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*Wholly Owned by the
American Institute for Economic Research*

Investing in a Participant Directed Retirement Plan

Lifestyle Portfolios Using the Passive Asset Class Approach to Investing

Long before it was in vogue, we have been proponents of Passive Asset Class investing.

Professional Asset Management (PAM) is a low cost discretionary investment advisory service for your entire portfolio through which we invest and manage your assets in accordance with your financial goals and investment risk tolerance. We monitor and adjust your portfolio on an on-going basis and provide comprehensive reports each quarter listing your holdings, purchases, sales, performance and more.

Our PAM service brings over seven decades of objective economic research from our non-profit parent, the American Institute for Economic Research to your investment planning as well as dedicated service from our team of experienced professionals.

Investing in a Participant Directed Retirement Plan – The Three Big Questions

Participant directed retirement plans, most commonly known as 401(k) and 403(b) plans, have become the overwhelming trend among employers. As the title suggests, individual employees have the option to participate in these plans or not and, if they participate, they “direct” where their retirement savings are invested. In other words, the burden is on the individual participants to decide for themselves where to invest among the various options available in their plan. This immediately raises three major, critical questions:

1. Who determines what investment options are available?
2. Are the options cost effective and do they provide reasonable choices and returns?
3. How do participants know what to do?

We have developed an investment lineup and education program designed specifically to address these questions. As will be explained in this brochure, with our approach, participants can achieve superior risk adjusted returns at the lowest cost. Further, plan sponsors get the best of all worlds because we provide flexibility and straight forward oversight at relatively low cost while maintaining high fiduciary safeguards.

Passive Versus Active Management

There are two general approaches to investing in the capital markets, active and passive:

Active managers attempt to “pick stocks” as they “time the market.” They claim to be able to consistently recommend securities that will be stellar performers and to know in advance the direction of the market. They believe, implicitly, that securities and markets are “mispriced” and that they possess a unique ability to determine the “correct” price.

Passive managers make no attempt to forecast prices. They believe that current market prices are the best estimate of value since the price reflects all known information and the collective judgment of investors. This is also known as the “Efficient Market Hypothesis.” The passive manager feels there are no “bargains” and it is impossible to consistently predict future winners. Instead they look at the characteristics and performance of classes of investments, e.g. large cap stocks or short term bonds, and then seek to invest in securities representative of the overall class. They often structure their portfolios to mirror the performance of common market indexes such as the S&P 500 or Russell 2000.

We have adopted a passive approach. Statistically speaking, passively managed mutual funds, such as index funds, have outperformed the vast majority of actively managed funds over the long term. Our research has convinced us that asset class portfolio allocation gives investors the best risk adjusted returns at the lowest cost.

Passive Management and Asset Classes

Our passive approach to investing reflects an abiding belief in the ability of capital markets to reward investors for the capital they supply. Markets are competitive—and that is good news for investors. Firms compete with each other for investment capital, while investors compete for returns. According to the Efficient Market Hypothesis, this relentless quest drives security prices to their fair value so that no investor can expect greater returns without bearing greater risk.

We often get asked the question “If you don’t pick stocks, then what do you do?” What we do can be summarized as follows:

1. We identify *asset classes*
2. We measure risk, return and volatility of each class
3. We identify the best passively managed investment vehicles representative of each class
4. We design and maintain portfolios of asset classes using these investment vehicles to maximize expected return while staying within the individual client’s risk tolerance

Which begs the question, what is an asset class? Simply stated, an asset class is a collection of securities that share the same characteristics identified through statistical reasoning. A few examples would be:

Large cap stocks: Companies whose market value is among the highest in the stock market

Small cap stocks: Companies whose market value is among the lowest in the stock market

Value stocks: Companies with low stock prices relative to earnings, dividends, or book value; they typically have a high cost of capital

Intermediate Term Bonds are bonds with maturities of 3 to 7 years

What makes an asset class distinct is the fact that historically, as a group the securities that comprise it have achieved positive returns over time yet they have their own unique risk/return characteristics from other groups of securities. They are also not strongly, positively correlated to other groups which mean they do not always perform the same way under the same economic conditions. For example, from 2003 through 2005, small cap stocks as a group performed significantly better than large cap stocks as a group.

Each class represents a different element of risk and by adjusting the amount of a portfolio invested in each class you can adjust the level of overall risk being assumed. This framework allows us to construct comprehensive portfolio options designed to meet the varying needs of participants in a manner that is measured and deliberate. Our objective is to provide a range of options which represent superior returns consistent with varying levels of risk.

This structured, rationale and quantifiable approach to portfolio construction stands in sharp contrast to the rudderless approach of traditional investment managers who implicitly

believe that markets fail—they attempt to pick stocks that are “mispriced” and second guess the fluctuations inherent in capital markets. Though their rhetoric may be compelling, their track record is typically not. The evidence clear: Investors are better served by simply maintaining broad passive exposure to the appropriate segments of capital markets in a disciplined, low cost manner, consistent with their preference for risk.

Risk Adjusted Returns and Lifestyle Portfolios

We have examined decades of historical data to develop an understanding of how asset classes have performed in a variety of economic environments. By adjusting the percentages of a portfolio allocated to different asset classes, we can tailor a portfolio to provide varying exposure to risk. The trade-off is straightforward:

Higher risk portfolios will have higher allocations to equity (i.e. stock) asset classes and carry greater potential for long term return, however, they will be more volatile and the investor has greater potential to lose money.

Lower risk portfolios will have higher allocations to fixed income (i.e. bond) asset classes and carry lower potential for long term return, however, they will be less volatile and the investor has lower potential to lose money.

Naturally, there is a spectrum of options in between depending on the precise risk that is to be assumed. Once a portfolio is designed, the overall return is referred to as the “risk adjusted” return meaning the return received is a function of the risk assumed rather than an absolute measure compared to the “markets.”

Since managing the trade-offs inherent in asset class risk and return is not common knowledge among most participants in a retirement plan, we have made things easier by creating five risk adjusted portfolio allocation models. These models are called “lifestyle portfolios.”

Each lifestyle portfolio represents a different level of overall portfolio risk from Risk Averse (very conservative, low risk) to Highly Aggressive (high risk). We have found that for the vast majority of participants, one of the five lifestyle portfolios will represent the appropriate level of risk for their circumstances. Participants can then easily emulate the portfolio that most closely matches their specific situation.

For example, generally speaking, a 30-year-old single person can assume a high level of risk in their retirement plan because they have a long time frame and, therefore, the Highly Aggressive lifestyle portfolio will be appropriate for them. However, a 60-year-old getting close to retirement can generally not assume much risk, therefore either the Risk Averse or Conservative lifestyle portfolio will be appropriate for them.

The five lifestyle portfolios and their allocation percentages are as follows:

Lifestyle Portfolio Allocation Percentages
(invest in each asset class using low cost, passive investment vehicles)

Asset Class	Risk Averse	Conservative	Moderate	Aggressive	Highly Aggressive
Cash & Equivalents	15	10	5	0	0
Short/Intermediate Bonds	50	40	30	15	0
Real Estate Investment Trusts	10	10	10	10	10
Large Cap Value Stocks	15	20	24	30	34
Small Cap Stocks	0	6	12	18	22
Large Cap Growth Stocks	5	6	7	9	12
Foreign Stocks	5	8	12	18	22

Participants have the ability to select one of these five options, or they can create their own “custom” portfolio using any mix of funds in the plan.

The Importance of Cost

Cost matters more than many investors realize—what may seem to be an inconsequential difference, say half a percentage point in mutual fund expenses, can compound to much larger differences over the long term. The following example illustrates the impact of costs on total performance over time: Assume two mutual funds each begin with \$5,000 and that each grows at 10% annually before expenses. Fund “A” has total annual expenses equal to 0.80% of assets while fund “B” has expenses equal to the mutual fund average (1.37%):

	<u>Fund A</u>	<u>Fund B</u>
Starting Value	\$5,000	\$5,000
Ending Value in 15 years	\$18,720	\$17,307

The difference accumulates to \$1,413, or 8.2% of the ending value of fund B.

It might be argued that Fund B has better prospects for superior returns so that an assumption of equal 10% gross returns is invalid, but this would be pure conjecture. Past returns are only a rough guide to the future and only results covering very long time periods and encompassing a variety of market conditions should be considered relevant.

Putting It all Together in a Participant Directed Retirement Plan - Education

All this theory is well and good, but unless the participants are informed and educated, it is all for naught. Therefore, we have developed an extensive education program which goes far beyond the typical perfunctory overview of fund options and the mechanics of enrollment and fund selection that most plan providers limit themselves to. We cover topics as diverse as the impact of social security on retirement planning to what to consider when taking a loan from your retirement plan to how to integrate retirement plan savings with other investments participants may have outside of the plan. It is our objective to give participants a well rounded education of investing and planning for retirement, not just a narrow slice about their plan options.

The investment and education package we implement in our participant directed plans provides the mechanisms for participants to understand and implement this three step process very easily through the use of lifestyle portfolio allocations models comprised of low cost asset class mutual funds.

Passive Asset Class Investing and Cost – The Bottom Line

We've all heard the phrase "Past returns are no guarantee of future results." This statement is true and should be heeded. Therefore, past performance by itself is not necessarily very useful criteria to make a decision about any particular investment opportunity. However, if we change the statement slightly, we can turn it into something that is very useful:

Past cost is often an excellent indicator of future cost.

One of the greatest advantages of following a passive asset class investing approach is cost. Passively managed investment vehicles are by far lower cost than actively managed ones. Even if an actively managed mutual fund were to outperform a passively managed one (which we contend is unlikely over the long run), it is likely that the return will be eaten up by higher management fees and therefore the individual investor whose money is at risk will never reap the benefit. It is therefore our contention that investors are best served by adhering to the following guidance:

Instead of trying to predict a future that can't be controlled, focus on the things that can be controlled:

- 1. Diversification among assets classes*
- 2. Discipline to stick to a plan*
- 3. Minimize costs*

The Fund Companies

We are constantly on the lookout for the most effective passively managed mutual funds in the marketplace. Within the participant directed retirement environment, our extensive research and review has boiled down to the funds offered by two companies:

Dimensional Fund Advisors (DFA): Founded in 1981, DFA is a pioneer in passive investment mutual funds. DFA effectively applies academic research to the world of practical investing. Their objective is to help clients structure globally diversified portfolios and add value through engineering and efficiency. They have over \$130 billion under management.

Vanguard: Founded in 1975, Vanguard has grown to become the world's largest pure no-load mutual fund company. They are known for providing competitive investment performance, a broad array of mutual funds and the lowest average expense ratios among families of retail mutual funds.

Dimensional is the backbone of the fund lineup. Their techniques are a significant improvement over indexing, the most common form of passive investment. This is particularly evident in the small cap and value asset classes. More details about DFA can be provided upon request.

A Final Word on Plan Sponsor Fiduciary Responsibilities

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Who We Are

American Investment Services (AIS)

AIS is a registered Investment Advisor with the Securities and Exchange Commission. Founded in 1978 to provide low cost independent investment management and advice to individuals, estates, trusts, pension and profit sharing plans and charitable organizations, AIS has been working hard to meet client needs for over two decades during alternating periods of economic boom, recession, and inflation. AIS provides investment services on a fee only basis and does not receive any commission or other compensation, either directly or indirectly, from any party, including brokers and investment companies, other than clients.

AIS also publishes a monthly newsletter, *Investment Guide*.

AIS is wholly owned by the American Institute for Economic Research (AIER). Our research is generated internally and is consistent with the methods of inquiry employed by AIER. We also rely on research conducted by Dimensional Fund Advisors, Inc. and other academic and financial research sources.