Core 4 Investing Method

A Step by Step Investment Approach

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"CONFRONTED WITH A CHALLENGE TO DISTILL THE SECRET OF SOUND INVESTMENT INTO THREE WORDS, WE VENTURE THE MOTTO, MARGIN OF SAFETY."

FROM "THE INTELLIGENT INVESTOR" BY BENJAMIN GRAHAM

INVESTMENT APPROACHES

Most investors claim to have an approach to investing. Some say they are growth investors, others claim to be macro, many profess to be value investors, while others are disciples of technical trading or trend following.

It is difficult for an investor to consider one approach in relation to the others. Often, somebody who fails at one approach tries another and fails there as well. Sometimes, a person will find an approach that works. The reality is that every approach works sometimes.

The ***Core 4 Investing Method*** takes into account four major investment processes and creates a step-by-step approach for uncovering some of the best investments in the markets today and tomorrow.

4 THINGS TO CONSIDER TO FIND GREAT INVESTMENTS

1. **Secular Trends – within the largest economic trends we want to look for opportunities.**
2. **Government & Central Bank Policy – the impact is often monumental or at least can change time lines by many years.**
3. **Fundamental Value – ultimately, we want to find assets and companies trading for less than their in their true intrinsic value.**
4. **Price Trends – respecting investor psychology is very important for investment entries and exits.**

SECULAR TRENDS

- The world is changing in ways that will impact economics and the markets.
- Certain parts of the economy and regions of the world are growing faster than others.
- Concentrating on the fastest growing sectors of the economy and regions of the world is a good start for finding great investments.
- Conversely, the slowest growing parts of the economy are often where to find investments to sell.
- Within each major secular trend are subtrends.

The 6 Biggest Trends

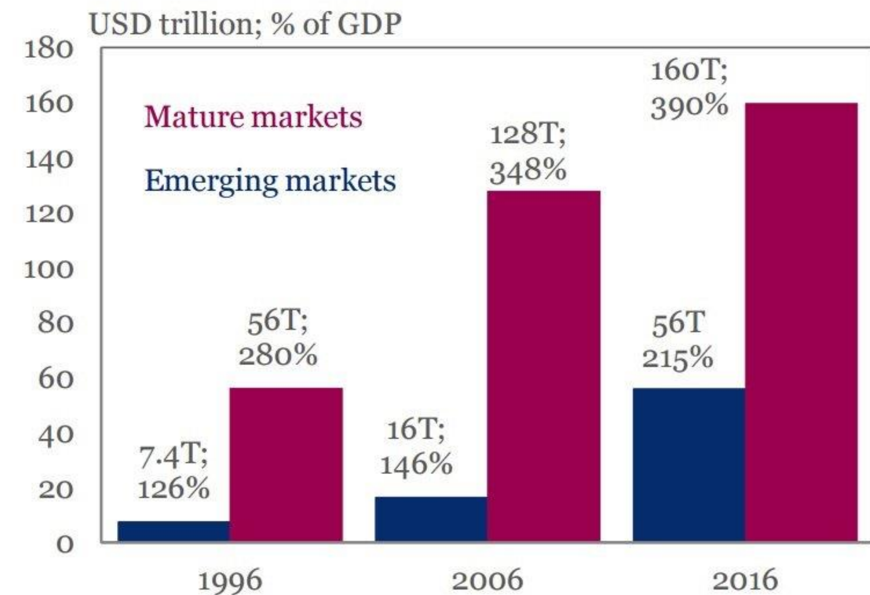
- Aging Demographics
- Global Debt
- Technological Change
- Climate Change
- Sustainability
- Multipolar Geopolitics

SECULAR TRENDS

Aging Demographics

- The 4 largest economies are all facing dramatic population aging curves – America, Europe, China & Japan.
- This will lead to major strains on national budgets due to spending on pensions, age related healthcare and social welfare programs.
- It will impact the global economy dramatically soon.
- Most of the ***developed*** world is facing issues linked to aging demographics.
- Most of the ***developing*** world is facing issues linked to aging demographics.

Global Debt



SECULAR TRENDS

Technological Change

- Technological change is impacting virtually every sector and industry within the economy.
- Healthcare
- IoT
- Artificial Intelligence
- Virtual Reality & Augmented Reality
- Communications
- Transportation
- Energy…

Climate Change

- Paris Climate Agreement with 195 signatories makes skepticism of some rather moot.
- Alternative energy will continue to grow at phenomenal rates.
- The coal and oil industries are now both in long-term "run-off," which will last decades yielding unexpected opportunities to be long and short.
- Efficiency will keep coming to buildings, cars, computers and industry.
- Climate "clean-up" technology will likely "save the world."

SECULAR TRENDS

Sustainability

- While the planet seems to be awash in plenty at the moment, but that is a matter of perspective.
- Over 100 million people are starving, 2.4 billion do not have adequate plumbing and 600 million do not have enough drinking water.
- Energy needs in the developing markets are growing faster than energy generation and transmission can be deployed.
- Waste is piling up and floating around to the point of killing off species.
- Unique solutions to sustainability issues, often using technology, are emerging.

Mutlipolar Geopolitics

- The United States is not the only superpower on the planet anymore, but is still the strongest superpower with the widest global influence.
- The rise of China is real, but they prefer to remain a regional power with global economic might.
- Russia is a "faux" power, with brutal, dishonest, thieving and manipulative leadership.
- Europe is influential, but will move in a sideways manner for a very long time.
- The Middle East is descending into greater instability due to the slow death of oil.
- The rise of India will be felt in the next generation.

- Within each of those six secular super-trends are many subtrends.
- It is vitally important to understand the deep impact of aging demographics on society and government.
- Ultimately, everything always revolves around taking care of and serving people.
- We can find investment opportunities, both long and short, by studying these major trends.

SECULAR TRENDS

GOVERNMENT & CENTRAL BANK POLICY

- The impact of government and central bank policies have a dramatic impact on the direction of the economy.
  - Consider ideas like: "Don't fight the Fed."
- Entire investment letters are devoted to government policy and central bank analysis, I subscribe to many, including sites like Stratfor.
- There are also many websites that are mainly "click bait" that focus more on conspiracy theories than analysis – stay away from ideology first "news sources."
- Our ability to control our own emotions and any self-validating ideological affiliation is a key to being a successful investor. It is one thing to vote a certain way, it is quite another to allow ideology to control investment decisions, as that will generally work out poorly about half the time.
- Ultimately, what will happen economically will always happen, however, government and central banks can extend and shorten time lines, as well as, amplify economic outcomes.

GOVERNMENT & CENTRAL BANK POLICY

- Governments control massive amounts of capital, including, human, natural resources, technological and financial. The policies of governments always have significant impact on the economy and the value of assets.
- Central Banks control the levers of finance, that is, money. While there is widespread criticism of central banks, much of it is dogmatic and incongruous. Beware falling into ideological traps and consider that central banks want to see a growing economy regardless of their motivations otherwise.
- Central banks have certainly made mistakes, but the Federal Reserve of the United States has clearly helped standards of living improve both at home and abroad. The issues of wealth inequality go far beyond central bank policy and probably more rightly fall at the feet of Congress.
- Central bank control of money is what influences long-term growth and inflation, as well as, the value of a currency.
- The value of the dollar, or any nation's currency, will ultimately impact national inflation. Consider that the "petrodollar" era has been a "free-ride" for two generations and that will change as oil becomes less important.
- Inflation is a double-edged sword that requires close monitoring. Much of the appreciation of assets is inflation based, but so are the losses on standard of living for many people in the middle class.

- By observing government and central bank policy, as ideologically free as possible, we can uncover truths about the direction of the economy and markets over all time frames: short, intermediate and long.
- Once we understand the general direction of things and the time lines, we can seek out investments that will be impacted the most, sometimes very positively and others very negatively.
- Governments and central banks are largely reacting to the secular super trends that I identified earlier.
- Some of the very best investments are supported by government and central bank policy.

GOVERNMENT AND CENTRAL BANK POLICY

FUNDAMENTAL VALUE

- Once we have found the sectors of the economy and regions of the world we want to invest in, it is time to turn to learning the fundamental value of a company or sector.
- Bottom up analysis starts with understanding a company's business model.
- The balance sheet will dictate if we believe a company, or group of companies, is strong enough to be invested in.
- From there we move onto growth characteristics and catalysts for growth.
- Profit growth, generally follows revenue growth.
- Ultimately, investment is based on a simple idea: whether we can buy stock for less than what the company is truly worth in the short-term future, which I normally define as 2 to 4 years.
- Sometimes, catalysts don't manifest within the 2 to 4 year time frame, so, we must consider whether or not to extend that time frame. If we were early, we generally stay invested, if it turns out we were wrong, we sell.

FUNDAMENTAL VALUE

- When studying individual companies, beginning at core primary sources, such as company investor presentations for an outline of the company and then moving onto SEC documents is mandatory. From there we move onto competitors documents and industry journals. Legendary investor Jim Rogers said this about reading and learning about companies:
  - *"The best advice I ever got was on an airplane. It was in my early days on Wall Street. I was flying to Chicago, and I sat next to an older guy. Anyway, I remember him as being an old guy, which means he may have been 40. He told me to read everything. If you get interested in a company and you read the annual report, he said, you will have done more than 98% of the people on Wall Street. And if you read the footnotes in the annual report you will have done more than 100% of the people on Wall Street.*

    I realized right away that if I just literally read a company's annual report and the notes -- or better yet, two or three years of reports -- that I would know much more than others. Professional investors used to sort of be dazzled. Everyone seemed to think I was smart. I later realized that I had to do more than just that. I learned that I had to read the annual reports of those I am investing in and their competitors' annual reports, the trade journals, and everything that I could get my hands on. But I realized that most people don't bother even doing the basic homework. And if I did even more, I'd be so far ahead that I'd probably be able to find successful investments."

- My goal is to find companies that I believe have a chance to give us a ***total return*** *(inclusive of dividends and buybacks)* of triple on our money within 5 to 7 years, and should at a minimum double. Because I am looking for catalysts in the 2 to 4 year time frame, that gives us a cushion, or margin of safety for achieving our goals.
- Sector and regional investing has the same return goals, but because we will be investing a group, we are generally looking to enter on deep value after a major correction. With company investing, we can often find opportunity when investors are uninformed and being myopic.

Fundamental Value

PRICE TRENDS

"In the short term, the market is a popularity contest. In the long term, the market is a weighing machine."

~ Warren Buffett

- While we try through fundamental analysis to determine what an investment "weighs," often the crowd, especially in the short-term disagrees. We can use that to our advantage.
- I am typically looking for reversals to buy into. Sometimes those reversals are in the short-term to allow me to buy into a longer-term upswing. For example, the PowerShares QQQ is in a long-term uptrend and will remain so for many years, so we want to use short-term declines as opportunities to buy. Thus, QQQ, is a classic buy the dips investment position.
- Other times, we are looking to find where the crowd's enthusiasm/greed or despondency/fear is giving us a great opportunity to be contrarian.

PRICE TRENDS

Here, I'd like to tell a short story:

I used to work at a firm that was related to a major independent brokerage. In 2006, I started giving seminars telling people to sell real estate they didn't plan to live in another ten years and sell stocks. I got laughed at.

In the second half of 2007, I saw that the stock market started to turn over. It was just an eyeball analysis. I already had my fundamental analysis that the market was in a bubble that would pop. However, getting timing right is extremely difficult.

I started to use point and figure analysis and studied the "Turtle Traders" who were early trend followers. I was mostly out of the stock market by spring 2008. I was holding a lot of cash. My brokerage told me to get it invested, that I wasn't getting paid to sit on cash. I ignored them. The Friday before the stock market crashed, I saw the faces on the people on TV and decided to open some positions in a double short bank ETF. I got an email from my brokerage telling me I'm not qualified to bet against the stock market. I ignored them.

In meetings with the other advisors, I heard stories of people losing 50-60% over the next several months. I was about even for the financial crisis depending on the account. When I shared that I was doing a loose form of trend following, I was told I was wrong.

In March of 2009, my colleagues told me that President Obama would ruin the markets and economy. My response, "isn't' it already ruined?" It was at that time, that the market capitulated and the semi-famous "**Haines bottom**" occurred. Mark Haines on CNBC talked about the 200-day moving average. That's one of the indicators I was following as well.

I started to buy stocks in Q2 2009, because there was a discernible reversal going on – and hey, the world never really ends, if it does, who cares, we're dead. Since then, I have become more of a student of the price trends that are reflections of people and machines. Knowing these price trends is power to get into and out of investments a little better than the crowd, and that's all you really need to be, a little better.

PRICE TRENDS

- **We only invest in companies that qualify for our "ETFavorites," "Very Short List" and blue chips that are out of favor.**
- The price trend of an asset is important for buys and sells. That is whether it is falling or rising in price and how much volume.
- There is no perfect way to measure whether an asset price will continue to rise or fall. There is not even a good way to determine price movements for short-term price swings. However, we can largely measure supply and demand for an asset, i.e. the volume of how many people are buying and selling an asset. This is very important information.
- I use 2 systems, one technical, one quantitative, as well as, my own analysis, to determine whether an asset is likely to have a move higher or lower in the intermediate term.
- If an asset has fallen, but selling pressure has abated, and it is in a consolidating sideways trend, then investors will start to accumulate the asset with a series of small purchases, on anticipation of a breakout higher in the short (under2 years) or intermediate term time frame (2 to 4 years).
- If a position has risen already, but demand based on volume continues to be strong and the asset is not overpriced based on fundamentals, it might remain a hold or even a buy on short-term pullbacks.
- These approaches are type of "trend following" and "reversal trading." Both approaches manage risk.

- Ultimately, the markets are reflections of investor psychology. We can use that to find opportunities when psychology does not reflect reality.
- Reversion to the mean is a constant that occurs repeatedly and reliably, cash flow analysis helps us find times to be a contrarian looking for reversals in price trend.
- By my nature, I am a contrarian, but I do respect strong uptrends that are grounded fundamentally.
- When we can find a strong long-term uptrend, that is in a short-term downtrend, that is often the very best time to invest.
- While a book can be written on this next idea, I will simply say that there is a battle between man and machine in the markets. I am acutely aware of it and will write more about it, but for now, I can say this, the machines are winning. Knowing that is a valuable tool.

PRICE TRENDS

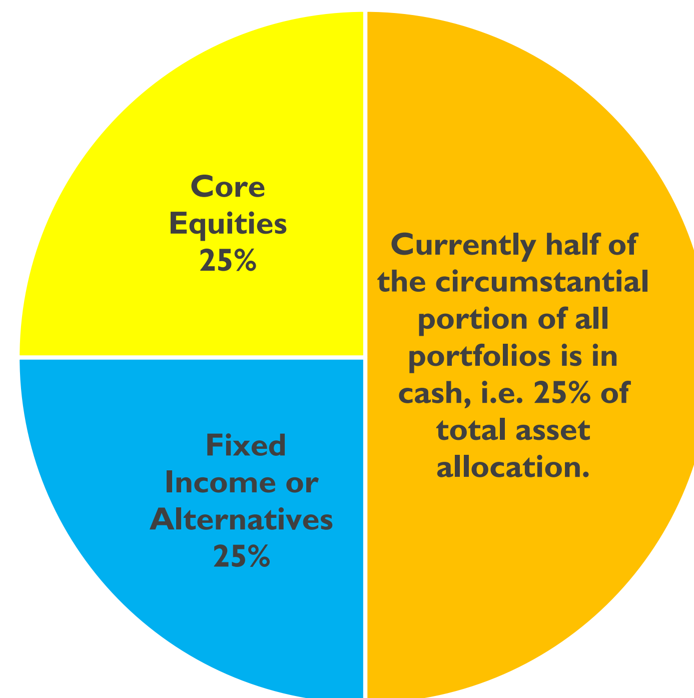
WHY QQQ? LOOK AT THE RESULTS VS THE S&P 500 *(THE MARKET)*

- **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



INVESTMENT POLICY STATEMENT OVERVIEW

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.

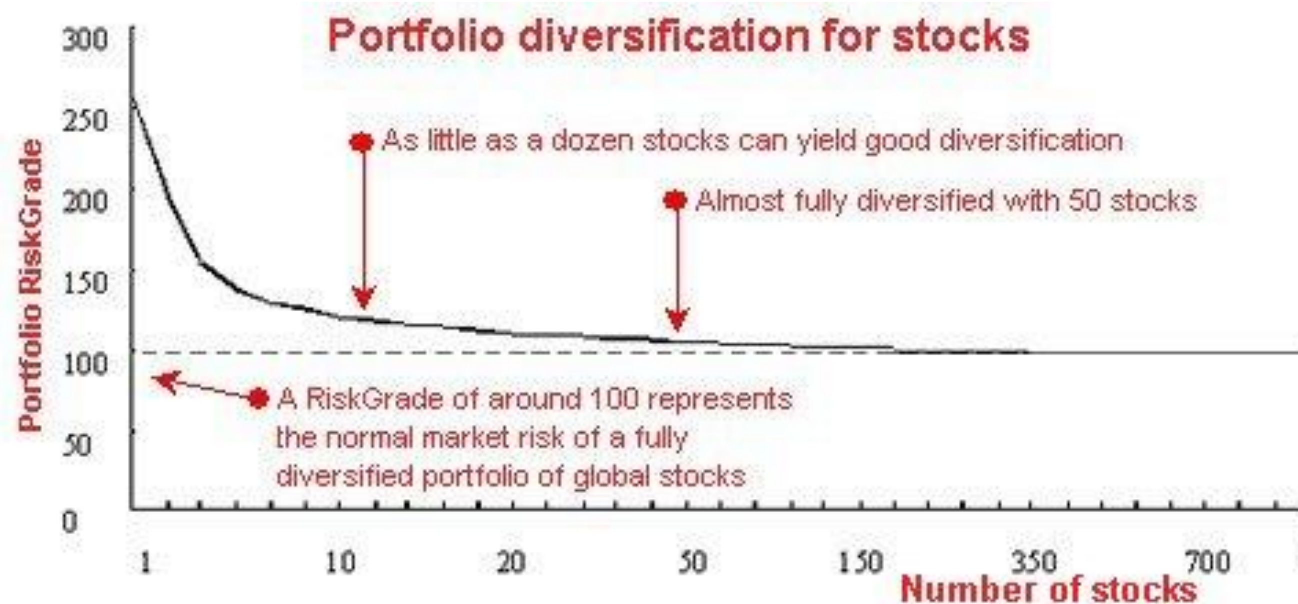
DIVERSIFICATION

- *"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.

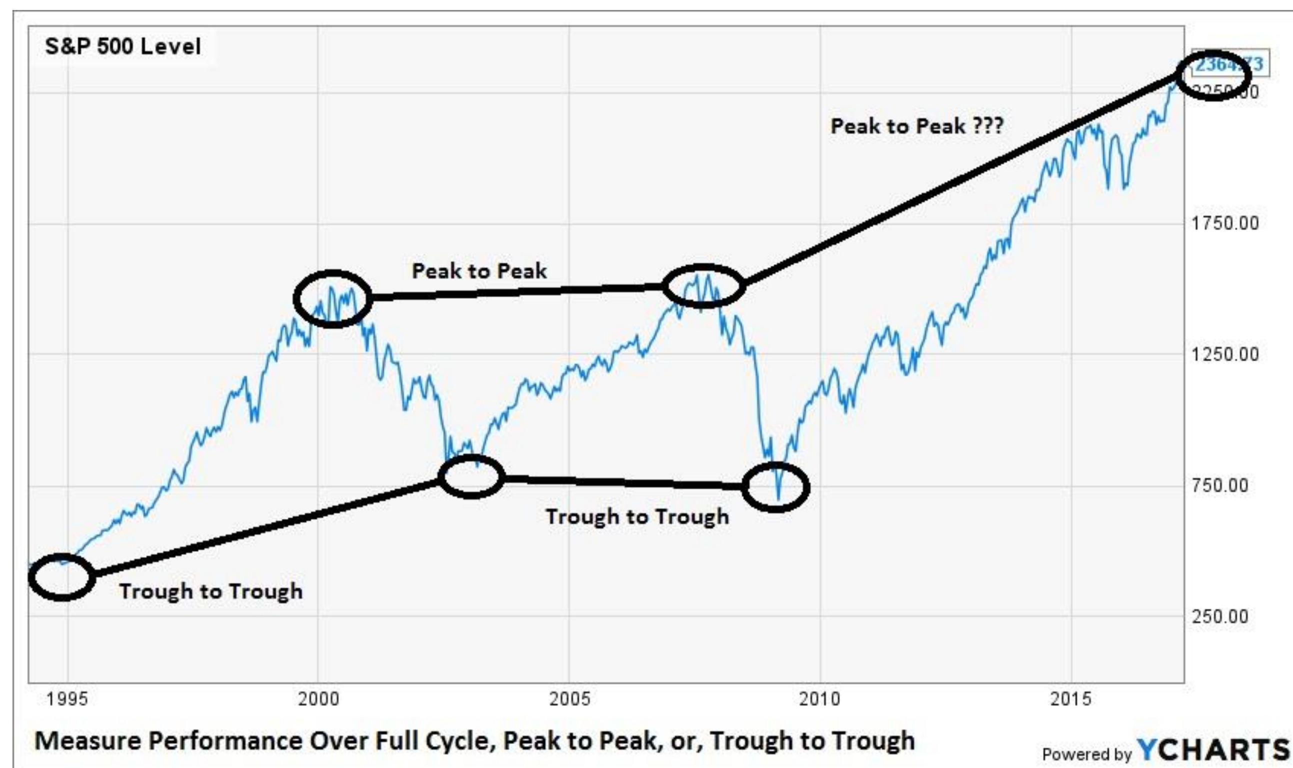


MONITORING A PORTFOLIO

- 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.



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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