Importance of Rebalancing Your Investment Portfolio versus Stock Market Timing

When you are about to put money to work or thinking about taking money off the table in your investment portfolio, is the “health” of the overall stock market a important factor you consider?

For most investors, their willingness to make an investment is strongly correlated to their personal evaluation about whether the stock market will continue to rise, coupled with a belief that the investment they are going to make is relatively undervalued. Picking through individual stocks and finding undervalued prospects is tedious work, and for many they simply do not have the time or expertise to do in-depth stock evaluations. In fact, the individual stock market is full of “noise,” with multiple talking heads pandering to the stock of the day in order to gain personal attention (like Jim Cramer on CNBC) only to change their opinion within a short period of time.

Investing is a long-term, not a day-to-day, process. Either you have conviction about the investments you own, or it is advisable that you sell and buy assets you are more comfortable with – for the long-term. More than likely you will lose money if you get caught up in what I call “trading noise.” Good portfolio management demands discipline and diversification, and the best option for many investors is to own ETFs of the major market indexes such as the S&P 500 (SPY) or the DOW (DIA). There are many studies which show the chances of beating the general market by trading stocks versus just owning the stock index is very low. In the case of 401-K retirement investment accounts, investment options are usually very limited – usually Stock Market Index, Treasury and Corporate Bonds or Money Market funds.

But owning stocks for the long-term does not mean that you never sell a position. Whether you buy stock index ETFs or hold a portfolio of stocks, the primary issue which all investors need to keep track of is when it is time to re-balance your investments.

Re-balancing is not timing the market on entry and exit from the next “hot” stock.

Re-balancing is not trading in an out of the market index ETFs to try to enhance market returns.

Re-balancing is an adjustment made to your portfolio to change your total holdings in equities up or down because conditions in the overall market have changed.

In my research, making investment decisions to take money off the equity table at the right time, and redeploy it into more stable assets is one of the most important, and also simplest ways to enhance portfolio return through time. Preparing your portfolio to withstand or even avoid “true” market corrections is a key to getting ahead financially. The data since WWII on the U.S. stock market shows that if a stock investor sold prior to a market correction and re-entered the market 12 to 24 months later, their overall return would double from 8.7% to 16% compounded annual return before dividends.

Why does this happen? The simple explanation is that as equities rise, assets other than stocks eventually become perceived in the market as more valuable to own. Eventually the divergence in relative value builds and owners of shares begin to sell and trade into the alternatives such as “risk-free” investments like U.S. Treasuries. Fear is usually the driving psychological force when the market unwinding really gets going and is readily identified by investors once it happens. But the market signals before the decline is what a very large segment of the investing public fail to comprehend. Time and time again the same signals are given by the market, yet investors do not heed the warnings. Leading up to the decline my research shows a systematic shift in the overall financial system which can be easily tracked and understood by knowledgeable investors – knowledgeable because they have taken the time to learn and understand the forces that drive the market and have a system to signal when a market wildfire is being lit.

To help investors looking for a system to track the health of the U.S. financial market, a Financial Relativity Index has been created based on a set of leading indicators derived from the research contained in the book, Theory of Financial Relativity. The index is a heuristic used to gauge the relative attractiveness of investing in stocks at a given time based on the interaction of major market forces and the resulting impact on the rate of change in the price levels of stocks (DOW Signal), money (Interest Rate Spreads) and energy (Oil). As explained in the investment research book, all of the signals in the multivariable model possess characteristics which have a high probability of being exhibited prior to a market correction; and likewise remain within certain parameters when the equity market is more attractive as an investment such as during a post recession rebound or an economic expansion. The more yellow and red the Financial Relativity Index becomes, the higher the probability of a sustained and deep market correction.

The Financial Relativity Index is published and periodically updated on the FinancialRelativity.com Investment information website. The index and signal summary is provided as a service for those who have taken the time to read the book and can appreciate the information provided by the metrics. In the words of the infamous Albert Einstein, “Everything must be made as simple as possible, but not simpler.”

The status of the Theory of Financial Relativity leading equity market indicators as of 12/31/2013 is show in the table below.

Major Index Levels	
DOW Signal	
10 / 5 Treasury Spread	
BAA1 / 30 YR Spread	
Fiscal Spending Rate	
Oil Price Levels	
Fed Policy	

(as of 12/31/2013)

At the end of 2013 there were two cautionary areas which indicated slightly elevated risk of an impending market reversal, but as a whole the status for equity investing remained green. The first yellow signal was triggered by the major market indexes trading above their previous all-time highs posted prior to the last correction. The prior correction highs were set in 2008. The history of “true” stock market corrections (where stocks decline on a year over year basis), not just a brief pull-back, shows that this market condition is necessary but not sufficient for a downturn to eventually ignite. The elevated level of the market at the end of 2013 by itself did not mean it was time to run for cover, only to invoke a higher level of caution in equity investing going forward. This signal can remain at a cautionary status for years before the other signals begin to confirm a market correction is imminent.

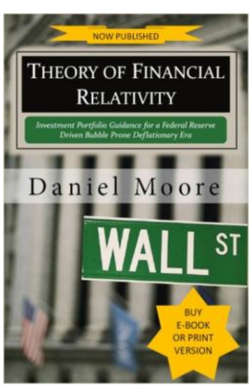
The other yellow status indicator as of 12/31/2013 was government fiscal policy, more precisely the rate of growth in government spending. It may come as a surprise to investors, but the yellow status is actually a result of the increase in government spending being too low, not too high, at the beginning of 2014. Government austerity is a deflationary force on the economy. The last time the government decreased its rate of spending growth to zero or below was in 1946, and a major market correction did occur in that time period. Since that time, however, the rate of increase in government spending always increased at a healthy pace, until 2012 and 2013, and was usually more likely an inflationary rather than deflationary instigator.

The negative force from the U.S. government budget constraints to deal with the massive National Debt problem at the start of 2014 was being off-set by other major market forces. One very visible driving force was the Federal Reserve Quantitative Easing program known as QE3, put into effect in 2013 and continued into 2014. Ben Bernanke announced in December 2013 that the historically large program of asset purchases (approximately $1T in 2013) will be curtailed throughout 2014.

If the transition from the crisis management Federal Reserve Bank QE program to private market driven economic expansion is successful, the majority of the indicators shown above will remain green until the economy begins to over-heat. If, however, the financial system cannot maintain "relative" balance, the next bonfire will be signaled in real-time, most likely in the long-term interest rate spread markets. Waiting for GDP figures, unemployment statistics or other government bureaucracy compiled data is an inadequate methodology because the data is too stale by the time it is announced. Real-time market data, however, produces signals more quickly and accurately.

History shows that the optimal return investment strategy is to stay invested until the financial system reaches the break-down point and then rebalance to weather the storm. As of the end of 2013 the weather forecast was partly cloudy with a small chance of rain; but as always the weather can change so stay tuned.

Daniel Moore *is the author of the book* Theory of Financial Relativity: Investment Portfolio Guidance in a Federal Reserve Driven Bubble Prone Deflationary Era. *All opinions and analyses shared in this article are expressly his own, and intended for information purposes only and not advice to buy or sell.*



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