Money Management

Think of your future in the market as a road trip. Your journey does not start 50 miles down the street; rather, it begins at home when you choose your destination, spread out the map on the kitchen table, and carefully plan the route for your upcoming adventure, keeping the big picture in mind. Proper money management is the mapping stage of your road trip. Before you pull onto the investing highway, you must thoroughly determine your personal financial position, truthfully establish your investment goals and motivations, and develop a deep understanding of how to advance from where you are today. So what exactly is *money management*? Frustrated with the absence of one agreed-upon definition within the financial world, I polled more than 80 investors throughout my classes—a combination of continuing education classes, daylong seminars, and multiweek sessions—to see what we could come up with. Collectively, we created the following comprehensive definition, which encompasses all that is necessary for a proper and effective money management plan:

> First and foremost, money management is an ongoing process. More descriptively, it is a documented, personally appropriate financial framework that describes the types of investments and strategies you feel will align best with your personal goals, objectives, and priorities. These guidelines describe the rules and tools you deem appropriate in managing your wealth. They acknowledge your risk tolerance and the risk management techniques you employ to protect your assets. Finally, they provide an ever-changing, lifelong timeline and roadmap recording the methodologies and resources you use to ensure disciplined stewardship of your assets as you attempt to maximize the return on your investments.

As an educator, my objective is to equip you with the tools and skills necessary for you to become profitable as an investor and consistently replicate

that profitability. Ultimately, these should be your goals, too. Your aim as an investor should be to make the right preparations and the wisest decisions to move the probabilities in your favor and become consistently profitable, and creating a detailed money management plan is the first step toward this goal. It is all about:

1. Knowing what you have,
2. Knowing how to protect it,
3. Knowing how to grow it, and
4. Writing it out in a personalized investment plan.

Too frequently, novice investors display a harmful overeagerness by choosing to jump in head first to step 3—growing your assets—while ignoring steps 1, 2, and 4. Buying a stock may be the most flashy and exciting of our four elements, but to pursue this item first is to kill your odds of success and lower your probability of making money on a consistent basis. Only after you've completed the first three steps (Figure 1.1) and written it out into a clear, actionable plan are you ready to actually jump into the market.

The first task—in reaching any goal—is to lay a solid foundation. You must start with the basics and work your way up. At the most fundamental level, this means you must learn to speak the language of the market. Every profession—from medicine to engineering to accounting to law—has its own unique vocabulary, and the stock market is certainly no exception. For example, knowing the difference between a market order and limit order could be the difference between a profitable trade and a losing trade. There is an extensive collection of glossaries and resources online that help explain the investment language. Find the one that works for you, and refer back to it frequently.

In addition, you must take the time to learn the structure of the market. For example, Dow Jones, Standard & Poor's (S&P), and the Frank Russell Company all create unique indexes or groupings of equities. They are then paid a licensing fee by users of their indexes. Understand that while these indexes may appear different, all three companies are slicing and dicing the exact same total market made up of the exact same stocks (Figure 1.2). Because the equities

FIGURE 1.1 Three Steps: Asset Creation, Asset Protection, Asset Growth

that constitute them are all the same, this means that the Dow Jones Industrial Average is a subset of the S&P 500 index, which in turn is a subset of the Russell 3000. Taking the time to properly educate yourself will prevent you from being confused by all this slicing and dicing and will serve you tremendously as you move forward through your investing career. Think of education as a prerequisite and a critical part of building your foundation because choosing to learn on the fly can quickly become a very expensive decision.

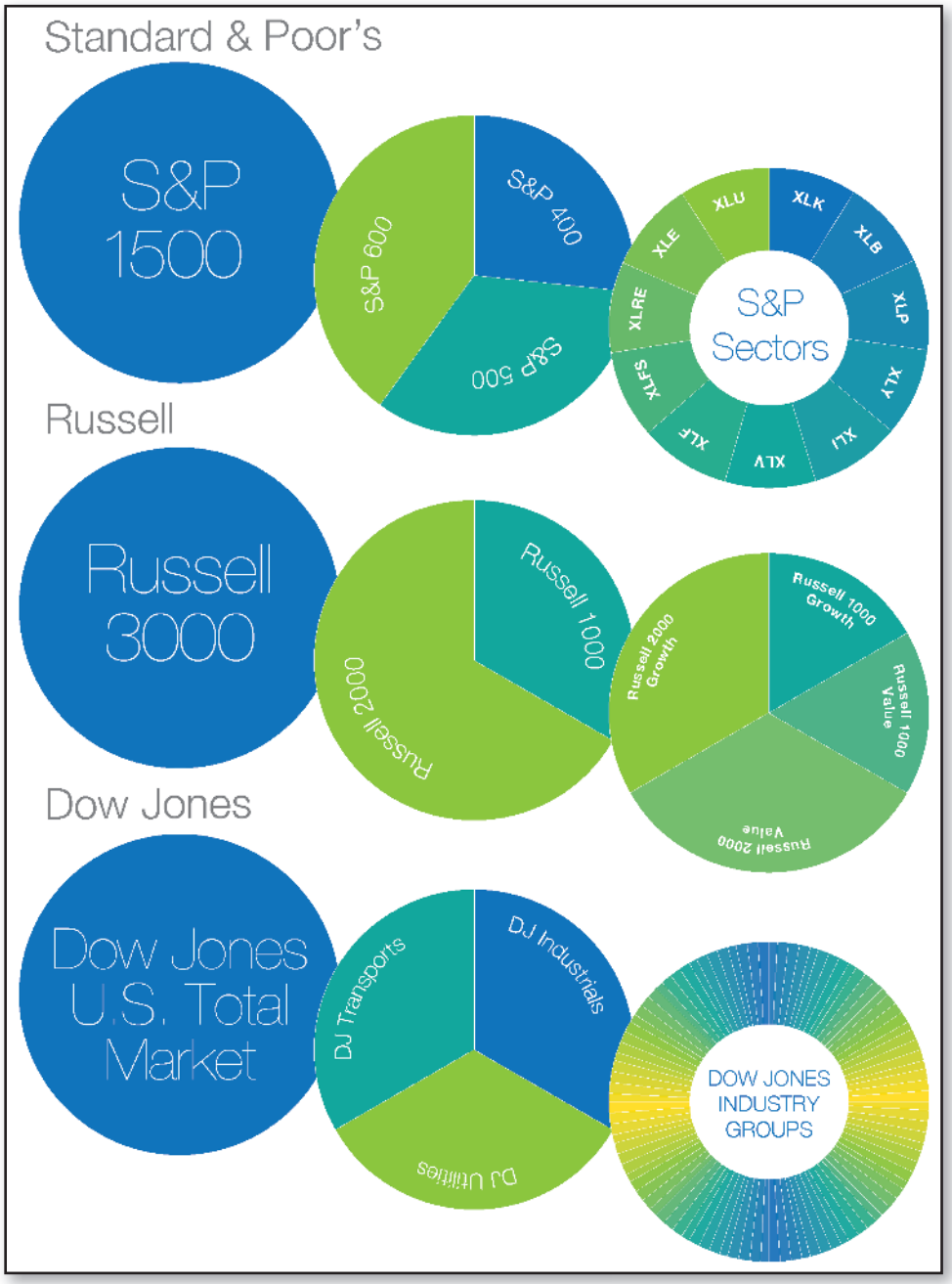

FIGURE 1.2 Market Index Pies

Let us address the first point in creating a detailed money management plan: knowing what you have. Before you can pass go and collect $200—even before you can set your piece down on the board to play the game—it is imperative that you thoroughly sort through your personal financial data to understand exactly what assets you own and where they are invested.

To do this, I update my net worth statement on an annual basis every January, and even in this short time frame, there is not a year that goes by without some sort of surprise popping up. That said, trust me: It is a relatively easy process that, if performed annually, will give you a clear and accurate picture of your total assets, liabilities, and investable base. A simple inventory like this can truly save your skin down the line. Whether you create your own or rely on a portfolio management software program, maintaining a logical system of organization for your financial data is not an option; it is a necessity.

But the organization does not end with the paperwork. You must also address the physical component of your organization by keeping a tidy and orderly workspace, efficient and functional filing methods, and a state-of-the-art computer system. In today's digital world, movements in the stock market are instantaneous and will not wait for you to be settled. If your desk is cluttered with papers, you cannot find your passwords, or you misplaced your stops sheet, you will miss precious opportunities when the market presents them to you.

Having assessed your financial standing and gained an accurate picture of your assets, you can now move to the next step: knowing how to protect your existing assets. A common sports cliché tells us that defense wins championships, and in the investment arena, a premier defense is paramount. Successful long-term investors know that after working hard to accumulate their assets, they must remain vigilant and protect them before turning the focus toward asset growth. I am often asked by wealthy and accomplished individuals for my advice on managing their assets. Having succeeded in their previous careers and mastered the art of asset accumulation, they have built up an investable base and have a solid understanding of their net worth. Anxious to dive headfirst into the stock market and begin buying equities, they fail to realize that they are skipping a step. I explain that before they can jump into the exciting stuff, they must complete the essential step of addressing the basics of asset protection.

Before you decide what and where to invest, having the patience to focus on protecting your assets will build a strong platform on which future success can develop. It is important to recognize that, in the stock market, there are only two losses you can experience: capital and opportunity. Seizing an investment opportunity is important, but if you push the envelope too far and fail to protect your capital, these opportunities will no longer be available to

you in the future. If you protect your capital, however, there will always be another opportunity. As such, protecting your assets must remain of prime importance.

Start your protection plan with a thorough review of the basics, such as insurance, estate planning, identity theft protection, professionally advised tax strategies, and secure record keeping. Find a competent estate attorney, keep your will up to date, and review it every two years. Make sure you have proper asset coverage, medical insurance, and liability insurance. Be prudent in protecting your personal information by using shredders and secure mailboxes. Devise proper password protocols, and hire a firm to monitor your credit agency accounts. Install software to inventory all your assets and reconcile your net worth annually. Seek the help of a good tax accountant to help minimize your tax payments. Set yourself up for success by ensuring these items are taken care of before you begin investing. Your future self will thank you for it.

It may sound somewhat self-evident, but paying off your debts and minimizing your liabilities is part and parcel of prudent asset management. We can debate the appropriateness of using leverage, but suffice it to say my position is to steer clear of this strategy. It has been my observation that debt and leverage make poor partners with wise investment decisions. On a personal note, I am an advocate of developing a savings attitude by learning to live on a specific percentage of what you earn while investing the balance. In my experience, even teaching your kids about money and the value of effective management can be part of your own money management plan. (You will be surprised by what you yourself learn in the process!) With these items in line, you will be on your way to a secure and well-protected asset base you can then grow comfortably, confidently, and consistently.

Crafting Your Money Management Plan

As you set out on your investing journey, the foundation you lay by carefully assessing, organizing, and managing your assets will become your secret for future success in the market, giving you an edge that all investors need but few truly have. Attempting to invest without a detailed and accurate money management plan is like trying to nail Jell-O to a wall: impossible. Creating this personal plan is imperative; it will help you remain in control of not only your investing but also your financial well-being as a whole. Your plan should include the following seven characteristics:

1. Based on a very personal and appropriate financial framework document.
2. Exists in writing.
3. Thoroughly describes your goals, objectives, and priorities.

4. Outlines your investment methodology and strategies.
5. Describes your trading tools and sets money management rules to help you remain consistent and focused.
6. Acknowledges your individual risk tolerance and describes the risk management techniques you will employ to protect your assets.
7. Updated on a regular basis.

Personal and Appropriate

In order to be successful, your plan must be based on a very personal and appropriate financial framework document. There is no one-size-fits-all approach, so you need to customize your plan to account for your existing assets, financial goals, risk tolerance, strategic preferences, and your stage in life—among other factors. This list is by no means exhaustive.

Your assets are yours alone, and they must be organized and managed according to what feels most appropriate for you.

Put It in Writing

Too often, people make the mistake of overestimating their abilities and believing they can keep track of everything in their head. Furthermore, a written document is a communication vehicle for sharing and validating your intentions with your significant other, your family, and any outside attorneys or accountants you may involve. Taking the time to write out your money management plan and put everything on paper is the most effective way to not only stay organized and accurate with your financial data but also be brutally honest with yourself about your financial reality. If your asset management plan is committed only to memory, it is easy to bend the numbers and convince yourself that pouring another $10,000 into a stock cannot hurt. But if this plan is written down, it may be obvious that another $10,000 is not prudent. Keeping your finances on paper introduces a level of precision and responsibility to your financial data that is more difficult to twist, helping to ensure that you are honest with yourself in your investment decisions.

Thorough and Descriptive

Your money management plan thoroughly describes your goals, objectives, and priorities.

This is a wonderful opportunity for you to reflect on where you are financially and where you would like to be moving forward. Again, it is vital that you be honest and realistic with yourself. If your goal is a 40 percent return in your first year, you may want to think again. Start smaller, and work your way

up to bigger, better, more ambitious objectives as your level of experience grows. Shortcuts are not an option, so be diligent and don't rush.

Methodology and Strategies

Your plan also outlines your investment methodology and strategies. Like the other parts of your plan, it's important that this be written down.

Detailing exactly how you intend to invest your money and the strategies you will use to grow your assets is a critical step toward successful investing. Without a specific and focused methodology, your investing will lack direction and consistency. Note, too, that your methodology and the strategies you use to support it will evolve over time and may take years to fully develop; this is all part of the investing game. Writing out a methodology now will start you off on the right path, and by embracing good habits, you will ensure a successful future for yourself in the stock market. We will cover the steps of constructing your methodology in later stages, but it is important to understand now that it is a living document that will be adjusted on an ongoing basis to reflect your personal growth as an investor.

Trading Tools and Money Management Rules

As your plan expresses your goals, it also addresses how to get there. It describes your trading tools and sets money management rules to help you remain consistent and focused.

In today's age of Internet overload, there are thousands of resources marketed as investment aids. By carefully filtering through these, choosing the handful that are right for you, and intimately familiarizing yourself with them, you will increase your efficiency and effectiveness as a trader. Note that for our purposes in this book, the terms *investor* and *trader* can generally be used interchangeably. This reflects the idea that each and every investor must identify the trading time frame that best suits his or her own temperament, goals, and priorities. In the larger context, investors tend to hold their equities for longer periods, while traders lean toward shorter periods. For us, this distinction is not important. What is important, however, is for you to identify and fully commit to the time frame you are most comfortable with. Make this a rule for yourself, and document it in your money management plan.

As you begin to invest in the market, a firm set of rules will become your guide to turn trades into profit. Using a tiered ladder system, for example, both when buying into a position and when selling out of a position, will add structure to your investment strategies. Numerous academic studies have shown this yields superior returns in the long run. If you are planning a total investment of $10,000 in a specific equity, first buy 20 to 30 percent of that

sum as a feeler for the investment. If the markets validate this first position and it shows a profit, buy another 20 to 30 percent, and continue to monitor the position. When both your first and second positions are profitable, buy the balance of the $10,000 total investment. The same structure applies on the sell side of the coin, modified slightly to reflect the fact that markets move down much faster than they trend up. Your first sell could be up to 50 percent of the position, your second sell could be 30 to 50 percent of the position, and your third sell should be the remainder.

In addition, set stops on your investments to avoid excessive risk and protect your precious capital. In a later stage, we will discuss in detail the mechanics of setting stops, but it is important to note here that whether you use hard stops (entered in the market) or soft stops (kept on your own desktop), this asset protection tool is indispensable. After a 25 percent run-up or higher in the price of the equity, your methodology should call for you to tighten your stops, locking in profits and avoiding the loss of a profitable trade. You must learn to listen carefully to what the market is telling you. Respect its power and stay consistent by monitoring your positions closely. This simple handful of rules has been my savior time and time again, and my strict adherence to them has made me a successful, profitable investor.

Risk Tolerance and Protection Strategies

In order for you to be successful, your plan must acknowledge your individual risk tolerance and describe the risk management techniques you will employ to protect your assets.

Always remember that without capital, there will be no market opportunities. Everyone has a different level of risk he or she can handle, both emotionally and financially. Understanding your personal risk tolerance is crucial to understanding yourself as an investor and aligning your decisions with your methodology in a manner appropriate for the current market landscape.

Updated Regularly

Your management plan is updated on a regular basis.

This is vital. Whether you do this every month, every six months, or once a year, find what works for you and stick to it. Your assets are constantly shifting, particularly as their growth becomes a more important part of your equation. This means you must routinely revisit your money management plan to reevaluate your goals, reassess your priorities, and refine your investment methodology as you continue to mature as an investor.

Taking a proactive, hands-on approach to writing your investment plan is the first step toward building a solid foundation for successful investing.

Writing out your plan, however, is only half the battle. Actually believing it and staying true to your words is the other essential half.

As you begin to put this plan to use and develop your investment methodology, you must truly embrace and understand the law of probabilities. Despite what so many market pundits claim, nothing is ever 100 percent certain—but making the proper preparations, formulating the right decisions, and remaining focused on your goals and objectives as written in your money management plan will put the wind at your back and increase your probability of consistently profitable trades.

Personally, I know that my beliefs in four crucial areas determine how my trading profits will stack up at the end of the year. I regularly ask myself the following four questions:

- Do I still believe 100 percent in my methodology as I have written it in my trading plan?
- Do I still have control of my emotions, and am I still displaying the appropriate behavior necessary to trade the markets successfully?
- Is my trust in my tools and indicators unwavering such that I can and will confidently risk my capital based on their readings?
- Do I still believe in the law of probabilities and have faith that by executing my system with consistency I will earn a profit?

In answering and embracing these four questions, I see myself as a trapeze artist, able to let go of the bar and trust that my partner will be there to catch me. In this sense, my beliefs become my trading partner. The bottom line is that as an investor, you must be intimately in tune with your beliefs, goals, and priorities at all times, and you must be aware of any indications that might suggest your faith in them is drifting off course. Understanding your own beliefs about the stock market and investing will empower you to produce consistent profits in a manner no other personal attribute can do.

Becoming a Successful Investor

At the most basic level, there are three central elements to becoming a successful investor. We have already covered the first: writing out your trading plan. Having a trading plan that is realistic, current, and actionable is essential as you strive to meet your investment goals. Personalized and adjusted over time to reflect changes in your life, the plan and methodology that you set out for yourself will increase your probability of success. After writing out your plan, you must put it to use and take action, which is our second element in becoming a successful investor.

On both the buying and selling ends of an investment, taking action is one of the toughest hurdles for budding investors to overcome. Too often, I see students let opportunities slip through their fingers because they are scared to put the hammer down and buy that stock. More tragically, I see students who have no fears about buying, but freeze up and become incapable of pulling the trigger when it comes time to sell. As the stock price continues to fall, this becomes a very, very expensive decision. Strangely, people often classify no action as the absence of decision making. But don't be fooled: Failing to pull the trigger is a decision in itself, and an incorrect one at that. When the markets are telling you that you are wrong, you must do everything you can to stop being wrong. In the scenarios above, these investors are making the wrong decisions, and the only way to fix the problem and turn the situation around is to take action.

With the proper preparations in place, you must believe in your methodology and have faith in yourself so you can go out and make it happen. Acting now beats waiting, because the more you wait, the more daunting that action will appear in the future. To help calm any concerns and make that hurdle just a little bit shorter to jump over, select the risk-to-reward profile that allows you to sleep comfortably at night without excessive worry. Broadly diversify your portfolio to limit your exposure, and take on riskier positions in only small portions. Depending on your risk tolerance, index funds, exchange-traded funds (ETFs), and mutual funds may be more appropriate for you than individual stocks. Finding the right balance between these investment vehicles and applying the principles of your trading plan is a crucial step toward getting you out of the locker room and onto the playing field.

The third element of becoming a successful investor is a theme I cannot stress enough: staying focused and disciplined. This is where the work you put into crafting your detailed money management plan will pay off. You have laid out your goals, objectives, and priorities and put them down in writing, and as you begin to invest, you must keep these in sight at all times. It is tempting to deviate from them in favor of short-term performance, but the impulsive decision to do so can prove costly in the long run and will steer you away from becoming the consistent, long-term investor that you know you can become.

Using benchmarks specific to your goals and priorities, such as the Russell 3000, to evaluate your performance will help you stay on the proper course. Just like your routine trips to the doctor's office, regular checkups and comparisons between your investment history and your money management plan will keep your portfolio healthy and your profits consistent. Most important, find ways to keep your investing fun and interesting—a hobby, if you will—rather than a burden or a source of stress. The global markets today allow you to trade 24 hours a day if you are so inclined, an unrealistic figure for even the most experienced of investors. By deciding exactly how much time you are

willing and able to devote to the stock market, you will feel more directed in your time management and be more effective during the time you do spend focusing on your investing.

For me, thinking of the stock market and my trading as a constant source of education has helped me remain positive and continuously passionate about my investing. I view losing trades as my way of paying tuition to the market, just as I did in college and graduate school. When I experience a loss in the market, I examine the experience and focus not on the immediate frustration of losing money but on the lessons the trade has taught me and the mistakes I made that I will correct in the future. This is a constructive method of personal growth that will help pull your head out of the past and turn your attention toward the future. Finding your own secret formula for making your investing perpetually engaging will keep your outlook positive, help you stay persistent in your trading, and prove profitable in the long run.

The Importance of Asset Allocation

Without exception, every one of the world's most powerful corporations devotes a large staff and hires expensive consultants each year to maintain its corporate strategic plan. An extension of the initial business plan, this annually updated document analyzes the competitive landscape, details current cost structures and sales channels, and explains how the company plans to outmaneuver its competitors on the battlefield of commerce. This process of methodically preparing and strategizing before continuing on with full operations is an essential element of any successful business.

As an investor, you must subscribe to a very similar concept of strategic planning. The equivalent of your own personal business plan is what we will refer to as your personal asset allocation profile. There is an endless array of puzzles you will need to solve throughout your investment journey, but none is more crucial than carefully and methodically crafting your own asset allocation plan.

Far too often, new, overeager investors commit the exact same classic mistake by ignoring this pivotal step. Rather than first looking in the mirror and asking what types of assets suit them best both intellectually and emotionally, they dive headfirst into the market—any market—without hesitation. Predictably, the markets quickly deem these impatient investors unworthy. After suffering the harsh realities of their careless urgency, they are eventually shamed into deep personal reflection and forced to ask the important questions they failed to consider before they began. These individuals learn the hard way that it is unavoidably critical to outline your goals, objectives, and expectations well before committing serious money to the financial markets

and placing any actual trades. This is the central theme of strategic asset allocation. Before moving forward, consider the following definition, which we've created for the purposes of Tensile Trading:

> For an individual investor, asset allocation can be defined as the strategic selection and assembly of a diversified assortment of financial assets with prudent correlation values in appropriate percentage weights that reflect the investor's personal risk tolerance balanced against his or her profit expectations, investment timeline, and other unique financial goals that the investor wishes to achieve.

At its core, asset allocation hinges on diversification. This alone is nothing revolutionary; diversification has been a central component of basic investment principles for many generations. You do not need a doctorate or a master's in business administration to recognize that putting all your eggs in one basket is a foolish investment plan doomed only to fail. The classic diversification model is most commonly represented as a pie chart split into four pieces (Figure 1.3). According to this model, invested capital should be divided between four broad asset classes to reduce a portfolio's exposure to downside risk throughout all phases of the business cycle.

As time has worn on and financial markets throughout the world have expanded, however, diversification models have become much more complex. Economists, mathematicians, and financial professionals have shown that utilizing more sophisticated models of diversified asset allocation can reduce risk still further while also potentially increasing total returns. In fact, diversification has become so widely embraced that in 1974, the government enacted federal Employee Retirement Income Security Act (ERISA) laws that established minimum standards for asset allocations in pension plans and required

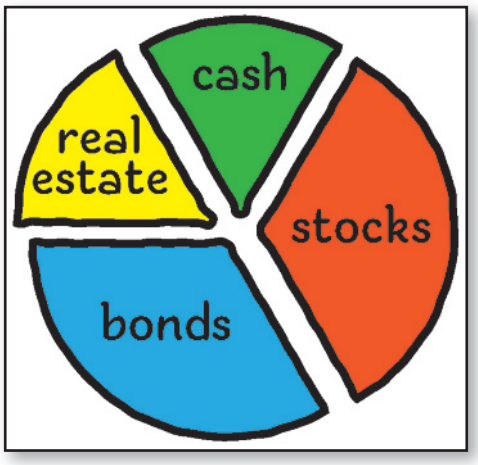

FIGURE 1.3 Elementary Diversification Model

FIGURE 1.4 Tensile Trading's Modern Diversification Model

compliance by portfolio managers. What this means is that the elementary diversification pie we previously sliced into four large asset classes is no longer representative of the investable landscape available to us (Figure 1.4). Instead, the pie has fragmented, giving us dozens more asset classes across which we can allocate our capital.

While the exact number of potential asset groups remains a topic of debate, my eyes have sliced the pie into a collection of 59 unique asset classes across which an investor can diversify his or her portfolio. What is perhaps most important to recognize here is that investing in the modern era is a game of endless choice. In the past few decades, the financial markets throughout the world have played host to unbelievable growth and innovation. Increased globalization, significant expansion of numerous emerging markets, and rapid technological developments have put the entire world only a click away, while the rise of ETFs has brought even more investment options to the table. For a long list of reasons, it is simply impossible for one individual investor in today's global markets to fully understand and analyze all of the economic influences, fundamental inputs, and political motivations that affect financial market prices across all asset classes. The basic reality is that the skill set it takes to manage high-yield bonds in Asia is very different from that required to trade small-cap equities in the United States, for example. As an investor in the twenty-first century, your job is no longer to find the best, most promising assets the markets have to offer in each asset class. There are simply too many options across too many asset groups for this to be even a remotely feasible task. Instead, it is your job as an investor to assemble a specific collection of the best, most promising asset classes that fit your own investor self.

Fortunately, there is an upside to the myriad investment vehicles available across dozens of asset groups: Such a broad array of options allows you to

dial in the precise amount of risk, volatility, and performance expectations that you as an investor deem appropriate for your specific personality, financial goals, involvement level, and more. If, for example, your objective is for investing to serve as your primary source of income, your asset allocation profile can be tilted toward more high-yielding asset groups. If you are fearful of inflation, you can invest a larger percentage of your portfolio in, say, real estate ETFs. If low volatility is your goal, you can build a more risk-averse profile by allocating your capital toward more defensive investments. Moreover, these parameters can be easily adjusted at any time to reflect changing liquidity needs, a new schedule, or estate planning decisions. The key here is that embracing asset allocation as your core investment methodology allows your portfolio to safely grow and develop along with you as an investor over time.

From both my career as a trader and my years as an educator, I would be willing to wager that, overall, individuals who focus diligently on asset allocation will outperform their simple stock-picker brethren and achieve far superior financial results in the long run. Moreover, they do so with lower volatility, smaller drawdowns, and much less stress. Any honest financial professional will tell you that it is nearly impossible for individual investors to consistently beat the market by managing a portfolio of exclusively handpicked individual stocks. This system lacks the structure and organization key to consistently returning a solid profit in today's massive globalized marketplace. Focusing primarily on asset allocation, however, puts the long-term odds much more in your favor while still allowing for some degree of hands-on, active management. I see it as the best of both worlds. By identifying the asset groups that are most tailored to your investing style and selecting the best investment vehicles in each respective group—be they ETFs, mutual funds, or your own active management—you narrow your focus from the infinite universe of individual equities to a much more manageable collection of specific assets.

I have always been both intrigued and impressed by the financial management records of many colleges and universities, and I have found that there are valuable insights to be gleaned by analyzing the strategies employed by these schools. Universities such as Harvard, for example, have been able to outperform the S&P 500 over the past few decades by margins that would shock you. Give it a quick search online, and you will see for yourself. What is most interesting to me is that, with multibillion-dollar endowments to manage, the financial experts at these powerful institutions choose to focus diligently on asset allocation. Part of what makes this strategy so effective is that universities prioritize capital preservation ahead of capital growth. The objective of managing a college endowment is to design a portfolio with very low risk and very low volatility. Over a longer period, this allows the endowment to grow at a modest and consistent pace with little risk of falling in value. Such a goal is achieved most successfully through healthy diversification, which helps

calm the extremes in all phases of the business cycle. Adopting this as a core financial objective of your own will have tremendous benefits in the long run, preserving the capital you have earned while still allowing it to grow for the future.

Constructing Your Personal Asset Allocation Profile

In the financial industry, the confusing reality is that the exact same terminology is often used to describe quite separate concepts, processes, and subjects. Asset allocation is one of those multifaceted terms. There are a host of subdisciplines within the broader concept of asset allocation, each differing in terms of the investment strategies it employs, the timing mechanisms it uses, and more. Two of these disciplines in particular stand out as the most common: strategic asset allocation and tactical asset allocation.

Strategic asset allocation is the process of creating a personalized portfolio that invests in a diversified mix of asset classes in specific, predetermined percentage weights. The key to strategic asset allocation is that the proportional representation of each asset class within the portfolio is determined by the investor's own risk and return objectives and the time frame according to which he or she plans to invest. Generally, once these parameters are set, the only remaining responsibility in the future is to periodically rebalance the percentage weights of each asset class in the portfolio to maintain the predetermined and desired proportional representations.

Tactical asset allocation, on the other hand, essentially begins with a strategic asset allocation portfolio and then regularly adjusts the individual proportions of each of the asset classes up or down to reflect current market conditions. The intention of this method is to continually overweight high-performing assets and underweight poor-performing assets, thereby more effectively timing investments to boost returns.

This brief background of these two common asset allocation concepts is important because the Tensile Trading asset allocation methodology—that is, the methodology we cover in this book—is a hybrid of both the strategic and tactical strategies. A primary intention of this modification is to capture the benefits of diversification while also accommodating most investors' desire to actively manage at least some portion of their portfolio themselves or implement some type of individual equity trading strategy. It can be a challenge to feel fulfilled by spending your time simply allocating capital across different funds and rebalancing portfolio weights. The reality is that, while immensely important, these tasks sometimes lack the excitement many individuals are looking for in the markets. The Tensile Trading approach proudly

acknowledges the hands-on nature of the typical individual investor. Instead of denying or minimizing such a tendency, this methodology seeks to harness it in the most constructive and impactful way possible, using what is known as a core-and-explore approach.

Core and Explore

Imagine two categories within your portfolio: core and explore. The core reflects the asset groups you have chosen to form your asset allocation profile. It consists of low-cost, broad-based index funds, ETFs, and mutual funds, widely diversified with proper correlations and limited risk. Your core positions are allocated not only domestically but also globally, and they should weight allocation percentages across an extensive spectrum of asset classes. Broad market allocation is the objective here, and your core should be constructed with the intention of protecting the assets you have accumulated and "staying rich."

With the core settled and invested, you are free to turn your focus to the explore portion of your portfolio. Extending into the explore territory is a gradual and careful process. As a novice, 100 percent of your portfolio should be invested in core positions. As your knowledge grows, your experience level increases, or your investment objectives change, you can slowly begin to shift a small portion of your portfolio into more aggressive explore positions, such as individual stocks, actively managing and trading this segment yourself. This allows you to pursue your capital growth objectives while ensuring that the bulk of your portfolio remains secure in the core. As your success rate expands and you learn from your experiences, you can extend your explore positions from 5 to 10 to 15 percent of your portfolio, all the while maintaining a solid base in your core positions.

The core-and-explore investment strategy is a tried-and-true method of simultaneously protecting and growing your assets. Exercising control and finding the proper balance between asset protection and asset growth by implementing the core-and-explore methodology is an important step toward joining the ranks of consistently successful investors.

Minimizing Costs

Let us pause here for a moment and address the important topic of costs. As an investor, I am a profit maximizer. Costs are counterproductive to this mission and are therefore one of my main hot buttons. Unfortunately, many new investors underappreciate the immense impact costs can have on their returns. Let us assume that, hypothetically, both you and your twin brother start investing $1 million at age 45. Your brother is frugal and pays 1 percent per year in fees. You are less careful and pay 2 percent a year in commissions

and fees. Assuming a steady, conservative 3.5 percent rate of return over the next 40 years, your brother's portfolio will have grown in value to $2.7 million—a staggering 50 percent greater than the $1.8 million your otherwise-identical portfolio is now worth. It is simple: fees and expenses matter.

There are the obvious expenses to avoid, such as loaded mutual funds and complex ETFs with high costs, low trading volumes, and wide bid-ask spreads. The less visible fees, though, can be quite ingenious. As an example, for a number of years I owned a mutual fund that is offered to investors in five different variations, each with its own ticker symbol. These separate variations of the exact same fund represent five different configurations of front loads, deferred loads, expense ratios, and 12b-1 fees. To circumvent this institutional trickery, resources such as investment research giant Morningstar (www.morningstar.com) can be critically useful. Morningstar breaks down all the available variations for any mutual fund, allowing you to compare and contrast your options. When faced with this sort of choice, always go for the lowest-cost offering.

ETFs are very much the same. It is common to find multiple ETFs that offer exposure to exactly the same market segment. As a result, none of the funds will provide any sort of meaningful performance advantage over the others. The only conceivable difference between them is the expenses they charge. So before you invest, it is crucial that you take these cost differences into consideration. Over time, this sort of investigative effort and careful decision making will prove its worth many times over.

Fortunately, asset allocation by nature generates fewer transactions than many other investment methodologies. While this may sound trivial at first, every transaction is accompanied by fees and expenses and triggers capital gains taxes that decrease profits. Reducing the number of transactions means more of your money remains just that: yours.

Asset Group Selection

In my own portfolio construction, I have chosen 20 asset groups in which to invest, the vast majority of which represent my portfolio's core. These groups have not been chosen at random; they are specific to my own investing personality. After decades of trading, I know myself well and have carefully selected the assets that best fit my investor self. Most important, by limiting the size of my portfolio to 20 asset classes, I restrict the complexity of my investing process. Together, these 20 asset groups form my asset allocation profile. As I have said before, your asset allocation profile is an extremely personal piece of your investing puzzle. I can provide you with the foundation, but it is ultimately your responsibility to build the house that suits you best.

In my own experience, allocating my capital across a collection of 20 asset groups seems to be my magic number, providing the level of statistical diversification my investor self demands. This spread has allowed me to sail through the turndowns of 1987, 2001, and 2008, for example. I recognize, however, that choosing a personalized collection of 20 asset groups across which to diversify your portfolio may seem like a daunting task for a new investor. I will not claim that 20 is the correct number for everyone; as with so many other elements of successful investing, you must carefully find what works best for you. Perhaps a selection of 10 asset groups provides a more suitable and manageable diversified portfolio. Maybe 20 is not enough, and you must cast an even wider net across 30 asset groups. These are the questions that only time and experience can truly answer. As you develop your own asset allocation profile, I encourage you to explore and experiment.

After you have determined the collection of specific asset groups that will comprise your asset allocation profile, the next step is to decide how best to invest in each of them. For some of these categories, passively managed ETFs may be your strongest option. In others, however, you may find that a specific mutual fund manager has been able to consistently beat a benchmark while investing in that particular asset class. In this case, a mutual fund may the right choice. For each asset group in your allocation profile, your job is to carefully sift through the available options to find the investment vehicle that combines proven performance with affordable costs. This process of determining the strongest, most promising investment option in each specific asset class fosters what I like to refer to as "niche dominance." It ensures that for each asset group you own, your money is invested by the very best of the best, be it in a passive ETF or an actively managed mutual fund.

As I mentioned, my own asset allocation profile consists of 20 asset classes that I have handpicked as most appropriate for the character of my investor self. Of those 20 baskets, I invest in 19 of them using ETFs or mutual funds, passing the management baton to others with the most talent in a particular market segment. I have chosen to actively manage the one remaining asset basket, which is large-cap U.S. growth stocks, myself, generally trading about 10 positions at a time within this asset class.

This constitutes the explore portion of my portfolio. On a daily basis, I am able to trade this basket with a hawk-like focus and overweight the attention I devote to its management. This is made possible only because the time and effort I previously spent carefully setting up the other 19 baskets in my asset allocation profile gives me the confidence to let the capital invested in them grow on its own. I have delegated the responsibility for these other 19 baskets to the professional fund managers or the ETFs who have proven themselves the best of the best in their respective asset classes. I am thereby free to simply supervise from a responsible distance and rebalance my capital allocations as needed.

From experience, I know I can successfully monitor 19 asset baskets and actively manage the 10 individual equities in my U.S. growth stocks basket. This self-awareness is crucial. I acknowledge that I am not Warren Buffett. His intellectual bandwidth could allow him to handle a much more extensive asset allocation profile. This is where brutal honesty about yourself is required. The unfortunate truth is that basic human nature works against you as an investor, always coaxing you to trade outside your boundaries. I have regimented myself to stay within my fence line and not venture outside my established comfort zone, even when the forces of temptation pull strongly. In doing so, I am able to oversee all 20 of my asset baskets and make the appropriate allocation adjustments necessary to limit risk, maximize returns, and sleep peacefully.

Asset Allocation Resources

For newer investors in the process of assembling their own asset allocation profile, there are three key resources that, collectively, help condense the market down into an easily accessible format. Taken together, these resources will allow you to compile a thorough list of currently available mutual funds and ETFs across all asset groups, giving you a logical array of options to consider for each. First, the American Association of Individual Investors (AAII) has an annual guide to the top mutual funds. Focus on AAII's groupings, not necessarily the individual funds. Second, Morningstar publishes a newsletter called *The Fund Investor* both in monthly hard-copy format and online at www.morningstar.com. Its asset class groupings differ from the AAII, and the same is true for Morningstar's other helpful publication, *The ETF Investor.* Try finding it at your local library, or investigate the free online features. Additionally, don't forget to check whether your brokerage house offers access to Morningstar as a complimentary account benefit. If it does, this is a feature I strongly encourage you to take advantage of. As you dive deeper into your portfolio construction, Morningstar offers a host of tools and resources that add tremendous value to your asset allocation efforts.

Another one of my preferred resources available to aid investors in their asset allocation decisions is StockCharts.com's Interactive PerfCharts. The PerfCharts tool allows you to quickly plot up to 10 symbols, all overlaid together on the same chart. This provides an easy way to compare performance between multiple assets, be they ETFs, index funds, mutual funds, or individual equities. Using the animation bar at the bottom of the chart, you can adjust the time period you wish to view and dynamically evaluate which symbols have outperformed or underperformed. This visual analysis tool provides a simple, yet highly effective method for narrowing your options down to a select few.

Once I have done this, I dig a bit deeper into the ETFs and mutual funds that appear most promising. Both ETF.com and Morningstar provide

detailed individual ETF reports that pack an astonishing amount of information into a concise, accessible format. For mutual funds, I use either Morningstar.com or my broker's comparative tools. Charles Schwab, for example, provides my favorite tool: Compare Funds. This resource allows five symbols to be observed side by side along with an extensive list of additional criteria. Most other brokerages offer similar resources to help guide your mutual fund or ETF decisions. The selection criteria will vary from investor to investor according to personal preferences and individual objectives, but I recommend that a premium be placed on the following elements:

- Relative historical performance
- Expenses
- Portfolio composition
- Assets under management (AUM)
- Alpha, beta, and *R*2
- Management personnel

Correlation Coefficients

The other part of the diversification puzzle you must consider is the correlation coefficients between the asset classes in your portfolio. Correlation is a statistical measure that represents the degree to which the prices of two different securities move relative to each other. Correlation coefficients are expressed within the range of +1.0 to −1.0. If the prices of two securities historically move in the same direction, they will have a positive correlation value that falls somewhere between zero and +1.0. If the two securities historically move in opposite directions, they will have a negative correlation value that falls somewhere between zero and −1.0 (Figure 1.5).

I personally create a 10-year correlation matrix in which I calculate all the correlation values between every possible pair of the 20 asset baskets

FIGURE 1.5 Correlation Coefficients

in my allocation profile. This helps me visualize and more accurately assess the true diversification level of my portfolio. To expand upon this concept, let me offer this brief example. Assume, for the sake of simplicity, that your asset allocation profile consists of only four asset groups. If you construct a simple four-by-four matrix using your four asset groups, you can then use a simple stock correlation calculator to fill in the matrix. Typically, I calculate the historical relationships between asset groups across the last 10 years. This provides a long-term view that is still relevant to today's market climate. To best solidify this concept, consider a small portfolio that invests in four asset classes, using ETFs for each. After calculating the correlation values between these ETFs, we can compile the data into a four-by-four matrix, which allows us to more accurately understand the portfolio's true level of diversification. Note that while this four-asset profile is small, the foundation and matrix style is the same for a larger portfolio with more asset groups.

To help you quickly calculate statistical correlation values between different assets, there are a number of easy-to-use tools available online. They can be found by running a simple Web search for a stock correlation calculator. The sites returned in this search will allow you to enter two symbols—whether stocks, ETFs, or mutual funds—set the price series interval to either daily, weekly, or monthly, and then select the time period across which you would like their correlation value calculated.

As you construct your asset allocation profile, these correlation values should play a significant role in determining the asset groups you choose and the specific vehicles you use to invest in them. I calculate the correlations among all 20 of the asset groups in my portfolio because of my primary diversification objective. Let us say you invest in 10 different asset groups with correlation values averaging +0.99. While you may feel that your portfolio is diversified because your money is spread across 10 separate asset classes, the correlation values prove that this is only a false sense of security. In reality, your portfolio is not actually diversified. It is not enough to simply choose a collection of asset classes and assume that your portfolio is properly diversified; you must dig deeper to determine the true historical correlations between the asset groups in your portfolio. Diversifying your investments across different assets with low correlation values to each other allows you to design a more efficient portfolio with considerably reduced exposure to downside risk. By utilizing this approach and understanding the specific historical correlation values between the specific asset groups in your portfolio, you can build an asset allocation profile that is better equipped to weather all storms and churn out consistent profits in the long run. If you feel overwhelmed, don't feel ashamed to ask for professional help, particularly if you are new to the investing game. This can be complex stuff!

Let me offer another simple example that illustrates the impact correlation values can have on your portfolio. Suppose that two siblings, Bill and Mary, both inherit equal small fortunes from their parents. They both decide to invest their entire inheritance across four asset baskets. Bill invests his inheritance as follows:

- 25 percent in the S&P 500 (SPY)
- 25 percent in the Industrials Sector (XLI)
- 25 percent in the Consumer Discretionary Sector (XLY)
- 25 percent in the Technology Sector (XLK)

Mary invests her inheritance, equal in value to Bill's, in a different assortment of assets:

- 25 percent in the S&P 500 (SPY)
- 25 percent in the Health Care Sector (XLV)
- 25 percent in the Energy Sector (XLE)
- 25 percent in the Utilities Sector (XLU)

Bill believes he has made some prudent and responsible investment decisions with his inheritance, but in fact the 10-year historical correlation for his portfolio works out to be an average of +0.92. This means his entire portfolio nearly mimics the performance of the S&P 500. This is akin to owning four identical cars in four different colors. Despite his good intentions, Bill did not achieve the diversification and risk reduction he expected. Mary's portfolio, on the other hand, has a much lower historical correlation average, +0.67. By diversifying her investments across a similar collection of assets but with lower historical correlation values, Mary has dramatically reduced the risk exposure of her portfolio and set herself up for a profitable future. Even though Bill had the right idea in spreading his money across an assortment of different asset groups, his failure to consider the correlation values between them weakens his probability of success.

To frame this lesson in one final context, imagine the following: As a longtime Amazon employee, a substantial portion of your compensation package has come in the form of stock options. These options represent a significant share of your total net worth and, intuitively, must be accounted for as you construct a larger investment portfolio. Given the value of these stock options, your financial success is largely dependent on the price performance of Amazon stock, leaving you overly exposed to not only one specific sector within the market but also to one single equity. As such, a primary goal of your portfolio construction efforts should be to offset the risk to which your Amazon options expose you. By finding and investing in other

asset groups with low historical correlation values to Amazon specifically—as well as to the consumer discretionary sector, of which Amazon is a part, more broadly—you actively reduce your portfolio's total risk exposure and markedly increase your likelihood of long-term success. The wider you cast your diversification net and the more consideration you give to your portfolio's correlation values, the stronger your probability of success becomes. See Figure 1.6 for an example.

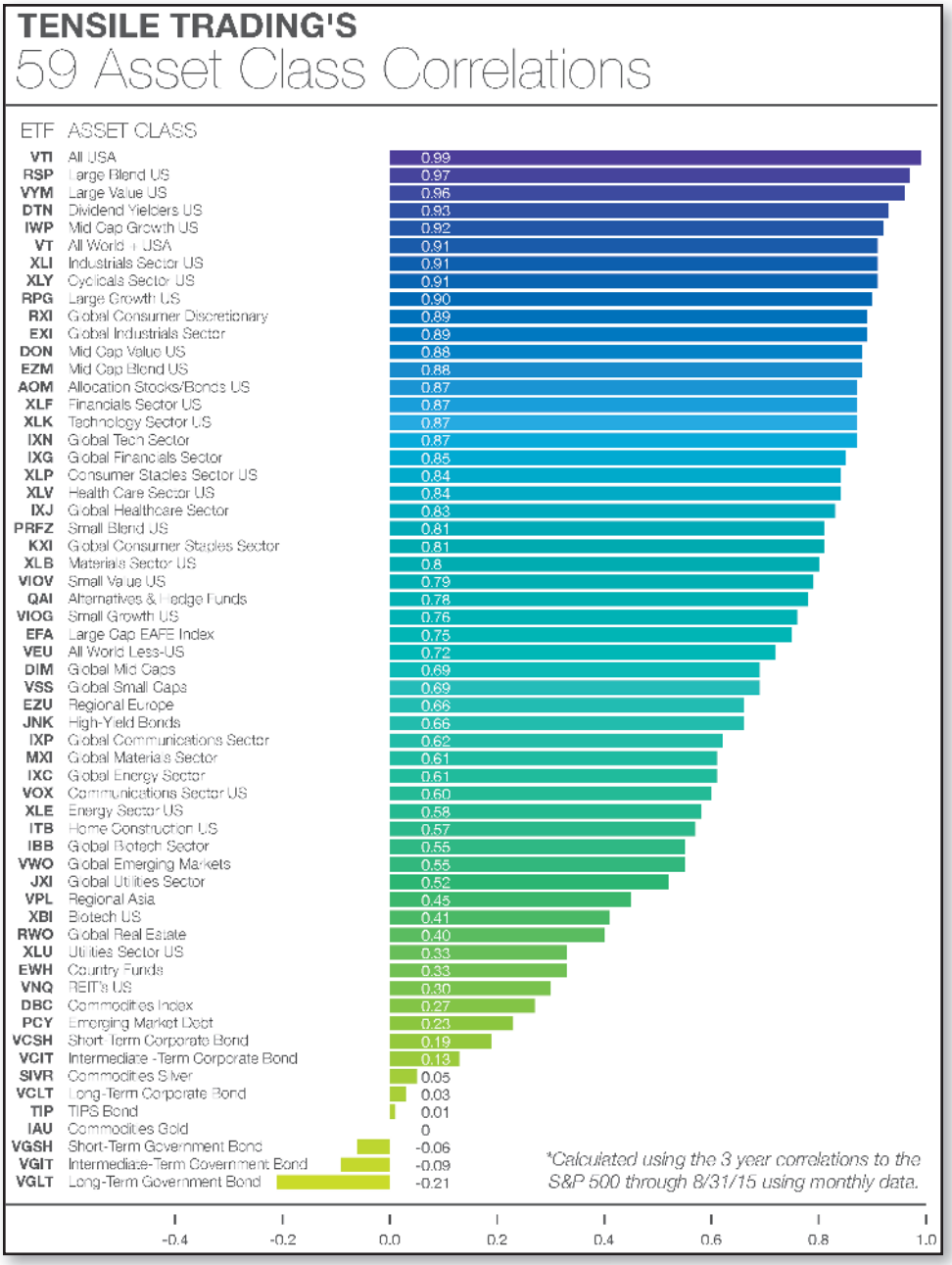

FIGURE 1.6 Tensile Trading's Asset Correlation Coefficients

X-Ray Magic

For the domestic growth stock basket I actively manage, I know exactly what I own, no questions asked. For the other 19 baskets, however, which are managed using ETFs or mutual funds, figuring out exactly what I own is not always as clear. To resolve this issue, Morningstar.com provides another amazingly useful service: the Instant X-Ray tool. After entering all your positions into the site's portfolio manager, the Instant X-Ray feature magically unbundles all of the ETFs and mutual funds you own into a compiled list of the underlying individual securities the funds hold. The tool shows you, in percentages, exactly what you own by style, size, geography (foreign or domestic), type (bonds, cash, and stock), and more. This resource is an incredible aid for your diversification efforts, helping you more accurately understand how and where your money is allocated across the different asset groups in which you have chosen to invest.

This Instant X-Ray exercise often has a significant impact on the individual equities I trade in the U.S. growth stock basket I manage myself. I never pile capital into an individual equity position before consulting the Morningstar Instant X-Ray tool. Time and time again, it surprises me to see the specific securities that the ETFs and mutual funds I have invested in actually own on my behalf. For obvious reasons, it makes no sense to buy into the same equities that your funds are already investing in for you.

On the flip side, the Instant X-Ray tool can also help weed out funds that may not be appropriate for you given your asset allocation profile. For example, as a competent trader of U.S. growth stocks, I have no need to buy ETFs or mutual funds that address that asset group. I do, however, seek out the most promising options or the very best talent in the other asset baskets that I want covered, leaving me with only the responsibility to monitor and adjust my allocations across the 20 different asset groups in my total portfolio. This process ensures that, for each asset group in my asset allocation profile, my money is wisely invested by the most capable hands.

Allocation Maintenance

I want to hammer home the point that how you allocate, adjust, and monitor the composition of your portfolio throughout the year will have a tremendous financial impact on your year-end bottom line. This is an immensely high-leverage activity. I adjust and monitor my allocations across all 20 asset groups in my portfolio using a relatively basic spreadsheet I have created. First, I decide how much money will be collectively allocated across all 20 asset classes. I have a fixed-mix allocation that I am comfortable with across

each of the 20 baskets. For example, for the international small-cap basket, I use an allocation of 5 percent of my portfolio. In other words, in a fixed-mix market, I would maintain 5 percent of my total capital in international small-cap equities. In reality, however, I flex allocations around that number based on the present market's expressed favor or disfavor for that particular asset basket. My target allocation for any asset basket will be either above or below that fixed-mix target based on what the market is telling me at that moment. My job then becomes one of merely flowing money into and out of the 20 asset baskets using the best-performing ETFs or mutual funds for each asset group.

I rebalance my portfolio allocations largely based on my in-the-moment observations and gut intuition, but this task can be completed monthly, quarterly, or annually depending on your investment timeline. In addition, modern seasonality tools allow you to track the past performance of your assets averaged over multiple years to determine historical trends that exist throughout the year. You can then use this information to rebalance into or out of different asset classes at their historically likely annual lows or highs. We will discuss seasonality more thoroughly later on, but keep this unique tool in mind.

Each year, there are four checklist items you should complete in order to keep your portfolio properly balanced and poised to succeed in the future.

First, revisit your target allocation mix for your portfolio. Sit down with your financial adviser or your significant other and consider whether there have been any changes to your financial situation, your investment needs, or your personal risk tolerance. If so, adjust your allocation weights accordingly.

Second, review each of the individual asset groups in your allocation profile. Are the asset classes you own still appropriate for your investor self? If you are dissatisfied with the performance of a particular asset group, note that you do not necessarily have to kick it to the curb entirely. Instead, try changing the investment vehicle you are using for that particular basket, switching, for example, from a mutual fund to an ETF or vice versa.

Third, recalculate the correlations among the asset groups in your portfolio. Don't assume that correlation values remain static over time. If you fail to maintain an accurate understanding of the relationships between your asset groups, your diversification and risk minimization objectives will suffer.

Finally, look back at your target allocation weights for each asset class, and rebalance your investments as needed to return to those levels. Understand that this task is best completed over a longer period of time rather than all at once. Do your best to buy into asset groups at their seasonal lows and sell out at seasonal highs. Likewise, endeavor to hit your target allocation weights for each asset group by investing new money gradually over the course of the year, not all at once.

Together, these four allocation maintenance routines will keep your portfolio running smoothly and in line with your core investment objectives throughout the year.

Key Takeaways

At this juncture I should reassure you that it is perfectly natural to feel overwhelmed. Don't worry. I have put you in front of a fire hydrant and invited you to take a drink. Continue on to Stage 2 with the intention of revisiting this first stage again at a later point in time. I suspect that, after working through the material we will cover in the later stages, a second read-through of the Stage 1 content will yield many more valuable insights. This stage has been jam-packed full of information, much of which will make far more sense once we have finished laying the foundation and begun constructing the walls. Rome was not built in a day, and your transformation into a successful investor certainly will not be, either! For now, focus on learning the market's unique vocabulary, begin to write down your personal trading plan, and start to develop an organizational framework for your investing. Above all, enjoy the journey, and have faith in the process.

Your Personal Money Management Outline

1. Personal Trading Philosophy
   - Personal goals and motivations
   - Investing goals and motivations
   - Can I explain my investing philosophy in 60 seconds?
   - What type of investor am I?
   - My personal investing time frame
   - What markets will I trade?
   - My beliefs about money
   - Personal weekly time commitment
   - My strengths and weaknesses
   - What is my trading edge?
2. Money Management
   - Net worth statement
   - Asset protection strategy
   - Estate plan
   - Asset allocation profile and correlation targets
   - Core-and-Explore split
   - Personal money management rules
   - What do I not buy?
   - Rebalancing and seasonality methodology
3. Investor Self
   - Investor self survey
   - Personal roadblocks
   - Keeping a trading journal
   - Personal discipline
   - Stress management techniques
   - Past blunders and blind spots
   - Lessons learned
   - Rating yourself
4. Investing Tools
   - Preferred brokerage houses
   - Organization paradigm
   - Computer hardware
   - Portfolio management software

- Investment accounting software
- Trading program
- Third-party support

5. Trading Methodology
   - Idea sources and resources
   - Screening methodology
   - Key fundamental indicators
   - Technical indicators and toolkit
   - ChartList organization and layouts
   - Watch lists and stalking strategy
   - Explicit trading methodology
   - Trading rules
   - Routines: daily, weekly, monthly, and annually
   - Travel routines
6. Risk Management
   - Monitoring routines
   - Reward-to-risk calculations
   - Ladder-in/Ladder-out percentages
   - Setting and adjusting stops
   - Triggers and alerts
   - Asset protection rules
   - Profit protection rules