Personal Investment Strategies

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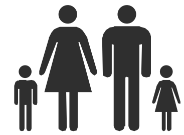
Why Do You Save (Invest)?

- Answers depend on:
  - age
  - dependents
  - income
  - assets
  - liabilities

Why Do You Save (Invest)?



- Example: young MBA graduates
  - low net financial assets
  - long horizon of future earning potential
    - "human capital"
  - future expenditure plans
    - buy real estate
    - pay off outstanding loans
    - pay for expenses of family (schooling, etc.)

How Do You Save (Invest)?

- Issues for young MBA graduates
  - want assets available to make down payments on housing
  - begin accumulating financial assets to pay for long-term financial goals
  - because human capital is (relatively) low risk, can probably afford to bear greater risk in financial investments
    - may want to assure that human capital is low risk by buying term life insurance and disability insurance

Why Do You Save (Invest)?

- Example: more seasoned/experienced parents of MBA graduates
  - higher net financial assets
  - shorter horizon of future earning potential
  - future expenditure plans
    - retirement
    - health questions
    - help children become established
    - bequest motives

How Do You Save (Invest)?

- Questions for seasoned/experienced parents of MBA graduates
  - inventory sources of income after retirement
    - after income from human capital stops
  - estimate future spending plans
  - this results in a plan for savings/investment to meet spending plans

How Do You Save (Invest)?

- Issues for seasoned/experienced parents of MBA graduates
  - diversification
  - risk tolerance
    - tradeoff risk and expected return
  - taxes

Diversification:

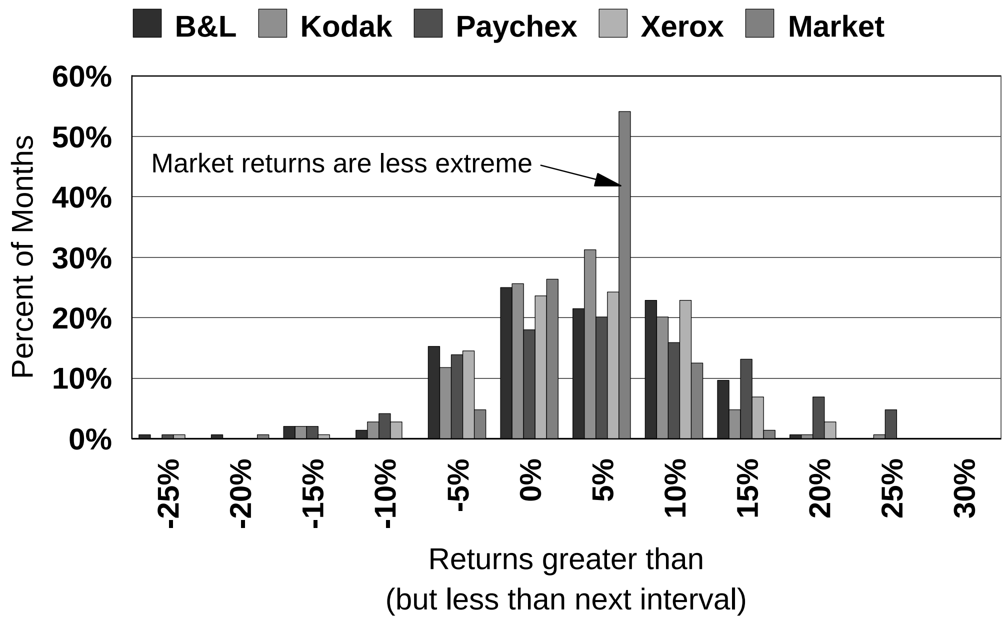
Don't Put All Your Eggs in One Basket

- Most people prefer a smoother (more predictable) path of income & consumption
  - this is what we mean by risk aversion

- Concentrating investments increases risk without increasing reward (expected returns)
  - see graph below for an illustration of the distribution of values for the S&P 500 portfolio and several individual stocks

Diversification:

Monthly Returns 1986-97



Diversification:

General Rules

- Portfolios of stocks that are chosen randomly and weighted equally become well diversified when you have about 15-20 stocks
  - e.g., don't have more than 5% of your money in any one stock
  - but, this is dart-board stock selection
  - most people tend to buy stocks that they know something about because of the industry where they work, the place where they live, the friends that they have, their hobbies, etc.

Diversification:
General Rules

- If you are not going to use the dart-board method:
  - buy stocks that are not related to your job
    - unless there is a big subsidy offered by your employer, avoid buying stock in the company where you work
    - you are "stuck" with your human capital (you can't sell it), so don't buy stocks that go up and down with your pay check

Diversification:
General Rules

- If you are not going to use the dart-board method:
  - buy stocks in a wide variety of:
    - industries
    - geographic regions (including countries)
    - stages of their life cycle
      - e.g., young & growing firms
      - or, mature & stable firms

Diversification:
General Rules

- Alternatively, you could buy mutual funds
  - no-load funds with low expense ratios
  - index funds
  - these investment vehicles provide low cost methods of getting diversification and low transaction costs

Stock Selection:
Who Can Pick Winners?

- Not Me
- But also not mutual fund managers
  - no evidence that future performance is related to past performance
    - except for some evidence that bad performance persists
  - despite the fact that cash flows into funds that have had recent good performance, there is no evidence that this strategy pays off

Stock Selection:

Who Can Pick Winners?

- Insiders
  - they buy before prices rise and sell before they fall
  - but it is surprising how small the returns are
    - could be due to US laws against trading on material non-public information
    - could also be due to uncertainty about the quality of insiders' information
  - note that half of the time insiders should have <u>negative</u> information about their firms

Asset Allocation:

How Much Risk Can You Stand?

- Once you have decided to hold a diversified portfolio (instead of trying to pick winners), you need to decide what mix of:
  - stocks
  - bonds
  - real estate
  - human capital
  - etc
- This depends on your horizon and how comfortable you are with risk

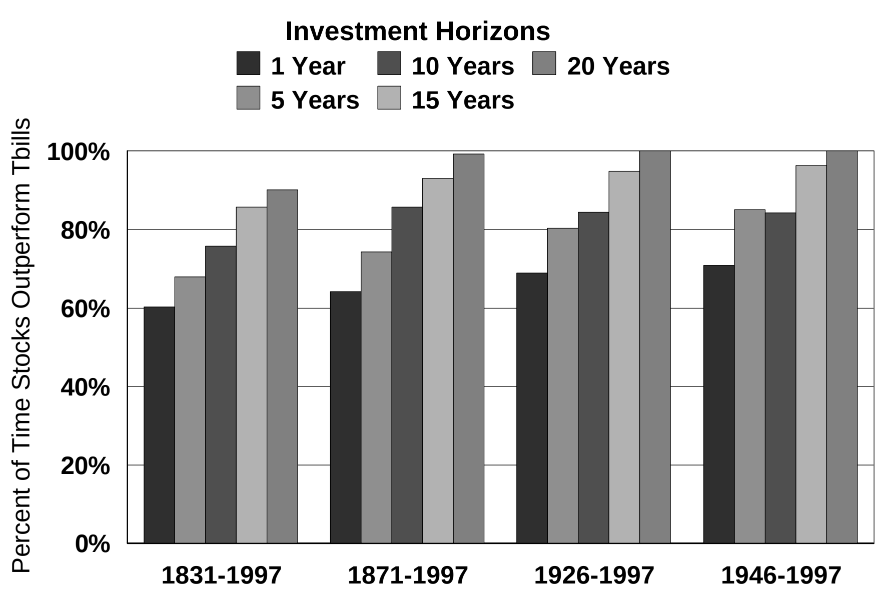
Asset Allocation:

How Much Risk Can You Stand?

- For example, stocks have generally returned more than Treasury Bills over long time horizons
  - see graph below
- Note that for one year horizons stocks underperform Treasury Bills about 1/3 of the time
  - relevant if you have a big expenditure to pay for in the near term

Asset Allocation:

How Much Risk Can You Stand?



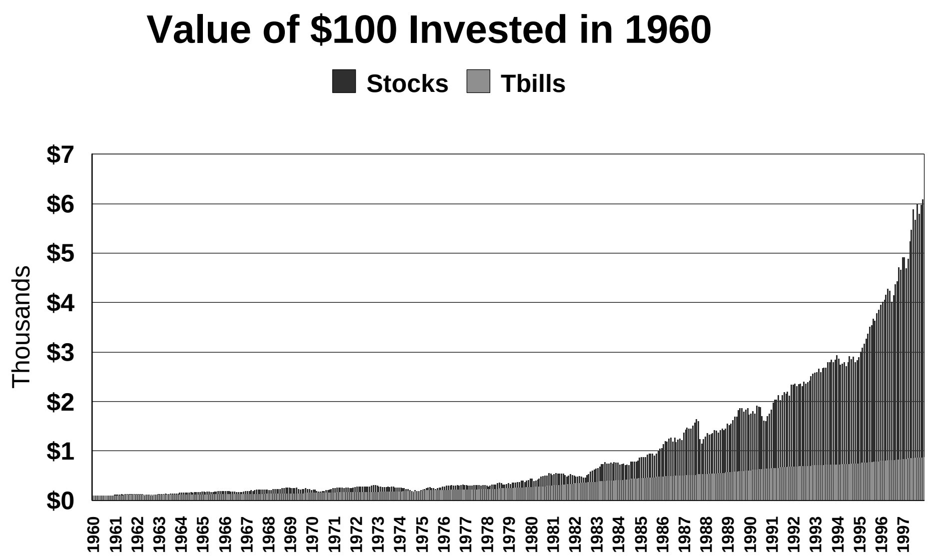
Asset Allocation:
How Much Risk Can You Stand?

- Remember to choose a mix of assets based on their diversification characteristics, not the latest investment fad
  - international investing was very popular a few years ago when "emerging markets" stocks were rising in price
  - similarly, high tech ".COM" stocks have performed well in the last couple of years, but it does not make sense to overload on these stocks
    - if you own stocks that rise, you may need to sell to rebalance your portfolio

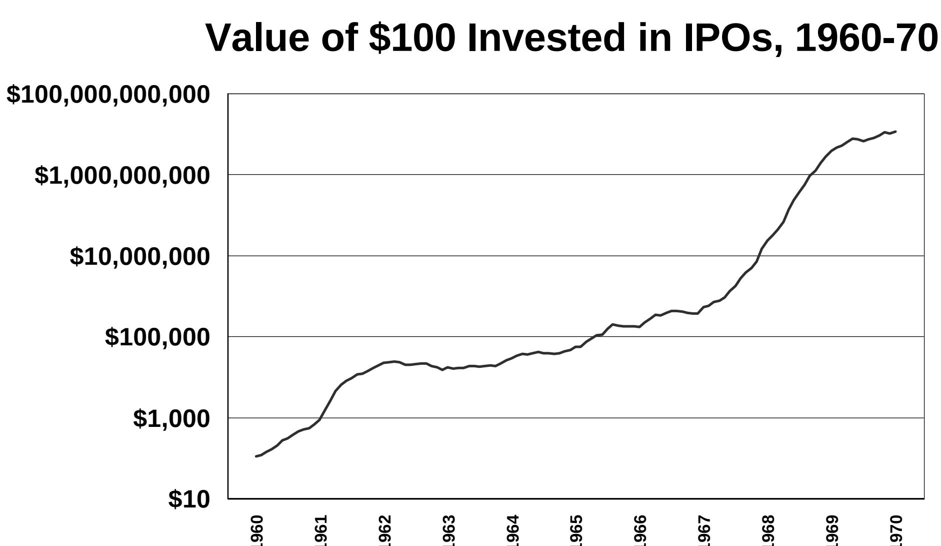
Asset Allocation:
Examples of the Value of Saving Early

- Compare value of portfolio if you invested $100 in 1960 in either the US stock market or in Treasury Bills

Asset Allocation:
Examples of the Value of Saving Early

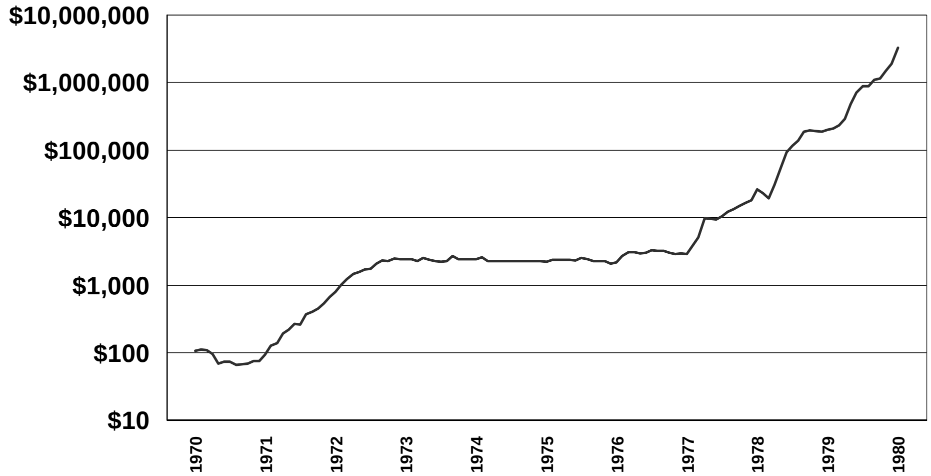


An Investment Strategy:
If You Know the Right People



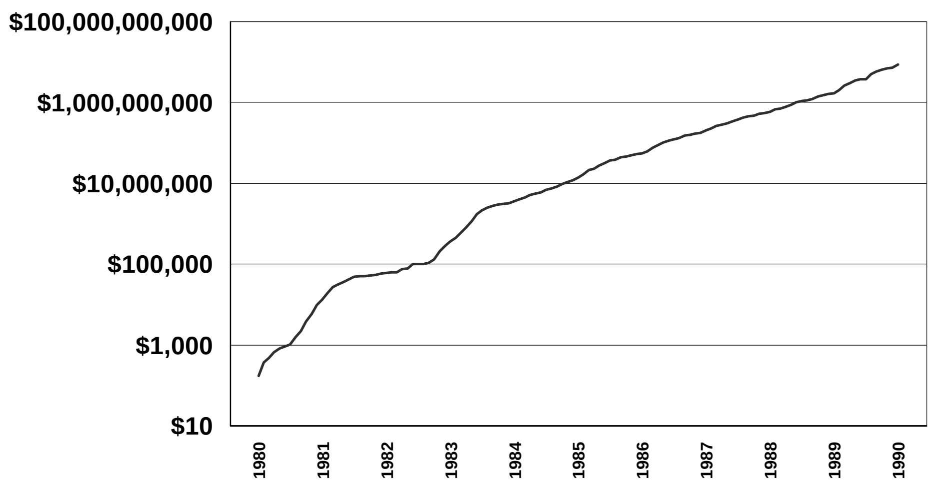
An Investment Strategy:
If You Know the Right People

Value of $100 Invested in IPOs,1970-80



An Investment Strategy:
If You Know the Right People

Value of $100 Invested in IPOs, 1980-90



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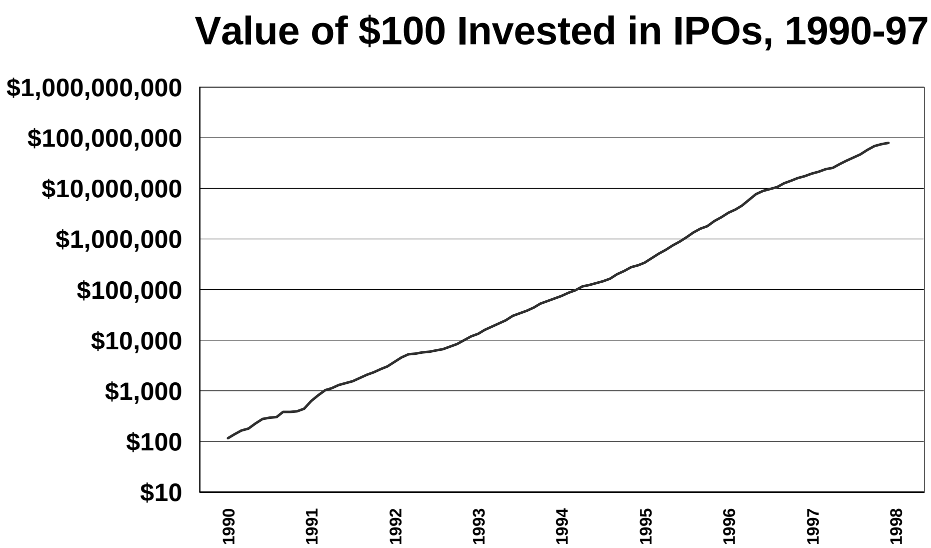

An Investment Strategy:
If You Know the Right People

- The problem is that you have to be able to participate in all of the IPOs that occur
  - then, "flip" the securities by selling after a few days (at most a month)
- Most individuals cannot get access to the most valuable (underpriced) IPOs
  - so, go back to the lessons about diversification

Tax Issues (US)

- Capital gains tax rates are usually lower than income tax rates (dividends and interest)
  - short-term losses can reduce taxable income
- Municipal bonds have interest that is exempt from Federal (and sometimes State) income tax
  - you need to calculate the after-tax interest income to know if this is appropriate for your situation

Tax Issues (US)

- Retirement savings plans (401K, 403B, Keogh, SEP, IRA) postpone taxes
  - but all of the payouts are taxed as ordinary income after "retirement age"
  - no special treatment for capital gains
  - sometimes there is a penalty tax imposed on people who have saved a lot (or invested wisely) in these plans
  - at death, income tax is paid first, then the remainder is subject to estate tax

Tax Issues (US)

- Estate taxes have high rates above $1 million
  - exempt for spouses
  - capital gains are not taxed first
- Charity
  - gifts of appreciated assets can be made at market value (not cost)
  - another way to avoid capital gains taxes

Conclusions

- Planning
- Diversification
- Asset Allocation
- Taxes