The All-Season Investor

Successful Strategies for Every Stage in the Business Cycle

Martin J. Pring

THE ALL-SEASON INVESTOR: Successful Strategies for Every Stage in the Business Cycle

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JOHN WILEY & SONS, INC.
New York • Chichester • Brisbane • Toronto • Singapore

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Art credited to the *Pring Market Review* was originally produced by the author in the following publication:

Martin J. Pring, editor, *Pring Market Review*, International Institute for Economic Research, P.O. Box 329, Washington Depot, CT 06794.

Published by John Wiley & Sons, Inc.

Library of Congress Cataloging-in-Publication Data

Pring, Martin J.
The all-season investor: successful strategies for every stage in the business cycle / Martin J. Pring.
p. cm.
Includes index.
ISBN 0-471-54977-0
1. Investments. 2. Securities. 3. Business cycles. 4. Finance, Public. I. Title.
HG4521.P835 1992
332.6'78—dc20 91-34336

Printed in the United States of America

10 9 8 7 6 5 4 3

To my daughter, Laura

ACKNOWLEDGMENTS

In putting together a book of this nature, I owe countless people a debt of gratitude. In particular, I would like to thank my colleagues at Pring-Turner Capital, Joe Turner and Bruce Fraser, for their constant encouragement and support and for their help in formulating some of the concepts used in the book.

I would also like to mention Sheila Silvernail for her dedication and diligence in creating many of the charts and for proofing the manuscript, making my job so much easier. Also Renee Pike for help with the risk/reward analysis and many constructive suggestions.

As always, thanks goes to my wife, Danny, for translating the original manuscript into readable English.

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Introduction: What Is Asset Allocation?

The cornerstone of any investment strategy is to maximize return while maintaining a tolerable risk. The process of allocating assets among several investment categories is a way of achieving this goal. The level of "tolerable" risk depends on an individual's psychological makeup, financial position, and stage in life. Younger people can assume greater risks than someone who is retired; a highly paid executive will be less dependent on current portfolio income than will a disabled person on workmen's compensation, and so forth.

Asset allocation can be handled in two steps. The first decision involves a general review of these financial, psychological, and life stage factors to determine overall investment goals. Is your goal current income, capital appreciation, or an acceptable balance? If you decide on capital appreciation, do you have the personality to ride out major declines in the market, or are you the kind of person who would be better off assuming less risk in order to sleep more peacefully? These are decisions that only you can make after careful consideration. Formulating decisions on these overall investment objectives is known as *strategic* asset allocation. It is a process that sets out the broad tone of your investment policy, and one that should be reviewed periodically as your status in life changes. Some guidance on these matters is presented in Chapter 12.

This book, however, is principally concerned with the next step, known as *tactical* asset allocation, in which the proportion of each asset category held in the portfolio is altered in response to changes in the business climate. For instance, a retired person may decide that his or her principal investment objectives are current income and safety. This would not preclude, but would definitely limit, the proportion of the portfolio exposed to the stock market. For this type of investor the range might be 10 to 25 percent. The tactical allocation process would determine whether the equity exposure fell closer to the 10 percent or 25 percent area.

WHY ALLOCATE ASSETS?

There are three principal reasons for an investor to allocate assets: to reduce risk through diversification, to allow for the times when a specific asset is attractive and the times when it is not, and to reduce the emotional aspect of decision making by carefully and gradually shifting emphasis from one type of asset to another. Let's consider each of these reasons in turn.

RISK REDUCTION THROUGH DIVERSIFICATION

It is a well-known investment principle that you shouldn't put all of your eggs into one basket. After all, what might seem to be a no-lose, high-reward situation at the outset may turn out to be a loser in the long run. Investing in more than one vehicle helps to cushion your portfolio in case one of your selections does not turn out to be as profitable as was originally expected. Asset allocation involves a lot more than just buying several different stocks; it also encompasses cash, bonds, and inflation hedge assets. In its purest form the asset allocation process would also include other asset classes such as real estate, oil leases, annuities, and so forth. Because these are not as liquid as assets like equities and bonds, they are not considered in this book.

The simplest way to allocate assets would be to hold small amounts in a variety of financial vehicles and never sell. Such a policy would cushion a portfolio from major stock market declines like the 1987 crash. At the same time it would also participate well in major bull markets such as the 1982–1987 equity boom or the 1978–1980 run up in the price of gold.

There are two problems with this approach. First, a major bull market in a specific asset, such as that for equities in the 1980s, would increase the proportion of that particular asset category well above the original intention. To make matters worse, this overweighting would occur right at the most inappropriate time—the top of the market! One of the principal objectives of asset allocation is to *increase* the allocation of an asset class in the area of a major *bottom*, not at a market top. Eventually it would become evident that this static approach would have to be adjusted or the portfolio would become skewed toward one particular asset, thereby diluting the beneficial effects of diversification.

The second disadvantage of a static approach is that it consistently fails to take full advantage of major bull markets and does little to provide protection during bear markets. No approach can guarantee full participation in every bull move or liquidation at the beginning of every bear market. Nevertheless, a continuous and conservative alteration in the asset balance as a response to changing economic environments is achievable and can result in superior, although not necessarily spectacular, results.

The idea of improving the risk/reward ratio is a key one in money management. All investments involve some kind of risk, but one of the principal objectives of investing is to limit risk as much as possible while not giving up too much on the reward side. Let's say, for example, that the dividend yield on the Dow Jones Industrial Average (Dow Jones) was less than 3 percent. This falls well below the historical norm and is often associated with bull market peaks. It would, therefore, represent a high risk/reward. On the other hand, a yield of 5 to 5½ percent is unusually generous and normally has been seen only around major market lows. This would represent a low risk/reward and, other things being equal, would justify a larger than normal equity allocation.

If these two extreme examples are plotted on a chart, as in Figure I.1, it is possible to see how an investment goal of maximum return for minimum risk can be achieved. The vertical axis represents the expected reward (an annualized rate of return, for example), so the higher the reward, the closer the plot is to the top of the chart. The horizontal axis measures the risk required to earn that reward. Low risk (more desirable) would be plotted close to the vertical axis while greater risk is plotted to the right. Because the objective is to achieve maximum reward for very little risk, the risk/reward profile for the ideal investment would be plotted somewhere in the top left-hand part of the chart.

Historically, there has been an excellent buying opportunity when equities have yielded 5 percent because the downside risk has

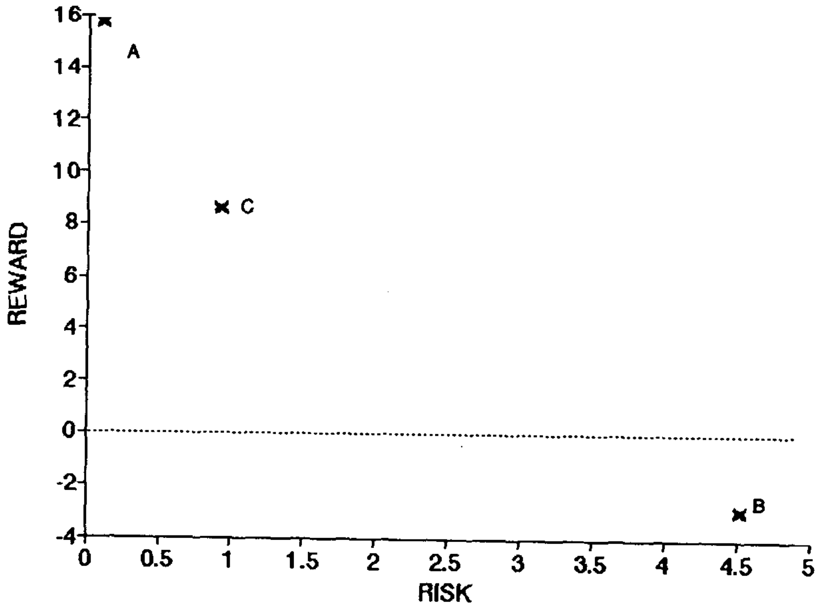

Figure I.1 Risk vs. reward for S&P 500 yield, 1948–1991. (Source: *Pring Market Review*) been limited and the upside potential substantial. The annualized rate of return for a two-year holding period would be plotted in the diagram at Point A, close to the risk-free area but relatively high up on the reward scale. Conversely, purchasing stocks when the market is experiencing a 3 percent yield has, on average, offered a negative return over a 24-month holding period. This is plotted lower on the return scale and farther out on the risk axis (Point B). Point C represents the risk/reward for the entire period covered (1948–1991). Naturally this falls between Points A and B.

As successful investors, we want to position ourselves toward the top left-hand chart if possible. In investment circles this is known as the *Northwest Quadrant.* In the real world it is not possible to achieve the idealized risk/reward of maximum gains and no risk because there is always a tradeoff. However, there are several techniques that can help you to gravitate toward the North-

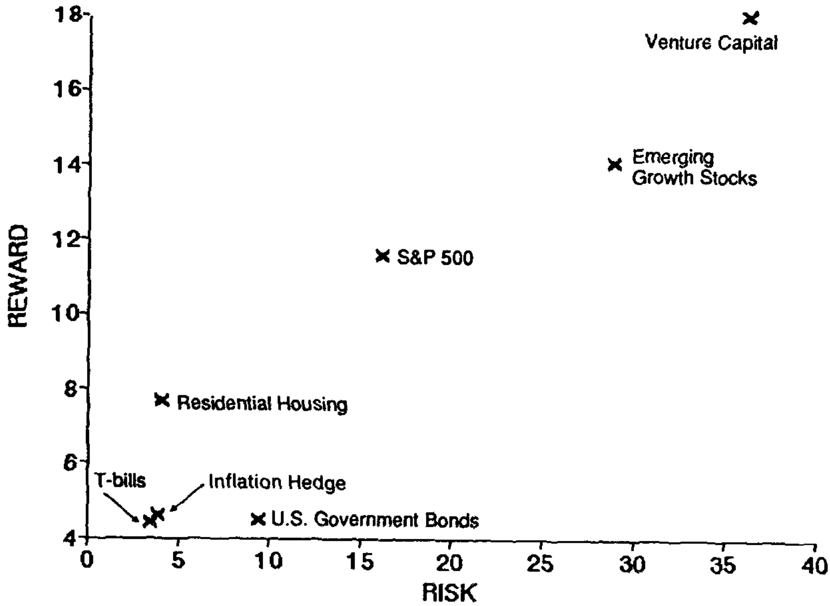

Figure 1.2 Risk vs. reward for seven asset classes, 1940–1990. (Source: *Pring Market Review*)

west Quadrant. The first is through diversification. The second is by emphasizing or overweighting an asset at the appropriate time in the business cycle. The third is buying when a particular asset is historically cheap and selling when it becomes overvalued. The latter point is to some extent a corollary of the second. Figure 1.2 plots the risk/reward (annualized monthly returns) relationship for various asset classes between 1940 and 1990.

THE SEASONAL APPROACH TO ASSET ALLOCATION

A significant part of this book is devoted to optimizing the tactical allocation of assets within a portfolio on the basis of business cycle conditions. This approach assumes two things. The first assumption is that the business cycle will continue to operate. The cycle has been a fact of life throughout recorded economic history, not only in the United States but in every other capitalist country as well. Typically it encompasses a time span of roughly four years from trough to trough, and is a reflection of human nature in action. Because human nature remains more or less constant, there are few grounds for expecting the business cycle to be "repealed."

The second assumption is that every business cycle progresses through a set, chronological series of events, each of which greatly affects the performance of specific asset classes. Subsequent chapters will describe these events and how they may be recognized. Most importantly, the chronological series of events is very similar to a calendar year moving through the four seasons. Every farmer knows that there is a season for planting and one for harvesting. The same is true for investors because the business cycle provides an optimum time for buying and a propitious one for liquidating each specific financial asset. In farming, if you are familiar with the crops that are suitable for the local soil and climate and know when to plant and harvest, barring an unforeseen natural disaster, it should be possible to obtain reasonable yields. Successful investing is no different. If you have an understanding of the characteristics of the various asset classes and can identify the points in the business cycle when they traditionally do well, it is possible to attain superior returns relative to the risk undertaken.

Unfortunately, the business cycle "seasons" are not as predictable as the calendar year seasons because they vary more in length and intensity. However, the guidelines presented later will provide you with enough information to identify the various seasons and the type of performance to be expected from each asset class during that stage of the cycle. We will discover the time to emphasize bonds or stocks and when it is appropriate to take a more defensive position. For most farmers, winters are a time for less activity because the risk of growing most crops is high. There is also a season in the business cycle when risk taking should be kept at a minimum. This means loading up with cash and waiting for the next opportunity.

During a business cycle, each asset moves through the four risk/reward quadrants indicated in Figure I.1. The objective, subject to the prescribed range established by the strategic allocation, is to assign an asset a very high weighting in the portfolio when it is in its Northwest Quadrant, gradually deemphasizing it as it moves toward the Southeast. These funds are then rotated into another asset that in turn is approaching the Northwest!

PSYCHOLOGICAL ASPECTS OF INVESTING

It is a relatively easy task to gain a theoretical understanding of why markets move up and down. Beating the market on paper is not that difficult, but actually putting that knowledge to work in the marketplace on a day-by-day basis is a much more difficult task. The reason is that as soon as money is committed to an investment, so is emotion. Every time we review the prices of our investments, we subject ourselves to the impulses of fear and greed. These have the effect of deflecting our judgment away from objective criteria to emotional ones. Of course, common sense dictates that periodic monitoring of a portfolio performance is a necessary part of the investment process, but if we get too close to the market, the tendency is *to respond to events and prices* instead of carefully laid out criteria. The asset allocation approach as described here makes a valuable contribution to this ongoing psychological battle that all investors have to face. First, the very adoption of the principles of