Intelligent Asset Allocation

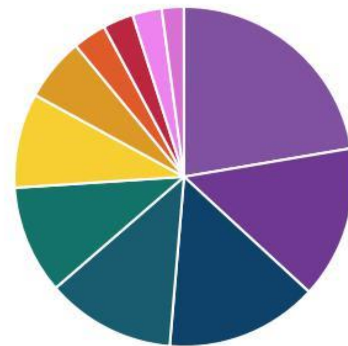
Better Returns & Lower Risk

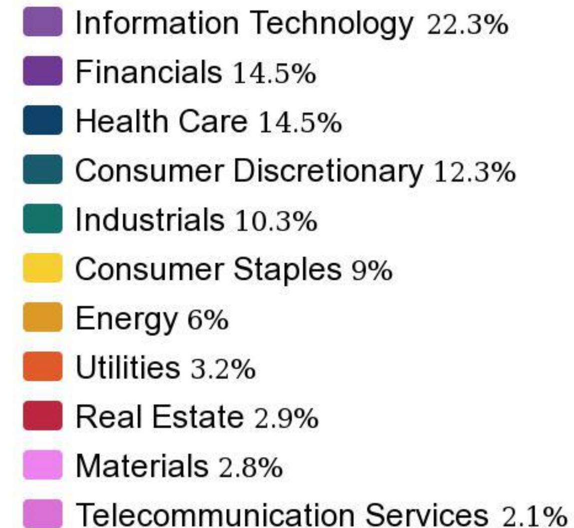
@KirkSpano ♦ Kirk Spano ♦ SeekingAlpha.com ♦ @SeekingAlpha

FROM "THE INTELLIGENT INVESTOR" BY BENJAMIN GRAHAM

THE IMPORTANCE OF ASSET ALLOCATION

- Multiple studies have confirmed that "Asset Allocation" accounts for about 90% of the volatility in your investment portfolio. That's huge.
- Asset Allocation is also responsible for about half of the actual returns in your portfolio over time.
- **Managing your Asset Allocation to maximize returns, while taking the risk appropriate to you, is your number on job as an investor.**





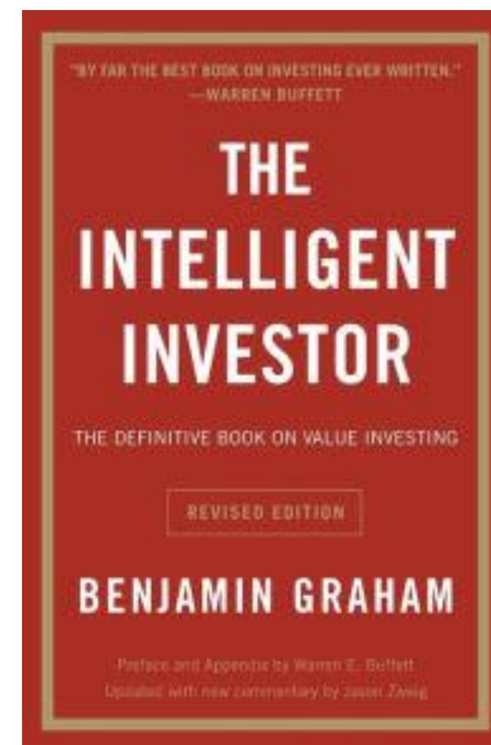
Based on GICS® sectors
The weightings for each sector of the index are rounded to the nearest tenth of a percent; therefore, the aggregate weights for the index may not equal 100%.
As Of Jun 30, 2017

WHAT IS ASSET ALLOCATION…

- **The typical definition of Asset Allocation is "an investment strategy that aims to balance risk and reward by apportioning a portfolio's assets according to an individual's goals, risk tolerance and investment horizon."**
- **I don't fully like that definition. The problem is that markets don't care about your goals, risk tolerance or investment horizon. Not even a little bit. The markets would like to take your money.**
- **Here is what I believe: Asset Allocation is how we choose asset classes and market sectors to invest in by excluding what we believe are the worst from our portfolios and adding more of our money to those that we believe are the best.**

INTELLIGENT INVESTORS & ENTERPRISING INVESTORS

- The **Intelligent Investor** and the **Enterprising Investor** are investor types from Benjamin Graham's classic "The Intelligent Investor." Graham's most famous pupil is Warren Buffett who became one of the greatest long-term investors of all-time and one of the 10 richest people in the world the past several decades.
- I have slightly modified the ideas on asset allocation found in the book to adapt to modern market realities such as computerized trading, hedge funds, activist investors, the rise of indexing and a more global economic landscape.
- I believe that by using the simplified ideas I provide for building your asset allocation, that you will experience lower risk and better returns over time. History supports my belief on this.
- By building a portfolio with a margin of safety, engaging in slow handed ebb & flow trading and controlling your emotions, I believe you will be able to protect and grow your financial freedom better than most other investors, including those with expensive investment advisors.



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INTELLIGENT INVESTORS & ENTERPRISING INVESTORS

- **Both kinds of investors are intelligent.**
- The **Intelligent Investor** is generally more interested in accumulating wealth through work, beating inflation and avoiding large risks to the majority of their portfolio. **Wealth preservation is primary to wealth creation**. Intelligent investors are willing to take moderate risk and will have a core fixed income portion within their overall portfolio. *Intelligent investors play defense first*. If you are close to retirement, already retired or simply prefer less portfolio volatility, you are probably an Intelligent Investor. Many small business owners are Intelligent Investors with their investment portfolio because of the inherent risks of being a business owner.
- The **Enterprising Investor** is generally more interested in creating new wealth with opportunistic investment of capital received from earned income or other sources. **Wealth creation is primary to wealth preservation**. Enterprising investors are willing to take more equity risk (own more stocks, not more risky stocks) and will generally not invest in fixed income except when it offers equity-like returns. *Enterprising investors play offense first*. If you are in your prime working years, comfortable with portfolio volatility and seeking to build wealth, then you are more likely to be an enterprising investor. Warren Buffett encourages this type of investing for most people in their working years who don't have specific risks (like being a business owner).

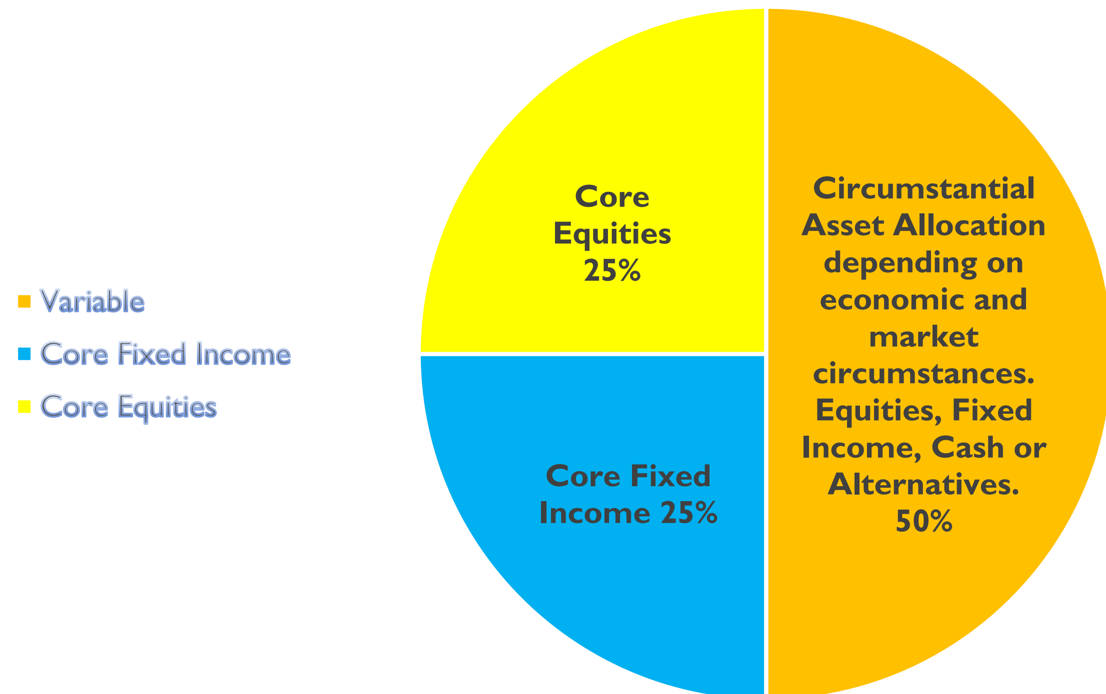
THE INTELLIGENT INVESTOR

BUILDING A MARGIN OF SAFETY AND SEEKING OPPORTUNITY THROUGH ASSET ALLOCATION

STRATEGIC ASSET ALLOCATION FOR INTELLIGENT INVESTORS

- The word "strategic" when building an asset allocation refers to the general outline we are planning to employ.
- This is the starting point for building an asset allocation, not the ending point.
- You will always hold at least 25% of your portfolio in equities in order to offset inflation.
    - The Powershares QQQ ETF (QQQ) which tracks the Nasdaq 100 is a typical core holding because of major secular trends.
- You will always hold about 25% of your portfolio in cash and fixed income investments.
- The other 50% of your portfolio will be invested purely on market conditions and can be invested in virtually any asset class.

Intelligent Investor Strategic Asset Allocation



BUILDING THE INTELLIGENT INVESTOR ASSET ALLOCATION

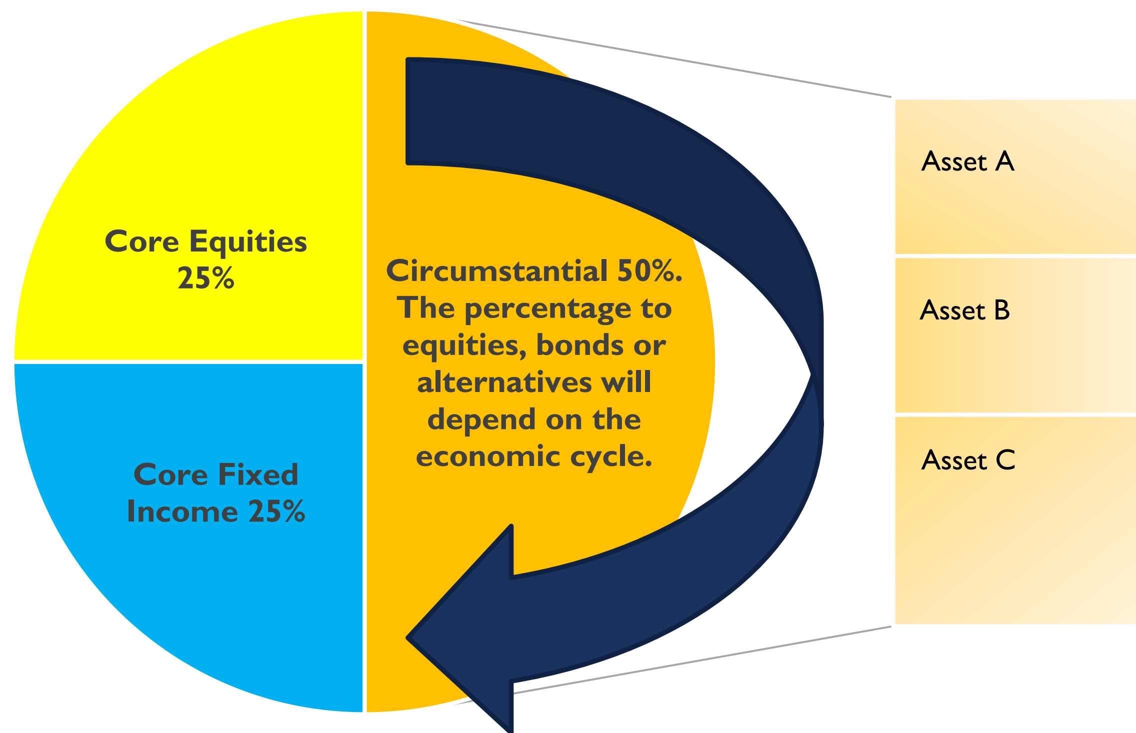
- Graham supposed that the base asset allocation model was ½ stocks and ½ bonds. I break this down into four quarters to allow for a more even handed approach to asset allocation.
- One-quarter of your portfolio has a base asset allocation of equities in order to offset long-term inflation, as well as, to take part in the growth of the markets and economy.
- One-quarter of your portfolio is made up of fixed income investments. This is done to generate portfolio income that can be paid out or reinvested, as well as, take part in currency, credit and interest rate opportunities.
- One-half of your portfolio will vary based upon market circumstances. Often it will be made up entirely of equities. As valuations within the market rise to above normal levels we will reduce equity holdings in most cases. When prices fall, i.e. after a correction, we will add to equity holdings. This is the easy to say, hard to do, "buy low, sell high."
- The Intelligent Investor generally never has more than 75% in stocks. The only exceptions are when the stock market rallies and we have not trimmed back yet due to price momentum that appears to remain in our favor and immediately after a major correction (think crash) when we might choose to go "all in" on cheap equities.

TACTICAL ASSET ALLOCATION FOR THE INTELLIGENT INVESTOR

- The word "tactical" when building an asset allocation refers to the changes we make to the asset allocation in real time and the assets we include in our holdings depending on economic and market circumstances.

- The different asset classes in the circumstantial portion of the portfolio cover the entire universe of asset classes.

- Asset A, B & C represent examples of different asset classes. For Example, Asset A might be Real Estate Investment Trusts (REITs), Asset B might be a Small Company Stock ETF and Asset C might be an International Stock ETF.



SEEKING OPPORTUNITY AND BUILDING A MARGIN OF SAFETY THROUGH ASSET ALLOCATION

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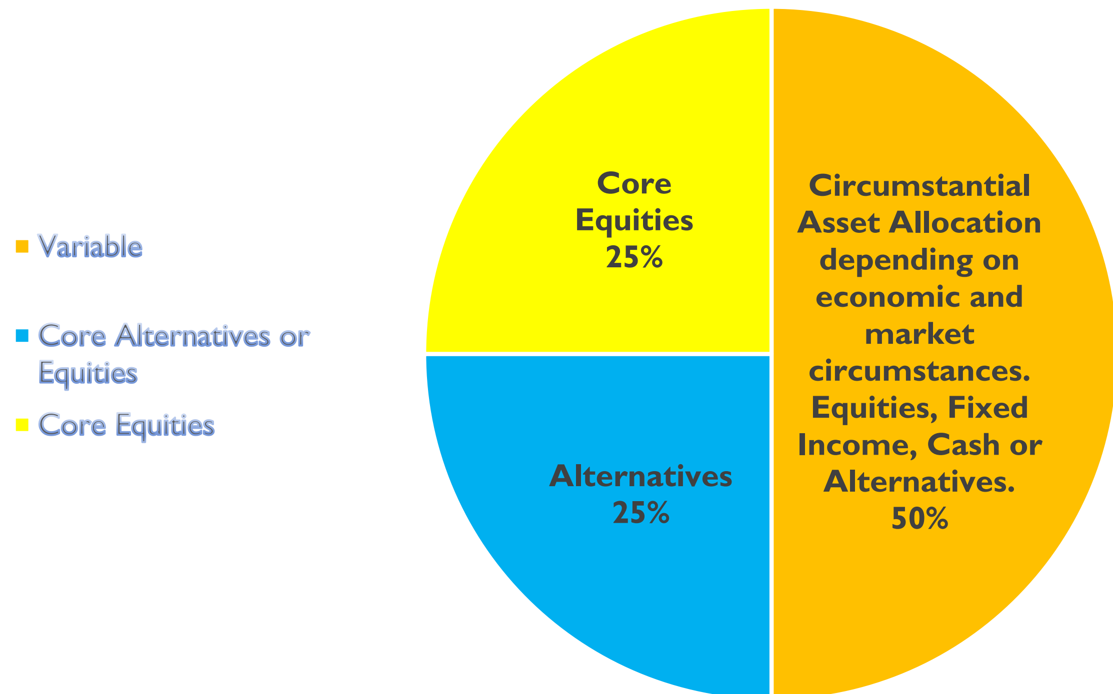
- You will always hold at least 25% of your portfolio in equities in order to offset inflation.
  - The Powershares QQQ ETF (QQQ) which tracks the Nasdaq 100 is a typical core holding because of major secular trends.
- You will usually hold about 25% of your portfolio in cash or alternative investments.
- The other 50% of your portfolio will be invested purely on market conditions and can be invested in virtually any asset class.



BUILDING THE ENTERPRISING INVESTOR ASSET ALLOCATION

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- One-quarter of your portfolio is made up of cash or alternative investments. This is done to give a portfolio optionality, generate income that can be reinvested and have hedges against inflation.
- One-half of your portfolio will vary based upon market circumstances. Often it will be made up entirely of equities. As valuations within the market rise to above normal levels we will reduce equity holdings in most cases. When prices fall, i.e. after a correction, we will add to equity holdings. This is the easy to say, hard to do, "buy low, sell high."
- The Enterprising Investor can have up to 100% in stocks for at least short periods of time following stock market crashes. A mix of 75% equities and 25% alternatives is typical.

TACTICAL ASSET ALLOCATION FOR THE ENTERPRISING INVESTOR

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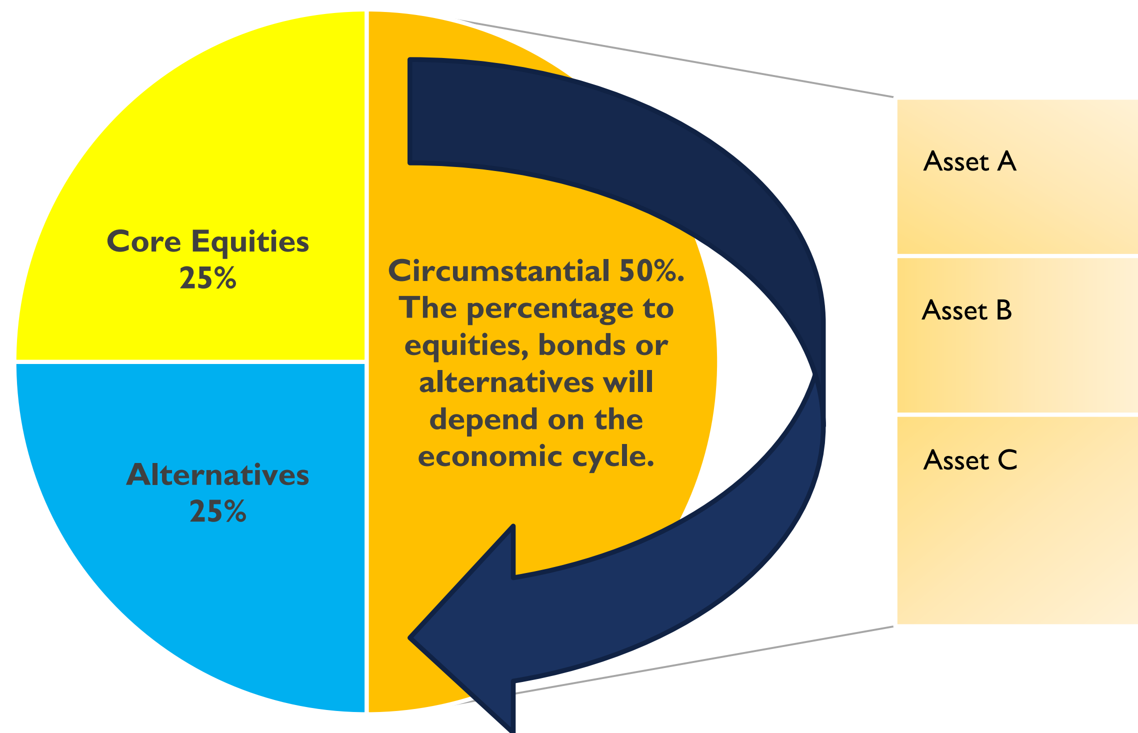


COMPARING BASE STRATEGIC ASSET ALLOCATIONS

Similarities

- Both are virtually always at least 25% in equity investments to offset long-term inflation and take part in the growth of the markets & economy.
- Diversification
- Willingness to hold extra cash when markets are unattractive.
- Tactical thinking to adjust to changing market situations.
- Open to making alternative investments, such as, REITs – Real Estate Investment Trusts.

Differences

- Intelligent Investors will generally have 50-75% in equity investments and about 25% in fixed income investments.
- Enterprising Investors will generally have 75-100% in equity investments and rarely have fixed income holdings.
- The core difference is the 25% cash & fixed income portion of the Intelligent Investor Strategic Asset Allocation vs the 25% cash & alternative investment portion of the Enterprising Investor Strategic Asset Allocation.

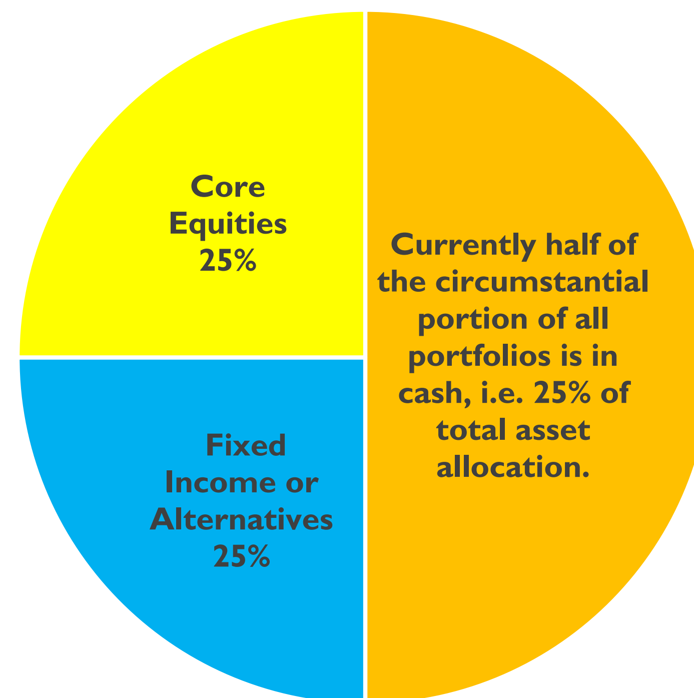
WHY QQQ? LOOK AT THE RESULTS VS THE S&P 500 *(THE MARKET)*

- **The simple explanation for the outperformance of QQQ is that it contains stocks that are benefitting from long-term favorable trends.**
- **QQQ is primarily invested in the technology, consumer, healthcare, communication and industrial sectors.**

NOTE ON ASSET ALLOCATION CURRENT AS OF JULY 2017

- As of July 2017, due to extremely high stock market valuations and very slow growth economic, it is suggested that all investors hold half of their circumstantial portfolio sleeve in cash or FDIC insured money market accounts, that is, 25% of your total asset allocation.
- This will greatly reduce risk of loss to sudden drops in the stock market.
- It will also give ***optionality*** to investors who are looking for lower priced opportunities in the stock market to invest in. In essence, having cash gives you the ability to strike while the iron is hot.
    - Optionality is the property of asymmetric upside (preferably unlimited) with correspondingly limited downside (preferably tiny). – *Nassim Taleb, Antifragile*

Asset Allocation July 2017



BUILDING YOUR INVESTMENT PORTFOLIO

INVESTMENT POLICY STATEMENT OVERVIEW

Kirk Spano’s Margin of Safety Investing

FOUNDATIONAL THOUGHTS

- Determine whether you are an Intelligent Investor or Enterprising Investor.
- Establish reasonable expectations & objectives for your investment portfolio.
- Sell holdings that do not conform to your long-term investment objectives.
- Buy holdings slowly & incrementally over time that conform to your long-term investment plan, unless there is a crash, then buy quickly.
- Think "tactically," that is, be willing to adjust to changing circumstances of the economy and markets.
- Remember, the market does not care about you, thus, there are no firm rules for investing based upon age or other circumstances, other than broad guidelines. It is much more important to be aware what the market is doing, because it does not care what you are doing.
- You should only monitor your portfolio weekly or monthly basis. More than that is obsessive for non-traders.
- We are not short-term traders. We are "position traders" which means we generally hold investments from several months to many years.
- Monitoring your portfolio does not mean looking at red and green numbers, it means getting to know your investments. You should go to the websites of companies and funds you are invested in and read their investor presentations at least once. Knowing more about your investments will help you sleep at night.

WHO ARE YOU?

- "Who are you" isn't just a song from "The Who." It is the most central question to how you invest.
- Your financial status, income, investment experience, age, goals and risk tolerance will help determine whether you are an *Intelligent Investor* or *Enterprising Investor*.
- While many people think and say they have a higher risk tolerance than most other people, experience has taught me that is usually not true.
- If you can not emotionally handle portfolio value swings of 30-50% then you should not be an Enterprising Investor even though those swings only occur occasionally.
- While many people will claim to be risk tolerant, that often only lasts until a volatile market and a significant drawdown. Be honest with yourself.
- Most people are ***Intelligent Investors***.

ESTABLISH REASONABLE EXPECTATIONS & OBJECTIVES

- Owning equities comes with risk. There are no guarantees with equity investments.
- People who own stocks and other equities should be prepared to be long-term investors for 10 years or more to recognize objectives within their portfolio.
  - Individual holdings are generally bought with a 2 to 4 year anticipatory window for catalysts to generate gains for our portfolios. Sometimes it takes shorter or longer for things to work out in our favor, and sometimes things do not work out in our favor. There is always a risk of loss on an individual holding. In cases where my judgement was wrong or things just do not work out, I try to sell before a big loss occurs.
- Much of the economy is cyclical, therefore, understanding about where we are in financial and economic cycles is important in managing risk and avoiding chasing returns, which virtually always leads to bad outcomes.
- We prefer to invest in positive long-term secular trends when we can do so at reasonable prices.
- Evaluating performance year to year is NOT a method that works well. Performance should be measured over a full cycle, peak to peak or trough to trough. Cycles can last anywhere from 2 to 10 years historically.

ESTABLISH REASONABLE EXPECTATIONS & OBJECTIVES

Intelligent Investors

- There is no "expected" rate of return, however, the Intelligent Investor can generally be thought of as trying to beat inflation with a small extra margin with as little risk as possible. If inflation averages 3% over 10 years, a very good return with mitigated risk would be 7% to 11% in my opinion.
- Must be comfortable with moderate swings in portfolio, at all stages of owning a portfolio.

Enterprising Investors

- There is no "expected" rate of return, however, the Enterprising Investor can generally be thought of as trying to opportunistically create new wealth. This entails a goal of earning 12% to16% on average over a long period of time – 10 years plus. This is a very difficult goal to achieve.
- Must be comfortable with large swings in portfolio value, at all times, especially in the early stages of building a portfolio.

SELLING HOLDINGS OUT OF "OLD" PORTFOLIOS

- Holdings that do not have the appropriate margin of safety and fit in the chosen asset allocation should be sold.
- In general, we will want to free up cash temporarily in order to have the "optionality" to invest from our list of preferred investments.
- "Optionality" is easily understood is having the ability to strike while the iron is hot. For example, if we have cash on hand when there is a pullback in some or all of the assets we are interested in, we are ready to buy when others are selling (hopefully at panic low prices).
- Holding extra cash can mean up to a year or two of being underinvested while the portfolio is being built as opportunities arise.
- Holding extra cash does add to safety from losses, so that is a short-term benefit while building a portfolio. Generally what we have sold we view as risky assets or at least not top holdings.

BUY NEW HOLDINGS SLOWLY & INCREMENTALLY, EXCEPT AFTER CRASHES WHEN YOU BUY QUICKLY & FULLY

- When building positions we want to do it over time. While technical and quantitative analysis can give us some idea that a holding we like is finished falling in price, there is no fool-proof way to know if you are buying at a bottom price. That said, we can make the most money finding market reversals on good fundamental assets.
- Building positions a little at a time over several months usually is a way to cost-average in at different prices. An important benefit of this approach is that we continue to learn about a holding as we buy it over time.
- There is an important caveat to buying slowly over time. A few times per decade the stock market undergoes a very significant correction or "bear market." That is a drop in values of 20% or more. Sometimes we get an opportunity to buy a lot of stocks over just a month or two. On these occasions, we need to be ready to move a little more quickly to get low cost basis (cheaper prices) on our holdings.

THINK TACTICALLY

- Tactical thinking means being able to adjust to whatever circumstances might occur.
- It is very important for investors to think tactically as no method of prediction is perfect.
- CEO's, governments, central banks and markets change circumstances unexpectedly all the time.
- Sometimes "black swans" occur that almost nobody sees coming, completely changing the investment landscape. 2008's financial collapse is one such event.
- It is important that we are able to analyze these situations and react quicker than most of the crowd to reposition, often the vast majority of a portfolio in a matter of weeks or months, i.e. Q2 2009 after the financial crisis bottom.
- Keeping track of various scenarios and potential outcomes increases our response time to making tactical portfolio adjustments, as knowledge is one of the great offsets to emotions such as fear.

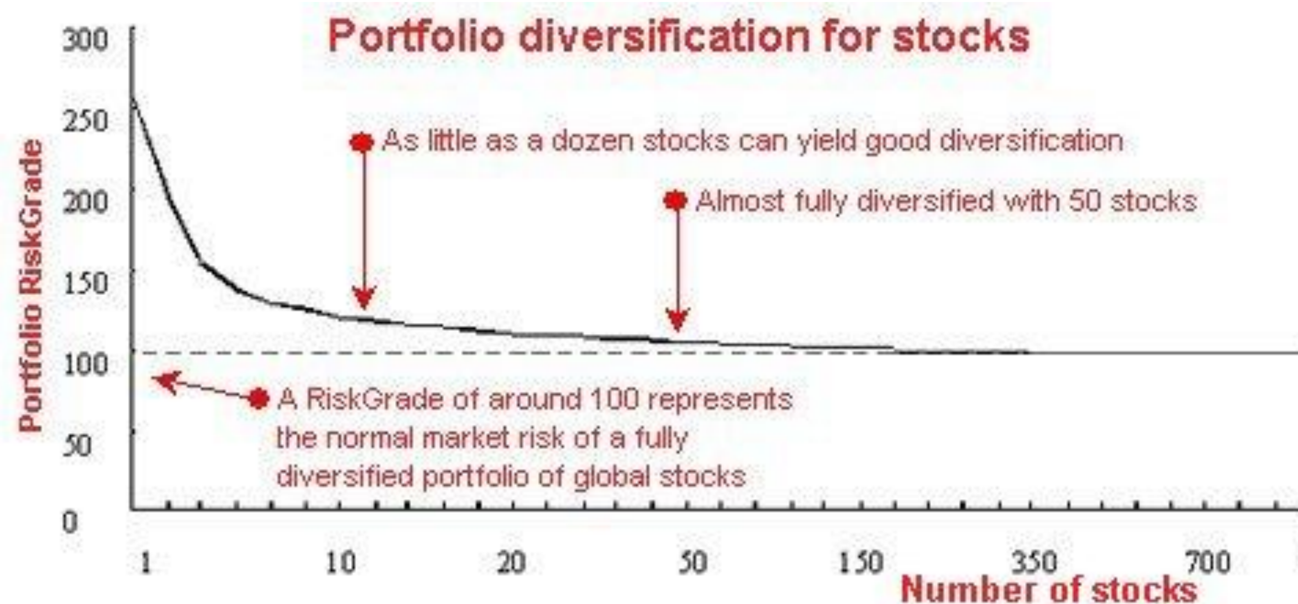
DIVERSIFICATION

- *"Diversification is a protection against ignorance. It makes very little sense for those who know what they're doing." Warren Buffett*

- We can get adequate diversification by using a smart asset allocation strategy. For example, if we own a few funds that focus on different asset classes, for example, oil stocks, India, small companies and technology, bonds, currencies, commodities and then add our favorite stocks to the portfolio, we will be diversified by having exposure to different parts of the economy and markets.
- We can be diversified without diluting our returns by owning a little bit of everything – which is what most people usually do in a very expensive way. We don't want to be "most people."

DIVERSIFICATION

- The idea of diversification has been abused by the financial industry to sell more products.
- The chart to the right demonstrates that 50-100 stocks, whether held individually or in funds, are generally enough to diversify a portfolio.
- For a global portfolio, generally exposure to about 200 total securities is about typical.
- Too much diversification stops reducing risk in a meaningful way and will usually water down portfolio returns, such as with people who have exposure to 500+ stocks via multiple index funds and mutual funds.
- If you still want hundreds and hundreds of holdings, buy index funds, hold a very long time and do not pay extra fees.

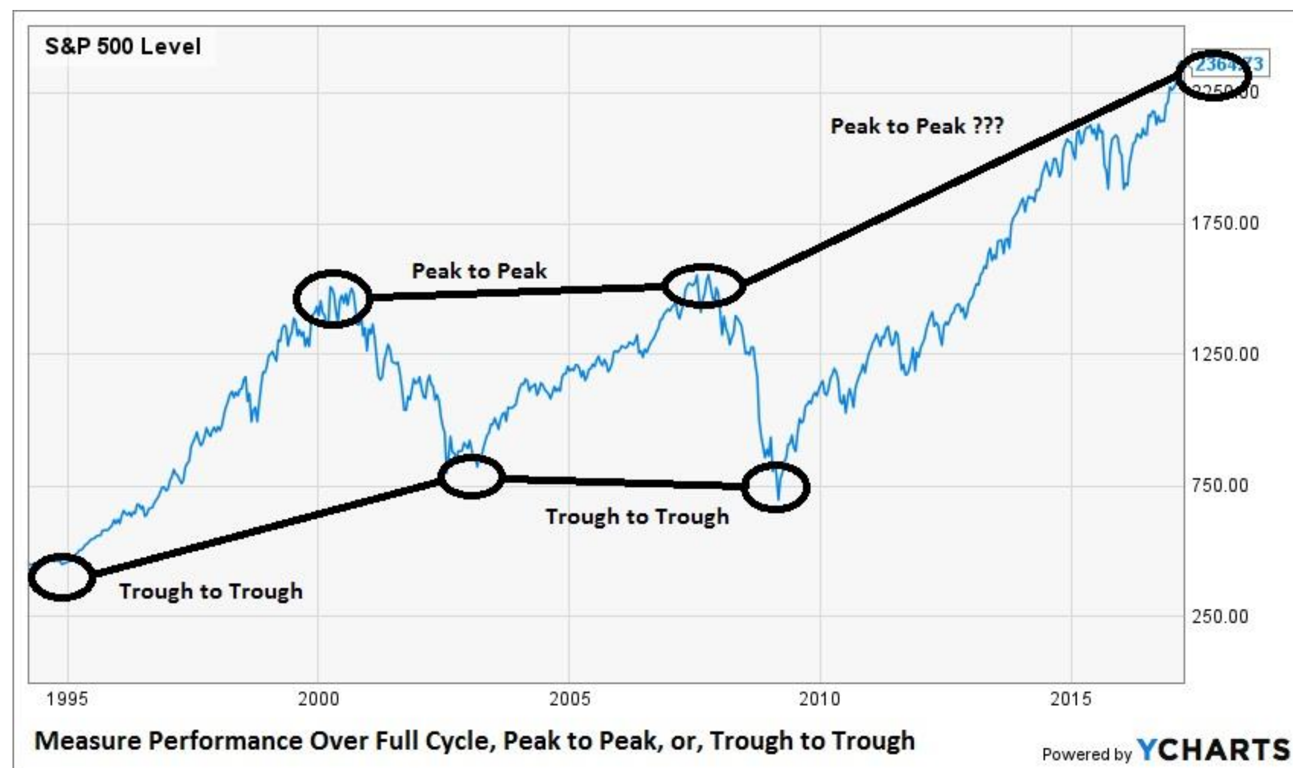


MONITORING A PORTFOLIO

- While many people fall into the trap of looking at their holdings daily, I strongly recommend against that for non-traders. Looking at red and green return numbers too often can generate emotional responses which make it difficult to make smart investment decisions – something that's hard enough already.
- Most people who pick their own investments should look at their portfolios once or twice per week and adjust any outstanding trade orders accordingly.
- You should spend your time reading the investor presentations of companies and industry journals of sectors you are invested in. 10-Q and other SEC documents are possibly the best source of in depth company information. The Wall Street Journal, Seeking Alpha (free), MarketWatch (free), Financial Times or Bloomberg (free) are good sources for stories and analysis related to your investment holdings for you to follow up on with your own research. There are many blogs and other sites, however, over half of it is junk, so be careful – it does serve as a great contrary indicator much of the time so be aware.

EVALUATING PERFORMANCE

- Shorter time periods are dominated by proprietary traders of big investment firms, high-speed supercomputers, hedge funds, day traders and offshore accounts.
- Investment performance should be measured over longer time frames as that is where individual investors have a true edge.
- Appropriate time frames for investment planning and performance measurement are over a full market cycle from peak to peak or from trough to trough.
- Cycles generally last from 2 years to 10 years, with many lasting somewhere near the middle of that range.



TYPES OF INVESTMENTS

TYPES OF SECURITIES AND USE

Stocks

- Classified many different ways, but generally either by economic sector, style (growth versus value) or by size (small, mid, and large capitalization) or both.
- Stocks are the primary driver of long-term investment returns above the prevailing interest rates.
- I try to understand the **fundamental value** of companies. Usually that value is based on assets, free cash flow and expected growth. We try to buy when stock prices do not fully represent underlying value of a company.

Exchange Traded Funds

- ETFs hold a basket of stocks (or bonds), differ by economic sector, style (growth versus value) or by size (small, mid, and large capitalization) or both.
- Owning a fund can diversify against company specific risk, however, can expose you to risk associated with the fund's objective.
- ETFs are very good for establishing a core portfolio, as well as, overweighting a portfolio towards asset classes that we find with favorable value or trends.

TYPES OF SECURITIES AND USE

Real Estate Investment Trusts

- A company that owns, and in most cases operates, income-producing **real estate**. **REITs** own many types of commercial **real estate**, ranging from office and apartment buildings to warehouses, hospitals, shopping centers, hotels and timberlands.
- Structured like a fund for all intents and purposes.
- Offers exposure to real estate for those who do not want to own and manage actual real estate.

Master Limited Partnerships

- A **limited partnership** that is publicly traded on an exchange qualifying under Section 7704 of the Internal Revenue Code. It combines the tax benefits of a **limited partnership** with the liquidity of publicly traded securities.
- Used within taxable accounts to generate income.
- Complex structure requires complete analysis. In recent years, oil & gas MLPs have suffered due to a lack of growth in the industry.

TYPES OF SECURITIES AND USE

Fixed Income

- U.S. Government bonds are typically considered among the safest bonds, particularly U.S. Treasuries which are backed by the full faith and credit of the U.S. Government. Agency bonds do not have that explicit guarantee.
- Corporate bonds issued by companies usually pay higher income than other sorts of bonds.
- Global bonds issued by governments or corporations often perform well when the U.S. stock market does not and give us an opportunity to take advantage of changing currency trends.

TYPES OF SECURITIES AND USE

Options you sell

- Cash-secured puts – for generating income and used for setting a price to buy a desired stock that might be fairly or undervalued as such price.
- Covered calls – for generating income and used for setting a price to sell a certain stock that might be fairly or overvalued at such price.
- Generally for Intelligent Investors who want to generate extra income.
- Must be willing to buy underlying stock in case of cash-secured puts.

Options you buy

- Calls and LEAPs – for generating an amplified growth effect for the underlying security.
- Puts – for "betting" against a particular assets, generally as a hedge to offset risk in "long" investments, sometimes as speculation for asymmetric gains.
- Only for Enterprising Investors or for Intelligent Investors only after significant stock market corrections.
- Must be willing to lose entire investment.

Do not use options until you have studied the CBOE website learning center for fuller explanations of the concepts in the column to the right. Also read the **Characteristics and Risks of Standardized Options**.

SUMMARY

- We have just touched the tip of the iceberg on investing. However, following this outline can keep you organized, on plan and lead to far better results than other more complicated approaches.
- Ultimately, how you adjust your asset allocation accounts for a substantial amount of your investment experience over time.
- Excess returns are generated by particularly well-done security selection, i.e. specific stocks and ETFs, see my "Core 4 Investment Method" report.
- For DIY investors, my experience is that investors should take the vast majority of my recommendations vs "cherry-picking."
- Please make sure to "follow" me as I am making the transition from MarketWatch to Seeking Alpha.
- Follow me **@KirkSpano** on Twitter or on **Facebook**.
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