Creating Your Own Personalized Wealth Plan With PRISM

AAII
AMERICAN ASSOCIATION OF INDIVIDUAL INVESTORS®

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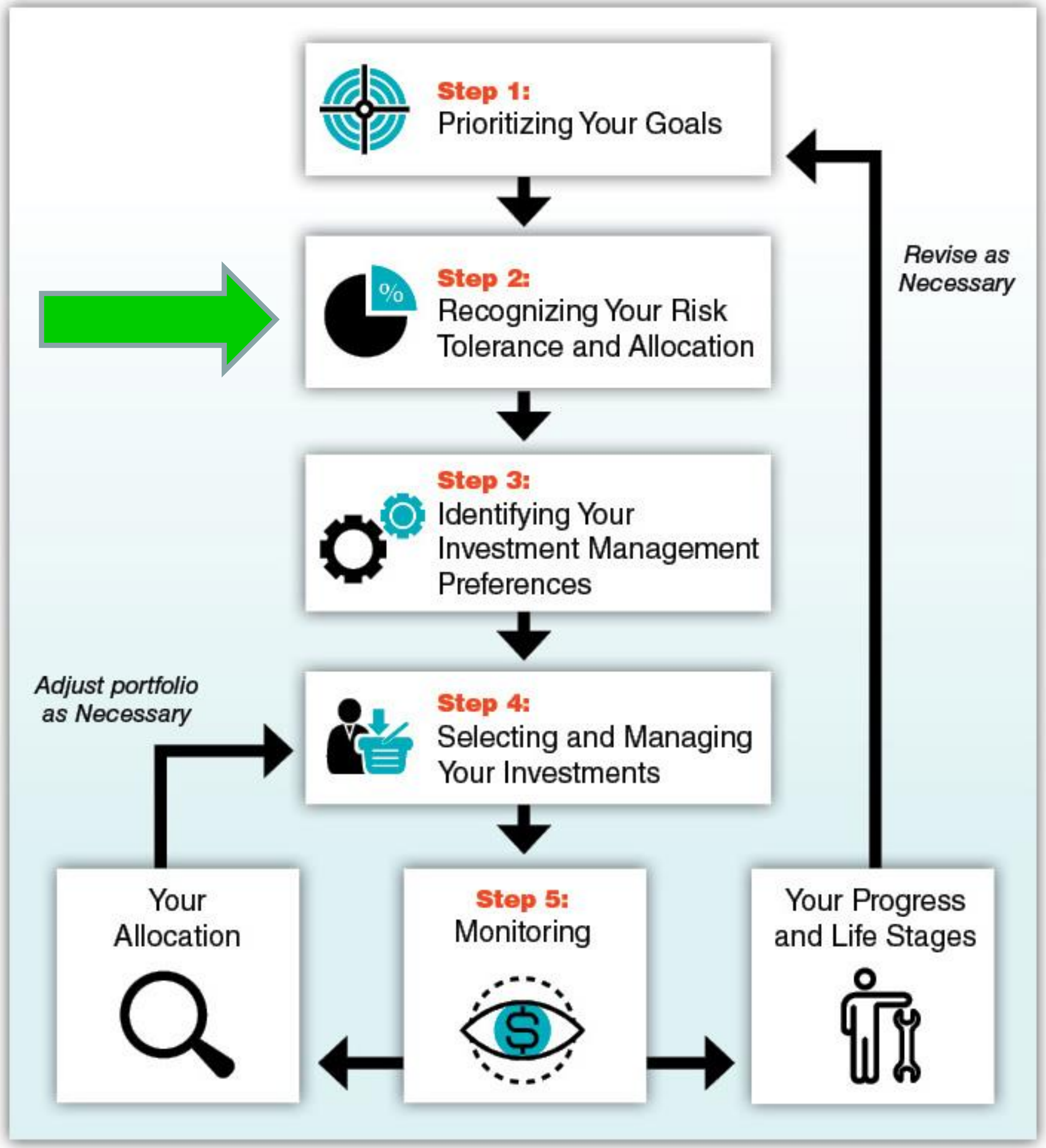
The PRISM Wealth-Building Process provides a framework for aligning your investment decisions with your goals.

The five steps of PRISM empower you to create a personalized investment plan and have the confidence to follow it.

Writing down goals leads to a 42% improvement in achieving them.

Source: “The Impact of Commitment, Accountability, and Written Goals on Goal Achievement,” by Gail Matthews, Dominican University of California, 2007.

PRISM: Wealth-Building Process



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.

PRISM helps you identify this strategy.

Risk Tolerance and Asset Allocation

- Risk considers the timing of when assets will be needed, the financial ability to withstand drops in portfolio value and the psychological ability to cope with volatility

- Allocation is the mix of asset classes and asset class groups used to achieve your goals

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

Pause for a Poll

1. If you completed the Risk Assessment worksheet, what was your overall risk tolerance?

   a) Conservative

   b) Moderate

   c) Aggressive

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

Why Do We Care About Short-Term Time Horizons?

- Short-term spending needs require a greater emphasis on preservation of wealth
- Sequence risk, an ill-timed series of bad returns, is the big threat
- There is less time to recover from drops
- Sequence risk particularly matters if there will be a large expenditure relative to wealth (e.g., a down payment)

Younger Investor Buying First House

- Elizabeth needs $40,000 for a down payment
- She puts the money saved for a down payment into the stock market
- A 15% correction occurs, leaving with her $34,000
- This could result in her losing out on her dream home

Recovery Time From Stock Market Drops (1945–2021)

Type of Decline	Number	Average Drop from Peak	Duration (Months)	Time to Recovery (Months)
Pullback (5.0–9.9%)	60	(7%)	1	1.5
Correction (10.0%–19.9%)	23	(14%)	4	4
Bear Market (>20%)	13	(33%)	13	27
"Garden Variety" Bear (20%–40%)	10	(27%)	13	27
"Mega-Meltdown" Bear (>40%)	3	(51%)	23	58

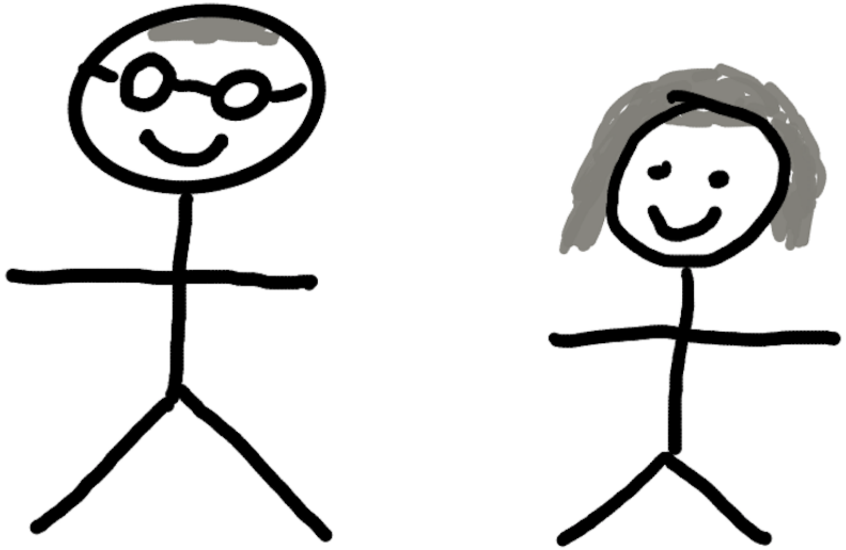
Source: "Correction Countdown," Sam Stovall, CFRA Sector Watch, February 22, 2021.

Why Do We Care About Long-Term Time Horizon?

- Long-term spending needs require a greater emphasis on growth of capital
- Inflation diminishes your purchasing power over time
- Plus, long time horizons give you the ability to recover from short-term drops and benefit from the power of compounded returns

Retirees Leaving an Inheritance

- Bob and Jane want to leave a financial legacy to their heirs
- There is a 1-in-4 chance of one living to at least age 90
- Plus, withdrawals may not happen for 10 years later
- Equities provide best chance for much needed growth of capital in excess of inflation



How PRISM Helps

- Ties the timing of when your goals will be reached and how long you will be spending on them into your assessment of risk
- Factors in the proportion of wealth that will be spent on goal rather than relying simply on timing alone

Applying What You Learned

In the AAII PRISM Academy community, we asked AAII members:

1. What are your timing risks for each goal?
2. What does timing risk tell you about your goals?

Participating in our online community helps you get more value out PRISM.

Step 2: Lesson 4 – Timing Aspects of Risk

American Association of Individual Investors

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

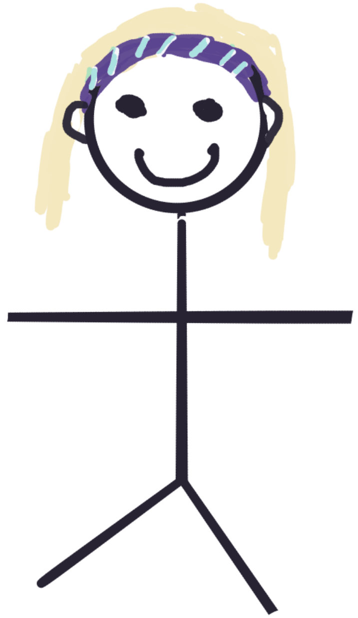
American Association of Individual Investors

Why Do We Care About Financial Risk?

- There is an inverse relationship between how dependent you are on portfolio withdrawals and your ability to tolerate risk
- High levels of non-portfolio cash flow prevent short-term drops from interfering with spending on goals
- Short-term drops can interfere with spending plans if an investor is highly reliant on withdrawals

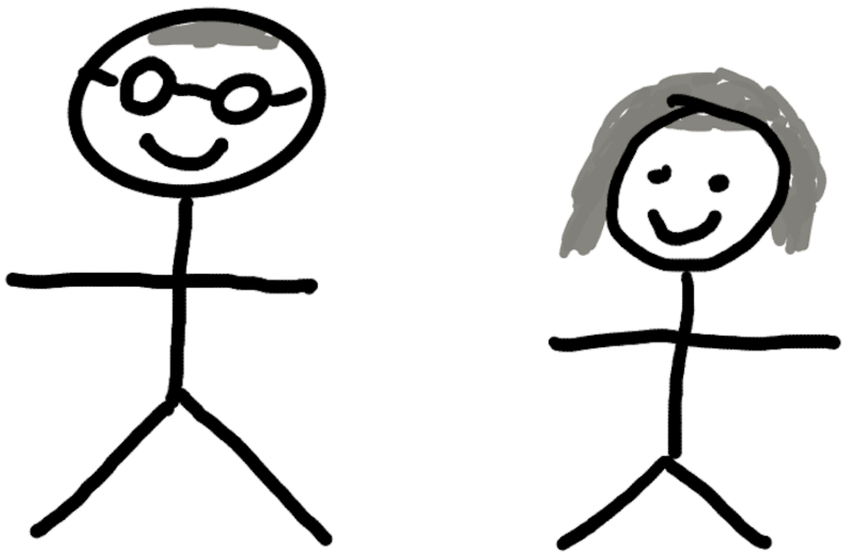
Younger Investor With Job

- Elizabeth’s job provides her cash flow via her salary
- She has a high tolerance for risk when it comes to retirement savings because no withdrawals will be needed for decades
- A down payment on a house, however, would represent a large outflow of savings



Funding Retirement Once Retired

- Bob and Jane have low financial risk if their pension benefits and Social Security benefits cover retirement living expenses
- If portfolio withdrawals were needed to fund retirement, they would have a lower tolerance for risk
- Leaving an inheritance may become more aspirational



The longer the period of time before you need to spend money

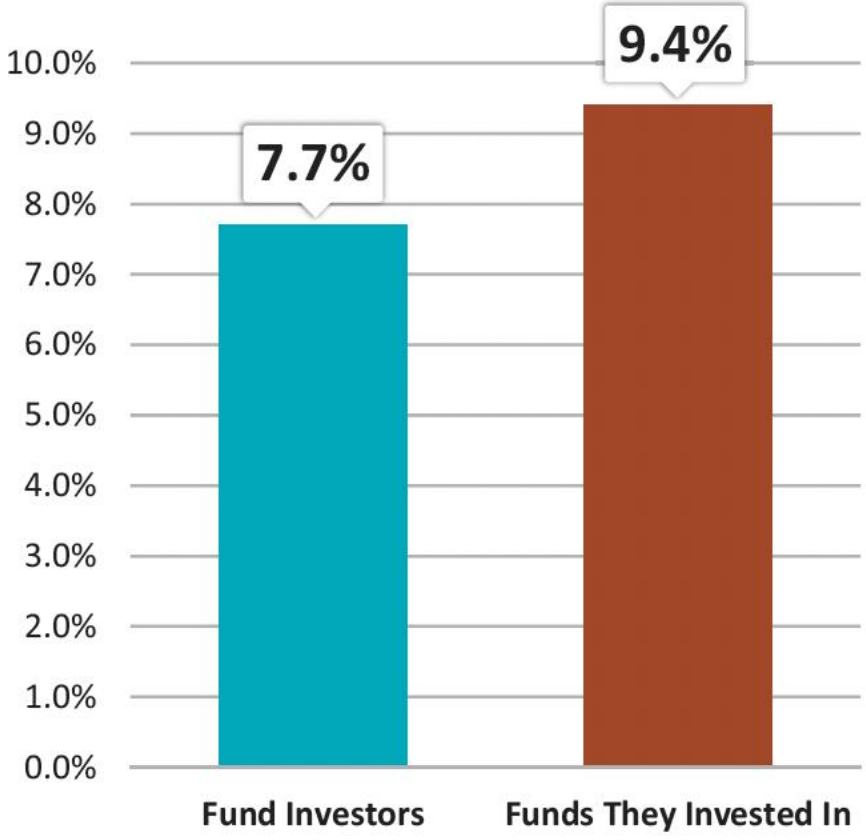
and

the less money you need to spend relative to your wealth, the greater your ability to tolerate risk is.

Why Do We Care About Psychological Risk?

- Evolution has left us risk averse
- How nervous did you feel during the March 2020 coronavirus bear market? What about the 2007–2009 financial crisis?
- If you've sold into downturns before, you may be more likely to do so again
- A lack of understanding market history may also make you too reactive to market headlines

Psychological Risk Leads to Lower Returns



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

How PRISM Helps

- Prompts you to review your past brokerage statements to see how you've actually reacted to past market drops
- Asks you to consider your knowledge of market history
- Factors in how your goal will be funded (portfolio vs. non-portfolio cash flow) into your risk tolerance assessment
- Ties your investment decisions to your written goals

Applying What You Learned

In the AAII PRISM Academy community, we asked AAII members:

1. How have you reacted to past market drops?
2. How has your response to market drops changed over time?

Participating in our online community helps you get more value out of PRISM.

Step 2 - Lesson 6: Psychological Aspects of Risk

Suggested Type of Allocation is Based on Your Risk Tolerance

		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

AAII Allocation Models

Aggressive Investor
90% Diversified Stock

Suggested Allocation Breakdowns

20%	Large-Cap Stocks
20%	Mid-Cap Stocks
20%	Small-Cap Stocks
20%	International Stocks
10%	Emerging Markets Stocks
10%	Intermediate Bonds
0%	Short-Term Bonds

Allocations

10% Fixed Income
90% Diversified Stock

Moderate Investor
60% Diversified Stock

Suggested Allocation Breakdowns

20%	Large-Cap Stocks
15%	Mid-Cap Stocks
10%	Small-Cap Stocks
15%	International Stocks
0%	Emerging Markets Stocks
30%	Intermediate Bonds
10%	Short-Term Bonds

Allocations

40% Fixed Income
60% Diversified Stock

Conservative Investor
40% Diversified Stock

Suggested Allocation Breakdowns

20%	Large-Cap Stocks
10%	Mid-Cap Stocks
0%	Small-Cap Stocks
10%	International Stocks
0%	Emerging Markets Stocks
40%	Intermediate Bonds
20%	Short-Term Bonds

Allocations

60% Fixed Income
40% Diversified Stock

https://www.aaii.com/asset-allocation

Returns and Drawdowns

	Aggressive Investor	Moderate Investor	Conservative Investor
	90% Diversified Stock	60% Diversified Stock	40% Diversified Stock
	Characteristics	**Characteristics**	**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
	8% Average Annual Growth in Value	**7%** Average Annual Growth in Value	**6%** Average Annual Growth in Value
	-38% Bad Year	**-21%** Bad Year	**-12%** Bad Year

https://www.aaii.com/asset-allocation

Pause for a Poll

1. What types of investments do you lean toward having in your portfolio?

   a) Stocks

   b) Bonds

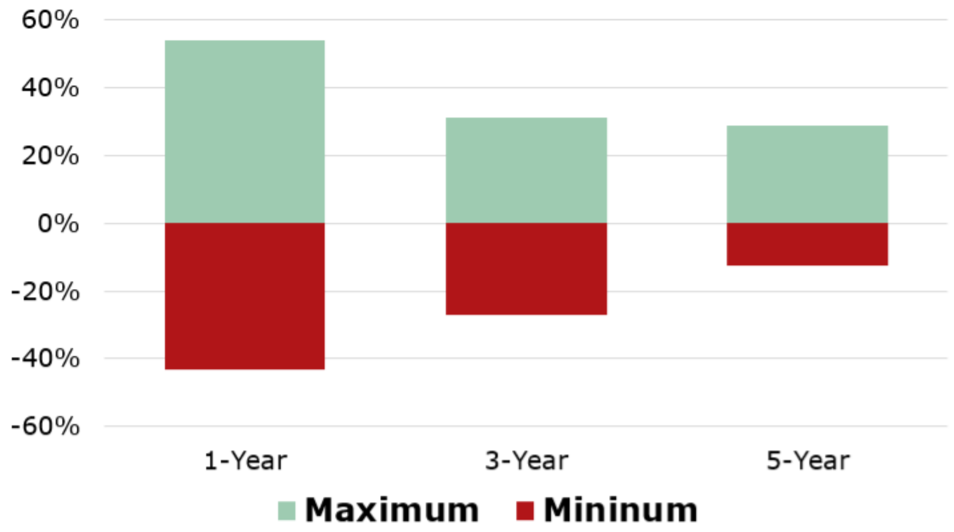
   c) Funds

   d) Other

Why Stocks?

- Highest long-term rate of return
- Best at fending off inflation and providing growth of capital
- Odds of losses decrease over time

Range of Large-Cap Stock Returns



Source: Roger G. Ibbotson and Duff & Phelps, "2020 Stocks, Bonds, Bills, and Inflation Yearbook" (Duff & Phelps, 2020). Data from 1926 through 2019.

The Bond Allocation

- Our models use intermediate- and short-term bonds, not long-term bonds
- You can ladder bonds or defined-maturity bond funds
- If nervous about interest rates, you could ladder certificates of deposit (CDs) instead
- Focus on investment-grade bonds; can use Treasury, corporate or municipal
- Investors with a high risk tolerance may be able to get by with just a cash-like allocation

Why Does Allocation Matter?

- Ties your portfolio composition to your goals and tolerance for risk
- Allocation has been found to influence up to 90% of a portfolio’s returns
- Though much of investing commentary is on specific investments, it’s allocation that really matters

Why Does Diversification Matter?

- It provides protection against systematic risks (e.g., the stock market falling, interest rates rising)
- It increases the odds of being allocated to the right asset class group at the right time
- The market does not compensate you for risks that can be diversified away

Pause for a Poll

1. On a scale from 1-3 how diversified is your portfolio?

   a) 1 – Not diversified at all

   b) 2 – Somewhat diversified

   c) 3 – Diversified

Annual Returns for Asset Class Groups

2021	Large-Cap Stocks 28.7%	Mid-Cap Stocks 24.5%	Small-Cap Stocks 17.7%	International Stocks 11.4%	Emerging Markets Stocks 0.9%	Short-Term Bonds -0.9%	Intermediate Bonds -2.6%
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%
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%
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%
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%
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%
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%
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%

Source: "The Building Blocks of a Successful Portfolio Allocation," by Charles Rotblut, *AAII Journal,* April 2021; Updated January 2022.

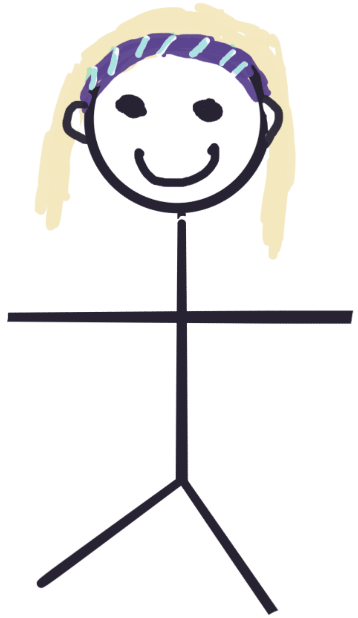
The AAII Asset Allocation Models harness the power of diversification.

You can use our asset allocation models or you can use your own allocation approach.

One of the great things about PRISM is that it is fully customizable to each investor’s needs and preferences.

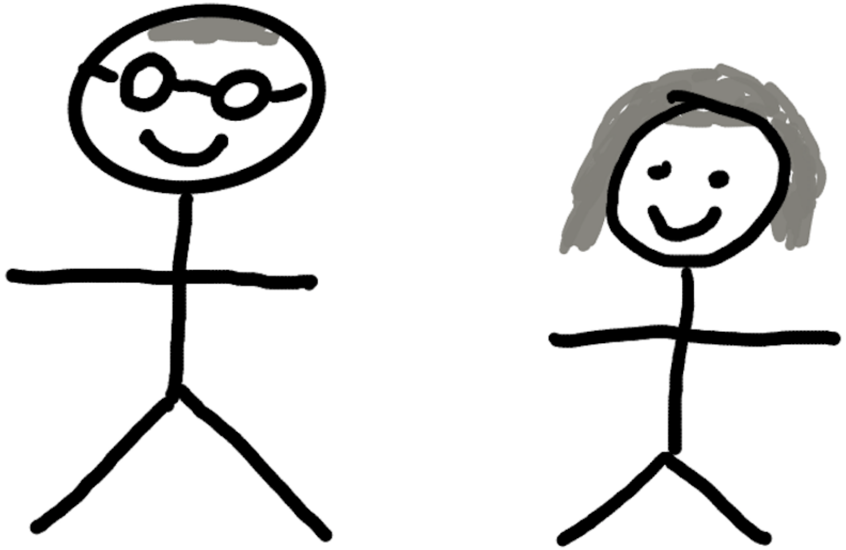
Allocation for a Younger Investor

- If Elizabeth is saving for a down payment on a house, she would opt for a conservative allocation to minimize sequence risk
- Given her age, Elizabeth would use an aggressive allocation for her retirement savings to maximize growth of capital



Allocation for Recent Retirees

- If Bob and Jane were reliant on portfolio withdrawals to fund retirement, they could consider a moderate or aggressive allocation
- An aggressive allocation for inheritance would provide growth of capital



Allocating for More Than One Goal

- Open a separate account or designate certain accounts for each goal
- Segment portfolio by timing of when withdrawals will be needed (aka a bucket strategy)
- Allocation strategies can be weighted according to size and timing of each goal, but this adds complexity

Applying What You Learned

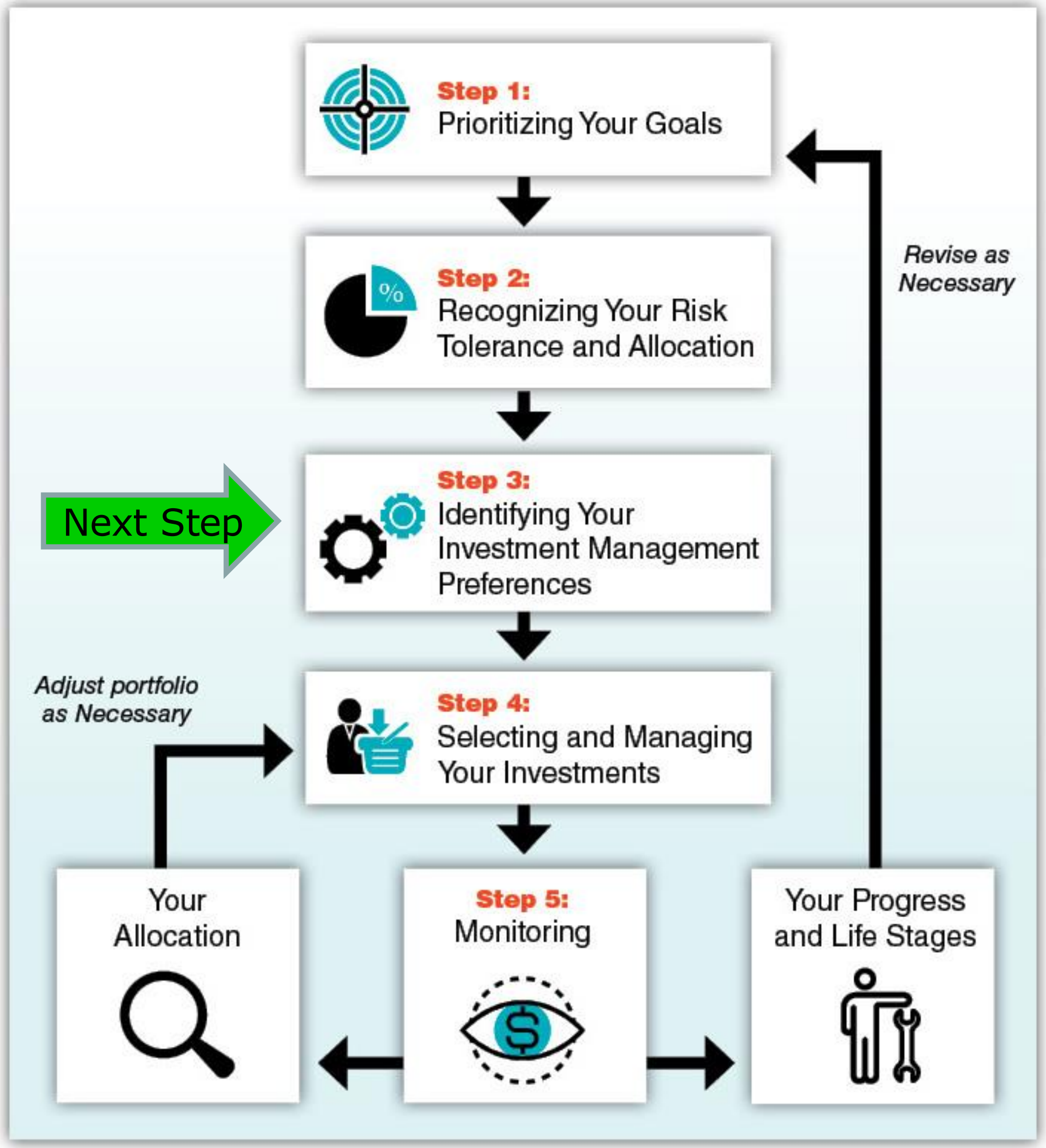
In the AAII PRISM Academy community, we asked AAII members:

1. How diversified are your portfolios?
2. What types of investments are your portfolio most allocated toward?

Participating in our online community helps you get more value out PRISM.

Step 2: Lesson 8 (Part 2) – The Importance of Allocation and Diversification (Coming Soon)

PRISM: Wealth-Building Process



American Association of Individual Investors

Participate In the AAII Community

Join us in the PRISM Academy and complete Step 2: Recognize Risk Tolerance and Allocation for your own portfolio and goals.

Participating helps you learn how to use the risk tolerance worksheet and results to better align your investment decisions with your goals.

Join Us on Step 2 In The PRISM Academy

PRISM Wealth-Building Academy

- An interactive experience to help you create your own personalized wealth-building plan with PRISM
- All new video instruction and tools
- Community forums to share ideas and discuss PRISM with other AAII members

AAII PRISM Academy Syllabus

Introduction: Welcome to the PRISM Academy

Step 1: Prioritizing Your Goals

- Lesson 1: Prioritizing Your Goals
- Lesson 2: Why Start with Goals?
- Lesson 3: What Are Your Goals?
- Lesson 4: The Key Components of Goals
- Lesson 5: The Timing of Goals
- Lesson 6: Wealth Required to Fulfill Each Goal
- Lesson 7: Prioritizing Goals (Final Lesson of Step 1)

Step 2: Recognizing Your Risk Tolerance and Allocation

- Lesson 1: Recognizing Your Risk Tolerance and Allocation
- Lesson 2: What Is Risk?
- Lesson 3: Short-Term vs. Long-Term Risk
- Lesson 4: Timing Aspects of Risk

NEW

- Lesson 5: Financial Aspects of Risk
- Lesson 6: Psychological Aspects of Risk
- Lesson 7: Understanding Your Risk Tolerance

COMING SOON

- Lesson 8: Importance of Allocation and Diversification
- Lesson 9: Allocation Models
- Lesson 10: TBA

PRISM Wealth-Building Academy:

https://www.aaii.com/learnandplan

AAII Community:

https://community.aaii.com/home

PRISM Academy Schedule

- Go to PRISM Academy to take advantage of Step 1 and Step 2
- February—Step 3: Identifying Preferences Webinar
- March—Step 4: Selecting Investments Webinar
- April—Step 5: Monitoring Allocation, Progress and Life Stages

Some Final Thoughts

- Your PRISM Wealth-Building Process will evolve over time as your goals grow closer and your life changes
- PRISM provides a framework for you to make investment decisions within; its goal is to help you become a more effective manager of your own assets
- If you have multiple goals, prioritize them and complete steps 2, 3 and 4 for each goal

Upcoming AAII Webinars

January
19

The Individual Investor Show:
AAII's Stock Screen 2021 Wrap-Up
Wednesday, Jan. 19, 2022 at 7:30 PM CST

February
2

Individual Investor Show:
Is It a Fad or Fab Fund?
Wednesday, Feb. 2, 2022 at 7:30 PM CST

To view and register for upcoming webinars, visit aaii.com/webinars.

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