The IRP System Ebook

(Taking Control of Your Investments)

A long term investment program:

➔ Choose your Assets
➔ Use our System
➔ Control your Portfolio
➔ Reach your Investment Goals!

John Crossman
Walsh McGuire, CFA

The IRP System in Practice - Walsh McGuire

Investment Background

My background is as an equity dealer and prop trader. I have worked for major global investment banks, where billions of dollars in risk positions were thrown around on a weekly or even daily basis. Much of this activity was to manage the exposure to products that had been sold to clients – so the true notional size of these positions was staggering. The actual goals and returns of these products related to various arbitrages, as well as risk management. The vast majority of trading that occurs is for the purpose of risk management.

Scaling To The Individual Investor

When it came to managing my own investments, however, the same style – trading intraday, managing gamma exposure, parceling out interest rate, foreign exchange, credit and market risk – was well beyond the scope of the individual investor. I had to choose some funds, or if I was feeling ambitious, some individual stocks, and hope for the best.
My results were in line with most indices. Like most people, securities markets professionals have no advantage when it comes to managing their own money. They are just at sea as everybody else – probably more so, as they suffer from overconfidence brought about by their own professional success. <u>I have never met a securities market professional who made significant money from trading his own portfolio</u>, aside from the apocryphal individual who bet the ranch on a small cap stock and saw it increase 100x (junior mining stocks in '08, internet stocks in '99, etc.)

There are numerous mechanical systems available, but they have so many "moving parts" that the number of signals generated becomes impractical for all but the professional trader. However, systematic mechanical methods can yield superior returns. This was my belief when I left the traditional financial world in 2006, and continued to develop my own portfolio systems.

Setting Up A Portfolio of Assets

December 1, 2008 I decided to put my system to the test. I choose a universe of funds offered by USAA. Not the best fund manager, not the worst. Not every asset class under the sun, but enough to make the exercise realistic. Below is an account of each trade, and the market circumstances at the time.

USAA Aggressive Growth	USAUX
USAA GNMA	USGNX
USAA Emerging Markets	USEMX
USAA Tax Exempt Long-Term	USTEX
USAA NASDAQ-100 Index	USNQX

USAA Precious Metals and Minerals	USAGX
USAA World Growth	USAWX
USAA Income	USAIX
USAA High-Yield Opportunities	USHYX
USAA Growth	USAAX
USAA International	USIFX
USAA Small Cap Stock	USCAX
USAA S&P 500 Index Reward	USPRX
USAA Capital Growth	USCGX
USAA Income Stock	USISX

A Year In Review

December 1, 2008 – I have created a spreadsheet and loaded 15 USAA funds. After generating ranking values and sorting them. The system tells me to buy USAIX – USAA Income, and USGNX – USAA GNMA. This is not surprising, 2.5 months after Lehman had gone bankrupt, there was intense anxiety in the markets. If we had known then what we know now – that the other banks were in peril in early October, the market may well have been 30-40% lower. The system said all equity was a bad investment. Ginnie Maes – backed by the US Government, and yielding 300bps over treasuries – seemed like a good bet, as did high grade corporates and treasuries.

March 14, 2009 – SELL USAIX, BUY Metals USAGX. The absolute bottom of the market. Metals stocks, which had been pummeled for 18 months, started to show some life. This was not surprising. With the exception of housing, they were the most battered stocks, and had bottomed out well before the rest of the market collapsed. Therefore any sign of life would surely be noticed. I put 50% in.

April 27, 2009 – SELL USGNX, BUY Emerging Markets USEMX. All Emerging Markets began to rally. Their financial positions (China, India) and natural resources (Brazil, Russia) all indicated they would have the means to finance their own recovery. It is interesting to note that many started to call for a market correction at this stage. All indices had rallied to sharply. But the IRP system continued to recommend staying in the market. So I did.

July 31, 2009– SELL USAGX, BUY USNQX. Buy tech. If things were going to recover in the US, this would be a place where it would happen. Metals had stalled out.

August 21, 2009– SELL USNQX, BUY USIFX. Buy international stocks, sell tech. The US Peso began to crumble, and non-US stocks began to show more and more appeal. While stocks began to stall out, international stocks gained, at least from a US dollar perspective.

November 11, 2009 – SELL USIFX, BUY USAGX. Back to metals. The sharp rally after a consolidation indicated that there was strong buying and a base of support. Regardless of your thoughts on the direction of the price of metals, increased demand and

brutal cost cutting at miners had made them leaner and meaner. Any incremental increase in spot prices would translate directly to the bottom line.

Gains for the year (12/1/2008 - 12/1/2009) were 48.4%. 5 trades. In each instance, the signal to switch seemed rational, given the market action. I was very confident in making each move, and by looking at the rankings on a daily basis, came to anticipate switches easily. They were not bolts from the blue. In addition, if I read, “Dividend Stocks to Make a Comeback”, I knew that, relative to other investments, they had to attract a lot more attention.

If I reflect back on Q4 2008, I see that at the time, we did not have nearly as much information as we do now as to the financial condition of global banks. This is almost always the case – information is imperfect, and we must rely on our judgment. Using the IRP system, it was obvious that the markets were reflecting pessimism and concern as to the health of the financial sector. If we look at the ETF XLF, it was $22 in mid September, $13 by December, and $6 by March of '09. If one had tried to catch the bottom in December, thinking, “The market is too pessimistic” (which may well have been the case), then s/he would have had to stomach a 50% loss of capital before any recovery. Emotionally, this is extraordinarily difficult to handle. In addition, the information regarding their perilous condition took 6 months to be reflected in the price. This is not efficient. But as each bit of information hit the wire, it was accumulated in the price. The IRP system is premised on this process, and the belief that information and prospects are NOT random.

A System to Make Money in the Markets

This E-book will give you some of the thinking behind the IRP System so that you understand how we developed it and how it works in practice. But, to be honest, you do not need to read this book unless you are curious. What you need to do is listed below. But, if you are curious and find some of the ideas agreeable, debatable or unacceptable, we are always looking to fine tune our system and would love to hear from you.

That is how the IRP System came about…curiosity. The partners have both been active members of the international institutional financial community for several decades and have seen a plethora of investment styles, strategies and tactical moves. This system was developed to crystallize the experiences of the partners into a process that could apply to an accessible range of assets. While it is fascinating to read about Warren Buffet, one of the problems with duplicating his strategy is the inability, for most of us, to buy whole companies. Alternatively, we also decided against designing a system that would use exotic derivatives or even options for that matter. There is nothing wrong with these instruments. We have used them extensively over the years. But, for the typical investor who does not have access to ISDA agreements nor the time and energy to follow the trades, the inclusion of such instruments is not practical.

The instruments we propose to use are mutual funds and ETFs. Why? Firstly because that is what most investment professionals are left with when investing their own money. Compliance departments are wary of approving a stock transaction because of the potential for insider trading. So, mutual funds and ETFs are very familiar to us. Secondly, because the people who run these funds have been our clients or colleagues for many years. They are diligent and trustworthy although, as we shall see later in the book, they are often constrained by their investment mandates. Thirdly, because we can execute this strategy in a variety of accounts to take advantage of low cost trading and tax considerations. And fourth, because the prices are transparent for all to see. The numbers underlying the performance charts that we show are checkable on any number of free sources.

It is important to understand that this is how we invest our money. We "eat our own cooking" here. The reason we do so…because it works. If we had a better way of making money, we would write about that instead. Once you start using the System to invest, you will start to question why you spent all those hours listening to Jim Cramer and his friends on CNBC. This is not "financial pornography" with whizzy concepts to wow the cocktail party circuit. This is a tool to achieve investment success.

So, how does one get started?

1. Set an investment goal – how much and when.
   (If you don't have a goal in mind, how will you know how you are doing?)
2. Determine an appropriate investment universe
   (Appropriate for you and your goals)

3. Use the IRP System to determine which asset classes to invest in today.
4. Act.
5. Review the rankings on a regular basis to determine when to switch asset classes.
6. Act.
7. Review your progress towards your investment goal. Repeat.

That's it. When you are ready to go, there is some heavy lifting (deciding investment goals and picking your asset class universe) but once you have done that, the System will keep you invested in the most promising medium term corners of your universe.

When should you start?

Now. Why wait? Putting off your investment planning and execution is not going to make reaching your goal any easier. What if now is not the right time to buy tech stocks or high yield bonds? That is what the System is for. With a broad range of asset classes (domestic stocks, international stocks, REITs, Bonds, Commodities, Currencies and Money Market Funds), you can be assured that some part of the financial spectrum is attracting investment flows at almost any time. Allocating your assets to catch those flows and switching out when better opportunities arise is how the System keeps your money working hard for you. Will you always be in stocks? Not if the markets look like the first quarter of 2009 again. At that point, the System was telling us that the best performing asset was next to zero interest in a money market fund. Preserving your capital and your gains is just as important as chasing returns. If you lose 50% one year and gain 100% the next, you're right back where you started. Our system is tuned to deliver solid, compoundable results so that you can reach your investment goals.

What is the IRP System?

How would we classify this system? We would call it a modification on Buy and Hold. While the system seeks to keep you fully invested (remember that the system treats cash as just another asset class) it also looks to keep you positioned in the most promising assets in your investment stable. To push the horse metaphor a bit further, the System works its magic when it signals time to switch horses. When it tells you to switch, does that mean the asset to be sold has gone wrong? Not necessarily. It may be that something better has come along. The System is impersonal and unemotional. It does not fall in love with any particular investment; it just ranks them for performance over the next 3 months or so. Will there be false starts and mistakes? Yes. We have observed that the system puts out false positives about 10-15% of the time. On the positive side, the system will catch those errors fairly quickly. This is not a crystal ball, nor is it a Bernie Madoff scheme. Markets are volatile and no system is perfect. The trick is to keep your winning trades and cut your losing trades so that the portfolio grows.

Important consideration for US Taxpayers

And that leads us to an important reminder for US investors. While we have tried to keep trading at a reasonable level (trading costs drag on overall performance), the System will signal trades that could lead to short term capital gains. Since taxes are a critical cost component and a serious drag on compounding for any investment program, US taxpayers should seriously consider using the system in a tax advantaged vehicle like an IRA, 401k, trust or annuity.

Time for Action

If you are ready to make money, go to the website, sign up for an account and see how the System works with a variety of different portfolios. If you see a portfolio that you like, a Gold Membership will give you full access to the current ranking so that you can get started today. If you would like to see a different portfolio, email us and we can have one up and running shortly.

Can it really be that simple?

Yes, because we have spent years trying to make it that simple. But, if you are not satisfied with simplicity, read on and you will see some of the complexity that lies beneath the exterior.

Email us:

john@irptw.com

walsh@irptw.com

Portfolio Request

gold@fund-king.com

Website Address

http://www.fund-king.com

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"The Biggest Financial Crisis Since the Great Depression!"

How many times have seen, read, or heard that one? So many times that you would think that the news media, investment experts and politicians have been on the story since the beginning of the meltdown. But, if you check your investment statements, you have very good evidence that almost no one told you about much less gave you a plan to deal with the biggest financial crisis since the 1930's.

As the markets stalled in 2007, the talking heads in the financial media were busy crucifying anyone who wanted to suggest that somehow the subprime crisis was more than a temporary bump on the road to greater prosperity. And then, as the recession clouds gathered over the US economy (but well before Bear Stearns and Lehman tumbled) a last ditch effort to keep the party going...decoupling. That’s right folks, the US consumer who had been the engine of growth for the past few decades was no longer important. China and India would pick up the slack and all would be well. Do you remember what it felt like back in the early months of 2008? There was hope that somehow some markets could avoid the damage that was starting to crush the US economy. Don’t believe it, start looking through YouTube clips.

But, despite all the promising stories that were floating around back then, China was already on it's way down from a mid-October 2007 high. The high for most US markets came on the first trading day of 2008. The equity markets, corporate bond markets and most property markets were poised to fall to what is now being called: "The Global Financial Crisis".

But hold on! How come no one warned us about this upcoming crisis? And, if we had known this crisis was coming, what could we have done about it?

And, as if to add insult to injury, how come no one was there to tell us to turn the switch back on in March of 2009? Why did most of us have to wait until June or July before we got the memo on the strongest bear market rally since the 30’s. And if we had been fortunate enough to hear one of the people who called the rebound, what should we have bought?

Why we don’t get the memo on major market moves (especially the downdrafts) and how should we take advantage of market trends and changes are the two important questions that this book will explore and answer. You might be surprised by the answers but we think it is important to accept their validity as we move to the larger goal of showing you how to deploy your assets to invest sensibly in the financial markets. The markets as they really are, not as we wish they would be. Once we can do that, investing successfully is only a few logical and systematic steps away.

Let’s start with a simple question:

"How come no one warned me about the Global Financial Crisis?"

Let’s answer that one with a question for now: "Who did you expect to tell you? Your stock broker? Your property agent? Your fund management company?"

But the deeper question to ask is: "Would you have listened if someone had warned you of an upcoming financial crisis?"

We will explore both issues. Why financial firms are not really built to provide you with independent advice and why you might not have listened even if they did.

The second question (What would you do about it?) doesn't have a direct answer because in fact we cannot know the future for sure. But, market prices do anticipate future developments so we can and must incorporate them into our system's design. Even during this Global Financial Crisis, there have been good investment opportunities. Commodities did well for a time and the Japanese Yen surged almost 30% in the second half of 2008 to name just two. If we can find a system that keeps us in the best performing assets (and out of the worst performing assets) at any particular time, even if that is a low yielding money market fund, then we should be investing in the strongest and avoiding the weakest investment opportunities. Isn't that what investing should be all about?

We think the answer is yes!

So where is this System? You can find it on our website: www.fund-king.com. We call it "the System" and it is the tool you need to take control of your investments. By investing systematically, by removing emotions from your investment decisions and by taking control of your asset allocation, you can define and reach your investment goals.

And you do not need to worry that this is just another way to sell you one company's products over another. The beauty of the system is that it is independent and lacks any feelings. The system's independence means you can trust the results because our goal is aligned perfectly with your goal, successful investing. And the System will work on many different pools of financial products. The fact that the system has no feelings means that it is perfectly suited to help you navigate the financial markets which, as we have noticed in the past two years, also lack feelings.

The next few years will see some great opportunities and lots of volatility as the Global Economy recovers from the Global Financial Crisis.

If you are ready to take control of your investments, read on.

Methods/System

"Buy Low, Sell High"

From an intellectual standpoint, it really boils down to those four words.

As with any undertaking, the way to achieve this goal is to have a plan or a system. There are too many investment options for one to evaluate them all personally. One must have a evaluation structure to look at all the investment possibilities and and execution structure to manage the buying and selling of investments.

All successful investors will tell you that they have a method or a system for investing. The method can be very simple: "Buy when blood is flowing on the streets" was attributed to Baron de Rothschild. " Buy stocks at less than their intrinsic value" according to Ben Graham. "Find an outstanding company at a sensible price" in the eyes of Warren Buffett. Most investors are very familiar with the idea of buying a stock at a relatively low P/E ratio in a business that has good growth prospects in the future.

Or the method can be very complex, using computers to sift through Gigabytes of data every second, applying complex algorithms to make sense of the world or just to clip a tiny margin on thousands of transactions an hour. There are systems and methodologies of varying complexity. And the asset mix has expanded greatly from the traditional Stocks, Bonds and Cash to commodities and property, structured notes, derivatives and other hybrid constructs to allow sophisticated investors to develop highly specialized investment vehicles. Whatever the system or the investment vehicle, all systems and methods can be summed up in the phrase "Buy Low, Sell High".

But what is "Low"? And what is "High"?

These are the two critical questions that every system of investment seeks to answer. But the answer is not as simple as it would appear. Why? Because when you buy, there is a seller. And when you sell, there is a buyer. By definition, your low entry point seems like a pretty attractive high exit point to the investor on the other side of your buy trades. And, your high exit price looks like a good low entry point for the next investor in line when you sell.

Why is that important? Because we can design a system to take advantage of current investment practice. Over the last twenty years, most financial institutions have been pushing a new ideology which can be summed up as "Buy and Hold". Buy and Hold is not a sound investment strategy for two reasons:

1. There is no attempt to discriminate when buying. So it is Buy but not "Buy Low", and

2. It is missing the second half of every successful strategy: "Sell High".

That doesn't sound so bad, does it? Well, yes and no. In a broad bull market like the one which has existed from 1982 to 2000 (with several bull runs since), a Buy and Hold strategy will give a good investment return at low cost with little thinking. But, it doesn't work when the market moves down. With no plan to sell from the outset, many investors froze in the face of the Bear Market of the last 18 months. Interestingly and apparently confirming the weakness of "BUY" vs. "Buy Low", most investors also froze during the bull run from March to May 2009.

So, for investors who have enjoyed the "Buy and Hold" era, but have not enjoyed the last two years, it is time to take out a clean sheet and review some basic rules and disciplines so that you can take the investment knowledge that you have gained and apply it profitably to the real investment environment.

The key to effective rules and discipline, which will underpin any good investment strategy, is to devise them at the start of an investment cycle and to stick to them.

So, what have we discovered so far?

1. Most of us have been following an investment rule that deviates from the core of almost all successful investment strategies.
2. To devise a successful strategy, it must simplify to the old dictum: "Buy Low, Sell High"
3. We need to devise rules that will work in a variety of market conditions.
4. We need to devise our rules beforehand and not make them so specific that we constantly need to change and tinker.

We need to follow the rules.

1 Rational

It is hard to be rational when it comes to investments for two reasons.

1. Because we are human
2. Because all the other participants are human

Humans are both rational and emotional. In later chapters, we will delve into some examples of how our brains like to work and why it can get in the way of a profitable investment strategy.

So, to construct a rational system, we need to look at the situation and see what tools can be applied.

The first building block is the investments themselves. There are broadly two types: sponsored and unsponsored. An unsponsored investment is generally a commodity investment. That commodity could be the EUR/USD currency cross, precious metals, financial futures, Treasuries, index ETF's, oil, basically investments that are so broad that they are not dominated by any class of investors and their destiny is not controlled by a small group (say a management team). Most people approach the unsponsored type of investments with macro research methods. Economists construct models of the world and guess at how trade flows, supply and demand will change the value of everything from the price of oil, silver and wheat to the value of the Japanese Yen against the Euro. The sponsored types of investments are ones that are controlled by a group of financial institutions, a corporation or some combination of the two. For these investments, the big financial houses hire teams of analysts to do "bottom up" or micro analysis to try to figure out which stock or corporate bond is over or under valued relative to the last trade. The time horizon can be measured in seconds for market makers all the way up to decades for sovereign wealth outfits and value shops like Berkshire Hathaway. But, whether macro or micro, both types of research strategies depend on making guesses about the future.

So there are broadly two types of investments but what type of intellectual bias do professional investors use? Whether micro or macro, there are basically three types of "styles" which investors employ:

1. Growth at a Reasonable Price
2. Value
3. Momentum

Of the three, Growth is by far the most popular both in terms of assets under management and number of participants. Value is the second most popular (think Warren Buffett) and is especially attractive to investors with a long time horizon. Momentum investors as a group are a smaller proportion of the market. The main reason is that their strategies are hard to scale.

Which is the best of the three? Well, that really depends on the circumstances. Most of the time, in trending markets, growth will deliver fairly reliable returns on investment. Value has its benefits and its moments, especially when used in hybrid with growth (as with Buffett). Sometimes in the economic and investment cycle, there isn't that much growth to be found. And momentum can help capture portions of the cycle that is hard to justify using growth or value.

Why mention all this? Because our system does not have to concern itself with whether is has a growth, value or momentum bias. We are concerned with meeting our investment goals. With all of these styles available from highly qualified investors, the rational investor can profit by devising a system that captures the best parts of the cycle of the various investments and strategies already in the market. To put it in simple terms: There is no reason to reinvent the wheel. The key is to use the wheel to do useful work.

The system we propose will use the information communicated by price action to determine where we want to invest our money. Why price action? Because all of the hard work is already done. You invest in Cathay Financial not because you want to run an insurance company with a bank subsidiary but because you believe that you can profit by owning a share of their business. You invest in Hon Hai not because you think you are as smart as Terry Guo or think that you will understand contract manufacturing by buying 10,000 shares but because you want to profit from his connections in the IT hardware world. The same is true for all investments. You are not trying to be smarter than the people who run the funds, companies and financial institutions globally. You are trying to profit alongside them at a reasonable cost.

So, we can see that the key parts of our system are pretty easy to identify and analyze. But we need to remember that the financial markets are not finely tuned machines that always kick out correct asset prices. That is because the prices in the market are set by investors. And, despite all the rational ideas that we have mentioned (macro research, micro research, analyst teams, supply and demand), the actual investment decisions (which determines the "last price"), can be subject to irrational influences.

In designing our system, we need to recognize that asset prices will not move in a smooth line from the current price to a future rational price. In fact, a quick glance at almost any chart of any investment will tell you that smoothness is the last thing one should expect. The system needs to recognize and profit from the fact that assets tend to trade at anything but their "fair, fundamental value". Therefore, while it is intellectually satisfying to identify a "fair value" for any particular asset, it is more important to recognize that the asset will almost never trade at that "perfect" valuation. Our system must

account for trends, find them and help us to put our money into them. But, trends do not go on indefinitely. Therefore our system must also watch and account for trends ending and reversing.

Realistic

Our investment method must be realistic in two ways.

1. Practical
2. Achievable

Practical. Although it is not too hard to recognize successful investments after they have occurred, without a time machine, we must design a system that can focus our attention on the best opportunities in the future. And, those opportunities abound. One of the problems with analyzing investments is that the analysis is never finished. There are always areas of uncertainties that, with enough time and resources, we could analyze to satisfaction. The problem is time and resources. While resources may not be a problem for the extremely wealthy, time is a limiting factor that does not discriminate between rich and poor. Therefore, whatever system or method we devise, it must be able to operate within an investment decision cycle. HTC will not spend 10 years designing a perfect new smartphone because it will only have a market life of 9 months. So, while, in theory, one could potentially work out a complete picture of the investment environment at any given time, the amount of time required to reach that level of insight would exceed the period that that insight would be valid. Basically, by the time you figured it out 100%, the market will have changed. So to be practical, our method or system must review the investment universe and isolate the best investment opportunities quickly enough to allow us to make the investment and profit from our work.

Achievable. While we would all like to find a way to multiply our wealth many times over in the shortest period possible, there are limits to what any investment strategy can deliver. The Austrian School of Economics teach that wealth is created when there is competition between investment opportunities. Good investment leads to wealth creation. Malinvestment leads to wealth destruction. As we have seen over the last few years in the US, the "malinvestment" in real estate has led to a significant amount of wealth destruction. Economies and therefore investment opportunities move in cycles. A brilliant investment one year may become overhyped and underperform significantly in subsequent years. A lagging investment may fall to such and attractive valuation that it becomes an attractive investment target.

But there is another side of investment that no one wants to talk about which impacts returns: losses. Although few investors like to think of them, losses are part of the investment process. Losses arise because of

1. Flaws in the investment process
2. Factors that were not considered
3. Changing investment/economic environment
4. Fraud or dishonesty

A realistic investment plan has to recognize the possibility of investment losses. Most investors deal with losses by ignoring them as long as possible. Sometimes that works out as economies grow and cycles change. However, given the opportunity cost involved, we think the way to deal with losses is to have a clear idea of where you want to stop them. Stop loss policies will vary with risk appetite but the key is to keep losses from getting out of control. A 50% loss this year means we need a 100% gain next year just to break even. 100% gains can happen by hard work and or good luck, but those 100% gains are relatively rare. By cutting a loss at 15% though, we can start making money again after a subsequent 17.6% gain. In our experience 20% gains are a lot more common than 100% gains.

The other part of achievability is related to the return you need from your investments. Three elements will determine the rate of return.

1. Your capital (both initial and incremental)
2. Your future liabilities (house, children's education, retirement, vacations)
3. The time between now and when your future liabilities come due.

The formula is fairly simple...$PV=FV/(1+i)^n$

Say that you want to pay for your child's Stanford education in 10 years time. Perhaps you would like to have US$500,000 saved at that point.

If you could secure a 10% annual return, you would need US$192,770. Or, you could start with US$80,000 and add US$20,000 per year. Is 10% per annum achievable? Yes, but not without a system. Without a system, something like 5-6% is a more likely compound return on your money. How does that affect our calculations? At 5% we would need just under US$307,000 for a one time investment, or US$130,000 initial plus $25,000 annual investments to reach our US$500,000 objective. At 6%, the one time investment is US$279,200 and the initial/incremental investments would be US$110,000/US$25,000.

When we talk about return, we need to be clear that no system will deliver 5% or 6% or 10% or 20% each year exactly for 10 years. The actual returns will be higher and lower. And that is the other issue about which one must be both realistic and practical.

The way to determine the return is not to add the percentages but to multiply them because that is what is happening to your investments. If you lose 25% in the first year and

gain 50% the following year, your return is not +25% for the two years but 12.5% for the two year period (1-0.25)*(1+0.50). In fact, your annual return is just over 6% for the two years $((1-0.25)*(1+0.50))^{1/2}$. That's why all the most successful investors stress cutting losses early.

But it is also important to reevaluate your actual returns against your goal on a regular (at least annual basis). If for example you have been investing in the Stanford education example (US$80,000 in the first year and $20,000 investment each year after), and had at year 8 achieved a 15% annual return, you might want to take a break because you are only a few hundred dollars shy of your US$500,000 goal. What should you do with the next two years? It depends on your situation but the correct answer in our books is close the chapter on the Stanford education goal and start a new investment plan. The money you will need in the short term to finance a business, house or a college education is not really the money you want to be risking in the market. But if you want to earn returns, make a new plan that incorporates even more aggressive stop loss policies than before. Since you cannot lose 15% of your capital in the final two years before you child goes to the expensive US university, even a 15% stop loss (which was probably more than adequate during the first 8 years) is no longer acceptable. 5% is probably closer to the mark. That means you will be investing the funds more conservatively, which will likely yield a lower return but also a lower risk. As you can see, investing by goal helps you to make the realistic decisions so that the money will be there when you need to fund the liabilities you set out to invest for in the first place.

What Doesn’t Work

Emotion

The two emotions that arise in investment are **Fear and Greed**.

What do we Fear? We fear looking foolish. We fear financial loss. We fear missing a golden opportunity. It is what makes us freeze when losses mount. It is what keeps us on the sidelines even though the evidence shows a bottom. Fear leads to losses and underperformance in the long run. It cannot be avoided but it can be controlled.

And what are we Greedy about? A rising investment fills us with confidence. A confident sales pitch, a brilliant track record, all of these things can make us feel more comfortable with investment choices than we really should. At the peak of a cycle, all investments look brilliant. Greed is what makes us continue to buy even when prices are too high on every reasonable measure. Greed is what keeps us from taking sensible profits because we don't want to leave anything behind. Greed leads to evaporated profits and underperformance in the long run.

What is interesting is that both Fear and Greed blind us to the proper workings of the investment process and opportunities to make good investments. After the markets have fallen for many months, Fear pushes investors firmly into cash and keeps them there. Fear of the pain of recognizing losses keeps statements unopened. It makes it hard to reenter the market when the cycle changes. And, after the market has already risen for months, Greed assumes that the good times will continue in a straight line. We ignore the warning signs of asset prices stalling at the top as investors run out of money to push prices even higher.

Emotions are powerful and in the "How does you brain work" section, we will explore why emotions appear to have such a powerful control over our investment decisions. We know that when investing, we should be sensible and measure the risks and rewards of every investment. If we are honest, we also know that many of our actual investment decisions were made at least partially based on emotional responses. Fear and Greed are a part of every financial market. One cannot wish these two powerful emotions away. But, one can design a system to both limit the impact on our own investment take advantage of the emotions powerful grip on the markets.

"Hot" Tips

When I first came to Taiwan, an elderly lady shocked me with the revelation that all investors traded on insider information. "Really" I asked. Could it be that everyone had insider information? She assured me that none of her friends would even consider trad-

ing unless they had some form of insider information. "How could that be?" I wondered and asked her how so many people could have that much insider information. "Oh, that's easy." She replied with a wink. "Everyone thinks they have inside information...most of them don't actually." And that is the problem with "hot tips" at the end of the day. There may be one or two good ones buried in there but for the most part, the tips aren't hot, just wrapped up and thrown in the microwave to make them feel warmer than they actually are.

The difference between investment advice and a "hot tip" is the amount of supporting evidence that comes with it. Good investment advice will normally go through the investment case and outline the upside potential and the downside risks. A "hot tip" is usually delivered in a sentence or less and is often based on a rumor of an upcoming event.

Other than the lack of analytical backup, the problem with "hot tips" is the motivation behind the person or group pushing the tip. One might be innocently trying to help a friend by suggesting a stock that one bought last week for one's own account. But, at some point, that friendly assistance crosses the line when the "tip" starts to push the price up. So at it's best, "hot tips" are probably just suggestions from friends...at worst, they can be a sophisticated method of manipulation. "Talking one's own book" is a common technique in the market and has been somewhat legitimized by TV investment shows. A fund manager or a hedge fund manager will let the interviewer ask which shares are in the portfolio which gives the fund manager an opportunity to promote the investment case of a particular stock or investment. While nothing illegal has happened, it certainly doesn't hurt to create some buying pressure in a name one already holds in the portfolio. Who knows, one might get an opportunity to sell.

Most stock manipulations work on the three layer method. The first layer is made up of the promoters. In general, this group will try to pick a relatively promising stock or investment opportunity so as to minimize downside risk. The second layer of investors are premier clients. These clients are generally prequalified and are often well aware that they are participating in a scheme. The third group is the non-premier clients, also known as the distribution group. If the manipulation is well organized, the promoters will make the most money, the premier clients will make some good money and the distribution group may or may not make money. In fact, there is a chance that the first two groups have pushed the shares up to a level that the third wave is unable to pass the investment to a final wave of investors.

So, unless you are promoting or are a first tier client in a stock manipulation, you are unlikely to actually benefit from investing in "hot tips." But the paradox extends beyond illegal manipulation to the mainstream media as well. Over the past decade, the financial media in the United States has exploded. But academics have done studies to show that popular TV stock pickers like Jim Cramer are unlikely to make you much money in the long run. The reasons have not been determined but the results are clear. Perhaps it is because a TV stock picker tries to be at the head of the crowd. If he picks stocks that are not being talked about, viewers might conclude that he is not worth watching. Whereas

if he is talking about the same stocks that others are talking about, he appears to be "in the know" and therefore worth watching. Unfortunately, by the time an investment makes the front page of the newspapers or the top of a "mingpai" list, it is usually most of the way through it's up cycle.

The next time you get a "hot tip", ask yourself why the tip is "hot". Is the person giving you the advice to push his own portfolio or is he just repeating something that he heard from someone else. Are you the third or fourth wave of a three wave stock manipulation or is someone just trying to generate volume in an illiquid investment.

If you can avoid investing in "hot tips" you will find better investment returns and lower stress levels.

The Crowd

Humans are social animals and we naturally prefer to stick close together in a crowd and move with the general direction. When our ancestors roamed the savannas, coming together was a great way to organize a hunt for a large animal, and defend oneself

This is a behavior that is positively reinforced nearly every day of our lives at school, at work, at restaurants and when we travel. Imagine if we decided to go against the crowd while driving on the highway...not a good idea. But there are other times when it doesn't make sense to follow the crowd. When we were in school, it was not a good idea to cheat on a test even if our friends tried to pressure us into it. Our current financial crisis was sparked by "the Crowd" who was convinced that real estate could not possibly go down and that debt was always cheaper than equity (so why not lever a bank at 40:1?). Individuals bought bigger houses than they could afford, companies borrowed money to buy back their shares at high prices and financial companies pushed their gearing to previously unthinkable levels using overnight borrowing to finance long duration projects and investments. It's easy to look back from today and see that there were some crazy ideas. But if you wanted to move to Silicon Valley in 2007, the real estate agent would have assured you that US$500,000 down and US$10,000 per month in a mortgage was a perfectly reasonable price to pay to live in a very small house in "the Valley". The "Crowd" made that sort of offer possible and the reason we are suffering from a Global Financial Crisis is that enough members of the "Crowd" bought that house. If you had said "no" in 2007, most Californians would have given you a funny look.

When it comes to investments, going with the crowd may or may not be a good idea. If you find yourself going with the crowd, make sure that you are going with the crowd for the right reason (the right side of the highway, being bullish in a bull market) and not for the wrong reason (jumping off a bridge with a friend or buying at the top of the market). Don't let the crowd confuse you or make you feel better or worse, make you feel comfortable. Plan your investment strategy, stick with it and evaluate the results coolly and rationally. The Crowd can be noisy...learn to block out the noise and look for the key

factors that will determine your investment success. That way, when the crowd tells you to stick with a winning investment even though your research shows you it is overvalued and time to take profits, you will be one of the first to make the right decision. Because, when the crowd changes its mind, the likelihood of getting out of an investment unharmed is low.

How does your brain work?

Fear of Scarcity

When our brains were developing, and pretty much until very recent times, we humans experienced a world where basic needs could not be counted upon. Most of humanity through almost all of its existence has had to worry about competition for food and shelter on a day to day basis. So it should come as no surprise that our brains were built for a very different situation than what we as investors find in our modern existence of well furnished, air conditioned homes, comfortable clothing and ample supplies of food. The Limbic System is the small portion of our brains between the brainstem (which controls breathing and heartrates) and the outer cortexes (where complex functions like thought and speech take place). The Limbic System includes parts of the brain where many of our most basic functions and emotions are formed, stored and acted upon. From an evolutionary point of view it is very old but it still exerts strong influence on our every action.

The Limbic System is the part of the brain that informs our "fight or flight" reactions to stimuli we encounter in the world. It also stores long term memories to help us recognize patterns, our sense of smell and controls many of the basic emotions. As with following the crowd, this is a highly useful part of the brain to have when we cross busy streets, encounter a large animal, decide whether to argue with a boss or decide on a mate. In the financial markets, however, the Limbic system is of considerably less value because the causes of the price movements are not related to the mass of a car barrelling through a red light, the sharpness of a lion's teeth, the color of your boss' face or all the cues that drive sexual attraction. If you allow this part of your brain to take over your financial decisions, the results can be damaging to your long term financial goals. When a market goes up relentlessly for several weeks and all the people around you are buying in, your limbic system is going to flash "buy" to the rest of your brain through the release of hormones. While buying may be a golden opportunity to buy, it could also be the top of a market move. The limbic system does not talk to the prefrontal cortex about valuations, it sees an opportunity and releases hormones so that you can react. Only by designing an investment process that does not rely on these flashes of hormonal emotions can one keep the limbic system from overwhelming all the hard work that we do to analyze the markets. And the other side of the cycle, when markets crunch down and everyone panics, it will be those with the cooler heads, who can ignore the panic messages that their limbic system is flashing to the rest of your brain and buy in.

Can the limbic system be turned off or disconnected? From the 1930's to 1950's thousands of prefrontal lobotomies were performed on mental patients, mostly with disastrous results.

No, it seems we need our limbic system well connected to our prefrontal cortex to fully

enjoy our lives. And after all, that is one of the reasons for developing a solid investment plan in the first place...so that we will have the resources in place to enjoy our lives to the fullest. So, we will need to design an investment program that does not require the participation (or the interference) of our limbic system.

Seeing Patterns

The other useful thing that our limbic system helps us with is our ability to recognize patterns in the world around us. The ability to recognize patterns was critical to our ancestor's survival and certainly today, we use pattern recognition to inform our actions and reactions.

Think about how a snake crossing in front of you on a path might make you freeze. Or perhaps how a loud sound makes one jump. These are patterns ingrained in our brain and once triggered, the Hypothalamus can get to work releasing the appropriate hormones so that our body and mind is ready to respond. You don't want to try to remember the formula for forces and vectors as a large car runs a red light while you are in the middle of the crosswalk. You want the limbic system to push the appropriate hormonal buttons to get you out of the way first.

But patterns that are useful in the jungle or savanna or crossing the street in Taipei (the shape of an antelope, for example) do not necessarily translate into the world of financial products. A great amount of effort has been expended to try to impose patterning on financial markets so that we can make sense of them. A head and shoulders pattern does not necessarily point to a trend reversal. It may be directionless trading that can be charted in a pleasing pattern but it's predictive powers are limited. A golden cross may mean something or it might just be a coincidence. While charting does have it's uses in presenting price information in a very efficient manner and showing correlations, the ability of technical analysis to ferret our future trends has very little support. We can use numbers to inform us about the strength of trends but the actual patterns that the prices trace on a chart have very little predictive value.

When designing your investment plan, do not bother with pattern recognition. Charts can summarize the past and even give us a visual "feel" of where we have to go and what gaps remain. But a particular pattern on a chart is unlikely to tell us about the next days, weeks, months or years.

How to make your brain work for you…

Rules

What are rules?

Rules help us organize activities and organizations. We use rules to teach practices and procedures. We use rules to codify past experience to inform future actions. Rules are the core of civilization. Also, they are largely created, learned and practiced in the more modern part of our brain, the pre-frontal cortex. Whether we are "left" or "right" brain dominant, the higher functions are contained in the large lobes that sit atop our old friend the limbic system.

But more important that what rules are, are how they are formulated. Rules are designed and articulated before an activity begins. Who among us doesn't remember the feeling of wrongness when a childhood friend changed the rules in the middle of a game? Rules are not decided "in the heat of the moment". They are decided upon calm reflection and often by the members of our society deemed to have good judgment and extensive experience.

So, how does this apply to our investment situation? Many investors jump into investing without much of a plan. The idea is to "make money." How much money? How to assess opportunities? What to do when the investment goes against you? When to take profits? What kind of investments to target? We have all brushed these questions aside when we think we have found a "sure thing" that we "know in our gut is a winner". But that approach will generally work out about as well as casino gambling.

To have a successful investment plan, it is critical to first lay out the rules you will follow when executing that plan.

A Plan

A Plan will help you organize your rules. But where to start? The best place is by taking an inventory of the investment vehicles you plan to use. For most of us, that means mutual funds, money market funds, some individual equities and perhaps a fewETFs. After all, there is no need to devise fancy rules for options or futures trading if you do not feel comfortable trading them.

A Plan also has to be **Your Plan**. What will meet your investment goals and fund your future liabilities? Just because your old college friend is a whiz at commodities, that doesn't mean you need to include them in your portfolio right away or in the same man-

ner as he does. By all means have an intelligent conversation to find out what the pits in Hong Kong or New York are saying about gold. One should always be looking for opportunities to learn. But if you choose to invest in gold, a mutual fund investing in gold producing companies or an ETF that just holds physical gold is probably more appropriate than jumping in with a full fledged futures account (or even a managed futures account) for most investors.

Your plan can also have some flexibility. Perhaps you want to keep some money aside to invest in a particular interest. Perhaps your friends are involved in a new materials business that looks promising. By all means, allocate some of your funds towards those types of investments but before you decide which ones, first decide how much (as a percentage of your total portfolio) you are willing to put in these types of investments.

Next is the much talked about investor typing. This is an attempt to codify a much older concept called the "prudent man rule". The prudent man rule is the one you should be thinking about. When you think about how you are going to invest, step back and think about how a trusted friend or relative would look after your money if you were to take an extended vacation. He would seek to take advantage of good opportunities while seeking to limit any losses. So, despite the fact that the industry investor typing might suggest an 80% weighting in medium to long term government bonds for an older couple closing in or retirement (using the age rule), a prudent man might wonder if that weren't putting too many eggs in one basket given current circumstances (historically low interest rates, massive government deficits and the possibility of accelerating inflation in the coming years). Just the inflation risk alone could cause severe stress if it were to lead to a large drop in capital values just as a couple was reaching their retirement years.

So this suggests that the plan should be robust but it should also be opened for review on a regular interval. How regular depends on your personal circumstances. Certainly it should be renewed as soon as any of one of life's larger changes come about. A single professional (male or female) might rethink his/her saving and investment strategy as soon as marriage, house buying and children are added to the profile. Besides those times, about once a year should be adequate for a full review although monitoring individual investments should probably take place on a weekly or at least a monthly time frame. Why weekly? Because changes in directions generally happen over a weekly period. Noisy signals from daily ups and downs tend to even out and the positions left on over the weekend tend to be of a higher conviction level than ones placed mid session or mid week. Why monthly? Well, that is usually when our statements arrive. If we are honest, most of us will have to admit that we check these statements a lot more closely when we are doing well in the markets than when we are doing poorly.

So, now that we have seen that a plan can help and have pointed out some of the short falls, we need to start.

The first place to start is with a piece of paper and a writing instrument. A computer will do if that is more handy.

Why are we going to write this down?

Because then we will have a much harder time making up stories later.

And what are we going to write down?

1. How much we have to invest right now. (Where we are?)
2. How much and what time periods we are going to add or subtract from our investment funds. (Where we are going?)
3. What are the likely needs for these funds: what liabilities are we trying to fund with our investment program. (What is our destination?)

How about an example?

1. I have NT$3m to invest right now.
2. I can add about NT$30,000 a month to my investments.
3. I would like to use the money to educate my child in a US university in 10 years time.

Although this seems very simple, it has all the elements one needs in a plan. It doesn't take long to analyze this plan and make some basic decisions about how to execute the investments. The place to start is of course at the end. A university education in the US is going to be denominated in US$...even 10 years from now. How much is that likely to be? Here we need to guess but let's say US$75,000 times 4 years for a nice round total of US$300,000. Assuming the NT$ stays in a range of 31-34 (where it has spent most of the last 10 years), we need to find a way to turn our investment into NT$9,300,000 to NT$10,200,000. So, that means we will need to average a return of 5.4% to 6.6%. It sounds plausible except for one small problem. There are no guaranteed 10 year investments that will yield 5.4% to 6.6% in the market. If there were, one could conceivably buy that instrument and hold on for 10 years.

Since there is no magic bullet, one must come up with an investment plan to match the assets (current investments plus planned contributions) to our future liabilities (an expensive US university education). As you can see, an annual review of this plan might make alot of sense. If one notes that between year 3 and year 5 that inflation in US university tuition is higher than we expected and it will likely cost US$85,000 per year for 4 years, our plan will need to be adjusted.

Can we do better than 6.6% over the next 10 years? We think you can. But one key part of turning in a better performance is avoiding damaging losses. The math is not very difficult. Annual returns are not added but multiplied. So if I make +20%, -40% and +20% for the last three years, my average return is not zero (20-40+20=0) but a 13.6% loss ((1+20%)*(1-40%)*(1+20%)=-13.6%). So, as we can see, one bad year can more

than wipe out two pretty good years of +20%. "But, I am not worried," you might say,"I invest for the long term." OK, then play around with the numbers. If you made 20% a year but had two down years of 20% each during that 10 year period, your return would be 10.7%. If you could limit that to two years of -10%, your return improves to 13.3%. Given our example above, that would be the difference between a final result of NT$16.8m and $13.9m: NT$2.96m in extra profit and almost as much as the initial investment. So, when we are building our system, let's make sure we build in unemotional mechanisms to limit our losses and take our profits.

Will our System work for you?

The results that our system generates are consistently better than a buy and hold strategy. Because we have unemotional stop losses and profit mechanisms, we are able to keep and compound the gains. That is what you want to do...keep and compound your gains. Remember the old phrase: "you worked hard for your money, now make it work hard for you!" Compounding gains is how you make your money work hard for you.

So, given our example and two years of 10% losses, what should we be targeting to reach our goals? Around 11.2% average for the up years should do the trick.

Now you have a plan. Over the next 10 years you will evaluate your investments, you will stop losses so that you do not lose more than 10% in any year and you will try to keep at or above an 11.2% rate of return for at least 8 of those years to reach your target. As you do regular reviews, you can watch these metrics and know how you are doing. If you have a fabulous year and gain 20% or 30% (ie, above the return trend you are trying to achieve), then you need to vigilantly watch for losses. You do not want to give back your gains because then they will not compound. As we have seen above in some of the examples, compounding positive returns will allow us to fund our future liabilities.

Be Aware

So, now we have a plan. We know how much we want to invest, how much we want to contribute to the investments every month and how much we need to earn to reach our goal of paying US college tuition in 10 years time. We have also implemented a plan for limiting our losses, taking profits and reviewing our investments on a weekly/monthly basis, (so we know where we are) and our goals on an annual basis (so we can be sure about where we are going).

Now we need to worry about the primitive parts of our brains taking control of the project. If you have constructed your plan well, you will be well placed to deal with the inevitable emotions that the markets will try to throw at you on a regular basis. But remember, the markets are not emotional, the buyers and sellers are. The markets are merely showing the net result of all the bullish and bearish sentiments in the market.

Given transaction costs, any attempt to follow every move of the market will end up with happy brokers but a diminished investment account. Also, the crowd wants to buy at the top and sell at the bottom. Why? Because human brains tend to extrapolate current experience into the near future. If the market fell today, your limbic system will send out hormones to prepare you for a bad day tomorrow. If the market rose today, the happy hormones will set your mood to expect a positive day tomorrow as well. If there is a trend, which can be revealed in the cold language of mathematics, there is nothing wrong with thinking that the trend will continue...until it doesn't. What a system will do is compel you to take action once a trend no longer holds up. Following a system, you will rarely buy at the absolute bottom or sell at the absolute top. But, with a system, you will participate in important trends and invest profitably.

If you doubt the importance of a system over the "wisdom of crowds" you need only look back to the second half of 2008. An organization called ECRI which looks at leading indicators, signaled that the US economy was heading for a recession at the end of 2007 and that it was definitely in a recession in the middle of 2008. At the same time, most of the financial commentators were unwilling to admit that things were likely to slow down despite all the negative signs. It turns out that ECRI was right because they stuck to their system which has been working for over 50 years. The optimists were listening to their emotions. They couldn't believe that sub-prime mortgages could bring down the entire global financial system. ECRI did not want to believe it either and issued papers warning policy makers to intervene. But their system showed them that it was time to get cautious and so they warned investors in May of 2008 to get conservative. Don't believe me? Look up ECRI on YouTube and watch some of the interviews that CNN or CNBC did around that time.

But this problem of a sensible investment plan being spoiled by the more primitive parts of our brain is not a new phenomenon either. During the dot com bubble, we were told and apparently believed that internet companies were growing so fast that old measures like revenue were not as important as "eyeballs". Laugh now but enough of us believed it to make for a heck of a party. And coming back closer to home to the Asian Financial Crisis, at the time it was quite sensible for Korean investors to buy a bond of a taxi company in Indonesia to keep their yields up. And why shouldn't Thai property developers borrow short term in US$ to build apartments and commercial space in Bangkok. We believed these things because they worked for a time. And the longer they worked, the longer we thought they would continue to work and so the more we were willing to pay for dotcom stocks, Indonesian corporate bonds and Thai property.

What about those investors who saw through the hype and decided to say on the sidelines? For many, it was a painful experience. Colleagues, friends and competitors pointed out that the naysayers were missing out on the New Thing. Or worse, perhaps they just didn't understand. Our system will not keep you out of a dot com bubble, in fact it would have participated for a good part of the run. However, remember the March-April 2000 period at the end of the dot-com bubble when stock prices stagnated and momentum fell dramatically? "New Economy" enthusiasts at the time insisted that it was

just a short term correction and actually an opportunity to buy more. At that point, the system would have more attractive investments and recommended a switch. Will you be switching too early by using the system? Perhaps, but set that decision against the risk of the cycle turning back in the other direction. In the coming years, we expect more cyclicality in asset prices, not less. The price of holding on for too long and giving back your profits is high. One cannot keep to a sound investment plan by giving back gains and losing the opportunity to compound returns.

“The System” - What Is It?

A Simple set of rules to rank investment choices

We have mentioned the "System" many times in the previous chapters. But what are we talking about?

There are basically three parts:

1. Categorizing your investment universe
2. Devising simple but time tested ranking rules, and
3. Following the system.

Once you have completed those three tasks, the "System" will rank all your investment options from strongest to weakest. With a few simple switching rules, the "System" can keep you invested in those investments which have the most potential for gains. At the same time, the system will signal when to switch out of existing investments that are losing momentum and starting to move in the wrong direction. If that sounds very simple, it is. That is one of the key goals of using the System to organize your investments: simplification. But it is not simplification for its own sake. We are trying to simplify our investment process so that we can concentrate on the investments with the most potential for meeting out long term investment goals.

First step: Your investment universe

When we talk about taking control of our investments, defining our investment universe is very important. Your investment universe needs to be broad enough to capture a wide range of investment opportunities. However, it should not be so broad that it includes inappropriate investments. If you don't want to invest in Eastern Europe or High Yield bonds or commodities, the time to decide that is here in this first step. Then, when the System ranks an investment at the top of the list, you have already decided that the investment is appropriate for your portfolio. You can review your universe from time to time but if you are doing so more than once a year, perhaps you did not pick a broad enough universe to start with. Remember, the universe is not the assets you will be buying on Day One of your investment program and holding until the end of the program. They are merely the asset classes that you would like the System to consider and rank during each ranking cycle. You will only be buying the top 15% ranked assets so if one of your asset classes underperforms for an extended period of time, the System will watch it but you won't be investing in it.

Let's look at three examples which range from narrow to broad.

1. **Domestic Universe** - Say that you choose an investment universe of 10 funds and ETFs that invest in the Taiwan Equity and Fixed Income market. The good news is that the system will work and should keep you pointed towards the better performing assets. The bad news is that the universe is fairly narrow and correlated. The System would likely signal fairly frequent switches. The high transaction costs on your portfolio from frequent switching and the volatility of a single market combined with the likelihood of missing investment opportunities outside of Taiwan would make this too narrow a universe. It will have a hard time meeting your investment needs.

2. **Global Equity and Bond Universe** - Given the wide variety of funds registered for sale in Taiwan, it is not difficult to select a broad universe of equity and fixed income investments. A universe of 3 domestic focused funds and 12-15 overseas funds would still allow you to participate in domestic rallies but would switch you into other opportunities. When equity markets are falling, the fixed income funds will rank higher and the System will signal a switch. When stocks come back, the momentum will show up in the System rankings and you will be given signals to allocate your funds accordingly. This is a pretty good set up and will work well in "normal" times.

3. **Beyond Stocks and Bonds** - Over the last decade, there has been an explosion of financial innovation. Some of the innovations have been good, some have been dangerous but the net result is that investors can access a broad range of investment opportunities. Even using equity like vehicles like ETFs, investors are able to invest in currencies and commodities without the hassle of managing futures contracts. By adding a few commodities and currencies into your universe, you expand your investment horizon to include assets that can help you when equity and fixed income markets move down together. The ability to invest in Gold, Oil, Japanese Yen and other non-equity or bond assets can help you to preserve capital and eke out positive returns while the markets in general are falling. And, if inflation does result from all the Federal Reserve money printing, you have assets in your universe that are poised to rise to the top of the ranks. As we have noticed, times are not "normal" and in fact are changing rapidly with every FED, BoE or ECB announcement. Best to have a few assets in your universe that can benefit under almost any circumstance.

Second step: simple and time tested ranking rules

In the Universe section, we have already hinted at the rules and the operation of the System.

In our Model System that you see on our homepage, we have tuned our system to balance potential investment return, volatility and asset turnover. The results are both clear

and, as we hope you will agree, logical.

The first rule is to rank all the investments in your universe. This may sound obvious but how many times have we overlooked or excluded investments only to find out later that they performed well. How many times have you overheard someone say: "Oh yeah, I saw that opportunity at the time but..." The System will often surprise you because it is tuned to find trends in their early stages. That is, before everyone has discovered them and magazines are writing about them. There will be "false positives" (a trend which doesn't hold) which we have observed to be between 12% and 15% of the time. And while a false positive might lead to a loss on an investment, the System is designed to switch you into a more promising investment before that loss becomes too burdensome.

The second rule is to set your ranking time cycle. Do you want to make decisions on a weekly, monthly or quarterly basis? You can watch the System everyday but it is important to allow natural market volatility (sometimes referred to as "noise") to work through the market. The shortest period we recommend is a weekly ranking and for most investors a monthly ranking would still give a good result with a lower turnover ratio. That doesn't mean you will be trading every week or month. If the trends are strong, certain assets can stay at the top of the list for several months before losing momentum to other opportunities. The quarterly ranking is generally used by financial institutions to rebalance asset linked products and notes.

The third rule is to allocate you funds evenly to the top 15% of the list when you buy. When one of your funds falls out of the top 15% category (at your predetermined decision time), sell that asset and use the proceeds to buy the one that replaced it. Should you rebalance the top 15%? Our tests show that the difference in return is not large enough to overcome the transaction costs. Remember that many funds in Taiwan have a 3% sales charge. In this environment, you do not want to pay that charge too often or it will start to have a serious impact on your investment returns.

So here is how it works.

1. The System tracks the trends in your broad range of funds/assets on a daily basis.
2. Each week, the System will rank them.
3. You buy (or continue to hold) the top three (or five).
4. When a fund drops out of the top three (or five), you sell that one to buy the new top three (or five) fund.

The beauty of the System is that it will keep you invested in the funds with the best prospects and price momentum. When that momentum breaks down, another fund will take its place. If you have defined the universe well, there should always be a few funds performing while the broader markets may be stagnant or down. When all the markets are running, it should position you with the medium term leaders. And, as we have seen in

the most recent market meltdown, it will put you in the funds that are still rising or falling the least when markets are weak. That's where you want to be and that is why the System can deliver a stress free method for your long term investment goals.

Why do the rules work? Because asset prices are not determined by mathematical formulas on super-computers. Market prices are not as efficient as certain famous business schools would like us to believe. We have observed that trends develop in asset prices and that those trends persist until they are broken. Our system is designed to isolate and identify the medium term (several weeks to several months) trends that we believe investors can participate in. The System can be tuned for different periods, volatilities or asset turnover profiles but that is something which needs to be done on a customized basis.

Third step: Following the system

This is a lot harder than it may sound because the results may surprise you. The System is designed to identify trends early. So, some of the signals it generates will not be "in fashion". As we have seen in earlier chapters, "popular" investments may be right at their peak valuation and may be losing momentum at the time you are considering investing. So the system may not rank a "hot" investment as highly as you might have thought. Or the system may pick up on an investment that has already run 20%. This is why using the System to select investments is difficult. Because the investments you pick may not be on the front page of the newspaper, you may feel that you are missing out on something. Your emotions, which are controlled by that very ancient part of your brain, are pulling you in a different direction. But remember, your goal is not to impress your friends and family but to make consistent profitable investments so that you can comfortably fund your future liabilities.

As with every good plan, the results are only as good as the execution. If you have set up an appropriate universe and applied the rules, the System should help you filter your investment universe and point you towards the strongest opportunities in that universe. But then you need to decide. Are you just watching or are you actually going to invest? That is a decision that only you can make.

So what should you do?

We think the easiest thing to do is to start off small. Test the system with just a part of your investment portfolio and watch the results for yourself. Your results will be different than the Model System because although we try to factor in all the expenses and other trading related costs, the Model System cannot account for everything. Then, as you gain confidence and perhaps adjust your portfolio universe slightly, you can make the System work for you. As you gain experience, you will find out what the System can and what it cannot do for you.

What it can do

Our System will give you a short list of investments to choose from. If you are going to use the list, you should invest when new investments come on the list. Hold them while they stay on the list and switch into the new short list items when they come available. So, to put it in familiar terms, the asset is a buy when it comes on the list, it remains a hold while it is on the list and it is to be sold when it drops off the list. Successful investment depends on the correct execution of all three parts of the investment process. To profit you must buy the asset and hold it for a certain period of time. To realize that profit, you must sell that asset.

Our System can be applied to almost any sized investment range and it will rank the most promising medium term trades. Why medium term? Because we believe that the markets are cyclical and inefficient. In the medium term, asset prices swing well above and below the "theoretical fair price" because the price at any time is determined largely by emotionally driven investors. That is what the system is trying to capture and take advantage of. In the short term (ie. less than one week), the movements of the markets are both random and oscillatory. The market may seize on a rumor, a news item or a datapoint today and run the price of oil up a few dollars. More often than not, you will see a balancing move the next day as investors rethink the datapoint or just take short term profits. Only over the period of several weeks might you see that despite the high inventories in the US, the price of oil has found a bottom and is trending higher as economic growth starts to resume. As we have seen this year, the newspapers picked up the trend only after the price of oil doubled from the bottom. The System would have alerted you quite a bit earlier.

We want to find trends and ride them for as long as the trend is in place. Once the trend starts fade, or if a stronger trend comes available elsewhere in our investment universe, we want to switch our investments so as to be in the most promising investments at any given time.

If we have picked a good universe of investments (ie. broad enough so that there will almost always be something going up), then the system can give you the investment returns you need while not monopolizing your time or adding to your stress.

What it cannot do

As important as what the System can do for you is what it cannot do.

It cannot protect you from investment losses and it cannot pick up a short-term sharp rally.

Losses

The System is not a fail safe method for never taking a loss. In fact, the one thing that we can guarantee is that there will be losses.

All good investment plans seek to help you buy low and sell high. But that is only one of four possible outcomes in the real world.

So let's look at all four possibilities of making an investment.

1. Buy low, sell high
2. Buy low and the price goes lower
3. Buy low and the price doesn't budge
4. Buy low, sell high and the price runs another 25% after we sold

The first case is our old friend "buy low, sell high". We find a promising investment, we put some money down, we hold it for a period of time, and sell for a good profit. This is what we are all hoping to achieve when we invest. It doesn't happen every time, but it does feel great to get one right.

The second case is one where we find a great investment and it goes down. Why does it go down? Sometimes we can point to a reason but many times, we cannot be certain why a particular investment falls apart on us. In fact, we often ignore the reason because we don't want to believe that our initial judgment was wrong. The key to successful long term investing is to not worry about the reasons or the right or wrong of it but to "stop loss". If we can learn a lesson, great. But be careful not to "try" to learn a lesson if there isn't an obvious one. And don't let the loss "blind" you to that investment in the future. Many investors have blind spots: they will not consider certain investments, no matter how promising, because they once took a loss on them. The most important thing we can do is make sure that this investment loss will not impair the overall portfolio and slow our progress towards our investment goals.

Case three is a tough one because investment means trading cash that we can use immediately to hold an asset which we have to hold and cannot consume. The longer we hold an asset, the more we give up by not having the cash equivalent to use for other investment options. There is an opportunity cost. This can be a large source of underperformance in portfolios. We know what to do when stock pop up, we think we know what to do when they crash but what do we do when they don't really move at all? That is one of the key advantages of using our system. We will not always be kicking out investments because they are bad. Sometimes they have just lost momentum relative to other opportunities. We are looking to invest in assets that have momentum now and in the near future. The idea is to try to make money in every period and minimize the wastage that comes from being in stagnant or falling assets.

Case four is something that we need to just come to grips with. The truth is, we cannot win every battle. If the System generates such an outcome, then hopefully it has put us in an asset that is growing even faster than the one we have sold. If not, the feeling of "leaving money on the table" is unpleasant but does not impair our ability to earn a good investment return.

The beauty of the System is that it can help you deal with the second and third cases. Using the System, let's think about what happens if one of the funds or assets is sold at a loss? Will this happen? Yes. It will happen because there is always a risk that assets can go down as well as up no matter how well you have researched them. The System actually helps in this regard because it is unemotional. How many times have you lost a little money on an investment and decided to hold it until it returned to profitability? Occasionally that strategy works. But more often, the investment keeps falling or stagnates at a lower level. The System can help you prune these underperformers and get your money back to work quickly.

Think about it: that fund which is 10% down doesn't care about you, so why should you care about it? It is just a vehicle to achieve your investment goals. If it is not helping you get to where you want to go, you need to find another vehicle.

Missing a short, sharp move

The other thing the system cannot do is prevent you from missing a short term move. Our system is geared towards catching the bulk of any gains available from a medium term market move. If an asset suddenly turns upwards, our system will need to see a trend develop before that asset rises to the top of the list. Does that mean that the system will miss some moves? Unfortunately, that is a situation that we cannot design into the System. If you use the System, you will miss a few short term opportunities. Since we are concerned with the long term performance and meeting longer term investment goals, it doesn't make sense to try to chase down every short term move. If that move develops into a trend, the System will pick it up. But you won't be buying in at the bottom.

Funds – The heavy lifting has already been done for you

Why do we pick mutual funds? Because most of the tedious work of investment process is done for you at a reasonable fee. Fund management companies are staffed with intelligent and dedicated staff who would truly like to see you make money. They are always on the lookout for new and interesting investment opportunities and compete fiercely for your investment dollar. They have systems to ensure that the assets you think you own are actually purchased, placed in the correct accounts and accredited to the correct investor. And, because they are doing all of these operations on a wholesale (rather than retail) scale, they are able to demand lower transaction costs which ultimately benefits you as the unit holder.

But remember to use the funds and the employees for their proper purpose. Because fund management companies are responsible for holding assets on behalf of retail investors, they are subject to very strict regulations both from the government and from the top management of the company itself. If you expect a fund or a fund management employee to do something outside of these very tight parameters they are expected to work in, you will often end up disappointed.

1. Mutual funds are managed w/ a heavy hand - >90% of the time, the manager is doing exactly what he has been told to do.
2. These people are not dumb – they are constantly looking for “better” investments. However, they have a very small sandbox in which to play.

If you take a universe of them, and rank them, you have a group of smart diligent people working for you, and when their part of the market moves, you allocate $$ to them

Mutual funds are managed w/ a heavy hand

One of the common questions that customers used to ask is "if you thought the market might go down, why did you continue to own such and such a stock?" The question was usually asked after, not before a big market downturn and the fund manager usually answered with a variation of "the mandate". Remember that all reliable mutual funds are governed by a "mandate". What is a "mandate"? It is a contract between you and the investment management company which determines how your money will be invested. Don't remember signing such an agreement? Well, actually, you often did. When you sign off that you have read the prospectus, you have agreed to the mandate. In the secondary market, when you buy a fund, you have effectively agree to accept the existing mandate. In many markets, the fund management company will go to great efforts to make sure that you have a copy of the latest prospectus. This is not a desire to use up paper. It is because that mandate will very narrowly define what the fund can invest in

and how it will operate.

Investment companies are not looking to risk their business model on "investment cowboys" who can blow up a fund any day of the week. It happens but very rarely and investment companies spend huge amounts of time, human resources and cash to measure, monitor and control the amount of risk fund managers are allowed to take. Depending on the company and the mandate, a fund manager is doing exactly as he has been told better than 90% of the time. An individual fund manager has very little discretion outside of the mandate. In fact, his job is to execute the mandate to the best of his ability. So, how do you take advantage of this situation? Since the micro decisions are already well under control, you will make money by concentrating on the larger picture. This is generally described as the macro environment and when practiced is called "asset allocation".

Can the fund manager help you with the macro side? Maybe, but that is not his job. Perhaps you can attend an informative seminar where you hear interesting ideas. Your sales representative, private banker or wealth manager might have some good ideas as well but that is not really his/her job. The fund manager's job is to deliver good performance against the mandate that is agreed between you as the investing public and the fund management company. Your sales person's job is to get you to buy some of the company's products.

These people are not dumb

That said, these fund managers are in a very good position to find attractive investment opportunities. Think about it, they spend all day looking at their portfolio and seeing if they cannot improve the performance by adding to a position here and subtracting or eliminating a position there. The fund manager spends all day speaking to analysts, company management and industry experts (as well as reading everything they can find) to keep his/her mind at the cutting edge of thinking about the fund's investment universe. Often, fund managers will have advanced degrees and many years of investment experience.

But, their ability to focus on such a small area of the investment field is one of the weaknesses that we as investors have to compensate for. A specialist in IT hardware is not going to perceive a great opportunity in banking shares because that is outside of his or her usual focus. If bank shares are running, he cannot help you. In fact, he will not even have the tools to explain why bank shares are running because all of his tools are focused on whether one should be investing in upstream or downstream tech products.

This happens in the non-investment world as well. You may have the smartest accountant in the world working for you but that is not the person you will send for a key sales pitch. The smarter the accountant is, the less likely he will be able to communicate effectively with the client. And the situation applies in reverse. No matter how smart and good at math your top salesman is, would you really ask him to run your accounting

system as well. He might be able to do an adequate job but the business as a whole will suffer.

So how does this affect our System?

Get smart diligent people to work for you

So run your investment portfolio like you would run a business.

You are the CEO and CFO put together. You will decide how much is going to get invested, when those investments will be made and how the assets will be allocated. As the CFO, you will regularly review the performance and decide if any changes in the plan are required.

Everyone else works for you. And, as we have seen in previous sections, they are not that expensive and they are pretty smart.

If you can implement the System to successfully allocate you assets across promising investment areas, the investment community will do the time consuming work of finding the right stocks, bonds, commodities and currencies. And, because there are many investment companies competing for your attention, you do not need to suffer with an underperforming fund. If another fund gives you the exposure you want and better performance, you can simply shift your asset allocations to pick from the best of the best.

Why not let the fund management company do the asset allocation work for you?

You wouldn't put your top engineer or sales person in charge of your accounting system no matter how smart they are. Why then would you outsource your asset allocation to the fund management company when the fund management company specializes in following the mandates and trying to maximize the returns available within those mandates. Fund management companies would love to help you with your asset allocation but that is not how they are structured (or compensated) so the result is going to be suboptimal at best.

Successful asset allocation starts with the investor but there are tools to make the work more efficient. Using our system to help you quickly identify where you want to allocate you assets will allow you to have a solid asset allocation process and allow you to take advantage of the smartest people in the industry.

Asset Allocation

This is where the System helps the most. There are three aspects to asset allocation that you need to consider if not accept.

1. Just as in real estate, there are 3 things that count – location, location and location. You have to be in the right “neighborhood” to see gains.
2. Stocks in particular are uncorrelated on the way up – one sector rolls, while others are flat, but they all tank when the market tanks. Look at growth vs value indices. Growth always lags in the latter stages of a bull, but always gets slammed on the way down.

Portfolio diversification – like putting all your chips in every number of the roulette table. Of course it will pay off. But you just make your money. And 1:36 times, “00” comes up and you lose it all.

Location, Location and Location

Property investors will tell you that there are only three things that count, "location, location and location". Why? Because one cannot possibly know everything about a property any more that a portfolio of stocks or the likely demand of corn versus wheat. But, if you are in the right neighborhood or the right sector of the market, your chance of success increases dramatically. Alternatively, the best house in a bad neighborhood or the best stock in a falling market or the best agricultural commodity in a down market for agriculture is still going to lose you money.

The reason?

The market, any market, is the sum of all the buy and sell decisions taking place at any time. Some markets are liquid and some are not. Just because a market is liquid today does not mean it will be in one month's time when you want to sell. So, if you had a choice between two investment options, you would like to be in the market where buyers are and where they are likely to stay: the good location. Even better if you can find a market where buyers outnumber sellers.

Why? Because more buyers than sellers will put upward pressure on your asset price and with more buyers than sellers, it's easier to exit an investment when you decide to take your profits.

Another way to think of the "three L's" of real estate is "well bought is half sold". That does not just refer to price but liquidity as well. You want to buy assets that will be attractive to other investors in the future. Growth and Momentum investors should always

have this concept in their minds. Value investors, on the other hand, purposely seek to violate this rule by buying out of favor investments today in the hope that they will come back into favor in the future. That approach can work but it can also take a long time. And time is part of the problem. If we have defined our investment plan correctly, we know that time is a key variable and not one that we want to leave to chance. Our System is not a "value" system (although it will pick up "value" sectors when there is positive momentum in those sectors). We are looking to buy good assets that other people want to buy both today and in the medium term future. With the right location, we can't guarantee every investment will be a winner but we can try to avoid getting stuck in "great values" (and losing our ability to compound earnings).

Stocks in particular are uncorrelated on the way up

When we talk about asset allocation, we need to think about correlation between our investments or assets. Correlation is the core of all risk management systems. The concept is almost entirely geared towards loss mitigation. But, this is a tricky concept because correlation between asset classes and within asset classes changes constantly. In the real (non-investment) world, correlation doesn't seem to change so much. A good friend today is very likely to remain a good friend whom we can count on tomorrow, next year and when we grow old. A less reliable business partner is likely to remain unreliable no matter what the circumstances. The same is true for most of our economic interactions. The reason that these correlations seem to persist is that they are based on human relations. If we are a good friend to someone, it is pretty reasonable to expect solid friendship in return. If we work hard and smart, it is reasonable to expect rewards. Unfortunately, when we transfer the concept of relations from people to assets, we often conflate the amount of correlation we expect to find. Since assets in general and asset prices in particular don't have feelings, conscience or worries about bad reputations, the idea of correlation is fuzzy at best. The relationship between two stocks, or between bonds and stocks or between bonds and properties is constantly changing in all market circumstances. It is only by defining an artificial period and ignoring some of the more extreme outlying data that we are able to zero in on concepts like beta. But can beta really help us going forward? In a limited fashion and over a limited time frame in a stable market, yes.

But, that was not what correlation was really designed for. It was invented to keep a portfolio from suffering catastrophic losses. But, if the recent global financial crisis has taught us anything, there is really only one time when assets are well correlated...in a global credit crunch. Just when investors needed uncorrelated assets to stay uncorrelated the most, risk asset correlation approached a value of one just as everything turned down.

So, we can see that correlations don't hold when stocks go up, which is commonly called

sector rotation. And, in downturns, we can see that correlations approach a not very useful value of one. So, the only time correlations appear to hold steady is when the market is stable. There are two problems with that. First, stable markets are not yielding profit opportunities and as soon as their are profitable opportunities, the carefully calculated correlations break down.

One classic example of the problem with correlation is the age old argument between growth and value in the US institutional market. While growth and value can have slippery definitions, it is broadly true that growth has done pretty poorly against value in the latter stages of the bull market but interestingly, the "low beta" performance on the way up is reversed when the downturn comes and the same growth stocks end up getting slammed.

That is not to say that there aren't important financial relationships that do not hold up over time. A bond will rise when interest rates fall. A rise in commodity prices will cause margins to shrink at industrial companies and a rising gold price is a very clear sign of a weak US Dollar. Our point is that these correlations are not constants and should not be treated as constants. They can help us understand relationships between various asset classes but we cannot count on them to limit our losses in a meaningful fashion when relationships change.

Portfolio diversification

As an asset allocator, the final concept you need to come to grips with as you take control of your portfolio is diversification. But beware of defining diversification too narrowly. Diversification to avoid single stock risk (a big intellectual driver behind the idea of portfolio diversification) is already covered when you invest in funds and ETFs. So with that side of the diversification issue covered, do we really need to follow every bit of current concensus on what constitutes a diversified portfolio today? We don't think so and that is why our System seeks to redefine diversification.

Through most of the last 80 years, the investment experts have expanded the idea of avoiding specific risk to advising investors to keep their portfolios as diversified as possible at all times. Diversification for its own sake works on the assumption that the markets are very efficient, correlations will hold through market cycles and trends (booms and busts) do not exist. But we know that markets do not trade at some perfect value and that the correlations which make diversification so attractive don't hold through the investment cycle. Trends and fads exist in the markets and our System has been designed to find those trends. So textbook diversification is designed to limit your access to market opportunities by spreading your bets as widely as possible. If you spread your bets too thinly across the table, your payback may be steady but probably far less than what you will need to fund future liabilities. And, if you run into unusual market conditions like some that we have observed in 2008 and 2009, you might get clobbered from time to time as whole classes of assets fall together.

Traditionally, investors are steered towards a fairly fixed formula of equities and fixed income which is largely age dependent. That makes sense and we should definitely pay attention to the standard recommendations. Just because the concept has been spoiled by sloppy thinking does not mean that there is nothing to learn. But we need to concentrate on the future liabilities (investment goals) we want to fund and the market circumstances for fine tuning our asset allocation. Stocks may have offered superior returns over the past 50, 60 or 80 years but will they offer superior returns next year or even in the next three months? Bonds may have lagged but perhaps there is a reason to look at them. And cash has two purposes. It can lower the overall volatility of a portfolio but it also allows you to take advantage of opportunities as they arise. If you are fully invested and the market drops 20%, there isn't much you can do. If you had 15% or 20% in a money market fund, you could take advantage of a short term drop in asset prices just as "the Crowd" is forced to watch from the sidelines.

Think of the cash portion as your "opportunity fund". How much do you keep in there? It really depends on your investment experience, the opportunities in the market and how much time you can dedicate to watch your investments. Experienced, active traders will try to keep 20% of their assets liquid so that they can jump on opportunities. They feel that the lost opportunity cost is made up with better than average performance of their investments. But that takes time both to research the opportunities and watch the market closely. If you are successful in your career, you probably do not have the time to watch the markets that closely. Our system allows you to capture most of the strong moves in the market with just enough set aside in liquid assets to make the switches work (5%-10%). But at certain times, many investments will look lousy and the best performing asset may be cash. If that is the case, do not be afraid to follow the system and give cash a full weighting.

What about the loss mitigating benefits of a well diversified portfolio? Let's look at that two ways. Specific risk, the risk that a single company will fail, is already well taken care of in the funds that are on offer. If one company goes bankrupt, it may impact a fund's NAV but it will not wipe us out. In terms of market risk, or the risk that the overall market will fall, I think we have had a good test of that over the last 18 months in the Global Financial Crisis. If ever there was a time for loss mitigation through diversification, that was the time to test the validity of the concept. Unfortunately, it largely failed those who thought only of diversification in terms of equities alone. China, US, EU, Taiwanese and most other markets that we think of all fell more or less in line with one another. For those who included commodities like gold, currencies and bonds into their mix, the results were more positive although here again being in the right currencies and bonds made all the difference.

How about approaching diversification from a different angle? What if we invest systematically by selecting the top 3-5 investments from a well diversified pool of investments? Do we have to own all the assets all the time to get the benefit of diversification? Or is it enough to constantly screen a diversified candidate pool and pick the most promising investments on a regular basis. As long as our selection criteria were solid and ap-

plied in good markets and bad, it should be possible to get the benefits of diversification (lower portfolio risk, steady and good returns), without some of the downside costs (over diversification). And, although there is no guarantee that at some point ALL assets will fall together, having the ability to go into commodities, currencies and other non stock/ bond investments should allow one to avoid most of the damage from a market melt-down when correlations all converge on the dreaded "1". Long gone are the days when you could buy half domestic stocks and half foreign stocks and think you were well di-versified. The world is a global marketplace and you need to find a way to benefit.

In fact, the System does just that type of diversification without owning all the assets all the time. The System works best over medium and longer term horizons when a broad range of investments are considered. With a broad range and non-emotional rules, the System can pick out the most promising investments at any particular time. The diversi-fication comes from the range of investments that you consider when designing your investment system in the first place. If you pick a basket of Taiwan tech stocks only, then the benefit of the System in terms of diversification is going to be non-existant.

So portfolio diversification is an important concept for us to consider as we transform into asset allocators but let's make sure that we execute our diversification in a sensible way that helps us meet our long term goals.

Final thoughts

So let us summarize some of the ideas that will help you as you reorganize the way you manage your investments.

1. "Buy and Hold", "Stocks for the Long Run", - who wrote these? (fund sales people) and when did they write them? (in the middle of a secular bull market 1982-1999. Will they keep working? Who knows…but for the last 10yrs, it has not worked.
2. The interests of the fund management industry is in keeping assets, not enhancing return.

Your goals are to comfortably fund future liabilities, not beat a benchmark. A 50% loss requires a 100% gain to get flat. Better to miss part of a rally than be wiped out.

"Buy and Hold", "Stocks for the Long Run"

"“Buy and Hold” and “Stocks for the Long Run”" are great marketing phrases that were written by fund management company's sales teams to encourage investors during the secular bull market of 1982-1999. If you had some extra money, investing regularly in a generic fund yielded excellent returns. If you put money in Emerging Markets, the returns were fabulous.

The problem, as we have mentioned previously, is that investment is about buying low and selling high. You trade your cash (in the economist jargon, assets with zero maturity) for assets of a longer maturity (indefinite maturity in the case of equities) in the hope of reaping more cash when you reverse the transaction. If one only plans for the buying phase of the investment cycle, then it doesn't really matter what price you pay. If you are never planning to realize your losses or gains, then those losses or gains are not really important. That sounds ridiculous but is it really? How many times have we decided not to look too carefully at our monthly statements because we know that there are paper losses. How many times have you, your friends and your family members said that it doesn't matter because the price will come back. During the secular bull market and subsequent smaller runs, that has been true. But what about the last 10 years? Has that hope that prices will recover helped your investment performance? Now, what about the next 10 years?

The answer is probably no. But do not despair. The solution lies in matching your buying habits with some good selling habits. If you adopt good buying and selling habits, you will have a system that can help you remove emotion from your investing and put you in better control of your investments. Remember that your job is to control your investments not allow your investments to control you.

The interests of the fund management industry

Please be clear about one thing:

Your interests and the interests of the fund management industry are not aligned.

Your interest is in using the products offered by the fund management industry to earn an investment return that allows you to meet your future liabilities, no matter if that is retirement, education, vacations or whatever you choose to use your money for.

The primary interest of the fund management industry is to hold and manage your assets for as long as possible. Fund management companies can increase the amount of funds under management in two ways. They can invest well and benefit from market rises. They can also sell more units and convince existing unitholders to stay with the fund. Almost all fund management companies pursue both strategies. The former strategy is more aligned with your interests. The latter is less aligned.

But surely the investment management companies want me to have a good return?

Absolutely, and almost all of the executives individuals who get into the fund management business do so to help customers reach their financial goals. Unfortunately, while that is the fervent wish of most executives, they are not paid from the customers' capital gains but by the fund management companies themselves. And since the fund management companies get paid a percentage of assets under management, the main focus of the business plan is not your individual investment performance. While every fund management company hopes to have a good investment return, their business model cannot depend wholly on the whims of the market because of the high fixed costs associated with running a fund management business. Therefore, most of the efforts of the fund management company will concentrate on selling more funds and convincing existing shareholders not to sell. If all of that effort is followed by a good period of performance, the investment company will thrive. But if the investment performance is mediocre, a strong sales effort and asset retention plan will make sure that the company is still in business. That is not to suggest that anything wrong or unethical is going on. The fund management houses offer products that allow you to invest in opportunities much more efficiently that one could on one's own. The fund management companies are important partners to achieving your investment goals. However, with any business partner, it is important to have a clear understanding of each other's goals. Where they meet, good business takes place. Where they clash, one must remember that your goals take precedence.

Your goals

Your investment goals can be as simple or as complicated as you like. Since your investment funds are separate from your daily living expenses, remember that you invest to fund future liabilities. You need to define those liabilities and set an investment plan to meet them in the time frame that you have determined. Notice that none of this involves any mention of indices or benchmarks. Benchmarks are useful and interesting but not really part of your personal investment process. You can beat a benchmark and still lose money...how does that help you fund a future liability? Be careful to keep your eyes on the real goal, which is funding that future liability. If you lose 50% because the index you were tracking went down 60%, you can feel good about that outperformance but you must realize that you need to have a 100% gain just to get back to flat. And that will take time. So, not only do you have to find an investment that will double your money but if you are successful, you are really no better off than if you had left that money in the bank earning low interest. Absolute return is the key. Sometimes that is not possible. The Global Financial Crisis has damaged conservative, risky, medium risk, absolute return and every strategy in between. But, with a systematic approach, you would have been able to stop the losses before they became overwhelming and you would have participated in the rise in commodity prices and the excellent performances available in Latin America, Emerging Markets and government bonds as they arose. Remember, you control your investment destiny and your goals are what counts. Will you hear stories of someone making more money than you? Absolutely. And, if you can replicate the strategy without risking your goals, you should try by all means.

But our purpose here and on the website is to get you to think about how to structure your investment plan so that it meets your needs. By thinking about the amount you can invest, the goal that you need to meet and the timeframe, it is possible to structure a personal investment plan that will meet your needs. And, if the markets do not cooperate for a time, it gives you a good mechanism to review and adjust your plan so that you can get your investments back on track. We encourage you to look at our "System" as a template for your investment decisions. We feel that a systematic, non-emotional asset selection process is the best way to meet your goals with a minimum of stress and unnecessary losses. Our website has a free section which will allow you to look at some of the concepts and subscription sections which will take you further into the system.