Using Asset Allocation to make money in a Flat Market

Contributed by Kirk Lindstrom
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I am often asked "How do you use allocation and individual stock volatility to beat the market without using market timing? This is a great question! My technique is to rebalance often rather than once a year. Using a computer I have my personal and newsletter portfolios update daily. When they change by a given percentage, I can reallocate to bring them back to my target. This has me buying stocks when they are low and selling them when they are high. The easy way to explain it is consider an example in a flat market where you are 50% in equities and 50% in bonds. Assume neither pay interest and we are just looking at fluctuations in capital. Lets start with $100,000 split $50,000 in bonds and $50,000 in the total stock market. Lets say the market starts with VTSMX at $10 goes down to $9 in Q1, goes back to $10 in Q2, continues higher to $11 in Q3 and finishes Q4 back at $10. Note: VTSMX is Vanguard's Total Stock Market Index Fund used here for the hypothetical example. How would you make money following my technique? Well, after splitting your investment 50:50 as shown in Table 1, the market goes down 10%. So now you have a total of $95,000 since only half was in the market. Next you rebalance your assets to get back to 50:50 as shown in Table 1 for April 1 where you end up with $47,500 in both VTSMX (Equities) and Bonds. You repeat this rebalancing every time VTSMX moves by $1.00 as shown in Table 1. Table 1 Quarter VTSMX
PriceStart Equities Bonds Total
PortfolioRebalancedEquities BondsJan 1$10$50,000$50,000$100,000 April
1$9$45,000$50,000$95,000$47,500$47,500July 1$10$52,778$47,500$100,278$50,139$50,139Oct.
1$11$55,153$50,139$105,292$52,646$52,646Jan 1$10$47,860$52,646$100,506 How about that! Your portfolio grew $506, or 0.51%, while the market completed a full cycle and ended back where it started! The skeptics will ask "what happens if the market goes up before it does the down cycle?" Lets see: Table 2 Quarter VTSMX
PriceStart Equities Bonds Total
PortfolioRebalancedEquities BondsJan 1$10$50,000$50,000$100,000 April 1$11$55,000$50,000$105,000$52,500
$52,500 July 1$10$47,727$52,500$100,278$50,139$50,139Oct. 1$9$45,125$50,139$95,264$47,632$47,632Jan
1$10$52,924$47,632$100,556 Well, it looks like you make $50 more for an additional 0.05% You will make even more when you consider that your bonds are earning income. I like Vanguard's Total Bond index fund (VBMFX) for its great diversity but you could probably do just as well with Vanguard's GNMA fund (VFIIX). At times when we were getting less than 2% in money market funds, we should not dismiss this potential to gain extra yield just from market volatility. For a $1,000,000 portfolio, an extra 0.5% translates to $5,000! Compound this over 40 years and this can really add up. Kirk, You have done even better. How do you get your better returns? The easy answer is I increase the volatility of my portfolio so there are more and larger opportunities to rebalance.

I add volatility with an "explore" portfolio that I recommend investors use for 5 to 20% of their asset allocation. For the remainder of their asset allocation, I recommend a "core" portoflio composed of seven index funds from Vanguard that include REIT and International exposure. This mixture of seven asset classes in your core plus some high quality but volatile stocks purchased when they are in the low part of their cycles combine to give what I think are risk adjusted returns unmatched by anyone in the industry.

note: REIT stands for Real Estate Investment Trust.

What I do is try to buy a handful of stocks I like very much for the long term but that are highly cyclical so they have very high volatility. One I like is Lam Research which can move up 50% and down 30% more than once a year! Here is a LRCX chart showing it has been quite volitaile as well as an exceptional investment since I added it to my newsletter explore portfolio in September 1998. I fondly call it my "Kirk's ATM."

In my newsletter, try to give good price points to add to positions and price points to take profits using a mixture of TA, FA and "seat of the pants luck (or skill)." For me, LRCX has acted like an ATM cash machine and I hope this continues. With ten or twenty stocks in my portfolio, it is easy to find stocks surging to take profits on when the market is going up, then when it corrects, I look for what is down to buy back or simply buy more shares of.

Of course, the profit taking and buying back or buying the right stock for the first time is the "art" part and this involves some skill and some good luck. Bad luck is part of the equation too and so you have to look at a total portfolio over time and compare it to the benchmarks to see if you are adding value. You should also notice that I make no claims to call market tops or bottoms as I believe this is impossible to do over and over without making mistakes trying to get back in or out too soon. On Suite101.com, I read of many who correctly lowered their asset allocation in January 2000 only to jump back into the teeth of the bear market in late 2000 by buying QQQQ. Market timing looks great when you can ignore the mistakes. Conclusion People can make electricity from the rise and fall of ocean waves. I got the idea of using the markets natural volatility from this and my example above shows how it works to make money even in a "flat market." For my example, I used a $1 change for VTSMX as the level to reallocate but a smaller number will allow more frequent reallocations and potentially more profit generation. Feel free to email me if you have further questions about this or my newsletter where I cover it in more detail.
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- Asset Allocation

- Kirk's Market Thoughts

Recommended Investment Reading

Kirk's Investment Newsletter : I advise a "Core and Explore" approach to investing. Core means place 80 to 99% of your money into a CORE portfolio of well diversified, buy-and-hold, no load mutual funds, ETFs and or blue chip stocks then Explore with the remainder as you learn. My newsletter offers both core and explore portfolios. Click for Free Sample Issue

The Intelligent Investor: The Classic Text on Value Investing by Benjamin Graham is A MUST READ if you buy stocks. It will help you understand the data I send my subscribers in my weekly updates between newsletters.

Common Sense on Mutual Funds: New Imperatives for the Intelligent Investor by John C. Bogle "The idea that a bell rings to signal when investors should get into or out of the stock market is simply not credible. After nearly fifty years in this business, I do not know of anybody who has done it successfully and consistently. I don't even know anybody who knows anybody who has done it successfully and consistently. Yet market timing appears to be increasingly embraced by mutual fund investors and the professional managers of fund portfolios alike. "
[John C. Bogle in Common Sense on Mutual Funds: , pg 20]
Stock Trader's Almanac 2007 by Jeffrey & Yale Hirsch

Technical Analysis of Stock Trends by Robert D. Edwards, and John F. Magee

The Intelligent Asset Allocator: How to Build Your Portfolio to Maximize Returns and Minimize Risk by William J. Bernstein

Dictionary of Finance and Investment Terms Barrons Educational Series