



Let's Get Naked: Why Individual Investors Should Shed the Emperor's Clothes of Wall Street Investment Experts | Robert Fischer

Investors pay mutual fund companies billions of dollars per year for performance that is usually worse than market averages.

Is there anything better that we can do?
Yes, there is.

In this manifesto, I'm going to introduce you to rules-based **mechanical investing** (also known as **naked investing strategies**), which has been available for years. In fact, Warren Buffett wrote about this in the forward of the 1973 edition of *The Intelligent Investor*.

But these techniques have languished for decades, as mutual fund companies—with big dollars to spend on advertising—have purchased the souls and minds of the financial press. And employing systematic naked strategies is simply a more effective way to make investing decisions than relying on the judgment of Wall Street investment experts.

WHY DO WE PAY SO MUCH TO SO FEW FOR SO LITTLE?

To paraphrase [Winston Churchill's famous 1940 speech](#), never in history have so many paid so much to so few for so little.

According to the [Investment Company Institute 2010 fact book](#), at the end of 2009, investors held over \$11 trillion in mutual fund assets. Of this, approximately 33% was held in domestic equity funds, or about \$3.6 trillion. According to the fact book, the average expense ratio was .99%, which means that investors paid these fund companies about \$36 billion dollars in fees alone during 2009. Note that this does not include fees paid for money funds, bond funds and international equity funds.

\$36 billion is a huge amount of money. What exactly are investors getting for this huge expenditure?

Not very much, according to leading marketing research firm DALBAR, which produces marketing studies for the mutual fund and investment companies.

Its best known study, the annual Quantitative Analysis of Investor Behavior, calculates the returns investors earn in mutual funds. Investor returns are frequently different than the returns mutual funds report because the funds report the time weighted returns of the mutual funds' share price. For example, when a report shows that a particular fund was up 10% over a given period, this number is based on the appreciation of the net asset value of a fund share, which includes dividends the fund paid. This is the price that investors pay before commissions to buy a fund share.

But actual investor returns can be very different because they are dollar weighted, which takes into account the timing of investor purchases. Let's say that, within the space of a year, an investor buys 200 shares of a fund at \$10 a share (\$2000) and the fund appreciates to \$16 dollars a share.

If the investor then purchases 500 more shares (\$8000), he will have invested \$10,000 into the fund. If the fund now falls to \$11 per share, the investor will have 700 shares, (worth \$7700) for which he paid \$10,000. He will be sitting with a \$2300 loss, but the fund will be showing a 10% gain for the time period.

DALBAR's 2010 report showed that the average return for investors in stock mutual funds for the twenty-year period ending in 2009 was 3.17%. This is over 5% less than the 8.20% the market returned over the same period—a shocking statistic.

Investors are paying \$36 billion dollars a year to get returns that are less than 40% of the market's return. Why do we endure all the risk of the market for such a paltry return? Because we've been conditioned to listen to experts.

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THE CALL OF THE “EXPERTS”

Experts are important people. We rely on them our entire lives. If you need a contract drafted, or wish to climb to the peak of a snow-capped mountain or want to rewire an old house, you will want an expert to guide you.

In these three examples, the attorney, the mountain guide, and the electrician all have credentials you can discuss before hiring them for their advice. In all three cases, these experts should be able to create a plan for you and predict how that plan will work in the future with a high degree of reliability. Unless you are extremely knowledgeable in these disciplines, it would be foolhardy to attempt them on your own.

Wall Street knows that we rely on experts—and they market accordingly.

When I say “Wall Street,” I mean the collection of investment firms, mutual fund companies, print, cable and network programs that come into our homes and offices to give us their marketing messages. And, while these messages are all different, they usually have one common theme: “Listen to me! I know better!”

Do you remember [the old commercial](#) from the E. F. Hutton firm back in the ‘80s? It usually featured an affluent looking man saying to his friend, in a public place, “My broker is E. F. Hutton. And E. F. Hutton says...” The room would suddenly hush while everyone looked at the man, waiting for his next comments. And, at that moment, an announcer’s voice would cut in and say, “When E. F. Hutton talks, people listen.” It never really told you anything, but it was Hutton’s message in the eighties, and it has been Wall Street’s message through the ages: “Listen to our experts and we will help you make better investment decisions.” If you pay careful attention to almost any investment ad, whether it is from an investment firm or mutual fund company, you will find this familiar theme.

Consider a recent example from Franklin Templeton funds. [The commercial](#) begins showing an Asian woman carrying a child in her arms and walking through an outdoor market with unrefrigerated meat hanging from sticks. First the announcer says, “You see a traditional market.” Next scene, you see the world through the magical future telling glasses of Franklin Templeton, and now you see the same Asian woman pushing her child in a grocery cart through a modern supermarket.

The announcer explains that at Franklin Templeton they saw something that you couldn’t see, “a new generation of shoppers.” This insight enabled them to make smart investments that benefitted their shareholders. They say, “Gain from our perspective” which is similar to the E.F. Hutton ad and, of course, just another way of saying “Listen to me. I know better.”

Remember [the ad](#) from T. Rowe Price about the North Sea? The announcer asks how the oil industry in the North Sea can affect marine legislation in the United States and food consumption in Italy. The voice then says that, “at T. Rowe Price, we understand the connections of a complex global economy; It’s just one reason to consider our disciplined investment approach.” The implication is that if you do not understand the connectedness of a global economy, you could benefit by working with someone who does, presumably by investing in their mutual funds. The message is similar to the E.F. Hutton commercials. It says this stuff is really complicated and if you don’t understand these inter-relationships, you should “Listen to us. We understand things better than you do.”

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and they market accordingly.

WHY THE EXPERT METHOD DOESN'T WORK FOR INDIVIDUAL INVESTORS

When it comes to investment advice, this expert method breaks down. That is because, unlike expert advice given in the sciences and other professions, the advice from the investment industry as a whole tends to be less reliable, more ambiguous, and often conflicting. This is further complicated by cognitive biases and emotional reactions. Here are five main reasons why individual investors have trouble using Wall Street experts:

1. Wall Street experts are less reliable than experts in other fields.

Let's contrast experts from two different fields—chemistry and investing. Chemist Jozef Bicerano is an authority on polymers—we know that because of his years of industry experience, his degrees from prestigious institutions and his prodigious writings. (You can review his credentials at [his web site](#).) He also wrote the definitive book on predicting polymer properties, such that when Dow Chemical's manufacturing customers need advice on a particular type of plastic, they rely on his advice. If you asked him which of three polymers were most resistant to damage from sun light or best to use for electrical insulation, he could confidently advise you on which you should choose.

Mario Gabelli has an extremely impressive [résumé](#). He graduated summa cum laude from Fordham University, worked his entire life on Wall Street, founded and managed one of the most successful fund management companies in the country and is one of the highest paid executives on Wall Street (in 2007 his compensation package was valued at \$70 million). Yet if you asked him a simple question like, "Which of three oil stocks will appreciate the most over the next twelve months?" he could not answer with any degree of certainty. He may have his favorite picks, but if he hazarded a guess on this, he might very well be wrong.

Unlike Jozef Bicerano, Mario Gabelli cannot know all the relevant facts about his subject, because chance and unpredictable events play a huge role in determining future stock prices. Even if investment experts get all the public information available and analyze it correctly, something improbable, like an oil spill in the Gulf of Mexico, can make all their analyses moot.

2. Wall Street experts often give confusing or ambiguous advice.

Sometimes investment experts are famously wrong and, when they are, the media likes to remind them at every opportunity. There are many examples of this. For example, on March 10, 2000, Ralph Acampora predicted that the NASDAQ, then at 5048, would hit 6000 in twelve to eighteen months. Over the next five weeks the NASDAQ collapsed to 3321 on its way to 1114, which it reached in October of 2002.

More recently, Jim Cramer [told a viewer not to worry about Bear Stearns](#) on his television show on March 11, 2008. Just six days later, Bears Stearns imploded and the stock's price dropped from \$63 to \$2 per share.

To avoid this type of notoriety, you frequently see people hedge what they say, or say something totally ambiguous. A good example of this is the comment by Mohamed A. El-Erian, chief executive of the bond giant Pimco. He was recently quoted in [an article](#) in *The New York Times*, saying “You are seeing ... concern about the structural headwinds facing the market, a large downward reassessment of global growth prospects and large technical unwinds.” It is hard to be wrong when you say something like this, especially because no one knows what you're talking about.

3. The Internet and cable television have spawned an explosion in the number of conflicting investment messages to the average investor.

I first became interested in the stock market in the late seventies when I was a high school student. At the time there was one weekly television show on the market—*Wall Street Week with Louis Rukeyser*. Today, there are scores of cable shows. Not to mention blogs, radio shows, web sites and print publications also touting investment advice. All these different platforms have resulted in a massive increase in the number of investment advice givers, which in turn has resulted in an explosion in the number of investment messages.

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Not only are Wall Street experts giving advice, but so are people who you normally would not think of as investment experts. Take, for example, former major league baseball player Lenny Dykstra, known in his playing days primarily for running into outfield walls and the amount of chewing tobacco he could fit in his mouth at one time. He was touted by Jim Cramer as “one of the great ones” in investment advice and given his own column on Cramer’s website, *The Streets*, before he was revealed as a fraud. With between \$10 and \$50 million worth of liabilities, he filed for Chapter 11 bankruptcy protection last July.

Do you think of Glenn Beck as an investment expert? Is he an expert in gold investing or is he just a spokesperson for advertisers that sell gold on his show? If you [watch Glenn Beck](#) on television or listen to his radio show, it is hard to tell.

Advertisements sometimes give us relevant information. Automobile ads, for example, frequently give information about price, warranty or financing that may be useful when you are looking for a new car. But if you were thinking about rolling over your 401(k) plan, much of the advertising you'd see would provide more confusing than useful information. Take the T. Rowe Price ad we discussed earlier. Like so much of advertising, it does not provide relevant, accurate and significant information. Let's analyze the ad for content.

This ad implies that T. Rowe Price can make better investment decisions because they understand how the oil industry in the North Sea affects marine legislation in the United States and food consumption in Italy. However, doesn't Congress, not the oil industry, create marine legislation in the United States, and isn't it incredibly difficult to predict what Congress is going to do? Don't things like political parties, lobbyists, poll numbers, pirates and the media affect marine legislation? Do you really believe that they can draw intelligent investment conclusions about what Congress will do with marine legislation by understanding the oil industry? And does anybody really understand how the oil industry in the North Sea affects food consumption in Italy? There are thousands of things that affect food consumption in Italy.

This ad, like many of the talking heads on television, does not provide any useful information. This is not to say that T. Rowe Price is not a good manager. It is just that there is no way to determine this from their advertising. This ad creates confusion and fosters uncritical thinking.

Of course you can say the heck with this. I am going to just delegate this to my financial planner or portfolio manager and let him make all the decisions. But you really have not solved the problem. You have just transferred it to someone else. And this is the fourth problem with the Expert method.

4. Investors and experts are prone to cognitive biases when making decisions, which frequently results in misuse of information.

In the last thirty years, researchers have done a tremendous amount of work to understand exactly how humans make decisions. What this work has shown is that humans are very imperfect decision makers. In fact, human beings, being creatures of habit, frequently make the same thinking errors over and over.

Even if investment experts get all the public information available and analyze it correctly, something improbable, like an oil spill in the Gulf of Mexico, can make all their analyses moot.

Heuristics are mental shortcuts that we use all the time to make the hundreds of decisions that face us on a daily basis. If it were not for these shortcuts, we might never get dressed in the morning since we could not decide which pair of pants to wear or we might starve to death analyzing what is the best thing to eat for breakfast. But when it comes to investing, these mental shortcuts frequently cause us to make suboptimal decisions.

Following are just a few of what psychologists call cognitive biases—psychological tendencies or mental shortcuts that cause the human brain to draw incorrect conclusions.

» **Recency** bias takes place when we give greater weight to recently received facts than prior facts, even if the most recent facts are less important. A common example is when people decide to change an investment strategy—carefully developed over an extended period of time—based on something they just heard in the news.

» **Confirmation** bias is as prevalent among investment professionals as it is among everyone else. This is the tendency to look for facts that support one's preconceived idea and ignore facts that don't support what we initially think. When a stock position is going south and you hear yourself saying, "But it is a good company and they have great products" and you decide to hold on to it nonetheless, you may be struggling with confirmation bias.

» **Anchoring** is another example of a bias that causes cognitive errors. Anchoring occurs when a person irrationally fixates on a number. Have you ever bought stock and seen it go down and then decided you didn't want to sell it until it got back to what you paid for it? If you have, you were likely a victim of anchoring.

» **Outcome** bias, another common cognitive error, occurs when you judge the quality of a decision based on the result. For example, if you take your entire life savings and invest it in one speculative stock that triples and you decide that your decision was good, you are suffering from outcome bias. The fact that you got a good result does not mean that putting everything you have into one stock was not foolhardy.

» **Semmelweis** reflex is the tendency to reject new information simply because it contradicts established knowledge, norms or paradigms. We will examine this later.

The point of this discussion of mental heuristics and cognitive biases is to point out that humans are very imperfect decision makers. It does not matter whether you are a novice investor or you have been managing money all your life. If you are human, these thinking errors will affect your judgment.

5. Both investment experts and ordinary investors are influenced by fear and greed when making decisions involving money.

Anyone who has ever worked in a brokerage office knows that when the market has a really bad day, the phone rings a lot. The calls are almost never optimistic clients who want to take advantage of dips in the market and pick up some great stocks at bargain prices. Instead, they are from frightened clients who sometimes make knee jerk decisions and sell in a panic.

It works the other way when the market has an extended bull market. Conservative investors who see their friends and neighbors making lots of money want to get in on the action. People who normally invest only in certificates of deposit have quietly watched other people getting richer. Now they are ready to try this stock market thing out. This frequently happens after hundreds of bullish media messages have acted on their brain. The recency error kicks in and they buy at the peak. Soon the market rolls over and they end up with a big paper loss. They frequently blame their broker or the analyst or fund manager or decide that the market is corrupt. Only occasionally do they blame themselves. And the cycle continues.

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What these investors are responding to are the base emotions of fear and greed. This wicked duo works in combination with cognitive biases and the expert method to cause investors to make some really bad decisions.

The best illustration of how fear and greed influence investor decision making is the CGM Focus fund. According to *The Wall Street Journal*, this was the best performing mutual fund of the decade that ended in 2009, with an average return of 18%. Yet despite this terrific record, the average shareholder lost money! Amazing as this sounds, it is true.

The reason for this is the way investors responded to the messages from Wall Street. In 2007, the fund was up an amazing 80%. Fortune magazine put the fund manager Ken Heebner on the cover and called him “America’s Hottest Investor.” Greed took over and investors poured money into the fund and it swelled in size. Then, in 2008, the fund lost 48%. Investors fled as the fund value plummeted.

Some people think that professional investors are somehow exempt from emotional investing. Nothing could be further from the truth. Fear and greed certainly affect professional portfolio managers who use their judgment to make investment decisions. Remember, they are only human, and not only is their money at risk, but also their self esteem, their reputations, and sometimes even their jobs, based on how their portfolio performs.

An excellent example of how fear and greed affect professional investors is described in Atul Gawande’s excellent book *The Checklist Manifesto*. In his quest to make surgery safer in third world countries, Gawande looked at how people control risk and make decisions in areas outside of medicine. He looked at aviation, building construction and portfolio management and interviewed three top hedge fund managers. All three confessed that at times they struggled to think clearly because of their emotions. One manager called his excessive optimism “cocaine brain.” Another said that he sometimes goes into “fear mode” and starts to see risks where they don’t exist.

(Read more about how professional investors can be victims off their own emotions on [my blog](#).)

“NAKED” INVESTING

I. RULES: THE ALTERNATIVE TO EXPERTS

If the expert method does not work for the individual investor, is there an approach that does work? I believe there is.

Three years ago, I stumbled on a book that changed my life. The book, written in 1954 by a psychologist named Paul Meehl, challenged the very core of everything I had been taught about investing.

In the book, Meehl hypothesizes that people with expertise in a particular field could make better decisions if they used that expertise to create a decision making model or rule set. He believed that over time the model would make better decisions than the expert who created the model, because the expert, being human, would be inconsistent in the application of his decision-making judgment. The rule set, however, would make the same decision each time.

Meehl and his colleagues spent much of the next fifty years testing this hypothesis in various disciplines such as psychology, radiology, cardiology, criminology and higher education. Time and again the hypothesis was proven true. But did Meehl's theory apply to stock marketology? Could

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decision making models or rules make investment decisions as well or better than the thousands of fund managers paid billions of dollars by investors to manage portfolios?

If Meehl's theory holds for the stock market, then investors have an efficient, effective and economical alternative to traditional stock market investing—an approach that doesn't require them to pay attention to traditional Wall Street research.

II. INTRODUCING MECHANICAL INVESTING

While it may seem like heresy to suggest that you can make money on Wall Street by ignoring the advice of experts, I am not the first to say this. In *The Intelligent Investor*, first published in 1949, author Benjamin Graham suggested that a mechanical or rule based approach be used instead of stock market forecasts.

Even though mechanical investing has been around for decades, the method has languished for years. It is efficient, effective, economical, and can be surprisingly simple to implement. It is specifically designed to avoid all the problems of the expert method.

When I wrote my book, *The Naked Portfolio Manager*, I decided to call the method “naked investing” because the rules are transparent and totally expose everything about the portfolio manager's decision making process.

Whereas the expert method relies on the judgment of a person, naked or rules-based investing relies on mathematics and the natural fluctuations of the market. These decisions are all data driven. This is the key difference between the two methods.

We naturally assume that when we add our judgment to a decision making process, we enhance the decision. But this is not what Meehl found in his studies. Time and again, he found that

data driven decisions were more consistent and ultimately more reliable. He found that when humans tried to override the data, they did not improve the output; they made it worse.

Rules-based decision making is, as the name implies, based on a set of rules. These rules are specific and unambiguous. Individual investors can use them to manage their own portfolios by themselves, but using an accountability partner to help stay on track is highly recommended. That partner can be your spouse, a good friend or it can be your financial advisor. It is critical that your partner agrees with the process.

The rules for making the investment decision are known to all parties. If you are using a financial advisor to implement the rules, make sure that you both understand exactly how the decisions in the portfolio will be made.

You can test whether you are truly using “naked” strategies by explaining the rules to a third party. If you, your accountability partner and the third party would all make the exact same decision, then you are using a naked method. Here is an example of a “totally naked” set of rules:

1. Invest 2.50% of your portfolio in each of 40 stocks.
2. Buy 4 stocks in each of the ten sectors of the S&P 500®
3. Buy only stocks over \$15 per share that are members of S&P 500®
4. Purchase the 4 stocks in each sector with the lowest price to sales ratio.
5. Rebalance the portfolio on January 15th and July 15th each year. At this time replace any stocks that no longer meet rules 3 and 4.

Please note that this is an example of a rule set and not a recommendation of these rules per se. As you can tell, they are clearly defined and unambiguous. They are not difficult to follow. Any intelligent eleven-year old could look at a spreadsheet and tell you what stocks to buy or sell according to these rules.

III. USING MECHANICAL INVESTING RULES

As we have already discussed, chance plays a huge role in investment results. Because of this, excellent methodologies will have periods when the results are less than desired. If we want to avoid the error of outcome bias—judging a decision based on the results and not based on the quality of the decision—we will need to consider the role chance plays in results and evaluate rules-based investing over a meaningful period of time. Let's look at some simple rules that can noticeably influence your returns.

Even though mechanical investing has been around for decades, the method has languished for years.

All of us would like to buy stocks at the bottom of their range and sell them at the top. We want to buy the best performing sectors and sell them when they peak. And we want to own stocks when they are going up and sell and hold cash or bonds when the market is going down. I wish I had the formula to do this, but it does not exist.

But what I can do is show you some rules that may not get all of your money in at the bottom and out at the top, but can be used to get more of your money invested at the bottom and to get some of it out when stocks get pricey and become vulnerable.

Following are three rules which are easy to implement and based on mathematically sound principles. Note that there are many different naked strategies. The three that we discuss here are appropriate for a core portfolio.

Rule Number 1. Rebalance Your Stock Portfolio at Regularly Scheduled Intervals

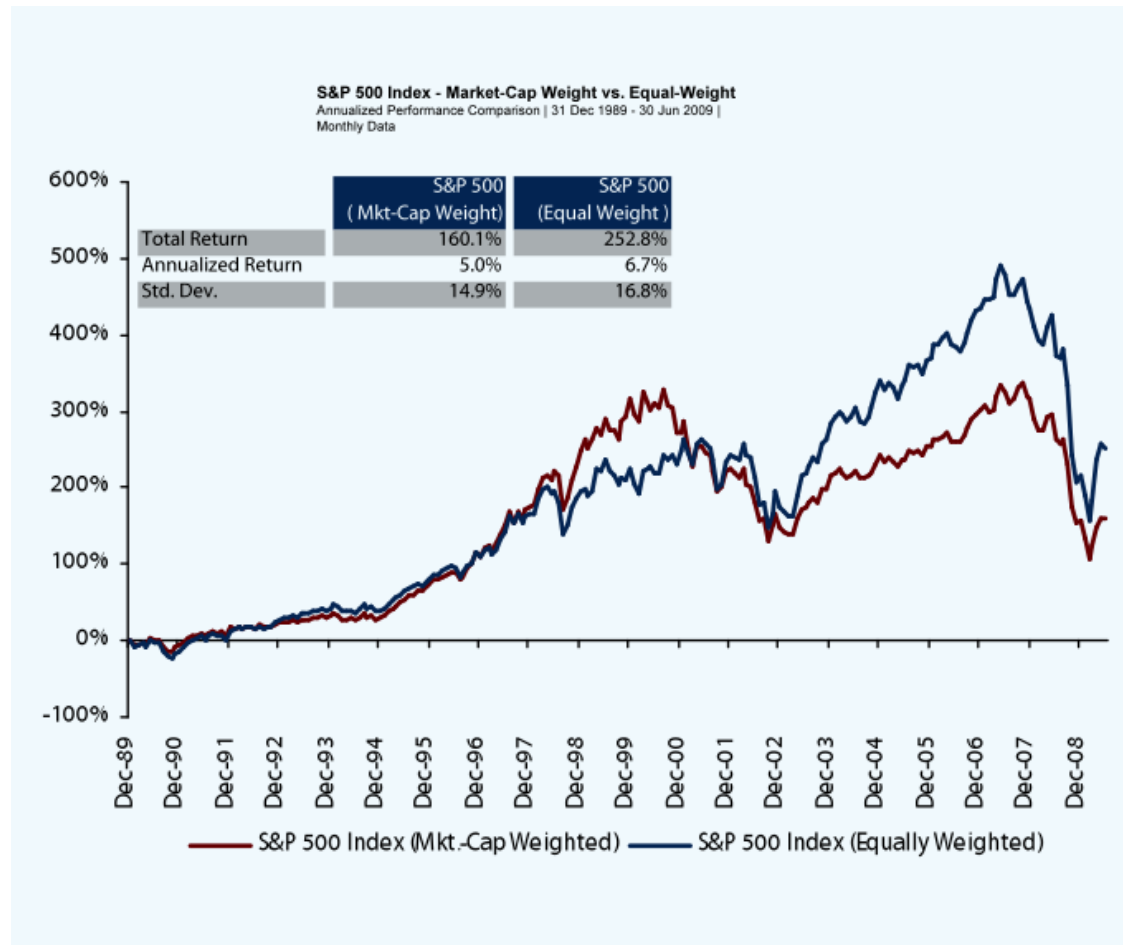
This rule is so simple, it hardly seems worth mentioning. How difficult is it to rebalance your portfolio? Can it really make much difference in your return? The fact is it can. Consider a world in which there are just two stocks.

		Indexer			Rebalancer		
Stock A	Stock B	Shares of	Shares of	Indexer	Shares of	Shares of	Rebalancer
Price	Price	A held	B held	Account Value	A held	B held	Account Value
\$ 10	\$ 10	1000	1000	\$ 20,000	1000	1000	\$ 20,000
\$ 11	\$ 7	1000	1000	\$ 18,000	818	1286	\$ 18,000
\$ 13	\$ 6	1000	1000	\$ 19,000	706	1529	\$ 18,351
\$ 14	\$ 8	1000	1000	\$ 22,000	790	1382	\$ 22,115
\$ 13	\$ 11	1000	1000	\$ 24,000	980	1158	\$ 25,472
\$ 16	\$ 12	1000	1000	\$ 28,000	924	1232	\$ 29,568
\$ 17	\$ 15	1000	1000	\$ 32,000	1006	1140	\$ 34,189
\$ 14	\$ 12	1000	1000	\$ 26,000	991	1156	\$ 27,753
\$ 19	\$ 16	1000	1000	\$ 35,000	982	1167	\$ 37,334
\$ 20	\$ 19	1000	1000	\$ 39,000	1045	1100	\$ 41,817
\$ 22	\$ 22	1000	1000	\$ 44,000	1073	1073	\$ 47,209

In the example, Mr. Indexer and Ms. Rebalancer each start with \$20,000. True to his name, Mr. Indexer invests equal amounts in each stock and holds them for twelve years until they appreciate to \$44,000. Ms. Rebalancer rebalances her dollars equally between the two stocks at the end of each year—buying or selling shares based solely on the price of the two stocks so that she begins each year with an equal dollar amount in each stock. As you can see, at the end of the period, Ms. Rebalancer has \$3209 more.

How would this principle work with real stocks? Consider the chart below.

This chart compares the S&P 500® market-cap weight vs. equal-weight. AT&T counts much more in the index than a stock like Apache Corporation in a capitalization weighted index, because its capitalization (share price multiplied by shares outstanding) is so much larger.



In an equally weighted index, every stock has the same influence on the average. To maintain an equally weighted index, it is necessary to rebalance the portfolio at regular intervals to adjust for changes in market price. This is not so with a capitalization weighted index.

As the chart indicates, the returns of the equally weighted or rebalanced portfolio were substantially better than the index. Again we see the application of mathematical principles. The rebalanced portfolio did better because of the effects of averaging. Automatically, more money went into stocks that got cheaper and automatically money flowed out of the stocks that got more expensive.

Again, note here that it was not necessary to know which stocks were going to do better and which ones would do worse. There is no need to rely on a Wall Street expert to implement this strategy.

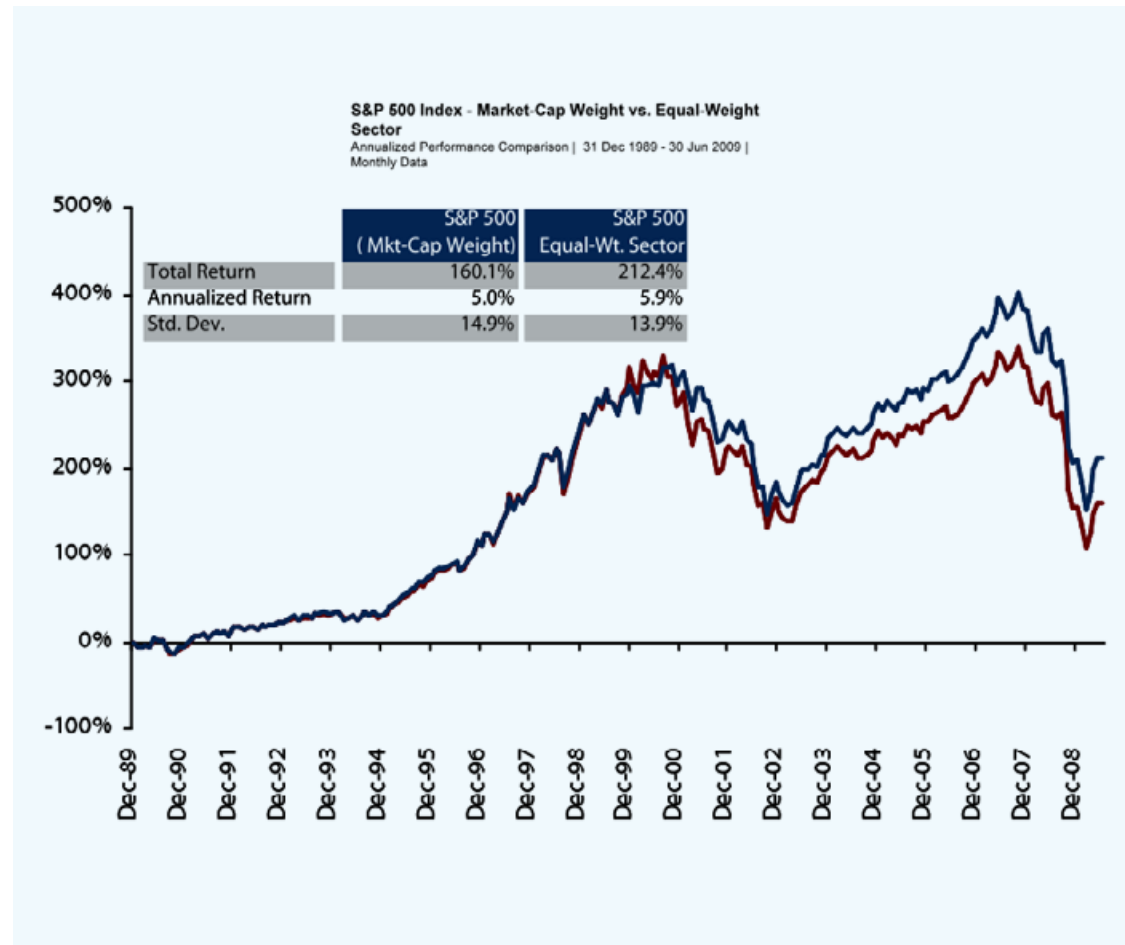
Also, of particular interest is the time period from 1997 through 1999. This was a period of time when large numbers of investors and the financial media fell victim to the cognitive error of outcome bias.

During this time, very large companies dominated the market and many financial writers, afflicted by outcome bias, recommended indexing based on this brief period of unusually good performance. Microsoft, for example, had two stock splits between 1998 and 1999 and nearly quadrupled in just 24 months. Yet as the chart shows, over time the largest companies are not always the best companies to own and an investor following a rebalancing strategy ultimately had the best return.

Whereas the expert method relies on the judgment of a person, naked investing relies on mathematics and the natural fluctuations of the market.

Rule Number 2. Maintain a Sector Neutral Portfolio

If rebalancing individual positions is a good strategy, what about rebalancing sectors? Can an investor add to his portfolio return just by maintaining a sector neutral portfolio? Over long periods of time, it appears that rebalancing sectors does indeed add value. See the chart below.



An analysis conducted by EquityCompass Strategies compared the results of the S&P 500® to a sector neutral strategy for the time period from December 1989 until June 2009. The study found that, exclusive of dividends, the return of the S&P 500® was 5% while the return of the sector neutral S&P 500® was 5.9%. And the sector neutral S&P 500® achieved this return with 7% less volatility. So we see it again. The same stocks over the same time period, yet the simple rule of rebalancing adds value.

It is important to realize that the same mathematical principles apply here also. While it may not be possible to know which sectors will do best over the next few months, by rebalancing at periodic intervals you are systematically moving money to the sectors which are relatively cheaper and moving money out of the sectors where the stocks are relatively higher priced.

Rule Number 3. Use a Systematic Allocation Formula Between Stocks and Bonds

As we have seen, systematic rebalancing can be used to get more money into relatively undervalued stocks and reduce the amount in relatively overvalued stocks. Rebalancing can also be used to reduce exposure to sectors that have appreciated significantly and put more money into sectors that are relatively cheaper.

What about the fundamental allocation between stocks and bonds? Can we use systematic rebalancing to enhance our portfolio returns here also? The evidence would indicate this is so.

Richard Cripps, Tim McCann and Michael Scherer, three analysts at EquityCompass Strategies, have done considerable work on a systematic approach that rebalances between stocks and bonds. The objective of the model is to get more money into stocks when they are poised to do well, and reduce equity exposure when stocks appear overvalued.

There is considerable anecdotal evidence that stock returns regress to the mean. In other words, periods of extremely strong stock market performance are frequently followed by periods of underperformance. Consider for example, that from 1995 through 1999 the S&P 500® returned 37.5%, 22.9%, 33.3%, 28.5%, and 21% respectively. The market followed this extraordinarily good period by three consecutive years of negative performance. Likewise, at the end of 2008, the trailing five year average return of the S&P 500® was a negative 2.2%. It was no surprise that 2009 was a banner year returning 26.5%.

If we were to divide our funds equally between stocks and bonds and rebalance the portfolio annually, we would expect that after good years in the stock market we would sell some stocks and move that money to the bond side to rebalance our portfolio, and after a particularly poor stock market year we would sell some bonds and move that money to the stock side.

While this method would probably work well, Cripps, McCann and Scherer were not satisfied with this simple approach. They were interested in developing a method that provided good returns, but also protected investors during vicious bear markets. To do this, they analyzed various allocations between stocks and bonds on a risk-adjusted basis from 1947 through the end of 2008.

See the results below:

Baseline Stock/Bond Allocation
Annualized Rolling 5-Yr Buy & Hold Returns | 1 Jan 1947 - 31 Dec 2008

Asset Mix		Standard Deviation	Annualized Return	Reward/Risk ⁽³⁾
Stocks ⁽¹⁾	Bonds ⁽²⁾			
0.0%	100.0%	5.1%	5.9%	1.16%
10.0	90.0	4.8	6.6	1.37
20.0	80.0	4.6	7.2	1.58
30.0	70.0	4.5	7.9	1.75
40.0	60.0	4.5	8.5	1.87
50.0	50.0	4.7	9.1	1.94
60.0	40.0	5.0	9.7	1.94
70.0	30.0	5.4	10.3	1.91
80.0	20.0	5.9	10.8	1.85
90.0	10.0	6.4	11.4	1.77
100.0	0.0	7.0	11.9	1.69

(1) S&P 500 Total Return Index
(2) S&P Long-Term Government Bond Index
(3) Reward/Risk is equal to Annualized Return divided by Standard Deviation
Source: NEO UBSIS Research

The table suggests that the historical optimal allocation between stocks and bonds on a risk adjusted basis was 60% stocks and 40% bonds because this allocation gave the highest return for each unit of risk. You can see this in the risk column in the chart to the left. While it is true that a portfolio that is 100% in stocks provided greater return, it did so with 40% more volatility as measured by standard deviation. Standard deviation is a measure of how spread out a group of numbers is. The more spread out they are the greater the standard deviation. (For a complete description of standard deviation click [here](#).)

Remember, these data are for five year periods. About 96% of the returns during this span of time will fall within two deviations from the mean. With the all-stock portfolio, this means that about 2% of the time your return will be higher than 25.9% over a five year period, but about 2% of the time your return will be worse than negative 2.1%.

Few investors have enough patience with a strategy to stick with it through a losing five year streak. But by using a 60/40 base allocation, Cripps et al. were able to reduce both the likelihood as well as the magnitude of a bad period. In other words, you are not only less likely to lose money, but when you do, you will likely lose less than an all-stock allocation.

Based on their study of the historical averages, Cripps, et al. developed the table below. To use it, determine the state of stock and bond markets at the beginning of the year and determine your allocation for the coming year. Single year periods were used so as to take advantage of long term capital gain treatment. At the end of the year, determine which cell to use and reallocate your portfolio accordingly. The table was constructed using standard deviation.

Strategic Stock/Bond Allocation Adjustment

Stocks

	Very Cheap	Cheap	Average	Expensive	Very Expensive
Very Expensive	80/20	75/25	70/30	65/35	60/40
Expensive	75/25	70/30	65/35	60/40	55/45
Average	70/30	65/35	60/40	55/45	50/50
Cheap	65/35	60/40	55/45	50/50	45/55
Very Cheap	60/40	55/45	50/50	45/55	40/60

For example, at the end of 2008 the average return of the S&P 500® for the previous five years was -2.2% which made stocks “Very Cheap” since stocks were more than two standard deviations below average. The average return of bonds for the same period however, was 9.7%, which made bonds “Average” since it was within one standard deviation of mean return. You can calculate which cell to use by determining trailing five year returns of the stock and bond markets yourself, but fortunately you do not have to. It is all published at the EquityCompass Strategies web site. So, on the table we see that at the end of 2008 the table suggests a 70% stock and 30% bond allocation. (Full disclosure: Cripps et al and I worked at the same firm until 2005 and I discuss investment ideas with them occasionally, but I have absolutely no financial relationships with them of any kind.)

While an ordinary rebalancing strategy would move more money into stocks when they got cheaper, and out of stocks when they got more expensive, **the idea of the table is to magnify the effect**

by increasing not just the dollars but also the percentage of dollars in stocks when they are relatively cheap compared to bonds.

Likewise, if stocks appreciated greatly the table would force you to reduce the proportion of your portfolio dedicated to equities (which is the exact opposite of what would happen with many people who were following the expert method since they might be bombarded with bullish messages due to recency error).

EquityCompass Strategic Allocation Simulation (Stock/Bond)
1 Jan 1990 - 1 Jun 2009

	Strategic Allocation	Allocation to Equity	Performance Comparison		
			S&P 500	Barclays Agg. Bond Index	Strategic Allocation
1990	60 / 40	Normal	-3.3%	9.0%	1.6%
1991	60 / 40	Normal	30.5	16.0	24.7
1992	60 / 40	Normal	7.6	7.4	7.5
1993	65 / 35	Overweight	10.1	9.8	10.0
1994	65 / 35	Overweight	1.2	-2.9	-0.2
1995	60 / 40	Normal	37.5	18.5	29.9
1996	60 / 40	Normal	22.9	3.6	15.2
1997	60 / 40	Normal	33.3	9.7	23.8
1998	55 / 45	Underweight	28.5	8.7	19.6
1999	55 / 45	Underweight	21.0	-0.8	11.2
2000	50 / 50	Underweight	-9.1	11.6	1.3
2001	60 / 40	Normal	-11.9	8.4	-3.7
2002	60 / 40	Normal	-22.1	10.3	-9.2
2003	70 / 30	Overweight	28.5	4.1	21.2
2004	65 / 35	Overweight	10.8	4.3	8.5
2005	70 / 30	Overweight	4.8	2.4	4.1
2006	65 / 35	Overweight	15.7	4.3	11.7
2007	60 / 40	Normal	5.4	7.0	6.0
2008	60 / 40	Normal	-37.0	5.2	-20.1
2009	70 / 30	Overweight	3.2	1.9	2.8
Annualized Return			7.3	4.8	7.9
Annualized Std. Dev.			15.1	4.0	8.9
Upside Capture ⁽¹⁾			100.0	19.0	69.4
Downside Capture ⁽¹⁾			100.0	-13.0	64.7

Indicates Bear Markets

Dividends included in performance calculations
(1) With Respect to the S&P 500 Index
Source: EquityCompass Strategies, Ned Davis Research

After constructing the table, Tim McCann backtested the results since 1990. You can see his results in the table at left.

As you can see from the table, the systematic allocation formula (labeled “Strategic Allocation”) produced returns of 7.9% versus 7.3% for the S&P 500®. What is more, the volatility as measured by standard deviation was only 8.9% versus 15.1% for an all stock portfolio. It is impossible to understate the significance of this.

One of the greatest risks investors face is the behavioral risk, so that after an extended period of stock market under-performance, they become discouraged with the method and abandon it completely. By using a method that reduces the volatility, you also increase the probability that the investor will be able to stick with the method.

There are two significant points to notice about the table. In the year 2000, everyone was giddy about stocks, having watched the market move at a blistering pace for 5 straight years. This method would have reduced your stock weighting to 50% just as we moved into a bear market. On the other hand, in 2003 and in 2009, the method increased stock weightings to 70%—above normal weightings—just before the market produced outsized returns of 28.5% and 26.5% respectively. Now, the method may not be perfect, but then again neither is the expert method.

You do not need to read analyst earning reports or watch The Financial News Network. The rules are not dependent on Jim Cramer's advice. Yet, they are very effective.

IV. EASY AND EFFECTIVE

These three simple rules are not difficult to implement. Equally weight your stock positions, maintain a sector neutral portfolio and use a systematic allocation formula. They do not require the use of complex statistical analysis, expensive software or proprietary information. You do not need to read analyst earning reports or watch The Financial News Network. The rules are not dependent on Jim Cramer's advice. Yet, they are very effective.

These rules are designed to take advantage of the mistakes of the average equity fund investor who buys near the peak and sells after extended periods of decline. We want to buy from him when he is disenchanted with investing and sell to him when he is wildly enthusiastic about a particular stock, sector or the market as a whole.

WRAPPING IT ALL UP

When people suggest that investing is too complicated to be left to simple rules I always think of Ignaz Semmelweis.

Dr. Semmelweis was a Viennese obstetrician who developed a simple, but radical theory in 1847: doctors should wash their hands between patients. He had observed that mortality rates from puerperal fever were much higher in the hospital when male doctors delivered babies than when women delivered using midwives.

But the wonderful thing is that you don't have to buy into Wall Street's game. You can play a different game. One you can win.

Gradually he eliminated possible causes of the higher mortality rate, and came to understand that the disease was being spread by some invisible substance on doctors' hands that they had picked up in the autopsy ward (midwives did not perform autopsies). At the time, it was common practice for doctors to do autopsies and then attend to live patients without washing their hands. Dr. Semmelweis instructed all his internists to wash their hands with a chlorinated lime solution between patients. When this practice was put in place, the mortality rate plummeted.

Semmelweis published his theory including all the data that showed that hand washing saved lives. But the expert medical community at the time never took his results seriously. "How could anything as simple as washing your hands affect mortality rates?" they thought, ignoring his data. It wasn't

until around 1860 when Louis Pasteur developed germ theory that doctors began washing their hands as a matter of practice.

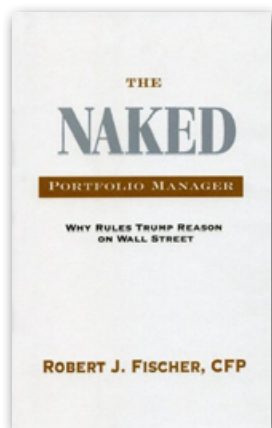
The moral of this story? Sometimes simple solutions are the best.

We understand the weaknesses of the expert method. We know that expert stock market forecasters are less reliable than experts in other fields. We know that Wall Street sends a huge number of often ambiguous messages. And we know that because of cognitive biases and emotions, we humans don't always do a good job of processing those messages.

But the wonderful thing is that you don't have to buy into Wall Street's game. You can play a different game. One you can win.

Naked investing is designed to take advantage of other investors' mistakes. It is designed to increase stock holdings when expert followers are selling in a panic, and it is designed to reduce your equity exposure when others are wildly enthusiastic about stocks. It is designed to make stock market fluctuation work for us so we can add to our holdings on dips and trim our positions when our stocks get ahead of themselves.

You now have the framework. All you need to do is follow it. 📖



BUY THE BOOK

Get more details or buy a copy of Robert J. Fischer's [*Naked Portfolio Manager*](#).

ABOUT THE AUTHOR

Bob Fischer brings a rare combination of skills, talents and background to his career as senior portfolio manager, and advisor for affluent individuals at a national brokerage firm. His noteworthy success in the investment field is based upon his in-depth knowledge of decision making, which he applies in a disciplined rule-based approach: the application of Statistical Prediction Methods.

Bob has written numerous articles on investment and financial planning for respected industry publications. He lives with his family in Midlothian, Virginia.

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