Personal Finance: Another Perspective

Investing 2: Your Investment Plan (IPS)

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"Now, I'm in real trouble. First, my laundry called and said they lost my shirt, and then my broker said the same thing."

Leopold Fechtner

Objectives

A. Understand the Importance of Financial Goals and How to Set Them

B. Understand the Importance of your Investment Plan and How to Prepare It

C. Beware of "Get Rich Quick" Schemes an Know How to Avoid Them

Investment Assignments for Today

- Investments 2: Your Investment Plan
  - 1. Open your copy of Investment Plan Example Template (LT05A). Using your asset allocation targets from before, determine an expected return for until retirement and in retirement (Sections 1.A.1-2). Use Expected Return Simulation and Benchmarks (LT27) to develop return expectations for your portfolio before and during retirement
  - 2. Add your investment constraints in Section II.B.1-4. Include your average and marginal tax rates
  - 3. Determine your investment policies in Sections III.A - III.F

Assignments for Today (continued)

- Investments 3: Securities Markets
  - 1. Determine investment policies to eliminate "fear and greed" in your investing. Determine the maximum amount you will invest in any single investment and include this in Section II.A.2
  - 2. Determine if you will use leverage to invest (I do not recommend it). Include this in Section III.A.3
  - 3. Choose your investment benchmarks for each of your asset classes (see Possible Benchmarks for Investment Plans (LT15) for help). Include these in Section II.B.1-2

A. The Importance of Financial Goals

- What is the relationship between personal goals and financial goals?
  - Financial goals are personal goals with a cost attached.
- Why must we attach costs to some goals?
  - Certain goals cannot be accomplished except through the attainment of specific financial targets.
    - If we fail to attach costs or targets to these personal goals, we will most likely not be able to achieve them.

How to Set Financial Goals

- Is the process different between setting personal vision and goals and your financial vision and goals?
  - No—the process is the same! What is the process?
    - 1. Catch your vision, identify your goals and write them down
    - 2. Prioritize your goals from most to least important
    - 3. Attach costs to your financial goals that need them
    - 4. Determine the completion date and amount needed for each goal
    - 5. Determine how much to be saved each month
    - 6. Start now
    - 7. Re-evaluate goals as necessary

Questions to Ask About Your Financial Goals

- How important is this goal?
  - What will happen if I don't achieve this goal?
- How much am I really willing to sacrifice to meet this goal?
  - Is it truly a goal, or just a wish?
  - Am I willing to stretch to achieve it?
- How much money do I need to achieve this goal?
  - Is that before tax or after tax, before inflation or after?
- When do I need the money?
  - Is it feasible within my current financial plan?

Questions

- Any questions on setting Personal Financial Goals?

B. Understand the Importance of your Investment Plan and How to Prepare It

- What is the most important document you will prepare in regards to your investing activities?
  - Your Investment Plan (also called an Investment Policy Statement or IPS)
- Why is it so important?
  - Your Investment Plan sets the framework on every investing activity. It states:
    - What you will do: what you will invest in, how you will invest, why you will invest, what percentages you will invest, etc.
  - In short, it is the key document that will impact your investment returns most for the rest of your future.

Your Investment Plan (IPS)

- What will your Investment Plan help you do?

1. Represent yourself.
   - It explains your risk tolerance, personal constraints, budget, and asset allocation over time
2. Articulate what you will and will not do
   - It states what you will and will not invest in, how you will invest, and what you will invest in
3. Provide an investment framework and guidelines for making wise investment choices
   - It gives guidelines to help you reason through decisions which could impact your future goals and retirement

Your Investment Plan (continued)

I. Risk and Return Goals and Objectives

- A. What are your expectations for returns?
  - Your return expectations will drive your asset allocation decisions. A return of:
    - 1-2%: an undiversified, very low-risk portfolio
    - 3-4%: a diversified, low-risk portfolio
    - 5-6%: a diversified, moderate-risk portfolio
    - 7-8%: a diversified, high-risk portfolio
    - 9+%: an undiversified, very high-risk portfolio heavily involved in high-risk assets
  - Look to the long-term history of your asset classes as estimates (see Expected Return Simulation (LT27))

Your Investment Plan (continued)

- B. What are your expectations for risk?
  - What is your risk tolerance?
    - Where you are in the life cycle will have an impact on how much risk you can take
  - Balance your risk and return requirements
    - Where are you in the life-cycle process?
      - Younger: may be willing to take more risk
      - Older: may be willing to bear less risk
    - What kind of investor are you (see your Risk Tolerance Test (LT16) results)?
      - The results of this risk tolerance test should show in your asset allocation results

Your Investment Plan (continued)

- How do you define risk?
  - Instead of stating "an annual standard deviation of 18% (which few understand)," stating your risk in terms of the risk of your chosen benchmark may be easier. For example: "I am willing to accept the risk of a portfolio that is:
    - 50% US large cap stocks, as measured by the S&P 500 Index
    - 15% US small capitalization stocks, as measure by the Russell 2000 Index
    - 10% international stocks, as measured by MSCI EAFE Index, and
    - 25% bonds, as measured by the Barclay's Aggregate Index"

Your Investment Plan (continued)

II. Investment Guidelines and Constraints

A. What are Your Investment Guidelines?

- What are the different phases in your life in regards to investing and how will you manage your assets during those periods?
  - e.g., Accumulation, Growth, Capital Preservation, Income Generation, etc.
- Your Investment Guidelines are the general road map on how you will be investing your assets over your life cycle
  - It integrates your personal goals and your financial goals into a complete financial perspective

Your Investment Plan (continued)

B. What are your Investment Constraints?

- *Liquidity*
  - The speed and ease with which an asset can be converted into cash
    - How much money will you need and when?
    - Examples: Graduate school, vacations
- *Investment Horizon*
  - When will you sell the investment?
    - How soon will you need money?
    - Example: Down payment on a house in 3 years

Your Investment Plan (continued)

- *Tax Considerations*
  - What is your tax position, specifically your marginal and average tax rate?
    - Are tax-free investments more advantageous than taxable?
    - Example: Municipal versus corporate bonds
- *Unique Needs*
  - What are your special needs?
    - Do you have diversification requirements related to employment?
    - Do you have special family or other needs?
    - Examples: Employee Stock Ownership Plans

Your Investment Plan (continued)

III. Investment Policies, Plans and Strategies

- What will you and will you not invest in, how will those investments will be evaluated, how will the assets be invested, how will your portfolio will be funded, and any guidelines for new investments
  - a. Acceptable and Unacceptable Asset Classes
  - b. Investment Benchmarks
  - c. Asset Allocation Strategy
  - d. Investment Strategy
  - e. Funding Strategy
  - f. New Investment Strategy

Your Investment Plan (continued)

- a. Acceptable/Unacceptable Asset Classes
  - Which asset classes will you invest in?
    - Invest where you have a favorable risk-return tradeoff, i.e., mutual funds and stocks (large cap, small cap, mid cap, value, growth, mixed, international, emerging market, regional); bonds (short-term, long-term, government); and money market (CDs, commercial paper, government paper, etc.)
  - Which assets will you not invest in?
    - Do not invest where you do not have a favorable risk-return tradeoff, i.e., foreign currencies, commodities, precious metals, art, options, etc.

Your Investment Plan (continued)

- b. Investment Benchmarks
  - How will you know if you are doing well?
    - Unless you have an investment benchmark (or standard by which to judge your performance), you cannot know how you are doing
      - Pick appropriate benchmarks for each asset class, i.e., the S&P500 for equities, Barclay's Aggregate for bonds, etc. (see TT 27 for recommendations for benchmarks)
  - Measure your performance regularly (e.g., monthly, quarterly, or annually)
    - Measure it on an after-fees after-taxes basis!

Your Investment Plan (continued)

- c. Asset Allocation
  - How much will you invest in each asset class?
    - Percentages should include your minimum, maximum and target
  - The first decision is between bonds and stocks
    - A good starting point is to invest your age as your percentage in bonds then your results from your risk tolerance test
      - The logic is the older you are, the less willing you are to accept risk
  - Next, you can add other asset classes (broaden), or separate the stocks or bonds components into deeper asset classes (deepen)

Your Investment Plan (continued)

- Set up a minimum, maximum and target allocation
  - Minimum: the minimum percent in an asset class
  - Maximum: the maximum percent in an asset class
  - Target: Your ideal allocation based on current conditions

		Min	Target	Max
Younger:	Higher risk assets/equities	50%	75%	95%
	Lower safe assets/bonds	0%	25%	50%
Older:	Lower risk assets/equities	20%	40%	60%
	Higher safe assets/bonds	50%	60%	80%

- Plan for your entire life, which will necessitate different allocations based on different time periods

Your Investment Plan (continued)
Major Asset Classes

Fixed Income: Risk

- Cash
- Money Market instruments
- Municipal bonds
- Government Bonds
  - Short-term (<1 year)
  - Medium-term (2-9 years)
  - Long-term (10-40 years)
- Corporate Bonds
  - Short-term (<1 year)
  - Medium-term (2-9 years)
  - Long-term (10-40 years)
- Junk Bonds

Equities:

- Large Capitalization
- Mid Capitalization
- Small Capitalization
- International
- Emerging Markets
- Hedge Funds

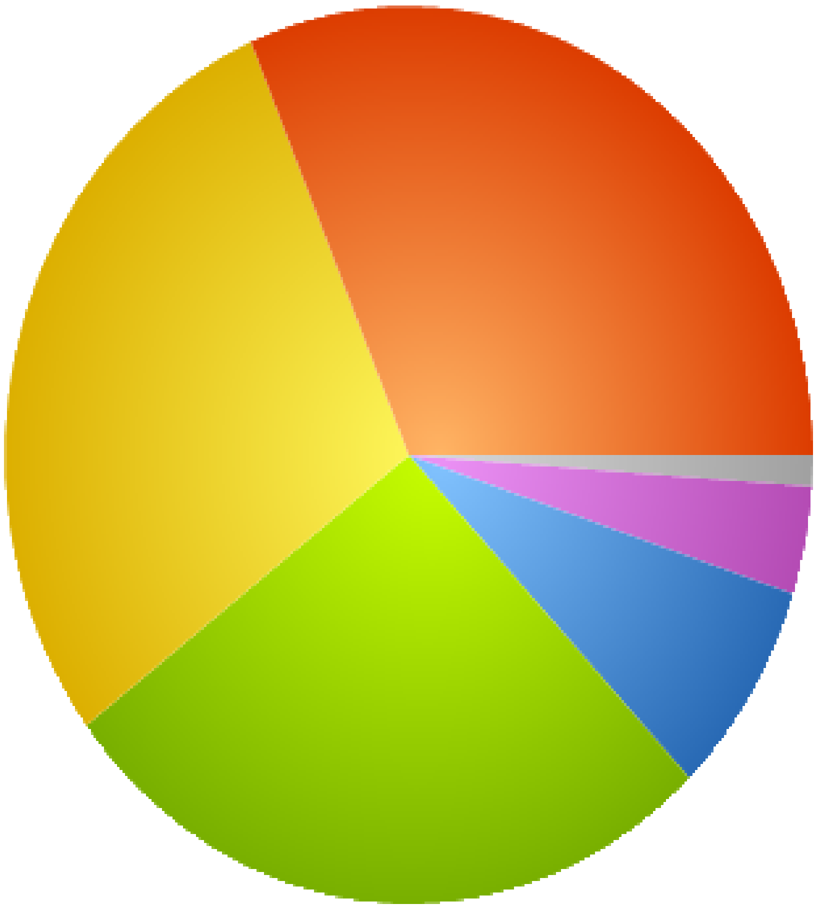
Real Estate

- REITs (Real Estate Investment Trusts)

Currencies

Commodities

My Asset Allocation



Large Cap Stocks	31.63%
Domestic Bonds	28.83%
International Stocks	26.82%
Other Asset Class	7.91%
Small Cap Stocks	3.93%
Cash	0.88%
Total	

Your Investment Plan (continued)

- d. Investment Strategy
  - How will you invest your assets, i.e., via what strategy: active management, passive or both?
    - *Active management*: Trying to beat market returns by the active buying and selling of funds/stocks
    - *Passive management*: Accepting average returns through purchasing index funds rather than trying to beat the market— much cheaper and more tax efficient
    - *Combination*: A combination of active management in certain accounts and passive in other accounts

Your Investment Plan (continued)

- Will you invest in mutual funds or individual assets?
  - Mutual/Index/Exchange Traded Funds (ETFs):
    - Professionally managed portfolios of similar instruments which offer the benefits of economies of scale and diversification
  - Individual stocks and bonds:
    - The individual development of portfolios which give the opportunity to selectively choose which assets to include in the portfolio. It is more time consuming and expensive, with the potential for greater risk and volatility
  - Mix:
    - Combinations of funds and individual stocks

Your Investment Plan (continued)

- What are your current investment assets (this is an example)?

  What vehicles will you invest in and why?
  - Emergency Fund: Cash: *Benchmark:* 3 Month T Bill
    - Asset: ING Direct Savings Account 25%
  - Core: US Broad Market: *Benchmark:* S&P 500 Index
    - Asset: Fidelity S&P500 Index Fund 50%
  - Deepen: US Small Caps: *Benchmark:* Russell 5000
    - Asset: Oakmont Small Cap Fund 15%
  - Broaden: International: *Benchmark:* MSCI EAFE
    - Asset: Vanguard International Index Fund 10%

Your Investment Plan (continued)

- Will you use leverage (i.e. debt) to invest?
  - I recommend against it. President Joseph F. Smith stated over 100 years ago:
    - If there is any one here intending to go into debt for speculation, … I would advise him to hesitate, pray over it, and carefully consider it before he obligates himself by borrowing money and going into debt. In other words, keep out of debt if you can. Pay your debts as soon as you can (*Conference Report*, Oct. 1911, 128–29).
  - I believe debt to invest includes buying on margin and short-selling

Your Investment Plan (continued)

- Will you buy on margin?
  - Buying on margin is borrowing money to invest
    - There is a stock you *are sure* will go up. You put down $10,000 of your own money and borrow $10,000 from your friendly broker (it is borrowing and debt!)
      - If the stock goes up and you sell the stock, you make a profit due to leverage
      - If the stock goes down, you may be forced to continue to put more money with the broker until you close out or sell your stock
  - Key risks: you can lose ***much much*** more than your original investment—don't take the risk!!

Your Investment Plan (continued)

- Will you short-sell?
  - Short-selling is borrowing shares to invest
    - There is a stock you are sure will go down. You borrow 100 shares from your broker, and sell those shares (you are borrowing and it is debt!)
      - If the stock goes down, you sell the stock and replace them. You make a profit due to selling the shares at a lower price.
      - If the stock goes up, you may be forced to continue to put more money with the broker until you sell or close out your shares
  - Key risks: You can lose ***<u>much much</u>*** more than your original investment. Don't risk it!!

Your Investment Plan (continued)

- What about new investments?
  - Decide the maximum percentage you will invest in any new investment, i.e., not more than 10% of my assets
    - Too many times people have made bad investments by putting all of their assets with one "sure thing" and have lost it all.
      - Decide the maximum you are willing to invest (or lose) with a single investment
  - Also decide the maximum percentage of your company's stock you will have in your 401k/retirement account, i.e., no more than 10%.

Your Investment Plan (continued)

- e. Funding Strategy
  - How will you fund your investments?
    - Set up different portfolios for each goal, i.e., Retirement and missions: 401K, Roth IRA; Kids education and missions: 529 Funds/Education IRA; House down-payment: Investment account
  - Recommendations:
    - Pay the Lord first (10% tithing plus other offerings), and pay yourself second (I recommend 20% but a 10% minimum)
      - Balance that among your goals, i.e., 10% to 401K, 1% to a 529/Custodial account, 4% to pay down house, and 5% to investment fund

Your Investment Plan (continued)

- IV. Monitor your Portfolio, Reevaluate and Rebalance as Necessary
  - Monitor your performance
    - Compare your performance to ***<u>your</u>*** benchmarks.
    - How did you do? How versus benchmarks?
  - Re-evaluate
    - Re-evaluate your goals and performance over 2-3 year periods.
  - Rebalance
    - Rebalance back to your asset allocation targets through inflows of new money and tax-minimizing selling

Your Investment Plan (continued)

- Thoughts on performance and monitoring
  - Develop a good asset allocation plan and stick to it
  - Beware of last year's best performers—winners rotate. Do not chase them
  - Remember the tax consequences of selling
  - Re-evaluate your investments as necessary
    - Rebalance annually or less often
    - Rebalance to with an eye to limiting tax consequences

Investment Plan Note

- Because of the detail and importance of this Plan, I have created an example Investment Plan Example Template (LT5A) or Investment Policy Statement)
  - Please feel free to copy this plan, and then change it to represent your personal views on risk and return, constraints, investment policy, etc.
    - Starting from a copy will help to make sure you have all the important sections of the Plan
      - While this plan contains the areas I deem important, you can add any additional areas to your plan you feel necessary
    - Instructions are found in Investment Plan Example Instructions (LT5B).

Questions

- Do you understand the investment process and how to write your investment plan (i.e., your investment policy statement)?

C. Beware of "Get Rich Quick" Schemes

- What are "Get Rich Quick" schemes?
  - Methods by which you can "supposedly" make lots of money in a short time in the markets without knowledge or risk President Hinckley cautioned:
    - We again urge our people to avoid unnecessary debt, to be modest in the financial obligations which they undertake, to set aside some cash against an emergency. *We warn our people against "get rich" schemes and other entanglements which are nearly always designed to trap the gullible* (italics added, "The Condition of the Church," *Ensign,* May 2003, 4).

"Get Rich Quick" Schemes (GRQS)

- Elder M. Russell Ballard further stated:
  - *There are no shortcuts to financial security. There are no get-rich-quick schemes that work*. Perhaps none need the principle of balance in their lives more than those who are driven toward accumulating "things" in this world. Do not trust your money to others without a thorough evaluation of any proposed investment. Our people have lost far too much money by trusting their assets to others. *In my judgment, we never will have balance in our lives unless our finances are securely under control* (italics added, "Keeping Life's Demands in Balance," *Ensign,* May 1987, 13).
- What are some examples of these types of schemes?

GRQS: Day Trading

- What is day trading?
  - It is the process of an individual giving up all his spare time in an area in which he has little or limited competence, in an attempt to consistently beat the market and other professionals after taxes, costs and fees. It is speculating--not investing!
- Don't get sucked in. In reality:
  - Most day traders are spending lots of time making little money at the expense of families and jobs
  - Few, if any, beat the market consistently after expenses, transactions costs and taxes
  - Most have great stories but little money to show

GRQS: Day Trading (continued)

Grant McQueen's day-trading buddy

His goal was to beat the S&P by 2% per year

$500,000 in stocks * 2% (above an index fund)	$10,000
250 days * 1 trade a day * $15 per trade	- 3,750
Gross Trading Profit	6,250
less taxes @ 35% federal + 7% state	- 2,625
Net Trading Profit	$ 3,625
10 hours/week X 52 weeks	520 hours

Equals $6.97 per hour!

- Not to mention costs of an office, computer, internet, real time data fee, and THE FACT THAT HE DIDN'T BEAT THE MARKET (or the performance from an S&P 500 index fund)

GRQS: Trading Rules

- What are trading rules?
  - Rules which give specific buy and sell recommendations for financial assets. By using these rules you supposedly can "beat" the market
- Don't get sucked in. Look to the seller's motives. Ask:
  - If this is so good, why are they telling you (charity)?
    - If it is really good, they will use it themselves and make themselves rich—they won't share it!
    - If it doesn't work, they will try making money by selling it to others—such as yourself.
- There are major problems in ***<u>all</u>*** trading rules—the most blatant being that all fail to work consistently

GRQS: Stock Market Secrets

- What are stock market secrets?
  - Short-cuts or secrets that only the professionals know, but they will share them with you for a price.
- Don't get sucked in. Look to the seller's motives. Ask:
  - If this secret is so good, why aren't they rich, and why are they telling you (don't assume charity)?
    - If it is really good, they will use it themselves and make themselves rich—they won't share it
    - If it doesn't work, they will try making money for themselves by selling it to others
- Learn about markets, instruments and trading. Taking short-cuts is always hazardous to your wealth

GRQS: Outright Lies

- What is an outright lie?
  - A promise of high and consistent above-market returns in the market without risk
- Don’t get sucked in
  - If it seems to good to be true, it usually is!
  - No one can guarantee a consistently high specific rate of return. Markets and returns are volatile
  - Guaranteed high returns are always neither: guaranteed or high
- The way to make money in the market is the old fashioned way—to invest in a diversified manner for many years

How To Avoid Get Rich Quick Schemes

- There are no "Get Rich Quick" schemes that work on a consistent basis. Beware of:
  - 1. The amount of time, energy, and money required to implement these schemes
    - Ask yourself: Do you have the time and money?
      - Spend time with your family and job, and keep your money invested and for yourself!
  - 2. The agency problem
    - Ask yourself: What do I have that that this person wants that I must give up for him/her sharing their "supposed" secrets with me?
      - If the answer is money, keep it for yourself

How to Avoid (continued)

- 3. The "I did it and you can do it too" pitch
  - Ask yourself: Did they really do it (show proof)?
    - Most salesmen have selective memory: selective *performance*, selective *funds*, and selective *time periods*
      - Most (if not all) have not done it!
- 4. The hidden costs of trading
  - Ask yourself: Have they taken into account all expenses including transaction costs, taxes, and other trading costs?
    - Most (if not all) have not
    - Once costs and taxes are taken into account, it substantially reduces their (and your) returns

How to Avoid (continued)

- The First Presidency counseled:
  - While all investments carry an element of risk, that risk can be managed by following sound and proven financial principles: first, avoid unnecessary debt, especially consumer debt; second, before investing, seek advice form a qualified and licensed financial advisor; and third, be wise (Letter from the First Presidency to be read in Sacrament Meeting, dated 27 February 2008).

Questions

- Any questions on “Get Rich Quick” schemes?

Review Objectives

- A. Do you understand the Importance of Financial Goals and How to Set Them?
- B. Do you understand the Importance of your Personal Investment Plan and How to Prepare It?
- C. Are you aware of “Get Rich Quick” schemes and how and why to avoid them?

Case Study #1 – Short Sell

Data

- Last year Anne sold short 400 shares of stock selling at \$90 per share. Over the 6-month period the company paid out two dividends of \$1.50 per share each (\$3.00 per share). Anne's total commission cost for buying and selling the shares came to \$125. She covered her short, i.e., she bought shares to replace the shares sold.

Calculations

a. Determine Anne's profit or loss from this transaction assuming the stock price declined to \$45 per share.

b. Determine Anne's profit or loss from this transaction assuming the stock price rose to \$250 per share.

c. What are the risks of selling short?

Sold short 400 shares at $90, the stock paid 2 dividends of $1.50 per share, with commission costs of $125. Determine profit or loss if a. Stock fell to $45 or b. Stock rallied to $250?

a. Anne sold short shares at $90, and the price dropped to $45. Profits were made as the market price of the stock fell to $45:

• Stock sold short at $90 (90 x 400)	$36,000
• Short sale covered at $45	-18,000
• Gross profit	$18,000
• Dividends (2 x $1.50 x 400)	-1,200
• Commissions	-125
• Net profit	$16,675

Sold short 400 shares at $90, the stock paid 2 dividends of $1.50 per share, with commission costs of $125. Determine profit or loss if a. Stock fell to $45 or b. Stock rallied to $250?

b. Anne sold short shares at $90, but the price increased to $250. Losses were made as the market price of the stock rose to $250:

• Stock sold short at $90 (90 x 400)	$36,000
• Short sale covered at $250	-100,000
• Gross profit	-$64,000
• Dividends (2 x $1.50 x 400)	-1,200
• Commissions	-125
• Net profit	-$65,325

c. The risk of selling short is that you can lose much more than you invest. Selling short is using debt or leverage to invest and should be avoided

Case Study #2 – Buying on Margin

Data

- Kim just purchased 1,000 shares of NS corporation at $15 per share, and 50% was purchased on margin (i.e., she borrowed 50% of the money to buy the shares). She held the shares for 6 months and sold them. Interest on her margin loan was 12% annually.

Calculations

- a. Assuming the price increased to $30 and Kim sold the shares, what is the total value of her investment after paying back the loan with interest? Assume her profit = total revenues – total expenses and assume the money she invested is part of her expenses
  b. Assuming the price decreased to $5.00 per share and she sold the shares, what is the total value of her investment after paying back the loan with interest?
  c. Generally, should an individual buy on margin?

Purchased 1,000 shares at $15, 50% purchased on margin. You held shares for 6 months, with interest on margin at 12%. What is the value of investment if price increased to $30? Decreased to $5?

- a. Purchased 1,000 shares at $15 ($15,000)

  Sold shares at $30

  - Sale of Shares $30 * 1,000 = $30,000
  - Original investment -7,500
  - Money borrowed (50% of $15,000) -7,500
  - Gross profit 15,000
  - Interest on loan $7,500 * .12 * 6/12 -450
  - Net Profit $14,550

Purchased 1,000 shares at $15, 50% purchased on margin. You held shares for 6 months, with interest on margin at 12%. What is the value of investment if price increased to $30? Decreased to $5?

b. Purchased at $15, price decreased to $5

- Sale of Shares $5 * 1,000 = $5,000
- Money she put up to purchase shares -7,500
- Money borrowed -<u>7,500</u>
- Gross profit -10,000
- Interest on loan $7,500 * .12 * 6/12 <u>-450</u>
- Net Profit -$10,450

c. No, buying on margin is using debt to invest and should be avoided at all costs.

Case Study #3

Data

- Bill is one of the 8,400 Utah victims of the 12DailyPro internet scam where they were suppose to receive a 12% return per day without any products or services except clicking on a few websites each day.

Application

- a. What advice would you give Bill about future products of this type?
- b. Which of the principles of investing did this scam violate?

Case Study #3 Answer

- a. 12DailyPro was a Ponzi scheme, where new investors money was the "return" to older investors. Investors had no idea of how the firm made money, but were only concerned that they made money. It seemed too good to be true, and it was.
- b. 12DailyPro violated two main principles: 6. Know what you invest in and who you invest with, and 9. Invest only with high-quality individuals and institutions. This scam violated both of these principles.