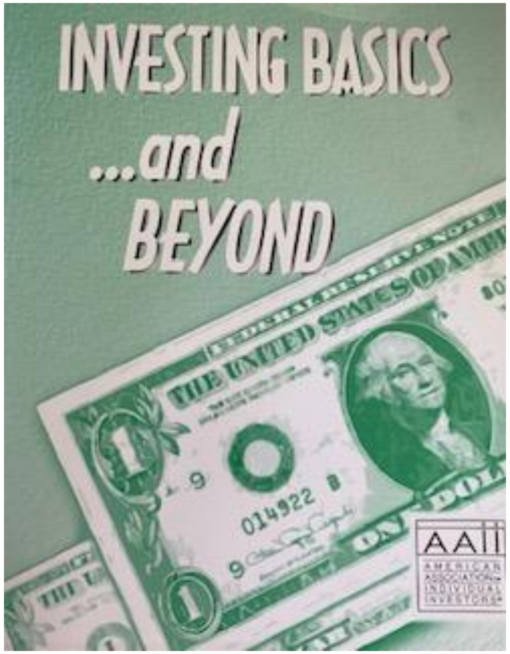
AAII AMERICAN ASSOCIATION OF INDIVIDUAL INVESTORS®

"The AAII Way" is a new project to help you create a comprehensive and personalized plan for investing.

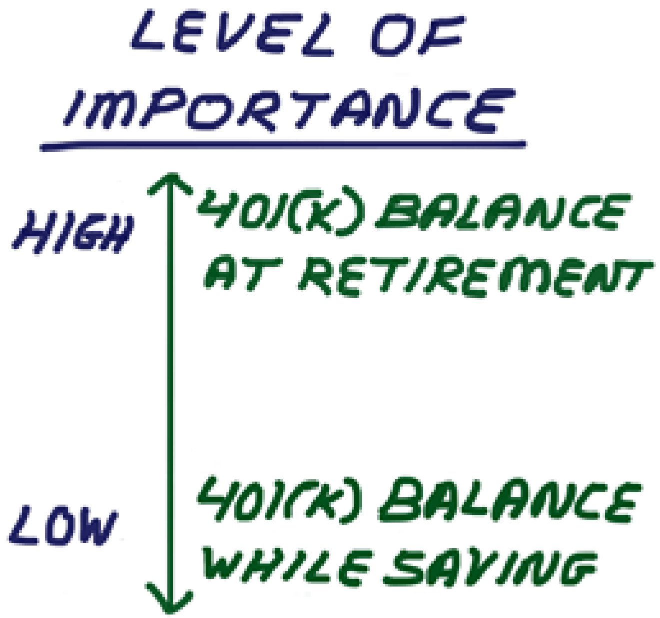
It will help you to become a more effective manager of your own assets.

Building on What We've Previously Done



Since AAII began, there has been a growing amount of research showing how systematic approaches lead to better outcomes

We Easily Lose Sight of What's Really Important



Source: "My Personal Portfolio Four Months After the Correction," AAII Investor Update, April 25, 2018.

Noise Affects Our Decisions

Jim Cloonan’s Rules for Investing Success

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

Source: ”Adherence to Rules Helps Model Shadow Stock Portfolio’s Performance,” by James Cloonan *AAII Journal*, October 2012.

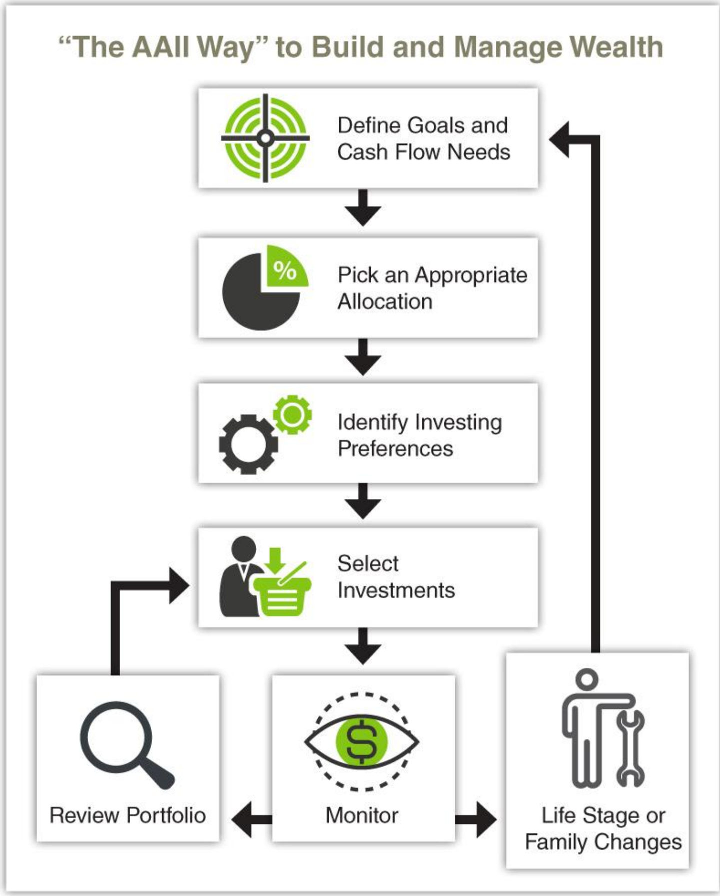
The optimal strategy is not one that maximizes return, but rather one that helps you stick to your long-term investing plan and achieve your goals.

The AAII Way will help you define what the optimal strategy is.

What Will It Encompass?

- A series of worksheets unveiled at www.aaii.com/AAIIWay
- Commentaries in the weekly AAII Investor Update
- Revised versions of the worksheets in the *AAII Journal*
- Longer-term: Integrated into AAII.com and potentially a new book

The Five-Step Process



Source: "A Process for Creating Your Own Wealth Plan," *AAII Journal*, June 2020.

The Process Is Based on Simple Premises

- Know who you are as an investor
- Identify and follow a strategy that's right for you
- Review and adjust as necessary

Lots of details behind these bullet points

The plan can be as simple or complex as you need it to be.

Some investors may have one portfolio managed by a professional; others may fully self-manage their portfolio to reach different goals

Regardless of how you invest, the process always starts with defining who you are as an investor.

What Are You Investing For?

AAII Way: Identify and Prioritize Your Financial Goals

Goal	Number of Years Away	Spending Duration	Priority	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.

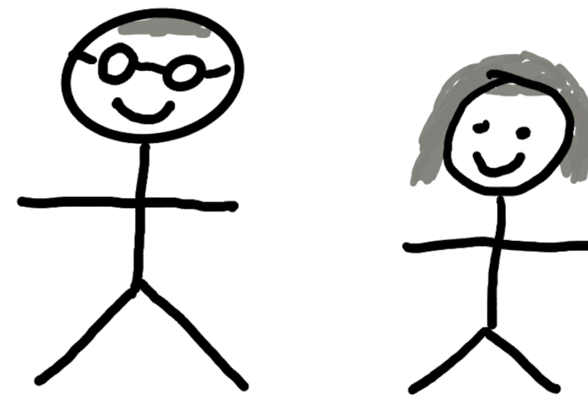
Priority is the numerical ranking of how important each goal is.

Why Do This Exercise?

- Writing down goals makes them more concrete
- Forces you think about why money is important
- Helps you define your time horizon and the level of risk you can take
- Makes you prioritize goals

Example: Retired Couple

- Bob and Jane are recently retired
- Social Security and pension benefits
- $1.5 million in savings
- Kids and grandkids



Bob and Jane’s Goals

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

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

Source: “Defining Your Investing Goals,” *AAII Journal*, July 2020.

Let’s define their tolerance for risk.

Why Do This Exercise?

- The timing of when you need the money and the duration of time you'll spend on the goal (lump sum, 20+ years, etc.) drive the allocation decision
- Wealth may allow you to be more or less aggressive
- Your emotional ability to tolerate risk may be different than your financial ability

What We Know About Bob and Jane

- They are affluent
- They have non-portfolio income from pensions and Social Security
- The timing of their primary goal, funding retirement, is now
- The duration of paying for the goal is potentially three decades or more

Bob and Jane’s Timing Risk

<u>Timing of Goal</u>

How many years away is the goal?

Now or in the short-term future (five years or less)	**1** x
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?

Now or in the short-term future (five years or less)	1
Intermediate — Five to 10 years	3
Long-term — More than 10 years	**6** x

Relative 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** x

Timing Score (total of scores above)	13

Based on your score, your timing risk is:

Short-term	0-5
Intermediate	6-9
Long-term	10-18

Source: “Our Revised Risk Tolerance Worksheet,” www.aaii.com/AAIIWay

More About Bob and Jane

- Fairly disciplined investors, but have reduced exposure to equites during past bear markets
- Cash flow provides a buffer against market volatility
- Understand investing concepts, but don't consider themselves experts

Financial and Psychological Risk

<u>Financial and Psychological Risk</u>

During market declines, you have:	
Significantly reduced my exposure to stocks and stock funds	1
Somewhat reduced my exposure to stocks and stock funds	**3** x
Maintained my allocation or bought more stocks	6
How much of your spending needs are covered by non-portfolio income?	
None	1
Some	3
All	**6** x
How would you describe your knowledge of key investing concepts?	
Basic/Low	1
Moderate	**3** x
High	6
Financial/Psychological Tolerance Score (total of scores above)	12
Based on your score, your financial and psychological tolerance is:	
Low	1-5
Moderate	6-11
High	12-18

Source: "Our Revised Risk Tolerance Worksheet," www.aaii.com/AAIIWay

Their Wealth and Cash Flow Allows Them to Be Aggressive

			Timing Risk		
			Short-Term	Intermediate	Long-Term
			0-5	6-9	10-18
Financial /	Low	1-5			
Psychological	Moderate	6-11			
Tolerance	High	12-18			x

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

Risk Tolerance

		Timing		
		Short-Term	Intermediate	Long-Term
Financial/	Low	Very Conservative	Cons. to Mod.	Mod. to Aggr.
Psychological	Moderate	Conservative	Moderate	Aggressive
Tolerance	High	Cons. to Moderate	Mod. to Aggr.	Aggressive

Source: "Our Revised Risk Tolerance Worksheet," www.aaii.com/AAIIWay

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 5 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 5 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

Source: "Our Revised Risk Tolerance Worksheet," www.aaii.com/AAIIWay

Given Bob and Jane’s tolerance and goals, an aggressive allocation of 90% stocks and 10% cash may make sense for them.

(The lack of cash flow needs allows them to seek long-term growth.)

What If Bob and Jane Had Less Guaranteed Cash Flow?

- Sequence of returns would matter more (greater timing risk)
- Psychologically, they might prefer less volatility in portfolio returns because non-portfolio income covers less of their spending needs (greater financial risk)

Without the high level of cash flow, a moderate allocation of 60% stocks and 40% bonds/cash may make more sense for the retired couple.

(They need to balance income needs with the requirement for portfolio growth.)

Preferences to Be Decided

- Do Bob and Jane want to manage the portfolio themselves?
- Is active management or indexing preferable?
- Do they want to pick stocks and bonds, or would they prefer mutual funds and ETFs?

If They Choose to Self-Manage

- Bob and Jane should have clear buy and sell rules (like AAII model portfolios do)
- If using funds, they'll need to consider portfolio allocations, changes in objectives and performance relative to category
- If buying individual stocks, they should analyze valuation, earnings, dividends and fundamentals

Monitoring

- Bob and Jane should regularly analyze their investments to ensure sell rules aren’t being violated (AAII’s My Portfolio can help)
- They should periodically assess their risk tolerance
- Any life changes (e.g., their health deteriorates, more grandchildren are born, etc.) would require them to reassess their goals

The goal for Bob and Jane is to develop a policy statement to guide them through their investing decisions.

An added benefit is that they’ll be able to articulate what they are doing and why.

This will make it easier for someone (e.g., one of their children) to step in on their behalf and make the decisions they would want to be made.

Watch Us Build the AAII Way

- AAII Investor Update: www.aaii.com/investor-update
- AAII Way: www.aaii.com/AAIIWay
- AAII Journal: www.aaii.com/journal

AAII Investor Update

Comparing the Five Major Categories of Stocks

Read Comments (2)

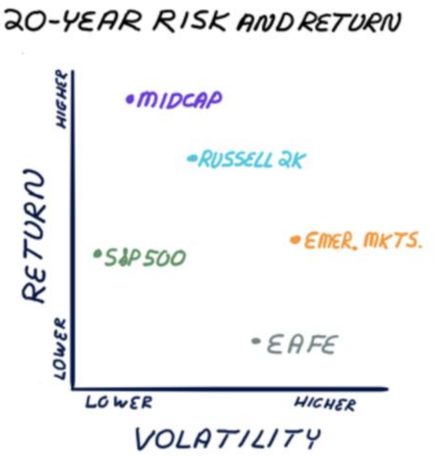
Thursday, June 25, 2020

Charles Rotblut, CFA
AAII Journal Editor

A quick note before I begin today's commentary. The Internal Revenue Service updated its guidance regarding the CARES Act. I haven't read the full notice yet, but I do know there are revisions affecting required minimum distributions (RMDs). RMDs taken this year—including in January—can now be rolled over to an IRA by August 31, 2020. In addition, rollovers of RMDs do not count against the one rollover per 12-month rule. On a separate note, we corrected the calculation of average one-year low and high returns discussed in last week's commentary.

Over the long term, equities have realized the highest returns of the major asset classes. Stocks provide growth of wealth. The price for this growth is volatility, particularly downward price moves. (No one seems to mind volatility when it pushes prices upward.)

There are a few ways to manage this volatility. One is to adjust how much portfolio exposure you have to stocks. We'll get to this in a couple of weeks when I introduce the next worksheets for The AAII Way. Another is to diversify among different categories of stocks.



At the end of this week's commentary, you'll find tables with historical returns for five well-followed indexes: S&P 500 index, S&P MidCap 400 index, Russell 2000 index, MSCI EAFE index and MSCI Emerging Market index. We also show additional data to provide insights on volatility and how a blend of all five has worked. But first, a few insights and observations about each index.

The S&P 500 is the most widely followed index. It tracks the performance of the largest U.S. companies. These companies are considered to be more fundamentally sound and many have international operations. They are also more likely to pay dividends than their smaller domestic brethren. The S&P 500's strong relative performance over the last 10 years makes it easy to forget that the same index fell in value between 2000 and 2009 (aka, the lost decade).

(www.aaii.com/investor-update)

We want The AAII Way to be useful to you. Try out what we’ve developed so far and give us feedback at journal@aaii.com.

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