HOW TO SELECT STOCKS AND BONDS

Once an investor has established their target stock/bond percentage (Diversification Ratio), they must select which stocks and bonds to buy.

If an investor had "inside information" that a particular company would soar in value, it might be wise to buy that stock. *(Although, depending on how they got the information, a purchase may be illegal).*

However, most investors **don't have inside information,** so they have "no competitive advantage." Information on a company's past performance and future outlook that is publicly available has already been factored into the trading price. Stocks with great outlooks will have already risen in price, and stocks performing under expectations have been discounted.

So, despite all the advertisements for "the next hot stock." and tips from friends and relatives, in the end, it is best not to purchase just one stock or even ten stocks because that is putting too many eggs in one basket – Even big companies fail unexpectedly (think Enron)

Studies have proven that individual stock picking does NOT work to the investor's advantage over the long run.

The savvy investor buys a portion of a "fund" that owns hundreds of stocks, bonds, or both.

HOW CAN AN INVESTOR WITH LIMITED FUNDS BUY HUNDRED OF STOCKS OR BONDS?

To access hundreds of stocks or bonds with limited funds, investors purchase a piece of a "fund" that owns hundreds of stocks or bonds.

WHAT IS A FUND?

A Fund is a group of investments. Funds have different characteristics,

- They can include stocks, bonds, or both.
- If they include stocks, they might focus on a particular domicile, size, outlook, or sector or be a combination.
- If they include bonds, they might focus on a specific issuing entity, term, credit rating, or taxable status – or they can be a mix.

The fund's characteristics are described in a written document called a "prospectus," but often, a clue to what is in the fund can be found in the fund name.

HOW ARE FUNDS MANAGED?

Funds can be managed by either a team of Fund Managers or through a mathematical formula. They are usually described as follows:

- **Actively Managed Funds are called Mutual Funds** and are put together by financial professionals called Fund Managers. The Fund Manager decides what to buy and sell to achieve the fund's prospectus objective.

- **Passively Managed Funds are called Electronic Traded Funds (EFT)** and are put together using mathematical formulas (think of a recipe). Investments are sold and purchased on autopilot because they are programmed to follow the formula.

  EXAMPLE: if an EFT were set up to contain stocks of the 500 largest United States publicly traded companies, it would have to sell the stock of any company that fell off the list of the 500 largest and buy the stock of a company that increased in size and joined the list of the 500 largest.

CHALLENGE
Which fund type is more expensive to run, a Mutual Fund or an EFT?

Handout 12.46 further describes the difference between Mutual Funds and EFT Funds.

HOW SHOULD YOU RESEARCH FUNDS?

One of the best fund research tools is MORNINGSTAR. www.morningstar.com

Morningstar was started in 1984 to give investors information previously only available to the professional financial community. https://www.morningstar.com/company/about-us

Morningstar does NOT sell any products except information. They provide the metrics for over 62,000 investments in 32 countries. While a lot of information can be found by going to the fund's website, the benefit of using Morningstar is that the information is displayed consistently and efficiently.

Best of all – 90% of Morningstar information is FREE.

All you need to do is sign on to the website and know how to navigate to the critical information,

WHAT CRITERIA SHOULD BE USED TO EVALUATE OR COMPARE FUNDS?

The critical criteria to compare is:

- Fund Expense Ratio – the % cost to run the fund for $1 invested (lower is better)
- Fund Portfolio – what is inside the fund (verify it matches the objective)
- Fund Performance – what has been the fund performance over different periods
- Fund Risk and Return – compared to the "Category," how does the fund stack up

All this information is available for FREE on Morningstar if you have the fund ticker symbol and click on the proper tab.

WHAT IS A CATEGORY?

To make fund comparison easier, Morningstar and the investment community have grouped funds into "Categories." A Category has a stated objective to contain a specific type of investment.

Below are examples of commonly used categories and funds with the listed attributes:

		Domicile	Size = Capitalization	Outlook	Ticker	Fund Name
1	Equity	United States	Large & Mega	Growth	VWUSX	Vanguard US Growth Investor
2	Equity	United States	Large & Mega	Value	VONV	Vanguard SCOTTS/VANGUARD RUSSELL 10
3	Equity	United States	Small Cap	Growth	VSGAX	Vanguard Small Cap Growth Index Admiral
4	Equity	United States	Small Cap	Value	VIOV	Vanguard ADMIRA/S&P SMALLCAP 600 VA
5	Equity	International	Large & Mega	Growth	VWIGX	Vanguard International Growth Inv
6	Equity	International	Large & Mega	Value/Blend	VTRIX	Vanguard International Value Inv
7	Equity	International	Small	Blend	VSS	Vanguard FTSE All-World ex-US Small-Cap ETF
8	Equity	Emerging Markets (Intl)	Mixed	Blend	VWO	Vanguard FTSE Emerging Markets ETF
9	REIT	United States		Blend/Growth	VNQ	Vanguard Real Estate ETF
10	REIT	International		Blend/Value	VNQI	Vanguard Global ex-US Real Estate
11	Bonds	United States - Govt Bonds		Long term	BLV	Vanguard Long Term Bond Fund
12	Bonds	United States - Govt Bonds		Intermediate term	VBIIX	Vanguard Intermediate-Term Bond Index Fund
13	Bonds	United States - Govt Bonds		Short - term	VFIRX	Vanguard Short Term Treasury Admiral
14	Bonds	United States - Corporate Bonds		Short - term	VFSUX	Vanguard Short-Term Investment-Grade Admiral

While the above chart shows the ticker symbol and name of Vanguard funds, every significant investment company provides funds with those same characteristics (category). In fact, you can find all the "competing" funds in the category through Morningstar and compare the metrics.

If you want to find a category fund from a different investment company, you can do a Google search. For example, if you googled. "Schwab US Large Cap Growth Fund Ticker Symbol." The result would be:

SWLSX | Schwab Large-Cap Growth Fund | Schwab Asset Management.

Handout 12.44 lists the 64 Morningstar Categories.

HOW DO YOU PROPERLY COMPARE FUNDS?

When comparing fund metrics, the funds must have the same stated characteristics and are in the same category.

For example, you might compare

- a Schwab US mid-cap stock fund to a Fidelity US mid-cap stock fund, as it would be apples to apples.

You would NOT compare a

- Schwab US Large Cap Fund to a Fidelity International Mid Cap Fund. The stocks in those funds represent different categories; it would be like comparing apples to grapefruits.

HOW MANY FUNDS SHOULD AN INVESTOR HOLD?

An investor needs to decide how many funds they want to hold. Investment professionals often recommend 12-18 funds to be diversified, with each fund having a different characteristic. This does achieve diversification, but it has drawbacks.

WHAT ARE THE CHALLENGES OF A MULTI-FUND PORTFOLIO?

- FEES - An investor generally pays a commission/trading fee to purchase a fund, so the costs add up if buying small quantities of many different funds.

- NEED TO REBALANCE - Fund values change daily. So, if you have a portfolio with 15 funds and start with the perfect ratio between funds, the ratio will be off balance by the end of the day. Over time, the balance can shift drastically, and the portfolio can easily stray from the asset allocation targets.

  To keep the portfolio at the desired targets, someone must periodically review it and "rebalance." Rebalancing means buying and selling funds to return to the desired targets. On a practical basis, an Investor would set a "target" for each fund and then a low-high tolerance range so that a trade is only made if the fund holdings go outside the range.

Rebalancing to maintain diversification requires making COUNTER-INTUATIVE trades.

- Funds that increase in value and exceed the high range must be sold.
- Funds that decreased in value and are below the low range must be purchased.

Rebalancing is work and time-consuming.

Some investment firms have developed products that automatically select 12-18 funds to diversify an investor’s portfolio among different categories and then use mathematical formulas to rebalance. They call these products “robo-advisor”. An example would be

- Fidelity Go https://www.fidelity.com/managed-accounts/fidelity-go
- Schwab's Intelligent Portfolio https://www.schwab.com/intelligent-portfolios
- Vanguard Robo Advisor: https://investor.vanguard.com/advice/robo-advisor

Those products can be an excellent alternative to achieve diversification and not pay fees to rebalance.

Other investors, investors opt to have fewer funds so that rebalancing is easier.

For example, a three-fund portfolio containing

- US stocks fund
- International stock fund
- A bond fund with bonds of mixed terms and mixed credit ratings.

Selecting only three funds makes rebalancing easier, but periodic trading is still required to keep the allocation aligned with the Investor's diversification targets.

ARE THEIR TAX ISSUES TO BE CONCERNED WITH?

- Selling investments in a retirement fund (Traditional IRA or ROTH) does NOT trigger capital gains tax because investments can be bought or sold without tax being due, provided the funds stay in the account.

- However, selling investments in a non-retirement fund will trigger capital gains tax if the sale results in a profit. Therefore, rebalancing in a non-retirement account has tax consequences.

IS THERE AN EASIER WAY TO ACHIEVE DIVERSITY?

Few individual investors want to be bothered with rebalancing, so the investment community has devised two solutions.

Both techniques allow the Investor to choose ONE FUND and remain in balance because the fund manager handles rebalancing.

 # 1 - ASSET ALLOCATION FUND (sometimes called a Balanced Fund)
An Asset Allocation fund has a preset mix of stocks and bonds. The goal of the Asset Allocation fund is to maintain a fixed stock/bond ratio. When the underlying stocks and bonds change in value, the fund managers make trades to keep the fund at the stock/bond ratio defined in the prospectus.

An Asset Allocation fund works when the Investor wants to maintain a set stock/bond ratio. Some asset allocation funds have 80% stock and 20% bonds, while others have a stock/bond ratio of 60/40, 40/60, or 20/80.

#3 – TARGET DATE FUND
While Asset Allocation funds can be great for non-retirement accounts, for retirement accounts, an investor usually wants to change their stock/bond ratio over time.

As Investors age and get closer to needing to withdraw money, they want less volatility and are sacrifice returns for peace of mind. Thus, they need to change their ratio every few years. In that case, Asset Allocation funds are not appropriate.

So, in the 1980s, the financial community created Target Date funds, whose objective is to change the stock/bond ratio over time. https://en.wikipedia.org/wiki/Target_date_fund#

The fund stock/bond ratio "GLIDES" over time to become more conservative as the "target date" approaches.

Target Date funds are the go-to choice for retirement investing (IRA, SEP IRA, 401K, 403B) when an investor only needs to determine "When will I want to start withdrawing funds?"

Target date funds are set up every five years; thus, there is a target date for 2025, 2030, 2035, etc. Most investors select a fund corresponding to when they will be close to age 65-70.

TARGET DATE funds are highly recommended for individuals who want to make only one decision
when will I need to start withdrawing the money?

Morningstar considers both Asset Allocation and Target Date funds a category, making it easy to compare metrics – aka "check out the competition."

TRIVIA OF INTEREST:
Vanguard and Wharton Business School studied 1.2 million investors with different portfolio mixes and found that those with just a target date fund did significantly better than those who purchased multiple funds and tried to do their rebalancing.

The main reason is that they were not jumping in and out of funds because they knew someone else was worrying about allocations. They had less concern about volatility as they were in it for the long haul.

https://www.pionline.com/defined-contribution/pure-target-date-fund-investors-see-significantly-more-gains

WHAT OTHER FUND METRICS SHOULD BE INVESTIGATED?

As stated above, the KEY fund metrics are:

- **Fund Expense Ratio** – the % cost to run the fund for $1 invested (lower is better)
- **Fund Portfolio –** what is inside the fund (verify it matches the objective)
- **Fund Performance** – what has been the fund performance over different periods
- **Fund Risk and Return** – compared to the "Category," how does the fund stack up

Additionally – investors might research

- **Length of Time Fund Exists** – generally, buying a fund with a longer track record is better. This way, you can review past performance (although that does not guarantee future performance).
- **Dividend Payments** – Some investors like funds that pay dividends because they want the cash to spend. However, most investors elect to "reinvest" the dividends to buy more of the fund. When measuring the increase in value, the dividend is counted as part of the growth.

For example:

- If Fund A grew in value from $100 to $104 in one year and paid NO dividends, it would have grown by 4%.
- If Fund B grew in value in one year from $100 to $102 and paid a $2 dividend, it would be recorded as having grown by 4%

WHAT ELSE SHOULD AN INVESTOR BE AWARE OF?

Selecting a Financial Custodian – A Financial Custodian holds investors' money, stocks, bonds and funds for safekeeping to minimize the risk of theft or loss. They may also offer investment products. When selecting a Financial Custodian, customer service is the king. An investor should watch

- Do they answer the phone promptly?
- Do they have a customer service team that will answer questions?
- Do they make opening an account easy?
- Are their statements easy to read?
- Can you access your account online and see performance information?
- Do they have branch offices where you can stop in? – if that is important to you

When choosing a Custodian, consider how often you will make investments. If you are trading with frequency (which I hope will NOT be the case), ask how much it would cost to buy the fund you have pre-selected as the best for your needs, even if it comes from a company other than the fiduciary.
Handout 12.33 What is a Financial Custodian, and how to choose one?

COMMISSIONS
The most common ways to charge investors are:

- Commissions to Buy AND Sell
- A Fee for "Assets under Management" - generally between .25% and 1% of invested assets
- Flat Fee for a year (rare)
- Hourly fee for advice (rare)

Paying an Assets under Management fee is not cost-effective because it is paid yearly and significantly reduces earnings.

It is generally better to pay a commission for trades but rarely trade. (Buy and Hold investing)

If an Investor decides on the fund, they want to purchase and opens up a self-directed account with the Custodian offering that fund (i.e., if they chose a Vanguard fund, they would open the account with Vanguard), they can often buy the fund without a commission. However, deciding on the fund first is critical because if an Investor goes to the Custodian without knowing what fund they want, the Custodian will generally suggest their "house funds," which may not be the best choice.

LOAD VS NO LOAD—Some funds charge a fee upfront to buy into the fund or at the end when the Investor goes to sell the fund—or sometimes both. Those funds are called "Load Funds." A "No Load Fund" is almost always better

IN SUMMARY – An Investor should:

1. Decide their stock/bond diversification ratio based on when they need to withdraw funds.
2. Decide if they want that ratio to remain fixed or change over time. If they elect a fixed ratio, they should research Asset Allocation funds; if they wish the fund to change its ratio and become more conservative over time, they should research the Target Date fund.
3. Compare funds in the same category. i.e., if looking into Target Date funds from various firms, ensure they are all the same Target Year. Then, using Morningstar, compare the five and ten-year returns. Did the fund outperform the "category/benchmark"? What is the funds Expense Ratio? Is the portfolio mix consistent with the fund's stated objective?
4. Once the fund is selected, open a self-directed account with a Financial Custodian to facilitate the fund purchase for free or at a low cost. (see handout 12.33)
5. Make an initial investment in that fund and elect to "reinvest" dividends.
6. Set up a mechanism for regularly funding the account; automatic weekly investments, even in small amounts, are a great way to make investing painless.