"The Pavich Perspective"
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Dynamic Asset Allocation

- A New Look at Diversification and Risk Management

With two separate corrections this decade that removed 50% of the value of the S&P 500 a maxim that has deep roots in investor psyche is being challenged. "Buy and Hold" is a philosophy that simplified the investing process and was blessed by icons like Warren Buffett the Oracle of Omaha and Peter Lynch of Fidelity's Magellan fame. I believe the strategy has its place, but is not the panacea many on Wall Street profess it to be. While the Bull Market galloped from 1982-2000 it was an easy process for the financial services industry to market. I believe the next several years may hold a distinctly different take for those promoting the strategy.

When I devised the Dynamic Asset Allocation Strategy (DAAS) in 2000 it was based on the research I did regarding Secular Bull and Bear Markets. With historical data pointing towards a Secular Bear Market unfolding in this decade, I felt the strategy most investors were using might become vulnerable. I found investors generally reluctant to embrace the program due to the traditional advisor adage "No one can time the market" being drummed in to them. What the comment truly meant was that the advisor did not know how to time the market. It was also somewhat disingenuous as just about every Wall Street firm employs traders that attempt to time the market for the firm's money.

In reality anytime a security is bought or sold a form of market timing occurs. Selling a stock for a profit is indicating the investor thinks the market has now fairly valued – or even possibly over valued – the stock. So the sell decision does involve second-guessing the market and I find that to be a form of market timing. I believe Wall Street's strategy to have their clients believe "Buy and Hold" is the only pure form of investing is to keep them optimistic about the long term. It is much easier to sell financial products to someone who has an optimistic outlook than one that is worried about what financial crisis may be lurking around the next corner. In my opinion the main shortcoming of managers using the Buy and Hold strategy is that – by definition – most do not possess a sell discipline that can help avert severe corrections a Bear Market brings.

There are generally three main allocation strategies investors can choose from. Strategic Asset Allocation is the traditional buy and hold model. Tactical Asset Allocation adds some timing decisions to SAA in an attempt to take advantage of perceived mispricing of different asset classes. Dynamic Asset Allocation is the most active and driven by timing decisions derived from a wide array of indicators and signals. Listening for the message the market communicates is a daily practice within the system.

DAAS Priorities

1. ***Do No Harm – Preserve Capital***
2. ***Listen For The Message Of The Market***
3. ***Profit When The Markets Are Cooperative***
4. ***Volatility Happens – Keep Draw Downs To A Minimum With the Discipline to Sell When Conditions Warrant***

The key component of my Dynamic Asset Allocation Strategy is flexibility. The ability to reposition the portfolio on a daily basis allows the system to move to the sidelines (money market) quickly and avoid corrections or worse a bear market. Capital preservation and risk management are a high priority with DAAS, but obviously not every decision works and the portfolios do incur some volatility. It is important to distinguish between volatility and a trend that leads to significant portfolio losses. The phrase every medical student learns, “First do no harm” is at the core of what DAAS attempts to accomplish in portfolio management.

One of the principles the strategy employs to mitigate losses is found in the premise “It is okay to be wrong, it is not okay to stay wrong.” This helped the portfolios side step the devastating corrections like those that occurred in 2000-02* and 2007-08. Many investors saw losses in the 50% range in 2008, only to gain 50% in 2009. Remember they are still down 25% from what they began and this is why I would rather miss an opportunity than participate in a severe correction.

The attempt to manage risk and take advantage of opportunity within the strategy can lead to frequent activity. There is an assumption that frequent activity correlates to higher risk. The thought is that the more decisions the more opportunity to be wrong. That is not always the case as investors using the Buy and Hold strategy found how risky that strategy can be in 2002 and 2008. Some started calling it the Buy and Hope strategy.

“It is okay to be wrong; it is not okay to stay wrong”

The flexibility of DAAS often leads the portfolio to a 100% money market position. Since the inception of the strategy the portfolios have spent over half the time in a 100% money position reducing the risk profile. This can be an added benefit if the country is struck by terrorists again. DAAS had only one model in 2001 and was 100% in money market fund on 9/11.

If you have been an investor for any length of time you have heard that you do not put all your eggs in one basket. Many say diversification is at the heart of risk management. Allocating among a variety of assets is usually considered the traditional way to reduce risk in a portfolio. Initially DAAS was marketed as a way to diversify the actual strategies within a portfolio. Because DAAS has out performed the major indices regularly with less relative volatility over the last several years, many investors have begun using it as a core strategy in their overall portfolio.

The platform to implement the strategy is the SGI-Rydex family of mutual funds. The family contains funds that mimic the movement of an array of asset classes. Those asset classes include equity indices (long and inverse), equity sectors, bonds, currencies, and commodities. The managers of these funds do not attempt to out perform their bench marks, but mimic them precisely. The performance of the portfolios falls upon DAAS to allocate among these asset classes and funds. There is no cost to administer these re-allocations, which contributes to the cost effectiveness of the flexibility. Rydex-SGI is the only mutual fund family with funds that price twice a day giving the system enhanced flexibility.

* The DAAS portfolio’s were not tracked prior to 2004 for performance

For a full disclosure of performance and associated expenses click here.

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