Dynamic Asset Allocation

Richard (Doc) Ahrens, Updated June 2022

> During secular bull markets, the investment strategy of "sailing" by buying and holding stocks and bonds can be very effective; during secular bear markets, the investment strategy of "rowing" with absolute return strategies can be very effective. — Investment Expert Ed Easterling

Dynamic Asset Allocation is a method of staying fully invested as much of the time as possible — sailing when conditions allow it and rowing when necessary. Its rules are simple and allow investors to increase their long-term returns by avoiding unnecessary risk.

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PART 1

Passive investors often criticize Dynamic Asset Allocation (DAA) without understanding what it actually is. Some even make up stories about what they think it is instead of researching it. So before we dive into what DAA is, let's clear up a few of the myths about DAA.

Dynamic Asset Allocation is NOT:

1. Market Timing

   "Market Timing" is generally defined as attempting to move money into the market when it is going up and to move it into cash when the market is going down. DAA is quite different. It is based on staying invested the market as much of the time as possible.

2. Darting in and out of the market

   DAA often keeps the same positions for months or even years. There is no "darting" going on here.

3. Chasing Performance

   Chasing performance means looking at mutual funds and buying the ones that did the best last year. DAA moves with the market, not what the market was doing months or years ago.

4. Profiting by taking on more risk

   DAA profits by reducing risk rather than taking on more of it. In other words, DAA increases profits by carefully managing risk.

What Dynamic Asset Allocation actually IS

Dynamic Asset Allocation an objective, rule-based approach to identifying and exploiting strength — as it occurs — in different areas of the market. It also employs rule-based risk management.

Underlying Principles

3 Inconvenient Facts of Life

1. No one can predict the future. It may be possible to estimate the probabilities of coming events, or the likelihood that certain trends will continue for some time. But probabilities are measures of the present, not predictions of the future.

2. Few people can fully understand global or national events as they happen. Historians know that our knowledge of events increases as time passes and the actual forces that were at work are gradually revealed.

3. No one fully understands what is going on in the markets on a day to day basis. Markets are complex adaptive systems driven by economics, politics, finance, business factors, guesswork, and human emotions. They are a maelström of interacting forces.

   Even if you could interpret the economics, politics, finance, business parts, you can never decipher the guesswork and emotions. And those last two often override all the rational factors. As Marc Chaikin said, "Fundamentals drive the markets, but emotions drive the markets to extremes."

The good news is that you don't have to understand what's driving the market in order to be a successful investor. Some people spend decades trying to understand the market and end up broke. The key to success is concentrating on what is happening and not wasting time worrying too much about why it is happening.

Ned Davis got to the heart of the matter when he posed the question, "Do you want to be right or do you want to make money?"

What Do We Know?

- Market prices trend. They do not follow the normally distributed, random walk that Louis Bachelier wrote about 120 years ago. Modern mathematics shows that markets have memory and they trend.

- You can't tell right away when a trend is over. . .but with a little patience the market will show you. You will never get in at the exact bottom or get out at the very top. But you will be able to enter and exit — with confidence — in plenty of time to catch the majority of the move.

The basic DAA concepts are simple:

1. Never buy anything that is going down.
2. Don't hold onto something once it starts going down.
3. Use limited diversification in bull markets.
4. Invest in strength.
5. Review your holdings at regular intervals.

Our objective is not to try to beat the market. **Our primary objective is to avoid losing money.** (Interestingly enough, when you minimize your losses, you end up beating the market in the long run. We'll talk more about that later.)

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PART 2

Market timers try to get into the market when it is going up and get out of the market when it is going down. We try to remain fully invested in the market as much of the time as possible.

Value investors move their money into securities that are cheap compared to the intrinsic value of their companies. Growth investors move their money into securities for companies whose earnings are expected to increase at an above-average rate. Momentum investors move their money into securities whose prices are rising faster than the market.

Dynamic Asset Allocation is similar to momentum investing but it adds rigorous risk management to the mix.

The first step in our risk management process is to concentrate on ETFs rather than individual stocks. Five of the biggest risks for individual stocks are:

1. Systemic Risk — When the whole market goes into a decline
2. Management Risk — When bad management gets a company in trouble
3. Earnings and Guidance Risk — When a company has a bad quarter that results in a decline in earnings or the necessity for less-than-optimistic guidance.
4. Analyst Risk — When a company's earnings do not meet the "earnings estimate" that the stock analysts pulled out of the air a couple of months ago.
5. Competitive Risk — A good ETF manager keeps track of the upstarts and disruptors that threaten their established corporations. Good managers buy the stocks of the newcomers so their ETF will profit no matter which companies turn out to be the winners.

Using ETFs lets us reduce risks 2, 3, and 4 that are associated with individual companies. Using carefully selected ETFs allow us to create focused diversification. (And active risk management reduces risk 1.) Choosing good fund sponsors helps reduce Risk #5.

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The second step in our risk management process is to develop a relatively small investing universe. A *universe* is a group of securities that provide us with a manageable assortment

of diverse ETFs to choose from. Keeping the number of universe members down to a one or two dozen ETFs makes our monthly analysis easier. Our primary collection of ETFs is called the "Core Universe".

How was our Core Universe selected?

In the autumn of 2015, I spent over 300 hours searching for and comparing ETFs. I had several objectives:

1. Liquidity — Significant daily volume makes it easy to buy and sell without paying a "spread premium" to do so (the difference between the "bid" and "ask" prices).

2. Low management costs — Lower fund management costs help control an undesirable drain on returns.

3. Low volatility — Low volatility makes position management easier.

4. Low correlation — We do not want ETFs that all move together. We need ETFs that moved independently so while some are going down others are going up.

5. Diversity in Holdings — ETFs that invest in an array of stocks tend to move more smoothly than ETFs that invest in a few highly-correlated stocks.

The work in 2015 created the first version of our Core Universe. It has evolved slowly over the years as better choices were found and poorly performing ETFs were removed. Here is the Core Universe as of September 2020.

Symbol	**ETF Invests In**
BND	Total Bond Market
EEM	Emerging Markets
EFA	Europe/Australia/Far-east
GLD	SPDR Gold Shares
IBB	Bio-Tech & Pharma
IGV	Software
ILF	S&P Latin America 40 Index
IWM	Russell 2000 Stocks
IYT	Dow Jones Transports
SHV	CASH EQUIVALENT
PFF	S&P Preferred Stocks
QQQ	NASDAQ 100
SPY	S&P 500 (Large-Cap Stocks)
TLT	U.S. 20+ Year T-Bond
USMV	USA Min Volatility
VGK	FTSE Europe
VNQ	U.S. REIT Index
VTI	Total Stock Market

At this point we have several "universes". This was necessitated by changing market conditions.

The third step is our investment process. The Dynamic Asset Allocation investment process differs significantly from buy-and-hold investing in several ways.

Absolute Return versus Relative Return Investing

Relative returns are a way of measuring buy-and-hold success by comparing your returns with the returns you could get from investing in a major index. The major index is referred to as a *benchmark* and as long as your returns are higher than the benchmark, then the you are considered to be doing well.

If your investments are going up faster than the benchmark when the benchmark is rising or even flat, then I agree that you should be happy with your results. It does not make quite so much sense when the benchmark is falling like a rock and your investing adviser is telling you you're doing well because your investments are only losing money half as fast as the benchmark.

In absolute return investing, our benchmark is zero. That may sound odd at first, but it means that we are trying to keep our investments increasing in value all the time. If our returns are less than zero (in other words, if we're losing money), something is wrong.

In my opinion, comparing your performance to an arbitrarily chosen index like the S&P 500 index doesn't really make a lot of sense. Investment advisors tell you that if you're not beating the index, then you may as well just put your money into an S&P 500 index fund like SPY. They say it like it's a perfectly logical choice, but is it?

Alex Bryan observed, "Beating the market is great if you can do it, but it's not a requisite for investing success. ..It's actually pretty far down the list of things that you should be worried about."

History shows that if you put your money into an S&P 500 index fund, you will spend 75% of your time waiting to get back up to breaking even, and only 25% of your time actually gaining wealth? When it's going up it's great, but the rest of the time it's not much fun.

Let's look at what acknowledged financial expert Ed Easterling has to say about the two approaches:

> Relative return investors seek to survive the waves of the market by realizing the long-term average return. Gains occur in rising markets and losses in declining markets. Since the long-term trend for stocks has been up, relative return stock market investors have always been proven right over a long enough period of time. Absolute return investors seek gains in all market conditions. They seek to ride the waves and avoid the breaks of the markets, and they seek gains from skill. The results are as distinctly different as their respective approaches.

And again:

> For investors who are accumulating for the future, secular bear markets are times to build savings for later investment. This is done not only through contributions but also through prudent investing with an absolute return approach to investment

> returns. The absolute return approach uses the dual strategy of risk management and investment selection.
>
> Investment portfolios should be diversified across a range of investments that are diligently selected and actively managed, especially ones that control risk and enhance return. In particular, investors should not avoid the stock market or bond market. Instead, their objective should be to seek in both markets investments that incorporate elements of skill to enhance returns. Secular bear markets are not periods during which to avoid investing; they are periods that demand an adjustment to investment strategy.

In the first paragraph, Ed mentions, "relative return stock market investors have always been proven right over a long enough period of time". We normally think of that in terms of months or maybe 1-2 years, but if you had put $1000 into the market on Jan 11, 1973, it would have taken you until 1986 just to break even on an inflation-adjusted basis.

More recently, it took the NASDAQ index 15 years to get back up to where it was in 2000.

World-class economist John Mauldin said:

> …consistent with my philosophy, you do not want to buy and hold forever. You need some kind of risk management rule. If nothing else, use the web to run a 200-day moving average on whatever index funds you choose. Check once a week and if your fund goes below the moving average, then rotate into a short-term Treasury fund. Jump back into the market when it crosses above.

In order to avoid losing money, we don't ride securities into the depths of bear markets. Instead we try to use market price movements as an engine. We work to capture the upswings and avoid as much of the downswings as possible.

We mostly work with about two dozen ETFs that provide enough diversity so that some of them are almost always going up, no matter what the rest of the market is doing.

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Part 3

We already talked about the basic DAA concepts:

1. Never buy any security that is going down
2. Do not hold any security once it starts going down
3. Use limited diversification
4. Invest in strength
5. Review your positions regularly
6. Adjust positions when needed
7. Actively manage risk

Now we'll talk about the reasons behind those concepts and how to turn them into practical rules.

1. Never buy any security that is going down.

When a security is going down, you never know how far down it will go. The only way to know when it is safe to buy is when it has started to go up again.

How can you tell when it has started to go up? One way is the reliable, long-term indicator called the MTA (Macro Trend Analyzer). The MTA is a deliberately slow indicator, so it does not get you back in until well after a security has hit its low point. That may seem like a questionable characteristic, but when there is a major bear market, there are usually several false rallies on the way down. They are called false rallies because each one is followed by an even lower low as the market continues its downward path.

For example, in the bear market of 2000, people using the MTA to invest in the SPX would have lost about 13% before the MTA signaled it was time to move to cash or bonds in October. After that, the MTA would not have signaled a move back into equities until May of 2003. People invested in the SPX during the same 32 months would have seen their capital decline an additional 42%, more than 3 times as much as the MTA followers.

To make things worse, the market would make 7 bear market rallies on the way down, luring many people to get back into the market just in time to see it fall even further.

During the awful bear market of 2008, the MTA would have gotten you out of the SPX in November, 2007 and not signaled a return to the SPX until August, 2009. This would have allowed you to miss the worst of the 65% decline in the SPX from the sub-prime lending collapse.

The MTA has also proven its value in numerous other ETFs (Exchange Traded Funds) over the years.

2. Do not hold onto any security once it starts going down.

Why is it so important to have strong exit discipline? Warren Buffet, John Mauldin, Tom Basso, and many other professionals have said that if you master exit discipline, you will easily outperform 80% of all investors.

Lost Time

Some people think that if an investment loses money, then it's all right because they have just lost some time in getting to their retirement goals. John Mauldin points out the fallacy in this line of thinking:

> Getting back to even can eat up precious time. Take that 10% loss over six months. Earning a steady 4% annually after that, you will still need 2.75 <u>years</u> just to get back to where you started. That time would be much better spent accumulating new money. Remember, the idea is to grow your money, not just regain lost capital.

Lost Money

There's an unpleasant rule in investing called the "Asymmetry of Gains and Losses". It says that if your portfolio loses 10% and later on makes 10%, and that happens over and over, eventually you wind up with nothing. This is because in order recover from a 10% loss, you must make a gain of slightly over 11%. In other words:

If you lose this much	You must make this much to recover
10%	11.11%
20%	25.00%
30%	42.86
40%	66.67%
50%	100.00%

The "Asymmetry of Gains and Losses Rule" is what makes it so important to cut your losses while they are small. And it is why *risk management* and *sell discipline* are essentials of successful investing.

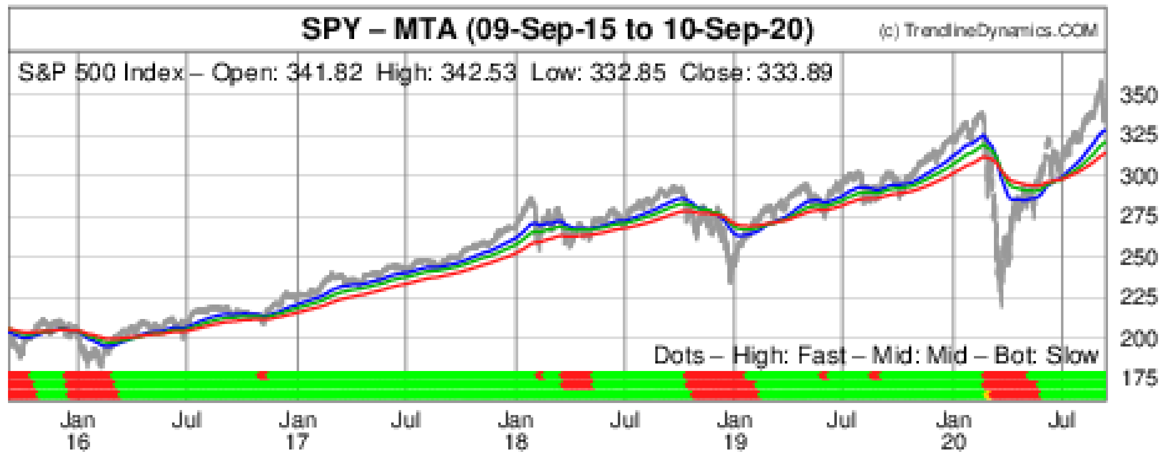
How can you tell if a security is going down?

There are a number of methods to gauge whether a security is going up or down. It's up to you to choose the one you are most comfortable with. Here are four of them, listed from slowest to fastest. None of them are right all the time. The important thing to do is pick one that fits the way you want to invest, and stick with it. (If you don't like any of these, there are lots of others. Ask me and we'll talk about it.)

Price Greater than 200-day Average

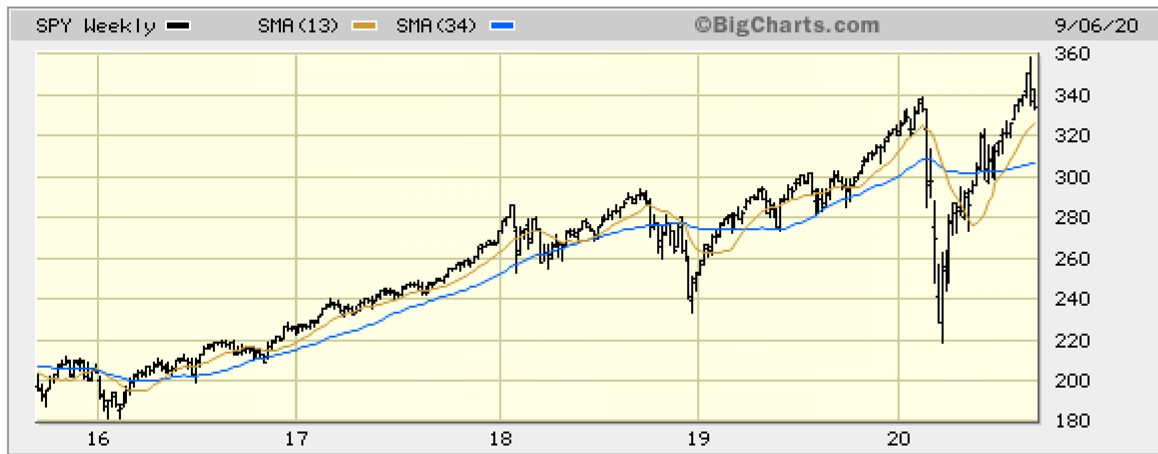
The SMA(200) [200-day simple moving average] is an indicator that will keep you in a security most of the time when it is going up, and it will get you out before you lose too much money on the way down. Some people get overly nervous and think it's necessary to get out every time price makes a little excursion below the average, but with some practice it's pretty easy to tell the difference between a pothole and an approaching cliff. (See Appendix B for a simple change that makes the SMA(200) chart easier to read.)

Macro-Trend Analyzer (MTA)



The MTA is designed to be less responsive to minor price changes than the SMA(200). Notice that in the first chart, price made several minor crossings below the 200-day average between 2016 and 2018. Meanwhile, the MTA gave a buy signal on 16-Mar-2016 and did not give an exit signal until 20-Oct-2018.

13-week/34-week Average Crossover



This is one of Ned Davis' favorite crossover indicators. You buy when the 13-week average crosses above the 34-week average and sell when the 13-week average crosses below the 34-week average.

MACD

The basic MACD is another crossover indicator, and it can be generated in any timeframe — daily, weekly, monthly, et cetera. This is a weekly chart and you can see that the MACD is a much faster indicator than the others we have looked at. You buy when the black line crosses above the red line and sell when the black line crosses below the red line.

The best way to choose which indicator(s) you will use is to work all of them for a while and pick the one(s) that speak to you.

Many years ago Colby and Meyers (The Encyclopedia of Market Indicators) ended their book by saying that none of the hundreds of indicators they tested actually worked. In other words, you couldn't just implement them on a computer and let them trade your money. The real value of the indicators was what they helped you, the analyst, see when you looked at the charts.

Some people love the stochastic oscillator. For me, it's useless. It doesn't show me anything I don't already see in a normal price chart. I also don't get anything out of the ADX indicator or Bollinger Bands. They just don't do anything for me. I can't "read" them. On the other hand, Chaikin's Money Flow tells me a lot — things I don't get out of a price chart. You have to pick the indicators that talk to you.

3. Use limited (or *controlled*) diversification

"Limited diversification" is yet another essential element of Dynamic Asset Allocation.

Some people hear of the concept of "diversification" and go out and buy a few hundred stocks, thinking that if a little diversification is good then a lot of diversification is even better. The problem here is that you cannot effectively manage a hundred positions or even a few dozen positions. Furthermore, beyond a certain point, holding more securities does not increase diversification because many of the securities are correlated to each other.

This is why we almost never invest in more than a handful of ETFs at any one time. Keeping the number of positions down to a handful makes it easy to: a) keep track of where our money is; and b) effectively manage our investments.

The Core Universe ETFs are carefully chosen and monitored over time. ETFs that are not performing well are removed. Other ETFs are added after being vetted. Core Universe ETFs are chosen for liquidity, low management expense, low correlation, low volatility, and high trend persistence.

Why use ETFs rather than individual stocks? ETFs reduce volatility and mitigate several kinds of risk associated with individual company stocks, for example: management risk, competition risk, earnings risk, and analyst risk.

If you are an experienced investor, you may find other ETFs that are better suited to your personal criteria. If you are a less-experienced investor, the Core Universe provides you with a good, workable starting point. [By the way, if you see an ETF that you think would be a good addition to the Core Universe, let me know. It is not possible for me to keep track of everything that is going on in the industry by myself. Your suggestions and questions help me keep up with changes in the ETF world.]

Invest in 6-8 positions or less

Under the guidelines of Dynamic Asset Allocation, no core universe ETF should be allocated more than 10% of our total holdings…except for our cash equivalent ETF.

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What's a "cash equivalent"?

A cash equivalent fund for your money is like a garage for your car. A garage is where you put your car when you don't want it to go anywhere. A cash equivalent fund is where we put our money when there isn't any better place to put it. Cash equivalent funds provide really lousy returns on your money, but it's still a <u>positive</u> return (and even if it goes down occasionally, it only goes down a tiny bit.)

The cash equivalent ETF is the only fund where you can put more than 10% of your money. Its purpose is to be your safe haven when everything else is going through the floor. During a bear market, it will not be unusual for you to have 100% of your money in your cash equivalent ETF.

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First, we'll talk about why we generally limit ourselves to 6-8 funds. Even if you are only holding a dozen positions, it can be difficult to monitor them all. It also becomes tiresome. When you have too many positions, it becomes really easy to talk yourself into skipping a periodic review, which can be an expensive mistake.

Even though I've been doing this for 30 years, I'm still not comfortable managing more than 6-8 positions at a time. It's possible to manage more when the market is calm and things are going your way. It gets considerably harder when you are under the gun in a choppy bear market. That's why I set the DAA guideline at 8.

If the market is turning down and none of the core universe ETFs are going up in price, it's common to end up with 100% of our money in the cash equivalent fund. That may be SHV, another fund you have chosen as your cash equivalent ETF, or cash itself. (If you are investing within a 401K fund, you may not be able to go to actual cash, so an ETF like SHV may be your only option.)

When the market starts to advance again, you will see one ETF after another turn up. As this happens, you can start moving money out of SHV and into the funds that are going up. If the advance turns into an actual bull market, after a while you will have all of your money invested — more or less equally — in 6-8 Core universe ETFs and none of it left in SHV.

Now, what do you do if you already have shares of 8 ETFs and another one suddenly starts going up faster than all the ones you are holding? We'll talk about that next.

4. Invest in Strength

Under the DAA guidelines, our objective is to keep our money in the strongest ETFs. In this segment we'll talk about what to do if you already have 5 rising positions open and another ETF starts showing impressive strength. But first let's look at how to measure "strength".

When talking about securities, the term *strength* means "relative strength". Relative strength is a way to measure how fast one security is rising (or falling) as compared to an index or another security. There are many ways to do this, but in the end they all come down to comparing the slope of one with the slope of the other.

There are many ways of measuring the slope of price. You can run a regression line through price and take the slope of that. You can use the slope of a moving average of price. There are more complicated ways to measure slope, but simple measures usually work the best. I use Marc Chaikin's algorithm for calculating relative strength. He uses the slope of a moving average.

Something I do every Friday evening is go through the Core Universe Summary Table and write down the 10 ETFs that have the highest relative strength (RelStr) values. I start with the highest, then the next highest, and so on. Those ETFs aren't necessarily the ones I will put my money in (I never invest based on a single indicator), but it's a good place to start.

The next step, selecting the top-ranked assets, involves looking at the trendlines, MTA, money flow, MACD+, and so on. But let's get back to deciding what to do if you already have positions in 8 ETFs and another ETF seems to be overtaking the leaders. Let's say that this is what your position list looks like one week, and you are holding the top ETFs in terms of RelStr. (Positions we are holding are highlighted in green and listed in order of RelStr.)

We'll use just 5 ETFs in this example.

VTI (5.4), EEM (5.7), IGV (5.8), IYT (6.0), QQQ (6.3)

Then, the next week we see IBB getting higher

IBB (4.8), VTI (5.4), EEM (5.7), IGV (5.8), IYT (6.0), QQQ (6.3)

And higher, passing VTI.

VTI (5.4), IBB (5.5), EEM (5.7), IGV (5.8), IYT (6.0), QQQ (6.3)

Now, maybe the move in IBB is just market noise. If we immediately sell VTI and buy IBB, we could end up having to sell IBB and buy back VTI if IBB drops back next week. So we wait a while and watch.

The following week IBB advances again.

VTI (5.4) , EEM (5.7), IBB (5.8), IGV (5.8), IYT (6.0), QQQ (6.3)

And again.

VTI (5.4) , EEM (5.7), IGV (5.8), IBB (5.9), IYT (6.0), QQQ (6.3)

Now IBB is in third from the top in RelStr. Once a rising ETF reaches that position, then it's safe to say this is not just market noise. IBB has earned a place in our holdings so it's time to sell VTI and buy IBB.

VTI (5.4) , EEM (5.7), IGV (5.8), IBB (5.9), IYT (6.0), QQQ (6.3)

This was a hypothetical example where most of the RelStr values remained static and we didn't talk about the other qualifications for being one of our holdings. I just wanted to demonstrate the process for a new up-and-coming ETF replacing an existing holding. This switching method keeps us in the best ETFs while limiting the number of times we have to change the funds we are holding.

5. Review holdings at regular intervals

In order to achieve effective risk management, we need to review our holdings regularly, either weekly or monthly. This step must be done without fail. The time you decide to skip reviewing your holdings is the time that the market will decide to jump off a cliff.

If you are going to be your own financial manager, then you have to pick a time you can commit to and do it faithfully. Nobody else will take care of your money as well as you will, but you have to be professional about managing your money.

If you are going on a vacation and won't be able to do your periodic review, sell everything and leave the money in cash. Reinvest it when you get back.

If you are:

- moving from one residence to another
- changing jobs
- going through a divorce
- seriously ill
- going through any sort of major disruption in your life
- get tired of managing your money

then close out all your investments and leave the money in cash until you are ready to take control again. All of these events are major disruptions. They will not only consume your time and energy, but they will also interfere with your judgment.

You may have noticed that I don't use the term "portfolio". *Portfolio* is a nice, comfortable word. It carries the connotation of something stable. "My portfolio" sounds like something solid that you don't have to pay much attention to. A lot of people think they can pick the right investments, build a good *portfolio* and then "set it and forget it". It's a tantalizing notion, but real investing doesn't work that way.

One of the reasons that buy-and-hold is such a popular notion is because most people dislike looking too closely at their investments. They are uncomfortable reviewing their holdings because they don't know much about choosing investments and they know even less about managing them.

Human beings do not like risk and they hate uncertainty. Investing involves both, so they don't like having to make decisions about it. They'd rather just put money into the market and hope for the best. Investing is the exposure of capital to risk in the pursuit of profit, and it requires making decisions under conditions of uncertainty. This is why psychology has such a huge impact on decisions made by untrained investors.

Another problem is that most of the time, the market is really **boring**. It goes up and up for years. Then, just about the time you think it will go up forever and you can go do something more interesting, it goes into a dive and wipes out a bunch of your capital.

Despite these difficulties, you have to get in the habit of monitoring your holdings every month or even every week. You can choose your own time frame, but once you have found

a review period that works for you, you have to do that review consistently anytime you have money in the market.

Periodic reviews are part of the discipline required for successful investing. If once a week turns out to be too much for you, then do it every other week. If that's too much, review your holdings once a month, for example, on the 20st of every month. Regularity works, but if you only look at your positions every once in a while when you think of it, I guarantee that one day you are going to look at your holdings and they are going to be down 30% or 50% and you're going to be angrily wondering what happened.

6. Adjust positions as Needed

We talked about how to add ETFs to your holdings after the turn up from a market bottom, and how to manage a newly-rising ETF that is outperforming some of your existing holdings.

We also talked about how to move your money out of a position as it turns down. If the ETF you're selling makes room for a new holding, then use the money from the ETF you sold to buy a good performer that wasn't in your holdings before. On the other hand, if there isn't any good ETF to put that money into, then just leave the money in cash or put it into your cash equivalent ETF.

Errors to avoid

1. If an ETF turns down and you get an exit signal, don't sit around hoping that it will turn back up. Hope is the single biggest destroyer of investing capital.

2. Pick a system that suits you and USE IT. When your system gives you an entry signal, execute it. When it issues an exit signal, execute it. If it turns out your system doesn't work well, then find a better one, but don't start second-guessing the system you have chosen.

3. Don't get bogged down in trying to get exactly 10% in each position. You'll drive yourself nuts and even if you manage to do it today, it won't be right tomorrow. When you see "10%" think "about 10%" or "about one tenth". It's always a good idea to keep a small percentage of your money in cash.

Be bold executing entries

When preparing to buy a security, you can do all the research in the world and still have the position immediately go the wrong way. No matter how much you know about the present, you can't predict the future. Do your research. If conditions look promising, then plan your trade and figure out how much you are willing to risk. Then jump in.

One of the things you learn from taking multiple-choice tests is that your first instinct is probably the right one. Sitting and thinking about a position doesn't improve your chances of correctly guessing where it will be next week or next month.

Be ruthless executing exits

When a position goes far enough against you to reach your bail out point, then bail out. Don't wait to see if it's going to get better. Dump it. Losing money doesn't make you a loser. But holding onto positions after you realize they is not working will eventually wipe out your account.

7. Active risk management

Active, consistent risk management is what separates the winning investors from the losing investors. If you don't close out positions when they first start to go down, the Asymmetry of Gains and Losses will cause your losses to cripple your winnings.

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Part 4

Getting started

1. Choosing an investing timeframe that suits you
2. Getting your 401(k) money under your control
3. Opening an IRA…or two
4. Education, Training, and Live-Fire Training

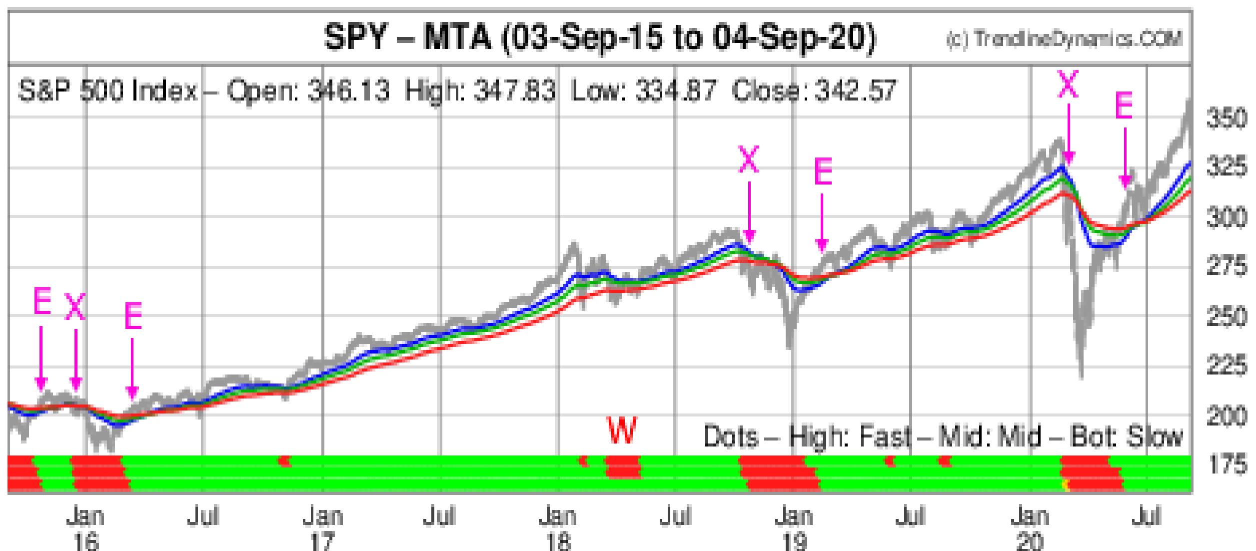
1. Choosing an investing timeframe that suits you

The term *timeframe* refers to how long you would like to hold onto the average investment.

If you would prefer a timeframe measured in years, then the more deliberate Macro-Trend Analyzer (MTA) is a good choice. The MTA tracks the big trends in ETFs. As the big turns develop, it will get you in a little later and it will get you out a little later, but it lets you avoid the shorter term, up-and-down gyrations in price.

The MTA indicator is very simple, just three moving averages. The MTA chart is designed to be read at a glance so you always know whether you should be long or out. The three rows of dots at the bottom of the chart tell the whole story. Any time the dots in all three rows turn green, then you should buy. You remain long until the dots in all three rows turn red, and then you exit.

Here is a five year MTA chart for SPY, the S&P 500 ETF. In those 5 years, there were only 4 entry signals and 3 exit signals.



The results are summarized in the following table:

Entry Date	Entry Price	Exit Date	Exit Price	Net
29-Oct-2015	$208.89	18-Dec-2015	$200.02	-4.25%
16-Mar-2016	$203.34	25-Oct-2018	$265.32	30.48%
15-Feb-2019	$277.37	06-Mar-2020	$297.46	7.24%
29-May-2020	$304.32	unknown		

This chart illustrates several things. The first entry and exit (2015) lost some money. If somebody tells you they have a system that never has a loss, they're lying to you. No real system is right all the time. The important thing is whether the system makes more on its winning positions than it loses on its losing positions. Another important thing is whether the system keeps you out of the bad declines, like the MTA did at the start of 2016, the end of 2018, and spring of 2020.

Another feature of the MTA is that it gives you a visual warning when changes are coming. If you glance at the chart and all three rows of dots at the bottom of the chart are the same color (all green or all red), you don't need to look any further. But if you're long and the top row of dots turns red, it's telling you the market is getting weaker.

If the top two rows turn red, you need to start watching that chart pretty closely because a turn may be close. Look at the red 'W' on the SPY chart in early 2018. That was an MTA warning. It turned out that the market got stronger and moved higher after that, but when you see two red dots appear on the right side of the chart — as you would have on 28-March-2020 — it's time to be ready to move.

If you look at the four entry signals on the chart, every one of them started with the top row of dots turning green. Then the second row of dots also turned green. So the MTA signals don't suddenly change from solid red to solid green or vice versa. First they give you a little nudge that says, "Pay attention. Something's happening."

The MTA also works well with other indicators, such as Relative Strength. For example, let's say we are in a strong bull market and there are a dozen Core Universe ETFs whose MTAs are all solid green. Relative Strength provides a good guide as to which ETFs you should look at first.

I also like to look at the other charts on the web page and see what they are saying. Money flow and OBV are measures of whether money is flowing into a security or out of it. MACD+ tells you about the short-term trend. I don't make decisions based on just the MTA and Relative Strength. They are long-term indicators so they won't often react as rapidly to recent changes like some of the other charts will.

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If the MTA is too long-term to suit you, you might be more comfortable using a two SMA (simple moving average) system like the 13-day/34-day crossover.

Like the MTA, this is easy to set up on most charting websites. With the crossover system, when the faster moving average is above the slower average, you go long. And when the faster average is below the slower one, you get out. (The turning of the faster average provides a degree of warning when price is starting to turn.)

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Because of the increased volatility in the market recently, I've switched over to using the MTA plus Relative Strength as guides, chart analysis for entries, and a 5% trailing stop for exits. It's a little shorter term and a little more aggressive (meaning shorter term positions but also better returns). When we get into the next outright bull market, I will probably switch back to the MTA as our main indicator.

There are lots of systems that will work in the DAA approach. The key is to find something you are comfortable with and stick to it. If you're not comfortable and confident, you'll start second-guessing and overriding your system. When that happens, you don't have a system any longer. Then you're just shooting in the dark, which never works out in the long run.

2. Getting your 401(k) money under your control

Many 401(k) plans have a very limit selection of mutual funds choices. You usually get 5 or so bond funds, a dozen stock funds, and then a few random things like "money market" funds (that no longer promise to protect your capital).

Lately they also have *target date funds* that invest in both stocks and bonds. They promise to keep your money in the "right" balance of stocks and bonds as you get older. The trouble is, they almost all provide substandard returns. Also, you should be aware that target date funds have a hidden agenda. Their real objective is to lock you into the fund from now until the target date.

However. . .If your 401(k) has a "self-directed" option, then you can free yourself from the artificially limited choices of your 401(k) plan and invest in almost anything you like. The quickest way to find out if your plan has this option is to call up the 401K fund management company and ask, "How do I activate my 401K's self-directed option?"

Don't ask them if there is one. Some 401(k) management companies are not forthcoming about the subject. By asking "how do I?" they either have to tell you how to do it or tell you that you can't. Asking the question in the right way cuts down on the singing and dancing.

If you can, activate your self-directed option, and then you can put your money in just about any security you want to.

The bad news is that many of the 401(k) plans with a self-directed investment option also charge fat commissions, as much as $50 per trade. The good news is that profits are still tax free, and you sidestep the 15% capital gains tax the IRS would charge you in a retail brokerage account.

3. Opening an IRA…or two

If you have an old 401(k) account from a previous job, it can be to your benefit to roll it over into an IRA. You want to minimize your investing expenses in every way possible. Like the 401(k) account, an IRA allows you to sell investments without incurring capital gains taxes, which can siphon off 15% of your earnings on every sale.

The difference is that most IRA account providers don't charge any annual management fee. These days they also have tiny commissions. Compare that with a 401(k) account that charges sizable commissions and may be charging you an account management fee of 1% per year or even more.

Keep in mind that the only real work your 401(k) "fund management" company has to do is to set up your account when you sign up with them. After that all they do is collect your monthly contribution, pass it out to the mutual funds you have selected, and keep track of the books. (And practically all those tasks are fully automated.) They don't do any of the work associated with actual investing.

So for letting their computers keep the books and for dealing with the occasional investor phone call, your 401(k) fund management company collects 1% a year of whatever money you have in your account. 1% a year may not sound like much, but over time it can make a huge difference in your final outcome.

If you invest in the same 401(k) fund for 30 years, the management company winds up with 30% of your money. That means if you put away a million bucks, you get $700K and they get $300K for keeping track of your money. Most people don't see the $300,000 go away because the 401(k) management quietly siphons it off at just 1% a year. And no one seems to notice what has been going on with their money.

Should you stop contributing to your 401(k) fund? Absolutely not, especially if your employer matches some portion of your contributions. Keep that 401(k) going in order to collect the matching contributions. In fact, you should gradually increase your monthly

contribution until it is maxed out — probably somewhere around 16% of your annual salary. Why should you do this? You maximum, tax-free contribution to an IRA is about $6500 a year, but as far as I know there is no limit on rolling pretax money into an IRA from your 401(k). I have done it myself.

If you have a an old 401(k) account from a previous job, it's easy to roll it over into an IRA account. And even from an active 401(k) account, you may be able to roll the money into an IRA by taking an "in-service distribution" from your 401k and depositing it in your IRA within 60 days. In fact, if you open the IRA account first then you can have the in-service distribution deposited directly into the IRA.

Your 401(k) management company may tell you that you can only take an in-service distribution once a year. That's fine. Let your 401(k) accumulate money from your payroll deductions, and then once a year transfer it over to your IRA.

Traditional IRA or Roth IRA?

A traditional IRA is funded with pre-tax income, so contributions may be useful for decreasing the income tax you pay in any given year. A Roth IRA is funded with taxed income; however, both shield your investment profits from capital gains tax.

A traditional IRA has limits on how much pre-tax income you can contribute each year. Last time I checked it was around $6500. Because the Roth IRA is funded with taxed income, I don't think it has any contribution limits.

Talk with your CPA or the IRA provider to find out exact details of either kind of account and which rules apply to you. If you are approaching retirement, there may be age regulations that will limit your contributions to either kind of IRA.

Most people aren't saving anywhere near enough for retirement. They are making a minimum contribution to their 401(k) and don't even have an IRA. In reality, they should be maxing out their 401(k) contribution every year and also making a maximum contribution to a traditional IRA. There is an easy and relatively painless way to get from where you are to where you need to be. Ask me and I'll tell you how.

Here are some informative links:

https://www.investopedia.com/articles/personal-finance/061913/hidden-fees-401ks.asp

https://www.investopedia.com/articles/personal-finance/053014/five-questions-ask-about-your-companys-401k-plan.asp

https://www.investopedia.com/articles/personal-finance/071715/8-reasons-roll-over-your-401k-ira.asp

4. Investing — Education, Training, and Live-Fire Training

Learning is not mandatory. Neither is survival. — Edward Deming

Education is essential, but it often tends to be more theoretical than practical, and it can easily degenerate into the academic format where the teacher talks and the students listen. The smarter students will challenge the instructor and ask tough questions.

Training is also a necessary step and emphasizes skills instead of knowledge. One form of investment training is called "paper trading". That's where you are actually analyzing opportunities in real time, planning positions, and then seeing if they work out or not.

The problem with paper trading is that there is no real risk involved. The worst thing that can happen is that you guess wrong and have to try again. With paper trading you can make excuses or think, "Oh, yeah, I should have done that instead of this. Next time I'll do better." (Unfortunately, next time you will probably won't do better.)

Live-Fire Training

In the military, live-fire training is where you have to crawl under barbed-wire while real machine-gun bullets are flying over you a couple of feet above the barbed-wire. It acquaints you with the sounds of gun fire and of bullets hissing passed you, and it instantly removes any question regarding the wisdom of your sergeant's advice about keeping your head (and other parts of your anatomy) close to the ground.

In the markets, the equivalent to live-fire training is where you are taking very small positions, but with real money on the line. There aren't any do-overs. You either:

a) guess right and win,
b) guess right but fumble the exit (that one really hurts),
c) do the right thing by cutting your losses short, or
d) do the wrong thing and suffer an even bigger loss.

There is no substitute for practicing with real money. As soon as there is actual money at stake, even if it's only a few dollars, there is a palpable change in your perceptions. The possibility of loss causes your survival instincts to kick in. As Dr. Rande Howell puts it:

> Your brain is designed to control outcomes or to maintain a sense of certainty, to be right, and not lose. It becomes confused if it loses control of certainty, which produces vulnerability, which triggers the attack/avoid response.

And again:

> Under stress, your brain confuses emotional discomfort with physical danger. When it cannot control the outcome by either force or will, instinctual survival mechanisms will trigger your fight/flight/freeze response to the perceived threat.

Even if it's just a dozen shares of some 50-cent, no-name penny stock, your amygdala starts to get cranked up, ready to override the rational processes of the neocortex. Training with small, real-money positions can teach you how to control amygdala hijacking.

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In Closing

Dynamic Asset Allocation is an effective method of increasing returns by active management and controlling risk. It is not complicated but it does require regular monitoring. (Ironically, most people who advocate Buy-and-Hold investing don't know that it also needs regular monitoring, because the real name of that investment style is Buy, Hold, and Rebalance. The monitoring period is longer than the DAA period, but in investing, there is no free lunch.)

Important Ideas that Didn't Fit Into the Essay

- Value Investing

  If you are a value investor, don't buy stocks when they are cheap. Buy stocks when they are cheap and rising. Stocks that are cheap can stay that way for a very long time. Since value investing is a long-term process, use something like the MTA or a 50-day/200-day crossover to identify the turn up.

- Selling is Not the End

  Selling is not the end of anything. Selling is just another step forward. Selling is the act of trading shares for money because the probability of a further rise in price is decreasing. If the situation changes a few weeks or months from now, then you may wind up buying the same security back again.

- Celebrate Corrected Mistakes

  <u>Everybody</u> makes mistakes. The sooner you can find and fix them, the better. Then give yourself a pat on the back because you did **two** things right. First, you fixed a mistake. Second, you started toward a new habit, the habit of accepting mistakes and fixing them instead of ignoring them or pretending they don't exist.

- Chart Reading in Real-Time

  When the high that marks a market top (or the low that marks a market bottom) first appears on the right edge of the chart, there is no way to tell if it is just another step along the current trend or if will be the last step. Most people will assume it is just another step, not the turning point that will end the trend. Be patient and let the market tell you if the turn has come.

- Chaos

  If the market gets seriously choppy; if you're seeing contradictory signals; if you're getting confused or frustrated — get out of the market. Sell everything and go to cash. When you get into a state like that, you will start making bad decisions. Then

you will lose money…and then you will make worse decisions.

When you can't figure out what's going on, disengage. Step away from the market and take some time to relax, calm down, and regain your objectivity.

- Psychological Training Pays BIG Dividends

  The mechanics of profitable trading are reasonably simple. The psychological impediments to profitable trading are numerous, obstinate, and wily. Robert Krauz estimated that 75% of investing is psychological and only 25% is market know-how.

  To get started, watch YouTube videos by Rande Howell and Mark Douglas. They will use the "T" word – *trading* – but investing and trading are just different sides of the same coin.

A final Thought from Ed Easterling:

> Many "rowing" strategies (active, diversified, risk-managed, reduced or no market correlation, et cetera) are criticized for not getting much return during market declines and then not being able to beat the stock market on the upside. The answer: if an investor can avoid the losses, it takes only 26% of the positive gains to match the market.

If you have questions about any of the information presented here, send me an email. Good questions help me improve and expand this essay.

Appendix A

What Most People Think They Know about Investing is Backwards

Some people believe that if they can just find the right stock, they'll become rich. They see investing as a 3-step process: a) find a winner, b) buy it, and c) hold onto it forever. If it is "the right stock", riches will surely follow.

There are only two problems with this notion. First, you can go through your whole life without finding a big winner. Second, even if you find a big winner, you are going to have to sell it someday. (Okay, if you're getting good dividends then maybe you won't have to sell. But if you're not getting dividends, then you have to sell to realize some profit.)

If you are in it to make money, here is how investing really works:

When you are looking for an entry, you are an analyst. Once you are in a position, you have to become a risk manager. A lot of people are good at analysis, but only those who can make the transition to risk management once a position is open will make money in the markets.

The key to making money is not knowing what to buy or even when to buy it. Buying is easy. Selling requires a plan and discipline. It takes both a buy and a sell to put money in your pocket. There is potential in buying, but capturing profit (or minimizing losses) is in the selling. That is the heart of risk management.

Making and sticking to clearly defined rules is important. Following your rules on when to sell a given security are how you capture profits and avoid big losses. There are a variety of ways to come at defining exit rules.

A number of people recommend selling a stock any time it declines 20% or more from its last high. Some prefer 10% from the last high. There is at least one successful fund that uses a strict 7% stop on all their investments.

Some people sell when a security breaks down through support. Other investors use a 50-day average and a 200-day average to decide if a stock should be sold. The respected market analyst, Ned Davis, suggests using a 13-week average and a 34-week average to make both the entry and exit decisions.

I've heard some people say, "Yeah, but if I sell it and then it goes up some more then I'll miss out." They see selling as a terminal event. They think when you sell it, that's the end. It takes some people a long time to get comfortable with the idea that even good securities get beaten down sometimes, and just because you sold it last month or last quarter doesn't mean it's not a good buy now that it is going up again.

There is psychological resistance to selling. If you made money, it makes you fear missing out on making more. This is greed. If you lost money, selling is proof you made a mistake. This is ego. You must overcome these psychological weaknesses in order to make money.

Manage your risks and the profits will come.

Appendix B

SMA(200) Chart Variation

By adding a 5-day moving average (SMA(5)) it makes the SMA(200) easier to read. Here's the SMA(200) by itself.

And here it is with an added SMA(5). The SMA(5) smoothes away daily noise and make it easy to see that those two little daily price crossovers in June were nothing to worry about.