WEALTHSHIELD

Rules, Rules, Rules

Clint Sorenson

"I don't think traders can follow rules for very long unless they reflect their own trading style. Eventually, a breaking point is reached and the trader has to quit or change, or find a new set of rules he can follow. This seems to be part of the process of evolution and growth of a trader."

—Ed Seykota

In order to have a successful investment approach and strategy, I believe that you must have a rules-based approach. You must have processes and procedures for absolutely everything. To go even further, I would argue that you need to automate as many of these processes and procedures as humanly possible. The reason is because rules create consistency and dependability. Consistency breeds trust from customers, and trust leads to solid client relationships and new client acquisition.

If you want to grow your business, start relentlessly following a set of rules for investing client money. The consistency and proof of a disciplined process will generate an immense amount of respect and trust. You will create loyal client advocates that will stop at nothing to sing your praises to all of their friends and family. The only caveat is that the rules have to work.

The best place to start with rule formation is the creation of your client questionnaire. The questionnaire should get at the heart of what keeps your clients and prospective clients up at night. This can be effectively generated through a web-based interface to make the client experience better and the process more automated. The questionnaires were all developed by our team in conjunction with our philosophy and strategy.

We ask questions about taxes, behavioral tendencies, and risk preferences. This gives us sufficient data to determine a starting asset allocation. Document the questions you are going to ask and how you are going to deliver the questionnaire. Then you can go to the next stage of the client investment process: beginning asset allocation.

You need to ask the following questions and start documenting your answers. The answers will help you compile your procedures manual for your investment approach. How do the answers to the questionnaire relate to the specific asset classes and weightings? How do you choose and define your asset classes? What indexes do you use to benchmark the various asset classes? What do you use to measure risk? Do you practice risk budgeting?

The broad asset allocation procedures then need to be taken down to the component level. For instance, you need to determine what securities universe will make up each asset class. You will also document your process for rebalancing, trading, and weighting. Your portfolio construction rules will be compiled and documented during this stage.

You will also want to compile procedures on how you convey the portfolio to the client. Is it over an online portal? Do you present the allocation in conjunction with a financial plan? Do you provide a comparison stress test? Essentially, you need to document the entire customer experience as well as the internal processes and procedures for building the portfolio. These segments are interconnected.

Our clients put their entire strategy in the form of rules and processes. It all starts with the asset allocation rules. Our investment committee meets quarterly to discuss these rules and the overall market environment to make the determination of what the asset allocation policy will be for the next year.

As we outlined in the book *Invest to Prosper*, one of our client firms looks to the overall valuations annually and then measures the underlying trends of various markets monthly to determine the asset allocation. The rules we outlined for both systems in the book are as follows:

The basis of our value-allocation process is that we rebalance a portfolio based on where the CAPE value is at that point in time. For simplicity's sake, we are only going to examine the S&P 500 and US ten-year Treasury bond. We will assume you are an investor with a moderate risk tolerance and a long-term time horizon of greater than ten years. The appropriate benchmark will consist of half stocks and half bonds: 50 percent S&P 500 and 50 percent US ten-year Treasury bonds. The fifty-fifty allocation happens to be close to the average allocation in all of the valuation-based market-timing strategies we have referenced. Most money managers allocate according to the benchmark and then rebalance at some predetermined interval or drift. Drift is a term used to describe the deviation from the predetermined weighting. In a simplified version of our Value Allocator, we instead allow for flexibility in the portfolio, allocating based on the following rules:

- *When the CAPE value is above the rolling thirty-year median, the portfolio will allocate 30 percent to the S&P 500 and 70 percent to US ten-year Treasuries.*
- *When the CAPE value is below the rolling thirty-year median, the portfolio will allocate 70 percent to the S&P 500 and 30 percent to US ten-year Treasuries.*
- *Each portfolio is rebalanced on an annual basis using the CAPE value as of December of the year before.*

The above rules describe how you could use the CAPE to set a broad asset allocation strategy for your clients and firm. Next we will illustrate the rules for the simple trend-following system in our book:

We can use simple rules to replicate a strategy that protects during market declines without sacrificing the upside. In our strategy, we use indices (baskets of securities tracking a particular market) to gain exposure because of their relatively low costs and high transparency. To illustrate *the effectiveness of trend following historically, we are going to provide a simple, rules-based tactical allocation system as a model. The rules are as follows:*[1]

1. *Rank the S&P 500, Russell 2000, and the US ten-year Treasury bond based on the three-month performance.*
2. *Pick the strongest index based on the ranking.*
3. *Run the ranking system each month.*

The rules we outlined for the Value Allocator and the trend system are just components of an overall asset allocation methodology. We separated the strategy into the component parts to simplify the process. When you are formulating your processes and procedures, it is helpful if you break down each process into the separate component parts. In this case, it was critical because they both played varying roles in the portfolio construction.

In efforts to remain pragmatic, we have combined the Value Allocator and trend following to provide a comprehensive approach.

The combination of the two strategies keeps an investor from moving the entire portfolio tactically and keeps a portion in a strategic posture. Tactical asset allocation is the practice of taking positions in various investments based on short- to intermediate-term prospects. Our strategic asset allocation methodology is based on valuations and expected mean reversion. The problem is that mean reversion occurs over a period of seven to ten years. Valuations tell us very little about what is going to happen over the subsequent one to three years.

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[1] The calculations were made using Global Financial Data index data for the Russell 2000 Small Cap Index, S&P 500 index, and US ten-year Treasury bond index until 2003. After 2003, ETF data were used to better replicate an investable index. The following ETFs were used: IWM (Small Cap Stocks), SPY (S&P 500), IEF (ten-year Treasury bonds).

Our tactical overlay is therefore based on reacting to the trend. This is an interesting relationship, as the two strategies can offer up diametrically opposed recommendations. For instance, when the US stock market is overvalued, the Value Allocator would recommend rotating to a more conservative portfolio. At the same time, if the trend is positive, the tactical overlay would recommend overweighting equities. You can see the conflicts that can arise, and we assure you they have surfaced in the past.

An investor must be able to stick with their investment plan in order to achieve success and reach their financial goals. The conflict between the two systems is exactly what is needed. Choosing the right proportion of strategic versus tactical is critical to establishing the proper policy. Determining how much of your portfolio should be in the tactical portion of the portfolio is a decision based on your personal circumstances. You must ensure that you are comfortable with the range of exposure to each asset class. If you are uncomfortable, the purpose of providing a more palatable experience is defeated.

Ideally, the tactical portion of the portfolio should be determined by first deciding the minimum amount of risky assets the investor can handle. How do you determine what percentage of stocks you are comfortable with? We suggest taking a deep look inside and determining what loss you can withstand before you pull the plug on the investment program. The goal is to invest in a way that will keep you engaged in the markets and prevent emotional decision-making. The emotional breaking point is what you should be after. We know the market has declined over 50 percent twice in the last fifteen years. That is as good of a place as any to start thinking about your portfolio's risk. We suggest you start thinking about how you would react if the equity portion of the portfolio were cut in half. In the past, when the market has reached the valuation level that it is currently, it has stumbled significantly.

The Value Allocator—as illustrated for a moderate risk tolerance—can rotate between 30 percent stocks and 70 percent bonds and 70 percent stocks and 30 percent bonds. The tactical portfolio is either 100 *percent in stocks or 100 percent in US ten-year Treasury bonds. The following matrix embodies all possible allocations when half of the portfolio is constructed according to the Value Allocator and the other half is based on the tactical program.*

	Undervalued Market	*Overvalued Market*
Positive Trend	*85% stocks /15% bonds*	*65% stocks/35% bonds*
Negative Trend	*35% stocks /65% bonds*	*15% stocks /85% bonds*

In our model, the investor can have as little as 15 percent in stocks and as much as 85 percent. The wide range allows the investor to adapt to all market conditions, protecting when the odds are poor and growing when the odds favor return enhancement. Instead of fixing the allocation on a static portfolio, investors are allowed the flexibility to adapt their risk tolerance to the current environment. For instance, if the current market environment is undervalued, and the trend is positive, the environment is favorable for stocks. Thus, the investor would be positioned heavily in that asset class.

The referenced rules are just an example of how we outlined a plan using an approach similar to the one used by some of our clients. The actual processes and procedures that you would use would be dependent upon your unique philosophy and investment strategy. For clarification purposes, we would like to stress that the rules we just outlined are an oversimplification of an actual approach to investment management.