Soundings

What's New – April 2019

Quote of the month:
"Investing is an operation that transfers wealth to those who have a process and can execute it from those who do not and cannot." William J. Bernstein

Those words have been proven over and over by research firm Dalbar, in its annual Quantitative Analysis of Investor Survey (QAIB). To that note, I've been outlining our process for the past couple of months. In February, we explored diversification, modern portfolio theory, and compared & contrasted fundamental versus technical analysis. Last month, we looked under the hood of technical analysis, introduced the research firm Nasdaq Dorsey Wright, learned about relative strength, and got a primer on their matrix tool called D.A.L.I. This month, we'll put all the pieces together and look at complete portfolio construction, including the important risk management component. I think you will appreciate the deliberate nature of what we're doing.

The first quarter of 2019 is in the bag and it was a winner. In fact, according to the Wall Street Journal, U.S. stocks have notched their biggest gains in nearly a decade. Fueled by more accommodating central banks and hopes for a successful resolution to the trade talks with China, the S&P 500 added 13%. Joey Madere, Raymond James senior portfolio analyst, Equity Portfolio & Technical Strategy believes valuation is fair and still has room to expand given the low inflation and interest rate environment. He cautions that the inverted yield curve deserves watching. Even so, Raymond James Jeff Saut still holds firm to the notion that "we are in a secular bull market that has years left to run." http://beacon1.rjf.com/ResearchPDF/2019-04/a9105149-a763-41cd-acd7-3d155cfdcf00.pdf

In this month's ***Market & Economic Commentary,*** I'm going to lift the curtains on our portfolio construction process. You will learn how we use both strategic and tactical guidelines when building our portfolios. You'll see that we are deliberate in every aspect of what we do, particularly in managing risk. As Jeff Saut often writes, if you manage the downside, the upside takes care of itself. First, the numbers…

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Market Update – Year to Date Returns

Major Indexes	(As of 4/1/19)*
Dow Jones Industrials	11.2%
S&P 500 Index	13.1%
NASDAQ	16.5%
DJ Global ex US	9.5%
Russell 2000 (small cap index)	14.2%
XAU (gold/silver)	8.1%

*** Source: The Wall Street Journal**

D.A.L.I. Page

D.A.L.I. Signals - 04/01/2019

Dom. Equities	Int'l Equities	Commod	Fixed Income	Cash	Currency
281 25.9% (+0)	**247** 22.7% (+0)	**169** 15.5% (+0)	**149** 13.7% (+0)	**147** 13.5% (+0)	**94** 8.6% (+0)

Source: Dorsey, Wright & Associates, LLC

- Inclusion of these indexes is for illustrative purposes only. Keep in mind that individuals cannot invest directly in any index, and index performance does not include transaction costs or other fees, which will affect investment performance. Individual investor's results will vary. The Dow Jones Industrial Average (DJIA), commonly known as the "Dow", is an index representing 30 stocks of companies maintained and reviewed by the editors of the Wall Street Journal. The S&P 500 is an unmanaged index of 500 widely held stocks that's generally considered representative of the US stock market. The NASDAQ Composite is an unmanaged index of securities traded on the NASDAQ market. The DJ Global ex US is an unmanaged group of non-U.S. securities designed to reflect the performance of the global equity securities that have readily available prices. The Russell 2000 index is an unmanaged index of small cap which generally involve greater risks. The Philadelphia Gold and Silver Index (XAU) is an index of sixteen precious metal mining companies that is traded on the Philadelphia Stock Exchange.
- The Barclays Capital Aggregate Index measures changes in the fixed rate debt issues rated investment grade or higher by Moody's Investors Service, Standard & Poor's, or Fitch Investors Service, in that order. The Aggregate Index is comprised of the Government/Corporate, the Mortgage-Backed Securities, and the Asset-Backed Securities indices. The Barclays U.S. Corporate High Yield Bond Index is composed of fixed-rate, publicly issued, non-investment grade debt, is unmanaged, with dividends reinvested, and is not available for purchase. The index includes both corporate and non-corporate sectors. The corporate sectors are industrial, utility and finance which includes both U.S. and non-U.S. corporations. The Barclays Capital Municipal Bond is an unmanaged index of all investment grade municipal securities with at least 1 year to maturity
- DALI is a proprietary matrix created by Dorsey Wright & Associates, an independent 3rd party. It presents the relative strength relationship of six broad asset classes or "teams", domestic equities, international equities, commodities, fixed income, cash, and currencies. Each are represented by an equal number of ETFs. Each team play against each member of the other teams, with net victories tallied in an effort to rank each asset class team by order of overall strength. Raymond James is not affiliated with and does not authorize or sponsor any of the listed websites or their respective sponsors. Raymond James is not responsible for the content of any website or the collection or use of information regarding any website's users and/or members.
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Market & Economic Commentary

We ended last month with an introduction to the Nasdaq Dorsey Wright matrix, shown in the middle of the previous page, called DALI. I wrote, "The Dynamic Asset Level Investing (DALI) tool evaluates the supply and demand forces of asset classes, and ranks them from strongest to weakest based on their relative strength score. The investible universe is divided into six broad asset classes; Cash, Fixed Income, Domestic Equities, International Equities, Commodities, and Foreign Currencies. Each of these "teams" is represented by an equal number of ETFs and on a daily basis, all of the members of each team "play" each other in the form a relative strength analysis. The wins are tallied and the asset classes or teams are ranked from strongest to weakest based on the number of "wins". This matrix can be a useful indicator of underlying strength or weakness in the market and can be a valuable tool in portfolio construction and risk management."

Looking at DALI, you can see that equities fill the top two positions, meaning they exhibit the greatest relative strength of all the measured asset classes. When this occurs, we are on offense and our model portfolios are tilted towards this area of strength. As an example, a moderate model, which has a baseline allocation of 60% equites, 40% non-equities, is realigned to an 80% equity, 20% non-equity posture. It remains this way until there is a change in relative strength. This matrix is not designed to change daily, weekly, or even monthly. It's designed to identify changing long-term trends that tend to last for extended periods. That said, on a monthly basis, I review DALI to see if a shift in tactical tilt is warranted.

As for the construction of our model portfolios, similar to a good workout routine, we begin with a strong core. From an inventory of exchange traded funds or ETFs, all based around the S&P 500, a relative strength screen is applied, and the top two ETFs are selected based on their relative scores. An ETF, defined by Investopedia, is "a marketable security that tracks a stock index, a commodity, bonds, or a basket of assets. They are index funds that trade like stocks on an exchange." We then expand the core inventory to include small and mid-sized companies in the US and International markets and run another screen, also using ETFs for their transparency, liquidity, and low expenses. Again, the top two ETFs from a relative strength standpoint are selected and added to the portfolio. Next, we add an active management component. Using mutual funds, we have a fixed income sleeve and an equity sleeve, apply a relative strength screen to the inventory, and select mutual funds based on their relative strength scores. Our models are screened on a seasonal quarterly basis, every February, May, August, and November. The ETFs and mutual funds in the models are adjusted as needed based on this objective, systematic process.

As discussed above, on a monthly basis, we evaluate the market environment and based on DALI, decide if and how we should tilt the models. On a quarterly basis, we review the individual holdings to see if there has been a shift in the relative strength that justifies a change to the individual securities. The last piece of the process is the risk management component. Our process uses what Dorsey Wright calls "Dual Factor Authentication" as an added level of objective, data-based risk management. I call them "circuit breakers" and both, again, use relative strength, to evaluate the condition of the markets. The first is known as the Core Percentile Rank or CPR. CPR is designed to measure the strength of the S&P 500 based assets versus all other asset classes. The second is the Money Market Percentile Rank or MMPR. MMPR is designed to measure the strength of the money market asset class versus all other asset classes. If the CPR falls below 40%, meaning that 60% of all investable asset classes are stronger than the S&P 500 based on relative strength, the first circuit breaker is tripped. If this occurs and the MMPR is also above 50%, meaning that the money market asset class is exhibiting better relative strength than more than 50% of every other asset class, the second circuit breaker has tripped. When this happens, we move the portfolio to 100% money market. We remain in money market until the last day of the month where we see if the circuit breakers have reset. If they are still "tripped", we stay in money market until the last day of the following month when we reevaluate. When the circuit breakers have reset, we adjust to the allocation determined by the current DALI and fund screens.

This is a lot to digest but after nearly 20 years in practice, I'm very pleased at where we've arrived. If it's been a while since we've talked, this could be a great time for a review.

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On a Personal Note

Words can be tricky things. We were honored to host a rehearsal dinner for nephew Jack Begley and his beautiful fiancé Kerrie Shaw. It was the second such event in the past year and we've got one more coming up this fall. The weather was perfect and everything went exactly as we'd all hoped. I've known Jack since he was about four. I've known his friends for about 15 years so it was great to catch up with everyone on such a happy occasion. I particularly enjoyed talking with Cody, Jack's long-time soccer buddy, now a Navy jet pilot in training in Kingsville, TX. It was great reliving those flight school memories and visiting with such a fine young man. But after a pretty young woman joined the conversation, I felt like I was at best monopolizing his time, at worst, cramping his style. I said, "I'm going to leave you to talk with more interesting people" and took my leave. Of course, what I meant was, "I'm going to leave so you can talk with more interesting people" but as I walked away, I thought they probably heard, "I'm going to leave you so I can talk with more interesting people." By that time, it was too late to go back and explain, like trying to explain a joke that didn't work. I guess I've transitioned from Jack's creepy uncle to Jack's creepy and rude uncle.

And everyone cried. On wedding day, Jack & Kerrie got lucky again with the weather. It rained in the morning but stopped several hours prior to the 5:00 pm service. Good thing because it was held outdoors at the Pensacola Country Club. It was dry but the frontal passage that had caused the rain was of the cold variety. The temps dropped to borderline tolerable for a fellow in a suit, but downright freezing for a woman in a dress. Goosebumps aside, everyone was beautiful and statuesque. Jack, who's always the prettiest human in the room, looked like he jumped off a wedding cake. But as he waited for his future bride to make the most important walk of her life, he had his back to all of us in the gallery. I thought it was a little odd but figured he was conferring with the officiant, a long-time friend and father of one of the boys in the wedding party. It turns out our tall, dark, and handsome groom is also emotional. The kid was balling, and when he turned around, it got contagious. Luckily, everyone was able to compose themselves and Jack finally made an honest woman out of his beautiful fiancé.

No more barriers to entry. The wedding weekend was a blast. Our boys made it home for the event but the visit was fleeting. Alex hit the road early Sunday morning. It's tax season and the kid is slammed. Collin and I did the same, both off to Orlando, me for a financial conference, Collin for life in general. I decided to head out a day early and go visit my folks in Sarasota for a quick visit. My pop just turned 85 and though we've gone through some storms over the years, we're at a really good place right now. In fact, it was the best visit I've ever had with the old man. We've all got walls we put up to keep folks from seeing our vulnerabilities. It's a wonderful thing when those walls come down. In 30 years or so, my own kids might see that I'm not as big an ogre as they thought. As for the financial conference, Collin came down for a solid day and I've got to say, I enjoyed the hell out of that kid. I even took the lead from my dad, and dropped my guard. I hugged him and got all misty when he left, letting him know how proud I am of whom he's become and how much I love him. Hope I'm not getting soft.

Got a light? I hope I don't hurt any feelings but I'm going to say it. Of all the extended family, the Juder takes the highest spot on the podium. A woman of exceptional character and equal quirks, you can read about her in her son's book, Un Moving Four Ward http://www.bobbellbooks.com/ My champion's single vice has always been nicotine. The Juder can do some damage to a pack of smokes. At 81, it's caught up to her, hospice is involved, but Judy is facing the inevitable as she's faced all of the challenges she's conquered along her fantastic voyage, with faith, humor, and lady-balls. Kathleen and I stopped by for a visit and caught her asleep after a long day. We left, grabbed a bite to eat, and ended up stopping by afterwards with a bag of leftovers. We arrived at the Pensacola home where Judy raised two kids and has lived for nearly 50 years, greeted by her daughter Karen. Did I tell you Judy was a smoker? We all took a seat in the living room and as Judy lit up, I said, "Give me one of those." Now it's been a long time since I smoked anything and the last time, it probably wasn't tobacco. That said, it was an honor having a smoke with my hero and friend. We also split a PBR. God, I love this family. As always, I hope you're enjoying each day as it comes. Warmest regards, *Jon*

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