

VI. Risk Aware Decision Making

Chapter 14. Asset Allocation – Tactical Decisions

*Strategy without tactics is the slowest route to victory;
Tactics without strategy is the noise before defeat.*
- Sun Tzu, Chinese military strategist, 490 B.C.

Key Points

- Tactics should adjust strategic risks
- Riskier investment portfolio strategies require more sensitive tactical controls
- Set tactical risk control boundaries within emotional and financial tolerances
- Recognize the risks that specific tactics add to strategies

Tactical Decision Making Overview

Tactics change strategic investment risks. A carefully planned wealth management strategy normally uses tactics to navigate through troubled changing circumstances. New situations may include personal risk tolerance, spending needs, or asset valuation changes. Tactical tools must be well understood for effective use. Investors and businessmen use tactics to adjust for risks differently than speculators. Investors employ tactics to support and maintain long time horizon strategies by attempting to reduce elevated risk periods. Speculators often use tactics with active strategies to take risks in noisy markets, where opportunities appear for short term gains. Riskier assets and portfolios need more responsive tactics and clearly defined risk boundaries to limit potential negative outcomes. A range of defensive and offensive tactics are analyzed to give the reader a sense of the market field of play in which investors and speculators operate. Finally examples, including the Martinez and Merton households, are presented to show tactical decision making in support of wealth management strategies.

Who uses tactics and why?

Investors and speculators use assorted tactics differently. The investor views tactics as ways to achieve arrangements or larger scale order to defend or support a strategy. The investor is normally focused on longer term wealth flows or strategies to meet objectives. The speculator sees tactics as stand alone maneuvers or offensive moves in short term battles to take gains from a counter party in the market place. A set of tools or tactics are used by the speculators to exploit market arbitrage

opportunities in order to achieve net winnings. Yet the speculator's strategy or pattern of using tactics to achieve gains normally does not tie to wealth flows; that are matching cash inflows to cash outflow spending or gifting. The investor usually uses tactics as defensive tools, while the speculator uses them as offensive moves. The Figure 1 Riskometer provides a visual depiction of adjusting the level of risk with tactics.

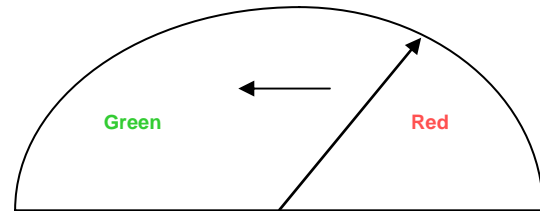


Figure 1. Riskometer

An investor may be driving through a rural section of an interstate highway with the cruise control set at 75 mph in a 70 mph speed limit zone. The risk taking is purposeful and the cruise control provides a tactic in quest of a strategy to arrive at an agreed upon destination on time. However, in the urban congested highway section the speed limit drops to 60 mph. The driver's risk increases. It is there appropriate to switch off the cruise control, drop the driving speed below 65 mph, and be more aware of driving. Attentively using manual controls at a reduced speed is an adjusted defensive tactic to arrive at the destination safely (primary strategy), even though delays may mean being a little late.

A speculator may be in the same situation, but uses different tactics to play an imagined game with potential highway patrol officers, while on his or her way to the same destination. Radar warning or linked cell phone patrol car warning systems are tactics to take risks, possibly driving at 80 mph in the rural highway zone. The warning tactic is adjustable in the congested area for the flow of traffic. Yet it is a risk taking tactic to remain near the red zone and gain extra minutes of time off the road. The focus is on a set of maneuvers or tactics to define a strategy, instead of adjustable defensive tactics to achieve a previously established strategy.

Investors are generally focused on long term strategies and try to stay within the tolerable risk green zone. Tactics are the tools to take one's

foot off the gas or hit the brakes as needed. Speculators use tactics to test where the red high risk zone may be. They at times take added risks or step on the gas to beat a forecasted storm arrival at their home or set a time record. There are times, when speculator tactics achieve objective results better than investor strategies/tactics. Yet investor tactics focused on protecting assets usually collect smoother cash flows.

The short sale (selling an asset prior to repurchase) is a special tactic used differently by investors and speculators. The investor uses a short sale (or inverse asset buy) as a defensive tactic to protect or offset a potential loss on an asset, which he or she does not or can not sell for various reasons. The investor is attempting to match a primary asset decline with a secondary asset decline. If primary and secondary asset prices drop and a secondary short position is bought back, gains on the short sale should offset the (protected) primary asset holding loss. On the other hand, a rise in the primary asset price would also be offset by a rise in the secondary asset (prior to repurchase) price.

The speculator may make an asset short sale as a simple bet that it will fall in price and he or she can buy it back at a lower price for a net gain. Probabilities of gains (losses) and estimated potential gains versus losses are calculated. The tactic is focused on the market price action. Underlying economic asset value does not matter. If a lower price is reached and the sold asset is bought back (covered), the speculator takes an offensive tactic gain from the market. If the asset increases in market price, it must be repurchased at a stop loss point without question. The pattern of speculator tactical bets and total transactions translate into an overall strategy.

Investor Risk Common Adjustments

An investor, as described in Chapter 13, usually uses strategies that try to match incoming and spending cash flows based on objectives. Time horizons and spending cash flow patterns are critical to adjust the riskometer into the comfort zone. Longer time horizon potential cash flows can be managed in the moderate 65 mph riskometer range with acceptable comfort, if gauges measure changing risks and tools govern the risks back into the acceptable zone. Gauges should measure asset valuations, behavior biases at the point of decision making, and current market prices. Tools should be fully understood

and as simple as possible. Decisions, when asset operating valuations fall below market prices, can effectively implement a range of defensive tactics. The simplest one is to sell risky (over valued) assets and consequently buy risk free assets (cash). Overvalued small growth company stock funds may be sold and proceeds held in a money market fund. More risky (equity) assets can also be transferred to less risky (balanced or bond) assets. Estimating overvaluation (or under valuation) is the hard part. Judgments should be focused on the future asset operating cash flows and market valuations. Time horizons are very important in deciding on the range of tolerable valuations. The simple decision is to sell an asset when its price falls below a strict stop loss price and preserve cash during uncertain periods. The judgment may be rationally simple, but its execution is frequently emotionally stressful. Market price charts are useful for noticing that unacceptable loss limits have been reached.

Speculator Riskometer Common Adjustments

Successful speculators operate with simple gauges and tools focused on rough and tumble market prices. Speculators often view markets in terms of volatility that match their time horizon comfort levels. Day traders open and close positions on the same day based on perceived favorable patterns using leverage, while scalping for small gains. Position traders tend to use more fundamental data, less leverage, and may hold asset positions as long as months. Successful speculators, such as Jim Rogers, usually hold positions for months. Data (information) feeds, useful charts, and the ability to make quick decisions are critical to quantify risk, as well as set entry and exit points. Speculation increases trading volume and tends to support liquid, continuous asset trading markets. Speculators add noise to markets by the nature of pattern seeking trades. Speculator risk adjustment tools, including trade return/risk and probability of success calculations, are useful. They both add and reduce market risk through taking price discovery bets and pausing after losing trades. Bubbles occur when investors lose sight of fundamentals and speculators drive the momentum vehicles far from fundamentals.

Changing Circumstances – Adjust Strategy

Investors should have long time horizon wealth flow plans. After strategies are put in place, changed circumstances tend to result in new spending needs. Births, divorces, and deaths occur more frequently than winning the lottery.

Human and financial capital must be applied. Strategy changes for unplanned circumstances are complex. The spending time horizon impact is often a multiple number of years. Adjustment tactics may combine human capital income and more certain lower risk investment cash out flows for the new spending needs. Risk reduction tactics generally respond to household budget gauges with value oriented spending. Longer term retirement spending objectives and related strategies may be reduced. Normally equity assets change to more secure dividend or principle repayment cash flows at lower expected total returns. Attractively priced equity value or growth and income funds may replace aggressive growth or emerging market stock funds. The suggested rational tactics for changed circumstances require self discipline and dialing down the risk meter. The convenient approach (not suggested) for many emotional households is to increase risk through taking on more debt and operating in the red zone.

New certain circumstances can also be addressed by transferring risks. Intermediate time horizon property, casualty, catastrophic health, income, and life human capital risks can be transferred to insurers for a premium. The tactical judgment is to buy only what is needed. Similarly, long term objective risks can be reduced by making full use of employer benefits. Both 401K tax deferred savings and pension plans can be used to reduce retirement spending objective risks. Naturally, they are most valuable with longer periods of participation. 401K plans with life time annuity payouts at retirement effectively transfer moderate risks to employers in the same way that lifetime pension payouts do. Transferring some risks is a sound tactic for reducing total risks.

Investment Outlook Changes – Investor’s View

Simple tactics are generally suggested for investors to deal with changes in cash flow sources or more broadly portfolio asset valuations. The approach is to preserve near term certain (risk free) cash outflows and to keep portfolios diversified with relatively strong price trend (not overvalued) asset classes, during the total portfolio risk level adjustment process.

The following portfolio gauges are suggested to monitor portfolio risk.

- Review asset price (also volume) charts, if available, to see if stop loss limits are exceeded and immediate action is needed.

- Review quarterly or monthly fundamental data provided to a federal agency (SEC), by a federal authority (FRB, Treasury, Labor, or Commerce Department) or by a corporate announcement (new CEO, product, M&A) to estimate if the asset outlook (valuation) has changed.

The idea is to set up investment tactics based on valuations and reduce holdings in assets, which are in clear declining price trends. A diversified portfolio should include enough assets for both varied (moderate and low) volatilities and different correlations ($0.0 < \rho < 0.9$) within a person’s capacity and interest to monitor. The ideal portfolio size for most investors is ten equally weighted assets.

Investment equity assets become over or undervalued based on the relationship of new fundamental data and present market asset prices. Yet, the critical psychological factor is investor sentiment. It is reflected in the effective premiums and discounts to normal Price/Earning (P/E) ratios (or E/P yields) paid for equity assets. During euphoric times such as the late 1990’s equity P/E ratios far exceeded the long term S&P 500 ratio of 14. Alternatively, during the uncertain late 1970’s through August, 1982 the P/E ratio fell to single digits. A forward 12 month S&P 500 P/E ratio between 12 and 16 indicates normal secular investor equity sentiment. Market P/E ratios above 16 generally indicate stocks are overvalued and low or non dividend paying assets are overly risky.

Buying assets on sale (under valued) and selling assets at uninformed buyer levels (over valued) is extraordinarily difficult in a dynamic market. An investor’s bias toward value type assets or growth type assets indicates what gauges and tactics will be personally most effective.

Value Asset Investing – Tracking Cash Flows

Value investors are often focused on longer term cash flows and a safety margin for their continued generation. Their preference is for stable, but not overvalued, good quality assets. The most useful security market price gauge is a weekly chart, without hourly or weekly price change noise. Simple weekly price charts and Point and Figure (PnF) charts serve the purpose of limited market information to identify trends. A normal PnF chart uses daily security price information with a so called 3 box reversal rule to depict trends as shown in Figure 2.

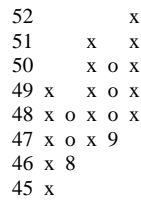


Figure 2. Point and Figure Price Gauge

The basic rules are increasing price (demand) is shown by an “x” and decreasing price (supply) is shown by an “o”. Each character equals 1 box (dollar) and 3 boxes in a direction are needed for a reversal. Time is shown by the month (8 = August, 9 = September, etc.) in the first character added in a new month. In the example, the chart (gauge) shows higher high prices, higher low prices, and a simple advancing trend. More details are used to establish intermediate or longer term reversals¹. The value investor looks for the longer term price trend reversals to indicate an alert to review fundamental valuations. Simple weekly price closing charts often include 39 or 40 week moving average overlays. A price crossing the moving average also indicates a price trend change, as will be mentioned in the speculator gauge discussion.

The investor fundamental data gauges are the macroeconomic monthly or quarterly data related to industry or asset funds and corporate security financial statements and declarations. Reviews are needed to maintain rational confidence that the trends are not unfavorable. Then asset price is periodically (i.e. quarterly) compared to valuation to decide if an asset is over or undervalued. The income type asset has an advantage of relatively slow price and valuation changes in contrast to the growth asset. Equity dividends or returns of capital and bond interest payments are tangible cash flows, which differ from projects for possible revenue and total earnings or corporate stock buybacks for statistically increased earnings per share. Value investors trade less when cash flows are steady.

Growth Asset Investing – Revenue Surprises

Growth investors are normally focused on unexpected or explosive revenue growth. Their biases often lead to smaller or single product related equity assets. Their motto is “larger returns require larger risk taking”. Growth investing requires more gauges than value investing. It is often a midway point on the spectrum between value investing slower

moving risk gauges and speculation faster moving gauges. Growth investors and speculators must consider behavior biases more than value investors. Growth story stocks such as the early 1970s “Nifty Fifty” (Xerox, Polaroid, etc.) and late 1990s “Techs & Telecoms” (Sun Microsystems, AOL, etc.) at times become extremely overvalued, when herd mentality of over confident gamblers play the “greater fool” momentum game to extremes.

Amplifications of behavior biases can occur at any time. Equity growth investors need more frequent market data to see both intermediate and short term risks. PnF charts are often inadequate because they lack the footprints of volume. Simple weekly price charts also lack enough data for most people to spot major volatile asset trend changes. Growth or high volatility asset investors usually need daily price and volume information to notice confirmation of changes in trends. Multiple above normal price/volume accumulation (up) or distribution (down) days are alerts that things are changing. Daily corporate, industry, or regulator news should be found to confirm the valuation change. If no fundamental related information is found, the high risk asset investor should consider that the market knows more than he or she does.

The growth investor must also have some knowledge of analyst or expert opinions. They may prove to be random in accuracy, since few analysts show consistent skills. However, they are often driven in herd patterns similar to normal investors. Even without conflict of interest or ethical issues, analysts are pattern seeking human beings. They forecast quarterly asset sales and earnings trends based in part on corporate or government data guidance. Forecasts and guidance patterns may become predictable with quarterly earnings report positive surprises and momentum speculators added demand. Eventually, the quality of earning statements or the actual earnings fail to meet forecasts. A 25% growth asset price decline in response to an earnings setback or poor drug late stage trial result is normal. Growth asset investors should seek and test new risk information gauges periodically. Judgment is needed to notice if asset valuations are getting ahead of fundamental valuations. Some tactics to deal with these high risk finding will be suggested.

Speculators – Be Aware of the SNR!

Scientists and engineers understand that a strong Signal to Noise Ratio (SNR) is needed to find signals in the midst of noise. It is easy to get fooled into thinking signals exist, generate false alarms, and never confirm tracked targets or clear real images. Talk with a radar operator or a biochemist about real data confirmations. The speculator has a more difficult SNR problem because speculators and other asset transaction players operate with different time frames and risk tolerances. Relying on past price patterns to find signal patterns in the midst of variable noisy transactions is darn near impossible. Speculators are trying to find robust SNR patterns that will continue so that a profitable transaction can be executed. A game of probabilities and clear decision rules are needed to avoid unrecoverable losses, while seeking to take some profits from the market. As market noise changes, the smart humble speculator is wise to close losing positions and recognize that new tactics may be needed.

Gauges for a noisy market should be based on a data frequency that is well-suited to a speculator's time horizon. If day traders plan to open and close transactions on the same day, their data should include more price and volume samples for manipulation into data moving averages (MAs), crossing MAs, and volatility measures. The idea is to exploit high probability pattern trades in nearly a zero sum game. Fundamental and behavioral data is ignored. The speculator's motto is "all information is reflected in the last transaction price." Their challenge is to remain aware of possible different term trends that may effect probability calculations within the speculator's time horizon. Equity market prices tend to advance in the long term due to productivity and currency inflation. It is wise for equity market speculators to be aware if their time horizon bets are supported by longer time horizon trends.

Risk Boundaries

Risk limits are boundary conditions, where investors and speculators say "enough, I am getting out of there". Normally, emotional stress (sleepless nights) is the primary reason why people sell assets that have declined to unacceptable market prices. Fear that the asset will decline to lower market prices, become illiquid, or worthless are powerful behavioral drivers to alleviate the stress, recognize the loss, and end the uncertainty. Yet, emotional stress

risk boundaries are variable, humanly normal, and usually an ineffective way to manage wealth.

A good approach to get a grip on behavioral risks is to do thorough pre transaction scenario analysis and post transaction learned lessons analysis. The rational approach requires self discipline, the ability to draw unequivocal loss limits, the wherewithal to execute the plan, and the perseverance to repeat the process until it becomes a habit. Documented scenarios will not play out precisely. Unimagined events will occur. Yet, past experiences and process used to briefly define worst, expected, and best scenarios may lead to taking measured losses bravely and unexpected gains humbly.

Experience leads to thoughtfully owning assets, whose market value range should be set within rationally defined risk limits about 95% of the time for low to moderate risk assets and 75% of the time for moderate to higher risk assets. Reflective risk boundary settings result in infrequent emergency control actions.

The following example illustrates risk boundary settings. A large capitalization index equity fund currently has a volatility measure of $\sigma = 10\%$ and expected normal annual return of 7%. That implies the normal price for the last 3 years has been above the -1σ level 84% of the sampled months and above the -1.7σ level 95.5% of the months. An investor may set a -10% loss boundary. In this scenario, a -1.7σ price loss ($7\% - 17\% = -10\%$) below the purchase price. A 4.5% down side probability event would trigger a risk boundary action. September, 2008 market declines would likely have hit the risk boundary. The specific response should be based on portfolio diversification. Selling $\frac{1}{2}$ of the fund shares may have been a good response at that time of great uncertainty and avoided a further 20% decline by yearend. Conversely, a 4.5% up side probability event ($7\% + 17\% = 24\%$) gain may be a gain risk boundary setting for transferring $\frac{1}{2}$ the mutual fund assets into a lower risk bond or balanced fund.

Risk boundaries for illiquid assets should be wider than liquid assets due to bid/ask spreads. Similarly risk boundaries for more volatile assets should be wider than for less volatile assets. Remember risk boundaries are emergency rational controls set prior to purchasing an asset to respond to high (over/under) valuation uncertainty. They are set to replace emotional

stressful inaction or rash action to end immediate stress (but lead to later investment paralysis). Recognizing human nature, the emergency brakes are primarily meant to limit losses. Yet, during long term periods of stagflation or sideways moving markets, risk controls are a good complement to over valuation analysis in spotting asset classes that become very risky. They are useful for all types of investors and speculators.

Tactics for the Moderately Risk Adverse Investor

The value oriented investor constructs cash flows that focus on quality assets, which either pay out income or a combination of growth and income. An orchestrated portfolio management approach includes asset types, which rarely require tactical adjustments, asset types, which may be trimmed under defensive conditions, and asset types, which are more likely to be sold under specific risk conditions. The strategy is consistent with a low to moderate risk tolerance focused on matching cash in and out flows. A retirement spending objective implements a suggested strategy, where the first 5 years of retirement (ages 65 to 70) have matched nearly risk-free pension, annuity, social security, and laddered maturing bonds (including bills and notes) and CD payments. No tactics are needed for these cash flows.

Assuming a household ultimate life time horizon through age 95, a goal of 25 more cash flow years is needed. Tactics are needed for growth and income cash flows with annually reduced risks for 15 years (to age 80). All subsequent cash flows should be near risk free. An example tactical approach uses a conceptual core and satellite portfolio asset set. Figure 3 is a schematic of the growth and income part of retirement spending cash flows.

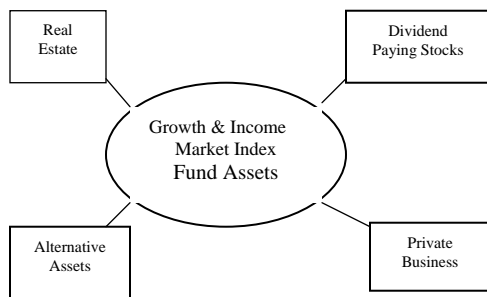


Figure 3. Core & Satellite Growth & Income Assets

The growth and income assets complement the nearly risk-free, yet illiquid and non changeable cash flows listed above. For many households 50% risk-free cash flows provide a good balance of retirement spending resources. The remaining 50% of assets will be managed with some degree of tactics. Core assets for the passive investors without significant real estate or private business holdings are suggested to be 25% of the asset values. Few tactical adjustments are expected if assets consist of market index domestic and foreign sets of equity and bond funds. Equity and bond (avg. duration 5 years) fund growth rates are expected to be 3% and 1% above inflation. In most cases, annual (June 30 mentioned Ch. 13) asset weight rebalancing based on asset valuations exceeding defining thresholds is part of strategic adjustments. In the long term equity asset valuations tend to advance toward their defined upper limit threshold weights more often than decline toward their lower threshold weights due to general economic productivity. For the retired household seeking gradual lower portfolio risk levels with time, rebalancing tends to result in transferring equity funds into bond funds. In economic downturns, the risk boundary alerts will most likely trigger the tactic to reduce equity weights. Yet, end of fiscal year rebalancing may be the likely decision point to increase equity weights to normal levels.

The dividend paying stock holdings will be the suggested primary satellite source of cash flows for most non-business, non-financial expertise households. Tactics will be primarily used with these assets, which may comprise 25% of total cash flows. The real estate professional or other businessman may accumulate a significant weight of wealth in real estate or a business. Similarly the financial expert with knowledge and a network of skilled managers may accumulate half of his or her wealth in private equity, hedge, or commodity funds. Those individuals develop operational tactics relevant to their specialized assets that differ from the core and satellite approach toward cash flow portfolio management.

Non controlling interests in dividend paying stocks, such as the S&P Aristocrats mentioned in Chapter 13, offer the opportunity of steady dividends, share price growth, less than normal stock price volatility, and less than normal correlation between asset price movements (if stock selection is diversified among economic sectors.) They also offer tax management

flexibility, when held in non tax-deferred accounts. That is tax gain/loss matching or tax loss harvesting. In recent years, a wide variety of available Exchange Traded Funds (ETFs) offer a comparable alternative to individual dividend paying stocks with less attention needed for specific company fundamental valuations.

Suggested tactics for equity asset holdings are:

1. Weekly evaluation of stock or fund price to determine uptrend or downtrend
2. Quarterly review of 10Q or annual review of filed 10K report, including the Management Discussion & Analysis and footnotes, in addition to appropriate financial metrics
3. Set border of tolerable over/under valuation (+/- 30% ??) and actions to be taken
4. Revise personal stock valuation based on financial report review. Then check at least one analyst review for any issues not found in your review. Modify valuation if needed.
5. Consider selling stocks in a price downtrend or 20% below the recent 3 month high level or valued more than 30% over market price.
6. Consider buying stocks in a price uptrend if valued under the market price or not trading in a price downtrend and value is less than 30% below market price.
7. Assuming 5 to 10 dividend paying stocks or value type ETFs about equal weighted for around a 25% portion of portfolio potential cash flows, then ½ position (sale/ purchase) adjustments are suggested. Other constraints include: any 2nd consecutive asset adjustment sale is suggested to be the total remaining asset holding (not ½ x ½). Finally, no asset value in the risky portfolio should exceed the smallest asset holding value by more than 2.5 times.

Less involved or inexperienced investors may consider the suggested tactics overwhelming. The tactics are general suggestions to manage asset portfolios for limited volatility, limited emotional stress, disciplined profit/loss takings, and steady risk adjusted growth.

Tactics require effort and study to determine if assets are over/under valued. Notice market uncertainty which may precede major corrections (declines). The tactics are not guaranteed to maximize profits or minimize losses. They are meant to support a balanced portfolio cash flow focused strategy with adjustments in risky asset positions as needed to earn modest growth, while preserving wealth during uncertain periods.

Are ETFs managed differently than stocks?

ETFs are managed with a macroeconomic (interest rates, leading indicators, inflation, etc.) or economic sector focus, instead of individual company fundamental focus. The macroeconomic news effecting employment, consumer sales, and production, as well as interest rates, inflation surprises, and exogenous uncertainties (wars, national threats, and natural disasters) are important and factored into general market expectations. Following reports from a single economist with an above average 3 year forecasting record is a better way to remain informed than watching the entertaining commentators, who generally add noise and confusion. Macro economic information simply supports convictions, when making decisions. Chart evaluations to notice up and down trends and max risk boundary settings are most useful. Yet, the boundaries should be thoughtfully set based on the volatility of underlying ETF assets. Determining when asset indexes ETFs are over/under valued is difficult to do precisely. Another tactic is to compare relative strength² (RS) between ETFs over the past 3 months and setting actionable borders (e.g. 15% changes) in addition to tracking price up/down trends. The tactic notices significantly lagging ETFs (economic sectors) during the beginning of a broad market rally. Only about 10% of the time will uptrend conditions be set up for adjusting effectively from lagging to strong leading ETFs.

Are simplified tactics possible?

Tactics can be simplified for investors, who prefer to have an advisor manage a portfolio with a similar strategy for a fee. Otherwise, the riskier part of the portfolio concentrating on risk adjusted growth, can either be transferred to an active or passive fund manager. Beware that an active mutual fund will usually be more volatile than a passive mutual fund. Yet, only the best 20% of active funds outperform passive funds. They also distribute more taxable gains and dividends related to their added asset turnover (transactions). Expect no more than a 2% annual advantage with an actively managed fund over a comparable (e.g. large value stock) passive fund. Lastly, plan to hold the fund for long periods without any tactical adjustments, if thoughtful previously discussed risk boundaries are not set. Be aware that studies show selecting last year's top performing funds is simply a momentum chasing approach that is normally less profitable than holding a comparable passive fund.

Moderately aggressive businessman tactics

The small business person with an emotionally high risk tolerance, as well as a time horizon more than 20 years from planned cash outflows, may use different risk adjustment tactics to control greater risks. The portfolio may include a very small growing portion of post retirement cash flow sources such as a pension and promised social security payments. However, his or her core and satellite approach would be different. Business equity should be the core asset. Satellite assets may be the low correlated, but potentially complementary assets depicted in Figure 4.

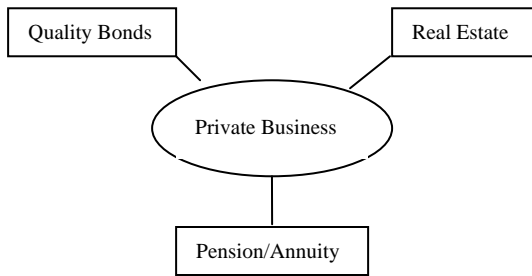


Figure 4. Core Business & Satellite Assets

The business owner is generally mentally programmed to take entrepreneurial controlling asset positions. His or her high risk taking is focused on the core asset; the business. The business tactics related to customers, suppliers, competitors, and regulators are expressed in non statistical volatilities and correlations terms. Tactics to control critical issues and hold a line of credit for liquidity are instinctive issues. However, a broader strategy for long time horizon retirement spending or legacy objectives is suggested. Real estate properties, such as residential apartments or small strip malls, are controlled assets, which business owners are familiar with. Annual or longer term lease agreements should provide steady income under most business conditions. The properties are also useful during emergencies for shelter or temporary retail and light manufacturing space as needed. Steady income and emergency usefulness may offset operating business variability. A portfolio of quality bonds, such as TIPS or shorter duration investment grade bonds may be difficult for the business owner to relate to. Yet the suggested debt assets are liquid and offer flexibility for possible capital projects that a banker may not fully fund. Real estate and debt asset resources provide the business owner flexibility to implement specific tactics to maintain and grow the business when proper.

Pensions or annuities are natural retirement cash flow source satellites for the business person to accumulate over time. The issuer manages assets for the agreed upon payout conditions. No pensioner or annuitant asset tactics are needed. The assets simply smooth out the retirement cash flows at a distant time horizon.

Speculators' Tactical Philosophies

The short time horizon speculator plays a zero sum game. His or her gain is the counter party's (market's) loss. Experience, an exhaustive screening/tactics methodology, and an anxious disposition are needed to spot and profit from changing market sentiment patterns. Successful speculators have fundamental knowledge and a time frame, days or multi-month positions, within which they know how to trade. They have fine tuned risk management tactics focused on precise asset price set up patterns and post transaction analysis for fine tuning position entry and exit points. Consistently useful speculation tactics can not be taught and used by large groups of people. When the same tactics are used by many speculators, they impact markets and others figure out how to anticipate the tactics and counter them at vulnerable trading lulls.

Risk management tactics focus on limiting losses and pondering the process, when uncertainty or anomalies overwhelm judgment. Successful traders notice and anticipate the moves of other players with quick decisions. They use price and volume charts, derived moving averages, crossing points, and volatility plots. Exploiting patterns expected to continue for a gain is the name of their game.

Program trading in groups of 15 or more stocks valued at over \$1.0 million per transaction averaged more than 30% of the trades on the New York Stock Exchange (NYSE) in the 2007 to 2009 period. Program traders are large scale speculators, primarily working for money center and investment banks. Goldman Sachs is now the largest and most profitable institutional speculator. Their success is based on detailed software programs executed to exploit general market mispricing opportunities. Complex program trading tactics include risk management buy (long) and sell (short) paired trade orders in multiple public (NYSE) and semi-private markets. From the individual speculator's view, program trades create big ripples in trading patterns that must be filtered out to spot the smaller scale individual securities opportunities.

CANSLIM – Quant Tactics - not a diet drink

A popular set of equity security tactics was developed by William O'Neil, the founder and owner of *Daily Graphs Online (DGO)* and *Investor's Business Daily (IBD)*. *DGO* is a detailed database of corporate financial data and related stock price and volume charts that is sold primarily to institutional investors. *IBD* is an innovative business newspaper that includes detailed stock information used in O'Neil's set of methodical tactics that are abbreviated as the acronym CANSLIM. The tactics include fundamental growth oriented screens, new operational or market catalysts, market liquidity, sponsorship, price relative strength, and market condition measures. C refers to current earnings momentum, A stands for stable annual earnings growth, N refers to a new revenue catalyst or high price, S stands for minimum shares traded, L refers to relative strength price leadership over the market in the past year, I stands for institutional ownership, and M refers to the stock market's intermediate term trend.

O'Neil's tactics are a rules-based methodology adjusted over the past 30 years, since he introduced them³ to his *DGO* subscribers. They are a quantitative growth set of tactics that is most effective in buying and holding growing small company stocks during intermediate term advancing markets. Specific tactics to actually buy and sell stocks require judgment, because stocks rarely set up in ideal price and volume patterns. The tactics result in volatile annual returns and high stock turnover for technical speculators, who have the disposition and discipline to quickly take losses and preserve resources to survive periods of declining market prices (bear markets.) Be aware that during an 18 month or longer bear market there will normally be 3 or 4 times, when CANSLIM market indicators turn prematurely positive. Stocks that are purchased during those periods often must be sold quickly to limit subsequent losses. The tactics are quite effective during market advances, when speculative fast growing stocks may rise 3 times as fast as the general market. The set of tactics is used by many hundreds of thousands of followers. Anticipation and specialist selling raids occur on fast rising CANSLIM stocks, which add volatility to a speculative quantitative set of tactics. Non value oriented quantitative small investors gravitate toward this organized set of tactics that sometimes leads to large gains in a portfolio of richly priced risky stocks.

Tactics define unstable speculator's strategy

Investors' tactics generally flow from and provide adjustments to strategies implemented to achieve objectives, such as retirement spending and wealth legacies. Cash flow matching is a favorable attribute of investor wealth strategies. Speculators' tactics usually have a purpose of walking away from the game with the largest pot of money. That is terminal cash out victory. The set of tactics, such as CANSLIM, are very effective and profitable during favorable stock market advances. They differ from gambling, because they are based on solid probability observations – long term increasing earnings result in high stock returns. Yet high market volatility results in a high risk strategy with erratic cash flows. The risk management approach requires discovery risk taking to find when favorable opportunities are available. Many successful speculators develop erratic financial accounts. Their wealth is ephemeral, if fortunes are not partially distributed during good times. Speculators live on a roller coaster and unfortunately the market has more resources than they do. The lack of a risk reduction strategy over time leaves them vulnerable to running out of resources during high risk times.

Tactics for the split personality investor

Shades of gray exist between investors and speculators. Human nature is multifaceted. Some take-charge people like investing most of their objective oriented assets rationally and speculating with some resources. It is important to think of the total portfolio of assets and keep the speculation to a minimum (less than 25%). Consider that most professional stock fund managers with over \$1.0B assets under management do not produce after tax returns for their shareholders better than a simple long term held S&P 500 index fund. All things considered, I suggest not expecting to achieve better speculative results than the index fund. The volatility of cash flows will likely be greater. Yet, it will be an interesting learning experience. The summarized O'Neil tactics are a reasonable place to start equity speculation. Other niches should also be explored, where knowledge and tactics may produce positive returns. Seasonal conditions due to tax loss selling may make purchasing attractively priced under valued assets possible after the beginning of the year. The bond market sometimes has low demand periods where tactics can support buying undervalued municipal bonds. These are a few ideas for your speculative interests.

Scenarios and tactics

There are periods when the investor's assets are undervalued and the speculator's price patterns behave abnormally. Both situations can be due to general pessimism and malaise, where economic and behavioral decision making relationships don't make sense. These fearful circumstances may occur after asset bubbles are burst and emotions take valuations to extremely depressed, illiquid levels. Probabilities should account for these worst case scenarios. The discussed back up risk boundaries may be reached and a tactic may be to just sell some uncertain positions. Alternatively a diversified portfolio may be held. Analysis should determine if under valued and illiquid assets can be held at zero tangible valuation without effecting intermediate term spending or other cash out flows. The capacity to hold on allows one to have faith and confidence that the asset valuation will return to normal.

Specialized Tactics – Risk Transfer for Wealth Preservation

Insurance has been discussed often as a risk transfer decision in exchange for a premium. A useful tactic, when an asset price decline is feared and premiums are low, is to purchase an option to sell (put). The time period specific right can be used to buy protection. Purchasing protection through put options on restricted company stocks is often more comfortable for investors than simultaneously shorting and holding the stock. The put right to "sell at a set price" until an expiration date is purchased at a market premium. An investor may consider buying an at-the-money put option with 6 months to expiration for possibly a 5% to 10% premium relative to the held asset to be protected. The protected asset's risk is nearly neutralized by the put option during the period of contract. At expiration the option maybe worthless if the underlying asset rises above the protected price or it may be sold at roughly a price equal to the difference below the underlying asset price.

Portfolio Tactics Involve Uncertainties

Portfolio investing and general speculating tactics deal with an undecided dynamic world. Tactical risks are taken to try to reduce strategic risks. Simply rebalancing diversified portfolios that drift out of acceptable weight ranges is the simplest rule based adjustment to guide a set of future cash flows within a tolerable portfolio volatility (risk) level. It should perform better than a simple buy and hold strategy that may be

prone to float to higher portfolio risk. Added discussed tactics are useful in a dynamic world where circumstances and cash flow needs change. Yet, tactics do not guarantee desired results. Higher numbers of tactical changes add the risks of poor logic or decision execution. Planning and the least number of high value tactical moves make as much sense in portfolio management as in a game of chess.

Common tactics to avoid

Some individuals entertain the idea of "doubling down" when plans are not working. That is either using financial leverage with various types of loans or confidence leverage through concentrating resources on a selected single asset. Both tactics, I believe, should be avoided. There are few sure things in life. At times, even long term trends, such as upwardly advancing home prices in a long term moderate inflationary economy, change. Financing a business with bank loans or lines of credit is often necessary. However, passive non-controlling investment leverage through various types of margin tactics is not suggested. Some people confidently concentrate investment resources on a single asset for a quick advance in market value. Ignoring diversification benefits will subject a portfolio to higher volatility risk.

Tactical Strategy Examples

The Martinez household is our simple middle class family example with SSA and pension monthly payments expected to supply nearly 50% of their retirement spending objective cash flow needs. Prior to retirement, Robert plans to grow a 401K portfolio of core moderate risk 60% equity and 40% bond index funds through contributions, company matches, and 8 years of modest positive returns. The plan is a simple core assets strategy. Rebalancing from equity to bond funds may occur at the annual asset allocation review, if equity fund shares appreciate significantly during a stock market advance. Recall that rebalancing is considered a risk reduction allocation measure and not a tactic. Robert may also set a risk boundary on his equity fund at a 10% nominal decline, similar to the previous discussion. (A 4% annual inflation is expected in addition to 3% real return for a 7% annual nominal return.) The risk boundary is the only tactic suggested and would be executed as a 50% transfer from the equity to the bond fund. Its purpose is to recognize uncertainty and move partially out of the risk of a bear market (20%) decline. Rebalancing and risk boundaries reduce

portfolio risks in response to different catalysts – increased risky equity portfolio weighting and uncertain decreased risky equity valuations. In either case, missing opportunities of increasing equity valuations after the change are possible. It is reasonable to expect less than one annual change of either type will be made with the suggested tactic.

The Merton family is our example of a small business focused household with strategies to potentially meet a dual objective of retirement spending and growing a legacy business for either Peter or Sarah to lead after Terrance's retirement. Tactics should primarily be developed to grow the core specialty machine parts business. Secondly, portfolio investment risk control tactics should also be developed to keep the total family business and passive investment asset risks diversified, as well as flexible.

Terrance and Carolyn are 35 years old. As their business grows, risk controls and tactics likely will concentrate on operational cash flows or the cash conversion cycle between accounts receivable, inventory, and accounts payable. In addition to working capital, tactics secure financing for equipment, software productivity aids, and overall stable lines of credit. Tactics respond to the volatility of sales agreements and financing policy provided to customers. A steady flow of specialty product contracts paid for on delivery should minimize account receivable and inventory levels. Stable, low levels of working capital with tight process controls require fewer related tactics. As the business grows and expansion projects increase, either the process controls must increase or the tactics to respond to new situations must improve. The process controls generally reflect a strategy and should result in limiting tactics to address unexpected scenarios.

The Merton's tactics with diversified personal investments may offer the flexibility to survive unexpected core business difficulties. The entrepreneur does not usually think in terms of growing satellite uncorrelated investments for potential use during tough times. That requires wide ranging diversification. Yet, Carolyn's defined background in this case study may be ideal to steadily grow a potential self financing business emergency account. The suggested investment account strategy includes a moderate risk tolerance because the time horizon for the

possible business use of the funds is undefined. Carolyn may begin the process by saving funds in tax deferred accounts. She may even purchase an adjacent building to the machine parts fabrication building as a household investment. Ideally, lease rental income will result in positive cash flow. If needed, at the end of lease term the building may effectively be leased or sold to the business account for an efficiently located building. Tactics are primarily suggested to implement strategic business decisions. Other liquid investment assets may be used to simply respond to a business cash flow crisis. Given the alternatives, it is better to plan ahead and be self reliant during difficult periods, than to use resources and much effort to work through a bankruptcy process that also harms lenders or other stakeholders in the business. The Mertons must develop a wider range of tactics than the Martinez household because their legacy wealth objectives are more challenging.

Summary

- Tactics control strategic risks
- They are primarily adjustment decisions
- Simplicity and precision minimize tactical noise risks; Remember Sun Tzu's comment

¹Dorsey, Thomas, *Point & Figure Charting* 3rd edition, 2007

²Big charts, www.bigcharts.marketwatch.com

³O'Neil, William, *How to Make Money in Stocks*, 4th Edition, 2009