Understanding Risk & Return in Your Investment Club

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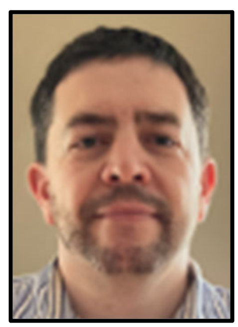

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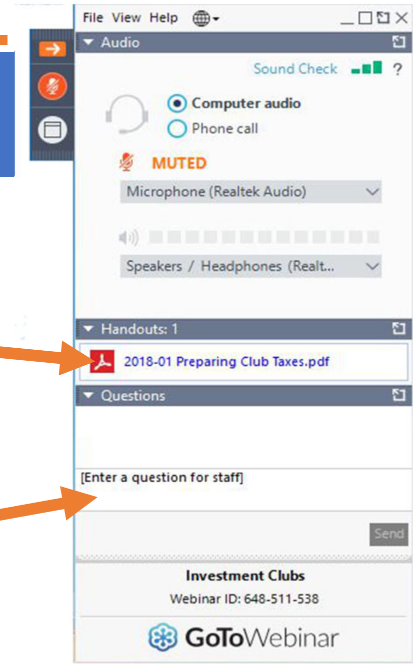
Handout & Questions

Handout in PDF format is available in Handouts tab.

Type questions in Questions box.



BASICS OF RISK, RETURN, VOLATILITY

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What Is Risk?

- Risk is any *uncertainty* that has potential to negatively affect your financial situation, such as:
- **Market risk**: How do market conditions affect your investment?
- **Business risk**: How do decisions made by management (such as whether to expand or merge) affects value of your investment?
- **Political risk & currency risk**: How do events or operations in foreign country affect your investment?
- **Liquidity risk**: Is it easy or hard to cash out your investment?
- **Concentration risk**: Are all your eggs in one basket?

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3 Primary Types of Investing Risk

1. Systematic.
2. Non-Systematic.
3. Company.

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Systematic Risk

- Also known as "non-diversifiable risk," "volatility," or "market risk."
- Affects overall market, not just particular stock or industry.
- Unpredictable & impossible to completely avoid.
- **Cannot** be mitigated through diversification.
  - Can be reduced through hedging or by asset allocation.
- ***Beta*** measures how volatile investment is compared to overall market.

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Non-Systematic Risk

- Also known as "diversifiable risk," "unsystematic risk," "specific risk," or "residual risk."
- **Can** be reduced through diversification.
- Examples:
  - New competitor.
  - Regulatory change.
  - Management change.
  - Product recall.
- Can also reduce by adding **uncorrelated holdings** to portfolio.

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Company Risk

- Financial uncertainty faced when owning specific business & exposed to ups & downs of single company's performance.
- Can be managed by:
  - Diversification.
  - Owning additional companies.
  - Owning uncorrelated assets.

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Investment Returns Always Bring Risk

- Level of **risk** associated with particular investment or asset class correlates with level of **return** investment might achieve.
  - Investors willing to take on risky investments & potentially lose money should be rewarded for their risk.
- Tradeoff is always that higher return always brings greater risk.
  - Stocks are "riskier" than corporate bonds.
  - Corporate bonds are "riskier" than Treasury bonds or bank savings products.

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Average Returns of Various Asset Classes

- **Stocks** have most robust average annual returns over long term (just over 10% per year)
- **Corporate bonds** (around 6% annually).
- **Treasury bonds** (5.5% per year).
- **Cash/cash equivalents** such as short-term Treasury bills (3.5% per year).

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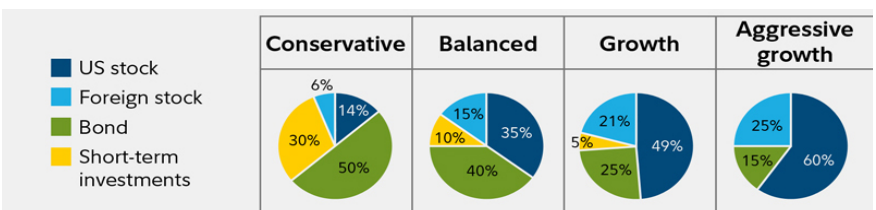
Returns & Risk in Various Personal Portfolios



Annual return %	Conservative	Balanced	Growth	Aggressive growth
Average annual return	5.96%	7.96%	8.97%	9.65%
Worst 12-month return	–17.67%	–40.64%	–52.92%	–60.78%
Best 12-month return	31.06%	76.57%	109.55%	136.07%
Worst 20-year return (annualized)	2.92%	3.43%	3.10%	2.66%
Best 20-year return (annualized)	10.98%	13.83%	15.34%	16.49%
Historical volatility	4.50%	9.56%	13.06%	15.75%

Source: Fidelity

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How Clubs Should Approach Asset Allocation

- Clubs should aim to be fully invested in equities (US, foreign).
  - Emulate approach of equity mutual funds.
- Clubs should **not** aim to be self-standing investing vehicle with multiple asset classes.
  - This makes it harder for individuals to match their club holding to their personal portfolio.
  - For instance, younger members may not desire/require bond holdings personally, so if club holds them it may unnecessarily decrease returns of those members.

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MEASURING RISK

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What Is Volatility?

- Volatility is statistical measure of dispersion of returns for given security (or index).
- Volatility can either be measured by using **standard deviation** or **variance** between returns from that same security or market index.
- Higher volatility means "riskier" security in **short-term** (not as useful long-term).

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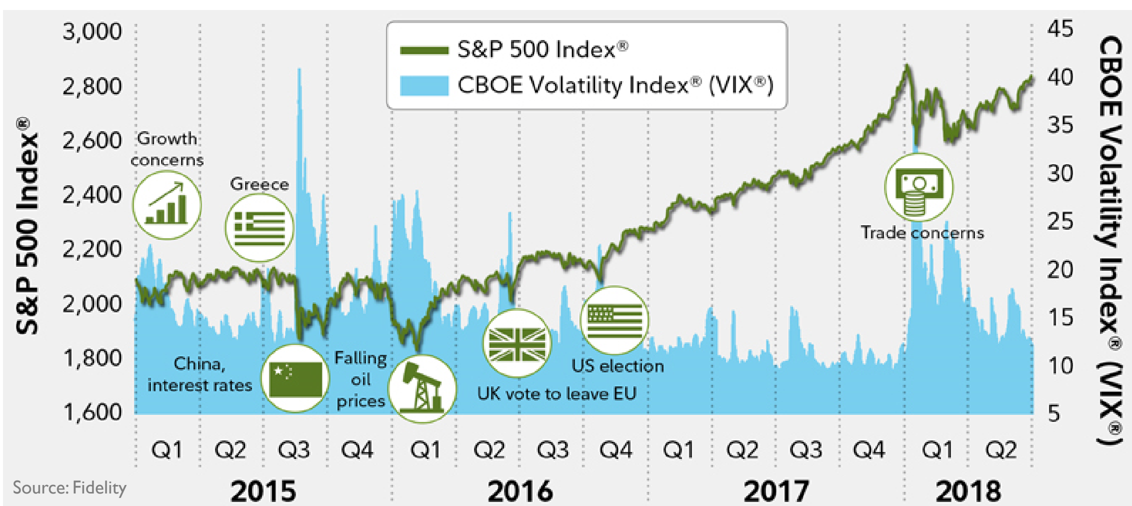
Volatility Is Normal Part of Investing



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Measuring Risk with *Beta*

- *Beta* measures how volatile investment is compared to overall market.
  - Beta of >1 means investment has **more** systematic risk than market but with more potential return in rising market.
  - Beta of <1 means **less** systematic risk than market but with more potential return in falling market.
  - Beta =1 means **same** systematic risk as market, so tends to move with market.

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Measuring Risk with Standard Deviation

- Often used as measure of volatility.
- Mathematical calculation that shows how price of asset deviates from its average price:
  - Calculate mean of each price in period.
  - Calculate difference between each price in period & mean price ("deviation").
  - Calculate typical ("standard") deviation of any price to any other in period.

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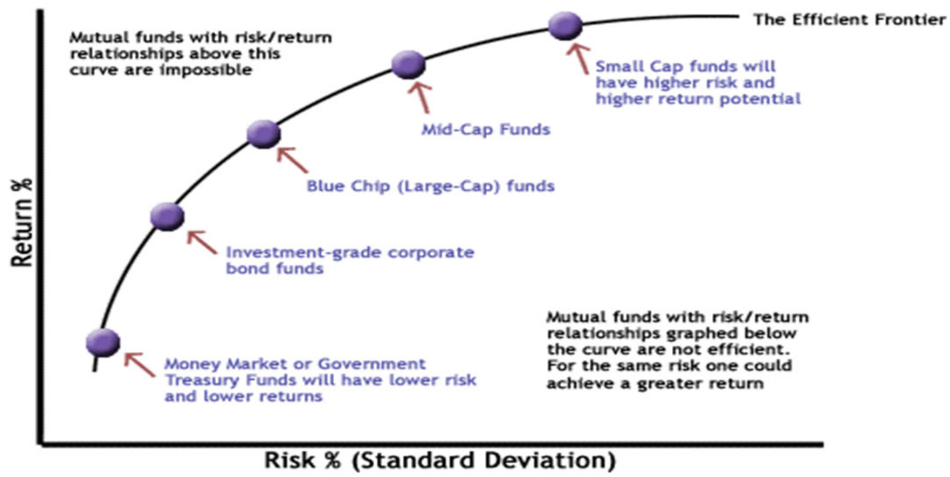
Risk & Return on the Efficient Frontier



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Ways of Managing Investment Risk

- **Asset Allocation -** Include different asset classes in portfolio (such as stocks, bonds, real estate, cash) to increase probability that some investments will provide satisfactory returns even if others are flat or losing value.
- **Diversification -** Divide money allocated to particular asset class, such as stocks, among various categories of investments in that class.
- **Hedging & Insurance** – Expensive & thus may reduce returns. May involve speculative, higher risk activity such as short selling or investing in illiquid securities.
- **Focus on Long-Term -** Target returns that are possible after next recession/bear market & ignore short-term gyrations of market or bear cycles.

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Another Way of Considering Risk

- Since volatility is short-term-focused & may not have much impact on long-term return in buy & hold portfolio, consider risk as **measure of how you might reach or miss long-term goals**.
- For example:
  - Holding cash in low-interest bank account may not help you earn enough money to retire happily. (High risk.)
  - Trying & failing to guess near-term direction of market may cause you to lose money & delay retirement. (High risk.)
  - Investing in broad-based all-equity portfolio in 401(k) may deliver long-term returns that allow you to retire early. (Low risk.)
  - Trying to avoid risk & thus earning below-average return on investments. (High risk.)

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MEASURING INVESTMENT RETURNS

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Understanding "Simple Return"

- Actual percentage change of investment's value.
- AKA "cumulative return."
- Sometimes used by stock promoters to tout outlandish stock performance.
- Since no time value is used in calculation, doesn't actually tell you much about performance of security.

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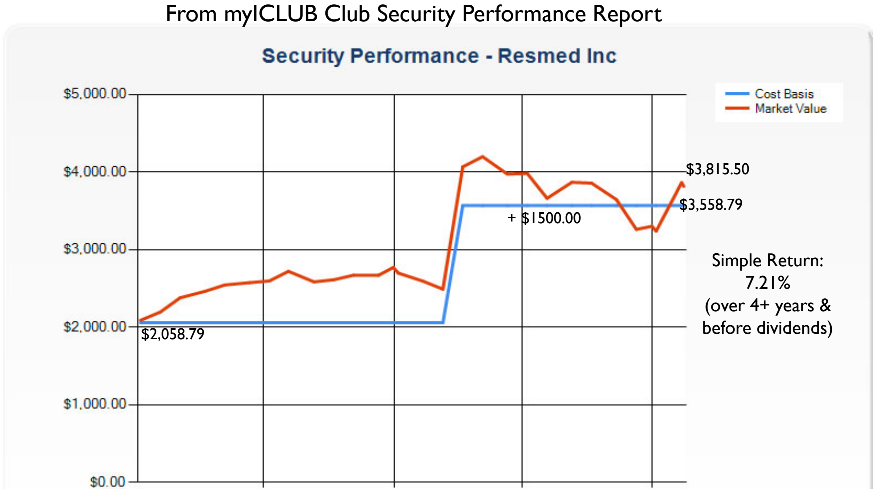
Security Performance

From myICLUB Club Security Performance Report



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A Better Method: "Total Return"

- Actual rate of return of investment over time including price appreciation & (usually) dividends.
- Displayed as percentage.
- Total returns are generally presented on **average annual compounded rate**.
- Note: SSG uses "Projected Total Return" in different context.

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Understanding "Compound Annual Return"

- CAR is very complex to calculate.
- Similar to compounded interest rate paid on mortgage or earned in savings account.
- Uses "Internal Rate of Return" to take into account:
  - Points in time in which investment was bought and/or sold.
  - Amount of money invested or removed in each transaction.
- Generally presented on annualized basis.

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Compound Annual Return: RMD

From myICLUB Club Valuation Statement:

Security	Total cost	Market value	Compound annual return 12/18/2016
Resmed Inc	$3,568.78	$3,815.50	4.17%

Compare this annualized rate to simple return of 7.21%.

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Problems with Compound Annualized Rates

Valuation statement as of 2/14/2017.

Security	Date first purchased	Shares owned	Cost/ share	Total cost	Price/ Share	Market value	Compound annual return 11/21/16
Apple Inc	11/21/16	15.0	$368.666	$5,529.99	$509.46	$7,641.90	301.46%

- Rates are calculated based on one-year periods – even if one year of history is not available.
- As such, results not as relevant:
  - For any short period.
  - For large price movements in short periods.

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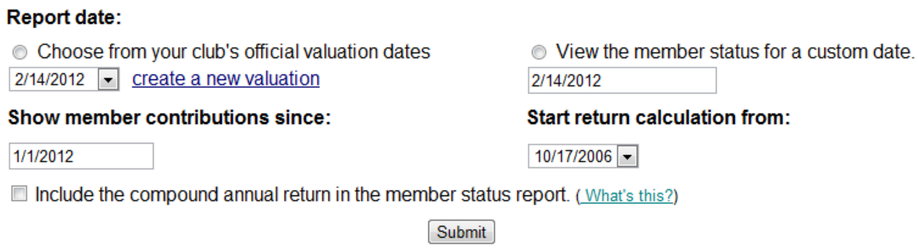
Displaying Compound Annual Return

- In myICLUB.com, can choose to include CAR in Valuation Statement & Member Status Report.



- New clubs should NOT include CAR for first few years of existence.

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LOOKING AT INDIVIDUAL MEMBER PERFORMANCE

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Individual Member Performance

- myICLUB can display CAR on Member Status Report for each member.
- Uses all member deposits, fees, allocated income, withdrawals.
  - For most clubs, at least 12 cash flows per member per year!
- Two members can have similar total amounts invested BUT different cash values, units owned, & CAR.

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Sample Member Status Report

Name	Paid in since 2/1/17	Total Paid in	Total paid in plus earnings	Units since 2/1/17	Total units	Market value	Percent owner-ship	CAR since 9/12/02
Angelfish, Sandy	$0.00	$3,238.25	$1,986.69	0.0000	107.1247	$1,918.05	3.61%	-5.53%
Catfish, Carol	$0.00	$2,291.00	$2,202.02	0.0000	206.4523	$3,696.49	6.96%	20.33%
Fisher, Jack	$0.00	$15,296.90	$12,908.21	0.0000	930.2765	$16,656.42	31.38%	0.82%
Salmon, Candy	$0.00	$1,175.00	$1,220.65	0.0000	106.8963	$1,913.96	3.61%	9.86%
Tarpon, Tim	$0.00	$4,938.16	$5,065.46	0.0000	439.7883	$7,874.33	14.84%	4.90%
Trout, Maeve	$0.00	$18,989.88	$15,377.78	0.0000	1,126.1734	$20,163.92	37.99%	0.51%

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HOW TO TELL IF PERFORMANCE IS "GOOD?"

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Understanding "Benchmarking"

- Benchmarking: Compare results to representative index, portfolio, security.
  - S&P 500 Index or Wilshire 5000 Total Market Index.
  - For ease of use, use ETF or Index Fund that tracks.
- Advanced: Separately benchmark portions of holdings to relevant indexes:
  - Small stocks to S&P SmallCap 600 Index.
  - Foreign stocks to MS EAFE Index.
- Best NOT to compare to simple return without similar cash flows.

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myICLUB Club Performance Report

- Compares overall club CAR performance:
  - To CAR of S&P 500 Index & Wilshire 5000 Total Stock Market Index, as represented by Vanguard Index Funds.
  - For YTD, Lifetime, & past 1, 3, 5, & 10 years.
- Considers each cash flow in & out of club as purchase/sale of underlying index.

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Sample Performance & Benchmark Report

Checkered Past Performance 4/18/2017

Club Performance & Benchmark Report as of 4/18/2017.

Return to myICLUB.com

Print

	1/1/2017* - 4/18/2017**	(9/13/1997-4/18/2017) Lifetime to Date	Compound Annual Return for periods ending December 31 1 Year	3 Years	5 Years	10 Years
Club	28.79%	4.31%	10.01%	13.94%	8.29%	7.20%
Vanguard 500 Index Fund	18.85%	7.33%	9.53%	20.95%	13.20%	8.47%
iShares 20+ Year Treasury Bond ETF	19.39%	0.21%	2.09%	10.63%	7.50%	6.40%

* Valuation date used: 12/31/2016
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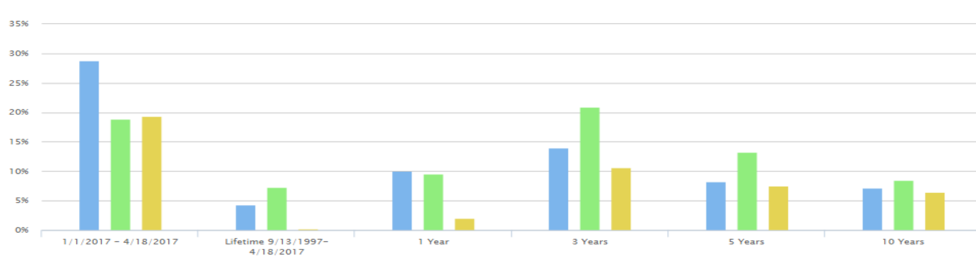

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Interpreting Benchmark Report

- Longer-term results are more meaningful.
- Expenses for newer clubs/investors can drag down results significantly.
- More conservative/risk-averse clubs/investors may be satisfied with underperforming indexes.
- Investment club's "education premium" may also justify lower performance.

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HOW OFTEN SHOULD CLUBS & INVESTORS REVIEW PERFORMANCE?

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Long-Term Performance

- New clubs should ignore for first 1-3 years.
- With long-term approach, clubs don't need to examine CAR every month.
- Annual review, perhaps after books are closed for year, may be useful.
- Longer-term results are more useful.

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If Results Don't Exceed Market

- Don't sweat it, especially if:
  - Your objectives may be to seek lower risk & thus willing to accept lower return.
  - Your club still has educational value.
- Consider causes of underperformance:
  - Too many expenses.
  - Bias towards large- & mega-cap stocks.
  - Under-representation of small- & mid-cap stocks.
  - Too many stocks (more than 20 or 2 per member).
  - Fear of selling/holding both winners & losers too long.

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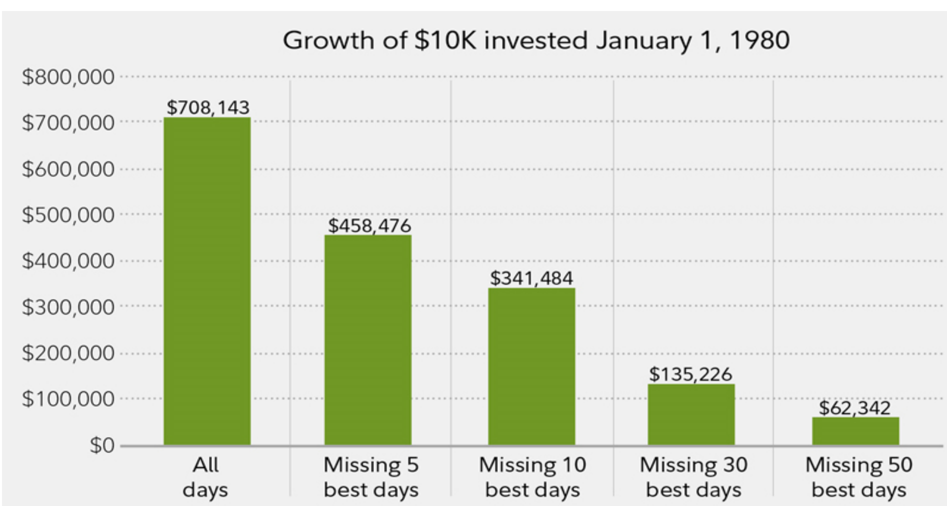
TIPS TO MANAGE VOLATILE MARKETS

Don’t Try to Time the Market



Source: Fidelity. 1980-2020.

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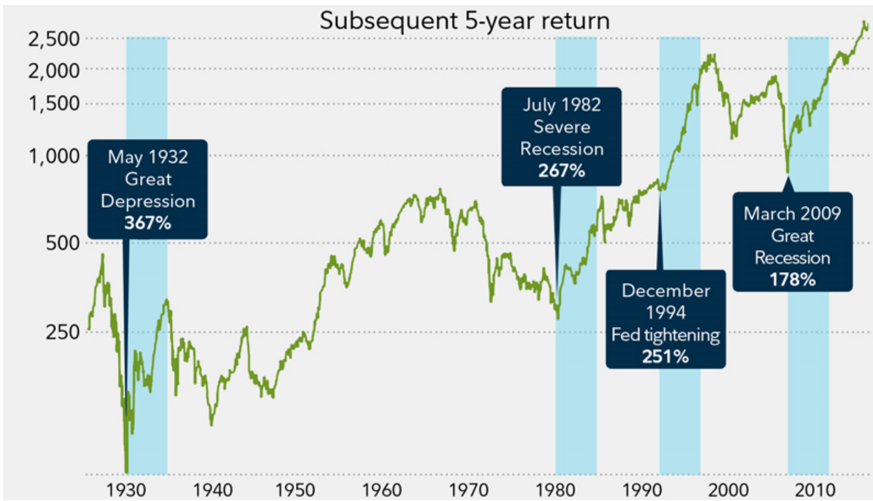
Invest Regularly, Despite Volatility

It has paid to stay invested in US stocks during troubled times



Source: Fidelity

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Take Advantage of Opportunities

- You can take some actions while markets are down to help put you in better position for long term.
  - Swap out current holdings for higher quality companies.
  - Sell stocks held at loss for tax-loss harvesting.
  - Continue to invest in IRA, 401(k), investment club, regular investment portfolio.
    - Boost regular investing plans (& club dues) during these periods!

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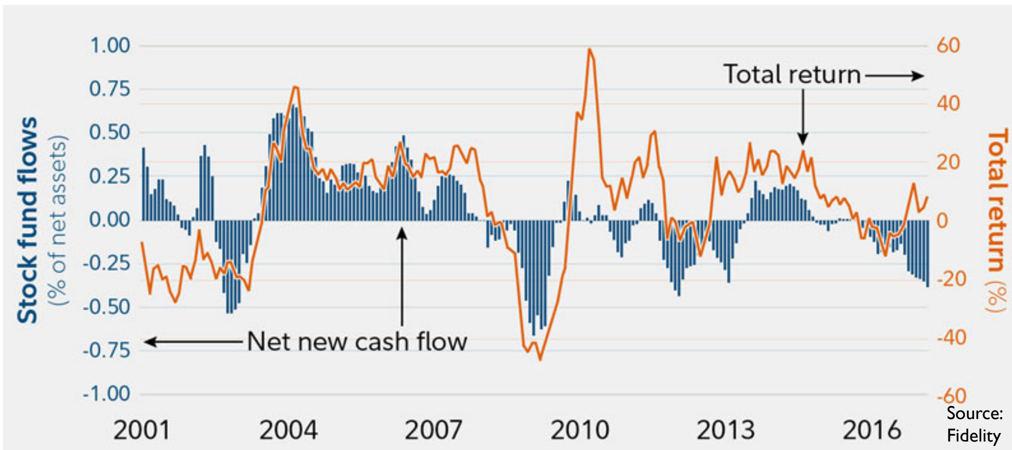
Above All, Stay Disciplined

Investors tend to chase performance, & catch downturns



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More Questions?

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