

All-Season Investment Strategy III: A Low Risk Solution

February 8, 2012 | includes: [AGG](#), [AMJ](#), [EFA](#), [GLD](#), [GSG](#), [IEF](#), [IWM](#), [JNK](#), [SHY](#), [SPY](#), [TIP](#), [TLT](#), [VNO](#), [VWO](#)

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Disclosure: I am long [SPY](#), [IWM](#), [EFA](#), [VWO](#), [VNO](#), [AMJ](#), [GLD](#), [GSG](#), [JNK](#), [AGG](#), [HYG](#), [TIP](#), [IEF](#), [TLT](#), [SHY](#).

"If you want to have a better performance than the crowd, you must do things differently from the crowd." - Sir John Templeton

In [Part I](#) and [Part II](#), I have introduced how to use two mechanisms, risk on/off switch indicator and cross-section momentum, to protect your portfolios, and even profit in the market downturns. In this article, I will show how we can combine both mechanisms to generate better risk-adjusted returns in both bear and bull markets.

There are numerous ways to combine the two mechanisms to improve your investment returns. I will show a simple strategy to combine them: if the risk is "on," select the two risk asset ETFs with the highest momentum; if the risk is "off," select the two bond ETFs with the highest momentum, to create an equally-weighted portfolio. The momentum here is defined by a combined rank of the past 3, 6, 9 and 12-month returns. The risk on/off switch indicator is a composite indicator of three different economic, technical and risk indicators.

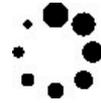
The ETFs I used to create the portfolio, which I repeat here, include:

- [SPY](#): S&P 500 Index
- [IWM](#): Russell 2000 Index
- [EFA](#): MSCI EAFE Index
- [VWO](#): MSCI Emerging Market Index
- [VNO](#): MSCI US REIT Index
- [AMJ](#): J.P. Morgan Alerian MLP Index
- [GLD](#): SPDR Gold Trust
- [GSG](#): S&P Goldman Sachs Commodity Index
- [JNK](#): Barclays Capital High Yield Index
- [AGG](#): Barclays Capital US Aggregate Bond Index
- [TIP](#): Barclays Capital Inflation Protection Treasury Index
- [IEF](#): Barclays Capital Treasury Index
- [TLT](#): Barclays Capital Long Term Treasury Index
- [SHY](#): Barclays Capital Short Term Treasury Index.

Table One summarizes the results of this combined strategy compared to the strategies in which we use only one mechanism. The risk indicator strategy can be described as: if the risk is on, buy S&P 500 index, otherwise, buy Barclays bond index. The momentum strategy works as follows: buy the two ETFs with the highest momentum. Impressively, the combined strategy delivered the highest return with the lowest drawdown.

Table 1: Performance Summary for Different Strategies

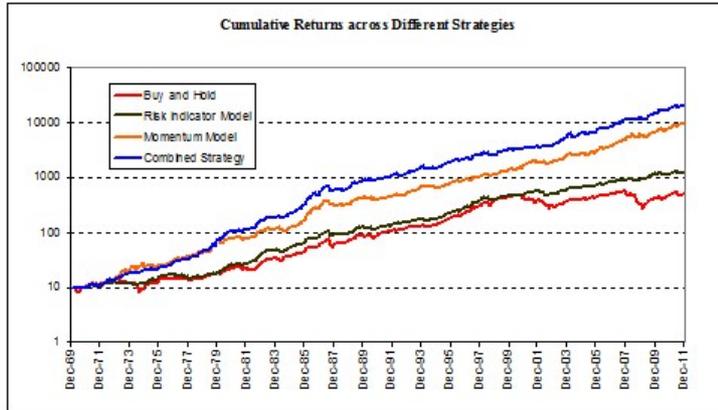
Performance Statistics	Buy and Hold	Risk Indicator	Momentum	Combined strategy
Average Monthly Return	0.9%	1.0%	1.5%	1.6%
Monthly Standard Deviation	4.5%	3.5%	4.4%	4.0%
Annualized Return	10.6%	12.5%	18.0%	19.7%



Annualized Standard Deviation	15.7%	12.2%	15.4%	13.7%
Sharpe Ratio (Risk-free Rate = 5.5%)	0.3	0.6	0.8	1.0
Maximum Drawdown (Loss)	50.9%	23.3%	20.9%	16.6%
Expected Time to Recover (yrs)	4.8	1.9	1.2	0.8

Figure One shows the cumulative returns of different strategies in the past forty years. Both risk indicator and momentum strategies outperformed buy-and-hold and successfully avoided the big market downturns. When I combined them, the performance was much more impressive.

Figure 1: Cumulative Returns of Different Strategies



One of the most attractive properties of the combined strategy is its ability to deliver positive performance in the bear markets. Table Two shows how the strategy performed during the market upturns and downturns by looking at the 12-month rolling returns. The combined strategy outperformed S&P 500 Index in both up and down markets. More importantly, in the down markets, the combined strategy not only delivered positive returns but also beat the S&P 500 index with 97% probability.

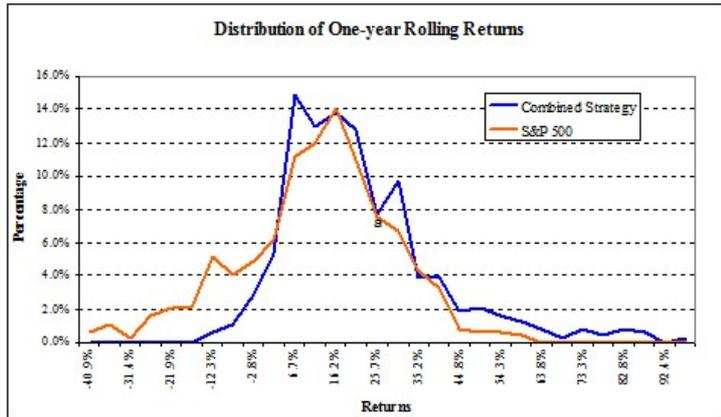
Table Two: Performance of Combined Strategy in Market Upturns and Downturns

Rolling 12-month Returns	Combined Strategy	S&P 500 Index
Average	21.6%	11.8%
Median	18.2%	13.3%
Maximum	99.5%	61.2%
Minimum	-14.5%	-43.3%
Skewness	1.4	-0.4
Kurtosis	2.6	0.3
Down Market		
Average	10.2%	-13.8%
Median	8.8%	-11.8%
Maximum	38.5%	-0.2%
Minimum	-14.5%	-43.3%
Outperforming Ratio	97.2%	
Up Market		
Average	24.7%	19.0%
Median	20.9%	16.8%
Maximum	99.5%	61.2%
Minimum	-7.1%	0.0%
Outperforming Ratio	60.4%	

Since I am proposing the strategies as good downside protection mechanisms, I will show you another graph to demonstrate that. Figure

Two shows the distribution of the 12-month rolling returns of the combined strategy compared with those of S&P 500 Index. It is clear from Figure Two that the combined strategy not only has the ability to limit the downside risks but also actively participates in market rallies.

Figure Two: Distribution of 12-month Returns: Combined Strategy vs. S&P 500 Index



In summary, I have introduced two mechanisms to help investors to avoid market downturns and protect your capital. More importantly, when we combine them, we have a tremendously powerful tool which can be used to achieve consistent returns in both bull and bear markets. To help investors, I will update the recommendations from the strategy in my [blog](#).

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