SEASONS OF INVESTING

Cornerstone Wealth Management Group

Many investors focus on determining which stocks or investments to buy, and rightly so: The goal of any investor is to determine which investments will perform well. In simple terms, deciding "what to buy" is a critical task.

So is determining when to sell - in short, following a sell discipline.

Seasons of Investing

By Scott D. Ford, RFC
President of Cornerstone Wealth Management Group

For wealth advisors, employing a sell discipline is based on constantly monitoring each investment and each client portfolio for any changes that could affect current prospects and future earnings. Sometimes investments have reached a point of maximum, or near-maximum, growth. Other times changes in the economy as a whole dramatically impact the outlook for certain investments. A wealth advisor's goal is to not only select the right securities and investments to buy but also to select the right time to sell. In a larger sense, the goal is to accept small losses in order to avoid large losses.

The goal is not only to grow a client's wealth but also to preserve that wealth.

To accomplish that goal, wealth advisors use a "seasons of investing" approach. Economies are cyclical. Markets are cyclical. One size—one approach—does not fit all. Buy and hold investment strategies work—sometimes. Short-term, opportunistic trading works—sometimes. Good wealth advisors and good investors recognize that markets have seasons, and act accordingly.

To understand the concept of seasons of investing and how investment approaches must adapt to those seasons, let's first take a step back and refute a little conventional wisdom of investing and how investment approaches must adapt to those seasons.

Modern Portfolio Theory

Modern Portfolio Theory (MPT), as it has come to be known, was developed by Harry Markowitz. He first published his finance and investing theories in 1952 in the *Journal of Finance*. To say that MPT influenced the world of investing is an understatement; in fact, Markowitz won a Nobel Prize in 1990 for his work.

The data and analysis behind MPT is fairly complicated, but MPT is based on a fairly simple premise. People who believe in Modern Portfolio Theory feel that diversification is the best way to minimize risk, a basic principle I agree with.

Think of it this way: If you invest in only one stock, your risk is that stock will not perform as well as you expect. If the price of the stock falls, you lose money. So what do you do? By investing in more than one stock and diversifying your portfolio, you spread your risk across a number of different investments.

That way you don't have all your eggs in one basket.

One of the goals of MPT is to quantify the benefits of diversification. One of the ways MPT quantifies those benefits is to calculate a deviation from an "average" return. Each stock has its own standard deviation from its "average" return . . . and that deviation is considered to be risk. By creating a blend of stocks in a portfolio, risk can be mitigated.*

MPT also assumes that investors act rationally and objectively and that markets are efficient. "Efficient markets" are markets where stocks always trade at a fair value because the price incorporates all existing knowledge and relevant knowledge about that stock. In efficient markets there are no surprises, no inside information . . . stocks are priced "fairly" because investors have access to all the information they need to make smart decisions. That means, of course, that it should be impossible for any investor to outperform the market as a whole, because making smart decisions or timing investments wisely won't matter: The market is efficient.

*There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not ensure against market risk.

"It's like a crapshoot in Las Vegas, except in Las Vegas the odds are with the house. As for the market, the odds are with you, because on average over the long run, the market has paid off."

- Harry Markowitz commenting on the stock market in "Risk Management: Improving your Odds in the Crapshoot" from *Bloomberg Personal* (July 1996)

I think we now know that markets are anything but efficient. Financial returns on individual stocks or even asset classes are not predictable. Individual stock values are not predictable. External economic events can dramatically impact investments. Markets are not always rational. People do not always make rational decisions.

If you like, think of markets as an efficient *process*. Over time markets do tend to sort out the value of stocks. During the Internet bubble, many dot-com stocks sold for amazingly high prices, even though the underlying companies were hemorrhaging cash. If you looked at the value of a company like, for example, pets.com, you would say the market was anything *but* efficient. Hype (and hope) led to high stock prices, but when reality set in, some stock prices fell to a realistic value—basically zero. So the process was efficient, because over time the markets did figure out the value of the stocks . . . but in the short term, many investors lost thousands or millions of dollars. Markets are not always rational, and markets are not always efficient—especially in the short term.

Again, I agree with the goal of risk mitigation. The goal is to not only grow a client's wealth but also to preserve his or her capital during down markets and economic downturns. But Modern Portfolio Theory also contains other principles—besides the idea that markets are efficient—that are not useful in today's investing climate.

Historical Data is... Simply History

Economists and financial analysts are consumed by history. They should be; by examining the past we can find clues to the future. But the problem with analyzing historical data, especially over a long time period, is that it can be incredibly misleading.

For example, let's look at the Dow Jones Industrial Average, an average of 30 blue-chip companies considered to be leaders in their industries. The Dow is used as an overall indication of how the stock market is performing.

MPT assumes that a swing of more than 7 percent in the Dow should occur only once every 300,000 years: If the Dow starts the day at 10,000, it should only swing by 700 points once every 300,000 years. Although that sounds predictable and stable, in reality during the last century the Dow experienced 48 days of swings of more than 7 percent.

If you prefer to use odds, Modern Portfolio Theory assumes the odds of a 7 percent drop in one day are 1 in 20 million (those are odds even lottery players might walk away from).

Core Cornerstone Belief -
"The goal is to not only grow a client's wealth but also to preserve his or her capital during down markets and economic downturns."

Yet it's happened.

MPT assumes the odds of the Dow falling 7.7 percent in one day are 1 in 50 billion.

That's happened, too.

MPT assumes the odds of the Dow falling 29 percent in one day are 1 in 10 to the 50th power (that's a 1 followed by 50 zeroes).

Yet even that has happened.

Why? Odds and statistics are great, but often statistical analysis is based on historical data and underlying assumptions that don't reflect short-term trends or results, and certainly don't reflect changes in markets, in investing styles, in investment options. . . . When you look back over dozens of years, it's easy to miss the details that make all the difference.

As investors, we're worried about the details—*today*. What happened yesterday (or 50 years ago) is interesting, but what is happening today and what may happen tomorrow are critical.

Buy and Hold

Another underlying principle of Modern Portfolio Theory is that selecting the components of an investment portfolio should be done in two steps:

1. Select investments based on past performance.

2. Refine those choices based on beliefs about future performance.

So far so good, but many investors focus on the first step and ignore the second step. The result is the "buy and hold" investor. Buy and hold is a long-term investment strategy that assumes that over the long term stocks, investments, and financial markets will provide a decent rate of return. Sure, there will be down markets, and there will be volatile markets . . . but over time the lows will be balanced by the highs. That's why buy-and-hold investors don't focus on investment timing—after all, if you wait long enough, good things happen, right?

In the past that may have been true. If you look at the stock market as a whole over the last 100 years or so, returns average about 10 percent (a number frequently quoted by buy-and-hold investors). The problem is that none of us is likely to be an investor for 100 years; we can't afford to wait until "good things happen." Modern Portfolio Theory recognizes that the past is no indication of the future. That's why the second step is to make choices based on beliefs about future performance.

Buy-and-hold investors, in large part, ignore the second step and focus on the first step. Many financial advisors do the same thing. Regardless of the market, regardless of larger economic trends, many financial advisors use MPT to allocate investments—whether the market is a bull or a bear. Although that sometimes works, especially when the markets are rising (since a rising tide raises all ships), it's a recipe for disaster when markets fall.

Here's a quick example. Keep in mind that the examples that follow are strictly hypothetical and in no way indicate a specific rate of return or specific investments.

In 2007 the Dow reached a high of more than 14,000. For the purpose of this example, I'll assume that your stocks will mirror what happens to the Dow—I'll assume a rational and efficient market. When the Dow was at its high point, your stocks were worth $100,000. Great!

Then the market falls—dramatically. But you're a buy-and-hold investor, so you do nothing. (Short-term blips are no problem, right?) A year later the Dow reaches a low of slightly more than 6,600. The value of your stocks has fallen by more than 50 percent; because the stocks you own mirror those of the Dow, your investments are now worth less than $50,000.

But you hang in there. The economy starts to recover, stock prices start to rise, and a year later the Dow is hovering around the 11,000 mark. Your stocks are now worth more than $78,000—that's much better than your low of $50,000.

But you're also down significantly from your high of $100,000, and several years have passed. Not only have you lost more than $22,000, you've also lost several years worth of potential gains. In real terms you've lost more than $22,000—you've also incurred an opportunity cost. Even if your investments only earned 5 percent, in 2010 your portfolio would be worth more than $110,000. In effect you've lost more than $20,000.

Buy and hold isn't working so well after all.

Now let's take a different approach. I'll stick with my basic assumption that your stocks are worth $100,000 when the Dow reached its high. But instead of ignoring beliefs about future performance, you and your wealth advisor were watching the markets and the economy as a whole and were alert to warning signs. The real estate bubble started to burst in the mid-2000s. Homeowners began defaulting on mortgages. The credit markets began struggling. Yet stocks were significantly overvalued even in the face of serious economic warning signs (proving that the theory of efficient markets is fundamentally flawed).

When the Dow starts to dip, you and your wealth advisor decide to be cautious. You don't sell your stocks right away; you've seen short-term dips before. (Plus, no one has the ability to predict the top or the bottom of any market; the only way to truly determine the top or the bottom is in hindsight.) Over the next few months you both decide that the boom has reached its peak and the short- and long-term economic outlook is negative. In order to preserve capital, you sell your stocks and shift into relatively stable investments when the Dow is at the 12,000 market. Your portfolio was down approximately 14 percent, so you've lost about $14,000. Although that's not a great result, you have managed to preserve the majority of your capital, or $86,000.

But you don't sit idle. You and your wealth advisor watch the markets and the economy. The Dow hits 6,600, but you don't jump back in at that point. You wait until the signs seem right, and you buy the same stocks when the Dow is at 8,000. In the meantime you've made a small return on your investment, so your $86,000 is now worth $90,000. The market continues to rise, and in 2010 your portfolio has risen almost 30 percent, and you now have almost $115,000.

Buy and hold: $78,000.

Capital Preservation Model with an Offensive Strategy: $115,000.

Which portfolio would you choose?

Statistical averages are fun to know, but aren't particularly helpful when you need to make specific investment decisions. The key to smart investing is to make decisions based on market trends. If you simply buy and hold, you enjoy market gains but you suffer market losses, too. Remember no strategy can guarantee success or prevent loss. The key is to identify trends and adjust investments based on those trends—not to simply buy, hold, and hope.

Seasons of Investing: Challenges and Opportunities

Modern Portfolio Theory and buy-and-hold strategies make sense during bull markets. A rising tide floats all ships. Bull markets come and go, but your need to reach your financial goals is ever-present.

That's why the average investor faces four basic challenges—and those challenges create opportunities.

Challenge 1 - Capital Preservation

Buy and hold doesn't work during a bear market. When markets fall, preserving capital should be an investor's main priority. When you lose capital you not only lose money—you also lose some of your ability to take advantage of future opportunities.

And you also incur an opportunity cost, as mentioned earlier. Say your portfolio is down 40 percent one year and is up 40 percent the next year; you broke even, right? Actually, you didn't. Say your portfolio is worth $100,000. If you lose 40 percent, you're down to $60,000. A 40 percent return on $60,000 is $24,000; although you have made a nice gain, your total portfolio is still only worth $84,000. In order to "break even," you'll need a return of more than 60 percent. And even if that does happen, while the value of your portfolio has returned to its earlier level, in the meantime you did not earn a return on your investments, plus inflation eroded the value of your portfolio.

In order to offset losses, your portfolio needs to do more than simply break even, especially over the long term. Capital preservation is a challenge; meet that challenge and you can take advantage of opportunities. As investment analyst Louise Yamada says in her book *Market Magic*, "There are two kinds of losses. A loss of capital and a loss of opportunity; but there will always be another opportunity if you protect capital." You must protect your capital; that way you have capital to invest when new opportunities arise.

There will always be opportunities; to take advantage of those opportunities, you need resources. Capital preservation investing helps ensure that resources are available so you can take advantage of changes in the markets and changes in season.

Challenge 2 - Seasons of Investing

Markets have seasons. Think of seasons as broken into two parts: Spring and summer, when values rise, and fall and winter when values fall. Over the past 100 years, the stock market has experienced seven major seasons, the seventh being the season we are currently "enjoying." Seasons tend to last between 8 and 25 years, with the spring and summer seasons tending to be shorter in duration. (In other words, bear markets tend to last longer than bull markets.)

What causes seasons? There are a variety of reasons, but a simple way to view seasonality is to look at price-to-earnings ratios. Price-to-earnings ratio (P/E) is a basic financial measurement that compares a company's stock price to its earnings per share. For example, if a stock is currently trading at $10 per share and its earnings per share are $1, then the P/E ratio for that stock is 10, or $10 divided by $1. In general terms, a higher P/E ratio indicates that investors think earnings will grow in the future, making the company and its stock more valuable. A low P/E ratio indicates investors think earnings will stay flat or possibly even fall. But remember that P/E ratios vary by industry; P/E ratios in some industries, like high-tech, tend to be fairly high, while P/E ratios in major industrial companies tend to be low.

Even so, P/E ratios tend to be one of the leading measurements of stock values because they can help predict future stock prices.

In simple terms, when P/E ratios rise stock prices also rise; when that happens we are in a spring and summer season and the rising tide will float almost all ships higher.

When P/E ratios fall, we enter a fall and winter season and stock prices fall because the falling tide lowers all ships.

"Modern Portfolio Theory and buy-and-hold strategies make sense during bull markets. A rising tide raises all ships. Bull markets come and go, but your need to reach your financial goals is ever-present."

Core Cornerstone Belief

Challenge 3 - Identify Seasonal Transitions

Preserving capital by following a sell discipline—and also making smart buy decisions—is based on predicting where the markets are likely to go. A key to making smart predictions is to identify transitions between seasons. I use a variety of research and analytical tools to identify both the investment seasons and the signs of a transition between those seasons. Quite frankly, correctly identifying seasonal transitions is probably beyond the skills or capabilities of the average investor; staying on top of the markets is a full-time job for skilled financial analysts. However, there are two simple opportunities the average investor has to help them ascertain, or predict, changes in market season.

First, the 200-Day Simple Moving Average (SMA) on the S&P 500 can serve as a solid indicator of transitions between Bull and Bear market cycles. If the S&P 500 is oscillating above its 200-Day SMA, it could indicate stronger market conditions ahead. If the S&P 500 trends below its 200-Day SMA, it may indicate trouble on the horizon. Investors can easily monitor this simple moving average to help them decide when to add risk or when to possibly scale back and move money out of equities.

Second, investors can monitor the Graham-Shiller P/E 10 ratio. This ratio tracks historical P/E's (Price to Earnings) ratios dating back to the 19th century by using a 10-year earnings average. The use a 10-year average allows the ratio to smooth out short-term ups and downs in profits. The average investor can monitor the ratio to determine when the market is overvalued or undervalued.

Challenge 4 - Beat the "Average"

Each of us has a different investing time frame. If you are 20 years old, you have 40 to 60 years of investing ahead of you. If you are in your fifties, your time frame is naturally shorter. That's another reason why MPT and buy-and-hold strategies are theories that don't work in practice for real investors.

Modern Portfolio Theory is based on a 75- to 100-year time frame; over that period of time it "works." But do you have 100 years to wait for MPT to work for you?

As I mentioned earlier, the stock market has historically averaged a 10 percent return. Some years were better and worse than others, though. More than half the time the market has fallen or risen more than 16 percent in any one period. If the market beats the average, great—but if it drops during your investing time frame, the effect can be devastating, especially if you can't wait 10 or 20 years for things to "average out." Seasons tend to last for a number of years; can you afford to wait 15 to 20 years for fall and winter to turn to spring and summer?

Invest with the Seasons

So what can you do? Adapting investing decisions based on seasons can help preserve capital as well as optimize returns. Again, in general terms:

During **spring and summer** a modified buy-and-hold approach makes sense. When the broader market rises, the goal as a wealth advisor is to take advantage of a bull market and not only enjoy the upswing but also work hard to beat the markets.

During **fall and winter** a dynamic management approach makes sense. The goal is to preserve capital and then make investments that take advantage of what opportunities do exist even during a bear market.

How does that work? First, I follow the basic steps in the Way 2 Wealth. I help my clients determine what True Wealth means to them and make sure that they thoroughly understand their goals. I then help clients analyze their current positions and establish their family benchmarks.

Then I apply a capital preservation approach to building wealth:

- Base investment portfolios on economic analysis and long-term uptrends.
- Monitor legal insider trading activity to verify trends.
- Identify the best investment vehicles to take advantage of economic conditions and long-term uptrends.
- Buy and sell by using quantitative analysis tools, ensuring that emotion is not a driver of investment decisions.

Sound simple? It is—and it isn't. To make the approach more clear, let's take a look at the recent market downturn and steps a theoretical investor might have taken.

When a market falls, potentially preserving capital is critical. Two ways to preserve capital and continue to grow wealth is to convert stock investments into cash or alternative asset classes. (That's why we like to think of our approach as a "Capital Preservation Model with an Offensive Strategy.")

Converting to cash is a simple premise to understand. If the market falls and you shift investments to cash-based securities like treasury bills or money market funds, you both preserve capital and are also poised to better take advantage of future market upswings.

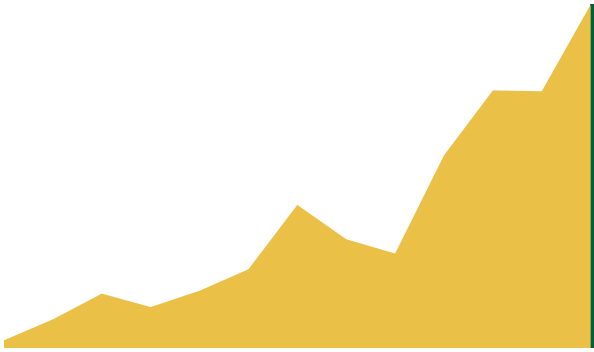
Alternative asset classes include:

- Absolute return strategies
- Real estate
- Commodities
- And so on

Alternative asset investments can be a part of any diversified investment portfolio, in any season. Alternative investments might not be suitable for all investors, as the strategies employed in the management of some alternative investments may accelerate the velocity of potential loss. But alternative investments can be especially important during fall and winter, when stock investments are generally unlikely to yield a reasonable return and may in fact be incredibly risky.

So what could our theoretical investor have done?

After identifying a seasonal transition, the first step might have been to convert a large portion of his stock investments into cash; that way capital is preserved and a variety of investing options remain open.



"Wealth advisors' goals are to work hard to actively manage portfolios so clients can preserve capital while also growing their portfolios, regardless of the season. Theories are fine, strategies are interesting . . . but flexibility, adaptability, objectivity, and hard work make all the difference. Theories are interesting. Results are all that matter."

Core Cornerstone Belief

For the remaining stock investments, that portfolio is actively managed, possibly including:

- More frequent portfolio rebalancing.

- A focus on dividend-yielding stocks.

- Overall active management of individual stocks and the portfolio as a whole.

Then a portion of the cash might be invested in alternative strategies. A portion may be invested in commodities. A portion may be used to invest in a start-up or small business. The investor may decide to purchase real estate, especially if he feels the real estate market is poised for an upswing.

In short, during fall and winter the investor seeks to preserve capital while taking advantage of other opportunities to build wealth.

The goal is to grow your portfolio and your wealth—regardless of the season.

Seasonal investing is based on a relatively simple premise: When the sun is shining almost anyone can make hay. When winter comes . . . it's not so easy.

During a bull market, the average investor enjoys a reasonable return. Smart investors enjoy better than reasonable returns, and while diversification does not guarantee against loss, in most cases an investor who creates a relatively diversified portfolio can enjoy a decent return on his or her investment.

But when summer turns to fall and then winter, the average investor—and the average investor's wealth advisor—tends to take a beating. Emotion tends to play a fairly large role, because most people hope to overcome their losses. Many investors are often hesitant to sell a stock that has fallen in price; they want to "make back their losses." I understand the feeling but disagree completely with the strategy.

For example, say you purchase 1,000 shares of stock at $30 per share. Your total investment is $30,000. If the stock falls to $25 per share, you've lost $5,000. If you're like many investors, the thought of taking a loss is incredibly painful, so you hang on to the stock.

And you wait.

And wait.

If after a year the stock does happen to increase in price, you may make up some or all of your losses, but keep in mind that the stock will have to rise to a price over $30 per share for you to break even because your loss includes an opportunity cost as well as the effect of inflation. And what if the stock does not rise in value, or even continues to fall? At some point you may eventually decide to sell . . . but at what eventual cost to you?

Investors who take a seasonal approach evaluate the market's season as well as the future prospects for individual stocks. If the stock price has fallen because of a fundamental weakness in the economy or in the company's prospects or business model, selling the stock—even at a loss—may be the best way to preserve the remaining capital and free up those funds to make other more profitable investments. As an investor, your goal is to achieve a return equal to or higher than your Family Benchmark on your total investments, not just on each individual stock or investment vehicle. When a stock price falls, emotion can take over. Most people don't like to lose, and when you sell at a lower price than what you paid, losing converts from being a paper loss to an official loss. Many people focus on paper losses or paper gains, but at the end of the day your investment portfolio still has an actual and absolute value—your goal is to grow that actual value and reach your investing goals.

Investing based on seasons requires an ability to not only understand the current season but to forecast transitions in seasons so you can be poised to take full advantage of that transition. But the seasonal approach does require a lot of hard work. Buy-and-hold strategies are relatively easy to follow. (Any strategy based on hope instead of research and analysis is an easy strategy to follow.)

Modern Portfolio Theory and buy-and-hold strategies only work in theory, and the other is incredibly long term; your portfolio—and your future—is anything but theoretical and matters to you and your time frame.

Wealth advisors' goals are to work hard to actively manage portfolios so clients can preserve capital while also growing their portfolios, regardless of the season. Theories are fine, strategies are interesting . . . but flexibility, adaptability, objectivity, and hard work make all the difference.

Theories are interesting.

Results are all that matter.

Scott Ford is president and founder of Cornerstone Wealth Management Group, a comprehensive wealth management firm in Hagerstown, MD.

Visit www.CornerstoneWealthGroup.com.