Intermediate Investing 1: Principles
Updated 2018/07/04
Objectives

• A. Understand the key principles of investing
  • 1. Know investment basics
  • 2. Know what to do before you invest
  • 3. Understand factors controlling investment returns
  • 4. Know and follow the 10 Principles of successful investing
  • 5. Understand asset classes and asset class risk and return history
A. Understand the Key Principles of Investing

• Elder Richard G. Scott commented:
  • Joseph Smith’s inspired statement, “I teach them correct principles, and they govern themselves,” still applies. The Lord uses that pattern with us. . .
  Your consistent adherence to principle overcomes the alluring yet false life-styles that surround you.
  Your faithful compliance to correct principles will generate criticism and ridicule from others, yet the results are so eternally worthwhile that they warrant your every sacrifice (“The Power of Correct Principles,” *Ensign*, May 1993, 32).
Principle 1. Investment Basics

• Understand key investment basics:
  • What is investing?
    • The giving up of something important to us now in order to get something better in the future
  • What is sacrifice?
    • The giving up of something important to us now in order to get something better in the future
  • Are they similar?
    • Yes
  • Do we all invest?
    • Definitely yes
Investment Basics (continued)

• Why do we invest?
  • From our view:
    • To accomplish our personal and family goals
    • To have resources for retirement, education, etc.
    • To grow our financial assets to serve and bless our families and others
  • From the Lord’s view:
    • To bring us to Christ
    • To help us achieve our divine missions
    • To help us return with our families with honor
    • To teach us to be “wise stewards”
Investment Basics (continued)

• What are your most important investments?
  • Here are mine (and they are not financial):

![Images of people]
The difference between investing and gambling?

Investing: The odds are in your favor
- There is a favorable risk-return tradeoff
- It is part of a long-term plan
- You have done your homework
- It involves the creation of wealth

Gambling: The odds are in another’s favor
- There is no favorable risk-return tradeoff
- There is no long-term plan
- There is no homework, only chance
- It is a zero-sum game—no wealth is created

Principle: Know the difference
Principle 2. Before you Invest

• Are there things you should do before you start investing?
  • Is there a priority to paying bills?
  • Are there certain things you should never do without?
  • Are their other bills more important than investing?
  • Is there a purpose to investing?
Before You Invest: The Hourglass Top

Are your priorities in order and are you “square” with the Lord?

Do you have adequate health and life insurance?

Are you out of high-interest rate credit card and consumer debt?

Have you written down your personal goals, do you live on a budget, and do you have a well-written Investment Plan?

If you can answer these affirmatively, you are ready to invest!
Before you Invest (continued)

• What does the top of the hourglass do?
  • It helps you keep your priorities in order
• And what should those priorities be?
  • God
  • Family
  • Personal responsibility
Principle 3. Factors Controlling Investment Returns
Factors Controlling Returns (continued)

What are the factors that control investment returns (Jim Seaberg, 2012)?

There are five factors you control:

- 1. How much you save
- 2. How long your investments grow
- 3. Your risk level or mix of investments, i.e., your asset allocation
- 4. How much you pay in expenses
- 5. How much you pay in taxes

There is one factor you do not control:

- 6. Your investment returns
Factors Controlling Returns (continued)

- **Principle:** Work on the things you can control!
  - Focus on saving each week and month
    - Reduce your spending
  - Focus on time your investments are outstanding
    - Keep your money in the market
  - Focus on your acceptable risk level (or asset allocation mix) that you are comfortable with
    - Develop a “sleep-well” portfolio
  - Focus on reducing your expenses
    - Invest in inexpensive funds with minimal fees
  - Focus on reducing your taxes and costs
    - Watch taxes in your investing and limit trading
Principles 4. 10 Principles of Successful Investing

• I teach investment differently from that taught in most textbooks
  • Most teachers and textbooks take a financial assets approach, in which the financial assets may change over time
    • However, new financial assets are being developed and sold each year
  • A principles-based approach is better
    • Ideally, the principles should not change over time
Principles for Successful Investing (continued)

• David A. Bednar commented:
  • Principles are doctrinally based guidelines for what we ought to do. Therefore if there is a doctrine of the Atonement, then the first principle of the gospel is faith in the Lord Jesus Christ. Brothers and sisters, doctrine answers the why questions of our lives. Principles provide us with direction about the what and the how (David A. Bednar “Teach them to Understand,” Ricks College campus Education Week Devotional, June 4, 1998, Rexburg, Idaho).
Principles for Successful Investing (continued)

- How have most equity investors done?
  - Each year, DALBAR puts out an annual book on *Quantitative Analysis of Investor Behavior*. It discusses how average equity fund investors have done versus benchmarks over the past 20 years.

<table>
<thead>
<tr>
<th>Year</th>
<th>Period</th>
<th>Investor Returns*</th>
<th>Index Returns</th>
<th>Difference</th>
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<tbody>
<tr>
<td>2013</td>
<td>1993-2012</td>
<td>4.3%</td>
<td>8.2%</td>
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<td>2018</td>
<td>1998-2017</td>
<td>5.3%</td>
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<td>-1.9%</td>
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</tbody>
</table>

* Dalbar 2013-2018
Principles for Successful Investing (continued)

• How have most bond investors done?
  • According to DALBAR, bond investors have done equally poorly versus the bond benchmark over the past 20 years.

<table>
<thead>
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<td>0.4%</td>
<td>4.6%</td>
<td><strong>-4.2%</strong></td>
</tr>
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* Dalbar QAIB 2013-2018, [www.dalbar.com](http://www.dalbar.com), ** Estimate
Principles for Successful Investing (continued)

- How have most asset allocation investors done?
  - According to DALBAR, asset allocation investors have done equally poorly versus the bond benchmark over the past 20 years.

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Principles for Successful Investing (continued)

How have most actively managed funds done?

Elder Dallin H. Oaks commented:

We live in a complex society, where even the simplest principle can be exquisitely difficult to apply. I admire investors who are determined not to obtain income or investment profits from transactions that add to the sum total of sin and misery in the world. But they will have difficulty finding investments that meet this high standard. Such complexities make it difficult to prescribe firm rules. *We must rely on teaching correct principles*, which each member should personally apply to govern his or her own circumstances (“Brother’s Keeper,” *Ensign*, Nov. 1986, 20, italics added).
Principles for Successful Investing (continued)

1. Know yourself
   - Know your vision, goals and plans
     - Have well-written and thought-out vision, goals, and plans
   - Know your budget
     - Live within your means, and save and invest
   - Know your ability to tolerate risk
     - Know what kind of investor you are
   - Invest accordingly
     - Develop a sleep-well portfolio – based on principles you can depend on for a lifetime so that you can “sleep well” at night
Principles for Successful Investing (continued)

• Watch overconfidence
  • Men trade 45% more than women
    • Their annualized returns were 2.7% less
  • Single men trade 67% more than single women
    • Their annualized returns were 1.4% less

• Watch on-line trading
  • Before on-line, investors beat the market by 1.9%
    • Afterwards, they underperformed by 3.6%

Carla Fried, “The Problem with your Investment Approach,” Business 2.0, November 2003, p. 146
Principles of Successful Investing (continued)

2. Seek, receive and act on the Spirit’s guidance

• Carlos E. Asay said,
  • When the Spirit is with us, we can think thoughts we’ve never thought before, we can say words we’ve never said before, we can perform beyond our natural abilities. That power is related to truth, to the scriptures, to the stirring of the Spirit within. And the power won’t come unless we’re actively courting the influence of the Holy Ghost (“Scriptures and Sunday Classes,” Ensign, January 1986).
3. Understand Risk

- Risk is inherent in all investing activities
- There are lots of different types of risk
  - Inflation, business, interest rate, financial, market, political and regulatory, exchange rate, call, and liquidity risk
- Invest at a risk level you are comfortable with
  - Find that risk level
    - Taking a risk tolerance test may help. Take TT16 – A Risk Tolerance Test to get a sense on how much risk you can tolerate
Principles for Successful Investing (continued)

4. Stay diversified

- Always invest in different asset classes and assets
  - Diversification is your key defense against risk
    - Make sure you understand the risks of each and every asset class you invest in
  - It’s a risky place out there. Be prepared!
    - Remember that the numbers you see for specific asset class performance are from diversified portfolios, not single assets!
5. Invest low cost and tax-efficiently

- Control what you can.
- You cannot control returns, but you can control your costs, fees, and taxes
  - A $1 saved is more than a $1 earned because:
    - You pay taxes on every new dollar earned, and a dollar saved can earn income and income on income (compound interest)
    - Realize that frequent trading incurs significant costs, both in terms of transactions costs and taxes
Exhibit 2: Total 2001 costs of investing: 4 representative large equity funds

Principles for Successful Investing (continued)

• Defer or eliminate taxes as much as possible
  • This can be done through the proper use of retirement investment vehicles
  • Remember, mutual funds distribute 90% of all capital gains and dividends each year that you must pay taxes on
    • Invest tax-efficiently so you don’t have to pay more taxes each April
Principles for Successful Investing (continued)

6. Invest long-term

• Avoid short-term trading
  • Its expensive and generates transactions costs and taxes

• Invest wisely
  • There are no get-rich-quick schemes that work.

• Stay at least partly in the market
  • Taking money out of the market or not continuing to save and invest stops your progress
Trade More, Make Less

By examining 5 categories of investors, Odean quantified trading’s harmful effects. Transaction costs slammed the net returns of the most active traders.

Barber and Odean, Trading Is Hazardous to Your Wealth.
Principles for Successful Investing (continued)

7. If you must invest in individual stock and bond assets (which is not required), know what you are investing in

• When investing in individual assets, do your homework
  • Know the key financials and strategic position of the company and be aware of the many different environments in which the company operates (financial, operational, legal, etc.)
  • When investing in mutual funds
    • Stay diversified
    • Know what makes a good mutual fund
Principles for Successful Investing (continued)

8. Monitor portfolio performance
   • Measure performance. President Thomas S. Monson stated:
     When performance is measured, performance improves. Where performance is measured and reported, the rate of improvement accelerates (General Conference reports, 1970).
     • How can you know how you are doing if you don’t check your performance against some benchmark?
     • Interestingly, most investors have underperformed the market benchmarks over the last 20 years
       • (DALBAR’s Annual Quantitative Analysis of Investor Behavior 2012)
9. Don’t waste too much time, money, and energy trying to beat the market, unless you have a lot of time, money, and energy

- It is very difficult, expensive, and time consuming to try and beat the market
- If you want to trade, trade tax-efficiently and in tax-deferred accounts
10. Invest only with high quality, licensed, and reputable people and institutions
   • When help is needed, don’t be afraid to get help.
     • But get good help from good people consistent with the principles discussed
     • And compare the performance of that help to your benchmarks after taxes (and to a passive portfolio)
   • Use the best resources available
     • Know how those resources are licensed and compensated, and get references
Principles for Successful Investing (continued)

11. Develop a good investment plan consistent with your goals, budget, and these principles, and follow it closely
   • Think it through and write it wisely
     • It’s your roadmap to success
   • If you write it wisely and invest accordingly, it will save you much heartache in the future
     • And you will likely achieve your personal goals
   • Principle: Invest using correct principles and you will have a successful portfolio
Principles for Successful Investing (continued)

Principles
1. Know yourself, your goals and vision
2. Seek, receive and act on guidance
3. Understand risk (there is lots of it)
4. Stay diversified
5. Invest low-cost and tax efficiently
6. Invest long-term
7. Know what you invest in
8. Monitor performance vs. benchmarks
9. Don’t waste time
10. Invest with good people and firms
11. Develop a good Plan (IPS) and follow it

Doctrines
Identity
Obedience
Stewardship
Accountability
Stewardship
Stewardship
Accountability
Stewardship
Stewardship
Stewardship
Stewardship
Principles for Successful Investing (continued)

Changing acts of obedience into holy acts of consecration

- I am a child of a Creator (identity), living worthy of the spirit’s guidance (obedience), striving to understand myself and my risk tolerance (agency), and learning to understand financial markets and instruments (accountability). I am developing my investing talents carefully (stewardship), so I can invest my resources wisely (agency), to accomplish my personal mission and individual and family vision and goals.
Principle 5. Asset Classes

- Understanding asset classes is critical
  - Investing is similar to going to an amusement park.
    - People go (invest) on rides in areas they like:
      - Higher risk investments are like the roller coaster—they require a stronger stomach, but the thrill (and return) is generally much greater
      - Lower risk investments are like the merry-go-round. While they are fun, they may be too sedate for some investors
    - Other rides are in-between
  - The key is to find out what you like to ride on and to ride on that ride comfortably!
Asset Classes (continued)

• What are asset classes?
  • Asset classes are broad categories of investments with specific and similar risk and return characteristics

• How are they distinguished?
  • Asset classes are distinguished by characteristics specific to particular groups of securities, such as type of financial instrument, market capitalization, maturity, geographic location, etc.

• What are the major asset classes?
  • Cash and cash equivalents, fixed income, and equities
Asset Classes: Cash and Cash Equivalents

• Major Goal
  • Liquidity and to preserve capital
    • Cash includes CDs, money market funds, T-bills, and commercial paper, etc.
      • Offers a fixed rate of return
  • Cash includes:
    • Money market funds which seek to preserve the value of your investment and still offer competitive returns
    • Short-term interest-bearing investments includes Treasury bills and Savings Bonds, loans to the U.S. Government, and commercial paper, loans to corporations
AC: Cash and Cash Equivalents (continued)

Advantages

• Liquidity and stability of principal. You can turn these into cash quickly and easily
• Low risk. There is little risk of losing principal since the borrowers have good credit and loans are for short periods
• Good investment for money you plan to use in less than 3-5 years and don’t want to take risks

Disadvantages

• Less attractive as medium-to-long-term investments (> 5 years) as returns on cash and cash equivalents are unlikely to keep up with inflation
AC: Cash and Cash Equivalents (continued)

• Thoughts on Cash:
  • Cash is great for liquidity—especially for your Emergency Fund
  • However, returns on cash are unlikely to keep up with taxes and inflation
  • Use cash for liquidity and some diversification, but realize that this asset class will add little to performance
Asset Classes: Fixed Income (or Bonds)

• Major Goal
  • Provide income and to earn returns in excess of inflation
  • There are different types of fixed income assets:
    • Taxable bonds include U.S. Treasuries, corporate bonds and agency issues (bonds issued by U.S. government agencies, like Ginnie Mae)
    • Tax-free bonds include revenue or general obligation bonds issued by local or state governments and agencies. Such bonds are generally free from federal and state taxes on income.
Types of Fixed-Income Investment Vehicles:

- Short-term bonds/bond funds
  - Bonds that mature in < 5 five years
    - Short-term bonds are less vulnerable to interest rate risk than long-term bonds
    - Generally considered good investments for anyone needing a dependable stream of income (dividends)

- Intermediate-term bonds/bond funds
  - Bonds with a maturity of 3–10 years
    - These are more susceptible to interest rate risk
AC: Fixed-income (continued)

• Long-term bonds/junk bonds/bond funds
  • Bonds with a maturity of 10 or more years
    • These have the highest yields, but are the most vulnerable to interest rate volatility
• Inflation Protected securities
  • Securities whose yield is linked to the rate of inflation as measured by a specific inflation index
• U.S. Government Savings bonds
  • I Bonds: Interest rate linked to inflation
  • EE Bonds: Fixed interest rate
AC: Fixed-income (continued)

• Bond mutual funds
  • Different from buying individual bonds. Mutual funds buy and sell bonds before they mature
  • Investing in a fund means you are buying a share in thousands of different bonds in a changing portfolio.
  • Income from fixed-income fund fluctuates as mutual funds buy and sell bonds.
  • The market value of your fund changes depending on whether the fund is selling bonds at a loss or gain.
  • The longer the maturity of the bonds (see the average maturity) the more dramatically your principal will gain or lose value as interest rates change.
AC: Fixed-income (continued)

Advantages

- Offer greater potential return than cash, but greater risk
- Good diversification tool when holding a long-term stock portfolio, as bonds move differently than stocks

Disadvantages

- Returns have been historically lower than stocks
- Very susceptible to interest rate and other risks
- Generally, fixed income assets alone are not good long-term investments because they don’t provide enough growth to beat inflation over long periods of time. Must be part of an overall portfolio
AC: Fixed-income (continued)

- Thoughts on fixed income
  - You get a fixed interest and the future principle
  - Investment income and capital gains may be subject to federal, state, and local taxes.
  - The longer the bond’s maturity, the higher the yield. This "interest rate risk" is because your principal is exposed for a longer period of time.
  - The lower the borrower’s credit rating the higher its risk, and the higher the interest you receive.
  - The value of your principal is not fixed because the price of bonds fluctuates with changes in interest rates. If interest rates rise, your bond becomes less valuable, unless you hold it till maturity.
Asset Classes: Equities (or Stocks)

• Major Goal
  • Provide growth and earn returns in excess of inflation. Over long periods of time, the stock market historically has been the only major asset class to consistently outpace inflation
    • A share is ownership in a businesses’ earnings and assets
    • You get a proportionate share of the profits by receiving dividends, and also benefit from increases in the company’s share price
    • Mature companies are a likelier source of dividends (rapidly growing companies often prefer to reinvest profits)
AC: Equities (continued)

- Equity asset classes
  - Asset classes are delineated by market capitalization (which is shares outstanding multiplied by the stock's current market price), type of company (growth versus value), and geographic area.
  
  - The benchmarks for each asset class tend to change over time, but equity asset classes can be generally defined as follows:
    
    - Capitalization: Large, mid, and small
    - Type: Growth, blend, and value
    - Geographic area: US, international, global and emerging markets
AC: Equities (continued)

• What is market capitalization?
  • It is one measure of the size of a company.
  • How is it calculated?
    • It is calculated by multiplying the market price of the stock by the number of shares (i.e. ownership pieces) outstanding. The greater the capitalization, the larger the company.
• How is it used?
  • It is used to weight companies in various benchmarks.
  • It is used to determine certain classes of companies, i.e. large-cap, mid-cap, small-cap, etc.
• Large-cap (capitalization) stocks
  • Large caps are stocks with a market capitalization greater than $10 billion in the US, and smaller capitalizations for international companies
  • These are the generally the largest, most well established companies in the US, with a history of sales and earnings as well as notable market share
  • Traditionally, large cap was synonymous with "dividend-paying company," but this is no longer a standard for classification.
  • These are generally mature corporations with a long track record of steady growth and dividends
AC: Equities (continued)

• Mid-cap or mid-capitalization stocks
  • These are stocks with capitalization between roughly $2 billion and $10 billion
  • These stocks tend to grow faster than big cap companies, and are generally less volatile than small cap companies
  • Mid-caps generally perform similar to the small-cap asset class. For asset-allocation purposes, mid-caps are generally not considered a major asset class.
AC: Equities (continued)

• Small-cap or small capitalization stocks
  • Small-cap stocks are companies with a market capitalization less than $2 billion
  • These are smaller, sometimes newer, US and global companies that are still developing and may have a smaller market share than their large-cap counterparts.
  • Small-cap stocks are subject to greater volatility and may fail more frequently than companies in other asset categories, but are generally expected to grow faster than bigger companies
AC: Equities (continued)

• Within the equity stock categories are two separate types of stocks: growth and value
  • Growth stocks
    • These are fast-track companies whose earnings are expected to grow very rapidly. Frequently these are companies developing new technologies or new ways of doing things
  • Value stocks
    • These are inexpensive (in terms of low PE and low P/BV ratios), companies that have potential for good long-term return through both appreciation and dividends
  • Blend stocks – part of both value and growth
AC: Equities (continued)

• International/Global/Emerging Market stocks
  • These are stocks of companies based entirely outside the U.S. or throughout the world
  • These can be of any size (small-cap, large-cap), any type (value, growth) and from any part of the world. Funds that contain a mixture of U.S. and foreign holdings are called global funds.
  • International investments involve additional risks, which include differences in financial accounting standards, currency fluctuations, political instability, foreign taxes and regulations, and the potential for illiquid markets.
AC: Equities (continued)

• Stock Mutual Funds
  • These are funds that own stock in specific groups or types of companies
  • You are buying a share in multiple companies which change over time depending on the fund manager
  • You are responsible for paying taxes on all distributions by the mutual fund, which are taxed at your level—not the fund level
  • Mutual funds are delineated by investment objective, which can be any of the equity asset classes discussed
AC: Equities (continued)

Advantages

• Offer highest return of the major asset classes
• Growth and value stocks tend to perform in alternating cycles—it makes sense to own both
• Good investment for long-term investing—they have consistently beat inflation over the long-term

Disadvantages

• Offer less stability of principal than other asset classes, and subject to short-term price fluctuations (so very risky for short-term investments)
• If you’re investing for less than 3-5 years, only a small portion (if any) of your investments should be in stocks
AC: Equities (continued)

- Thoughts on Stocks
  - Stocks have given the highest consistent returns of any asset class, although with the highest risk
  - While volatile in the short-term, over time they have continued to deliver returns far in excess of taxes and inflation
  - To grow your portfolio grow in excess of taxes and inflation, generally you will need to include some equities in this asset class
  - Through broad diversification, you can reduce some of the risk of this asset class
Principle 6. Asset Class Performance

- Understand how the different asset classes have performed historically
  - Different asset classes have performed differently over the past 85 years
    - Why study the past? President Gordon B. Hinckley stated:
      - All of us need to be reminded of the past. It is from history that we gain knowledge which can save us from repeating mistakes and on which we can build for the future. ("Reach with a Rescuing Hand," *New Era*, July 1997, p. 4.)
Asset Class Returns from 1925 to 2017

- Large Cap
- Small Cap
- T-Bonds
- T-Bills
- Inflation

Returns: Asset Class Returns
Annual Risk versus Return from 1925 to 2017

- S&P500
- SmallCap
- T-bond
- T-bill
- CPI

Annual Returns:
- 0.0% to 14.0%
- 0.0% to 30.0%

Standard Deviation:
- 0.0% to 30.0%
S&P 500 1 Year Annual Returns from 1926 - 2017
S&P 500 5 Year Annual Returns from 1930 - 2017
S&P 500 10 Year Annual Returns from 1935 - 2017
# Equity Asset Class Returns and Risk (through 2017)

**Total Returns For the Periods Ending December 31, 2017**

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<tr>
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<td>3.8%</td>
<td>9.4%</td>
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</table>
Key Lessons for Investing

• 1. Understand the “why” of investing
  • Understanding why you are doing something leads to purpose and better decisions

• 2. Since life is priorities based, our investing should follow our priorities as well
  • Priorities matter

• 3. There is a principles based framework for helping you invest
  • Learn and use it wisely

• 4. If you do what everyone else does, you will get what everyone else gets
  • Most investors underperform. You can do better
Investing Lessons (continued)

• 5. Correct principles lead to better lives and portfolios
  • Understand and live those principles
• 6. There is a generally positive relationship between risk and return
  • Invest at a risk level you are comfortable with
• 7. While equities are volatile on a short-term basis (annually), over longer periods of time the bad periods are offset by good periods
  • Invest long-term
• 8. The longer the time period, the more likely you will have positive returns
  • Start now
Review of Objectives

• A. Understand the key principles of investing:
  • 1. Investment basics
  • 2. Before you invest
  • 3. Factors controlling investment returns
  • 4. 10 Principles of successful investing
  • 5. Asset classes
  • 6. Asset class returns