A Market Turmoil Strategy

An Introduction to Dynamic Risk Management

February 26, 2018

Disciplined Financial Services, Inc

Focused on Your Financial Security

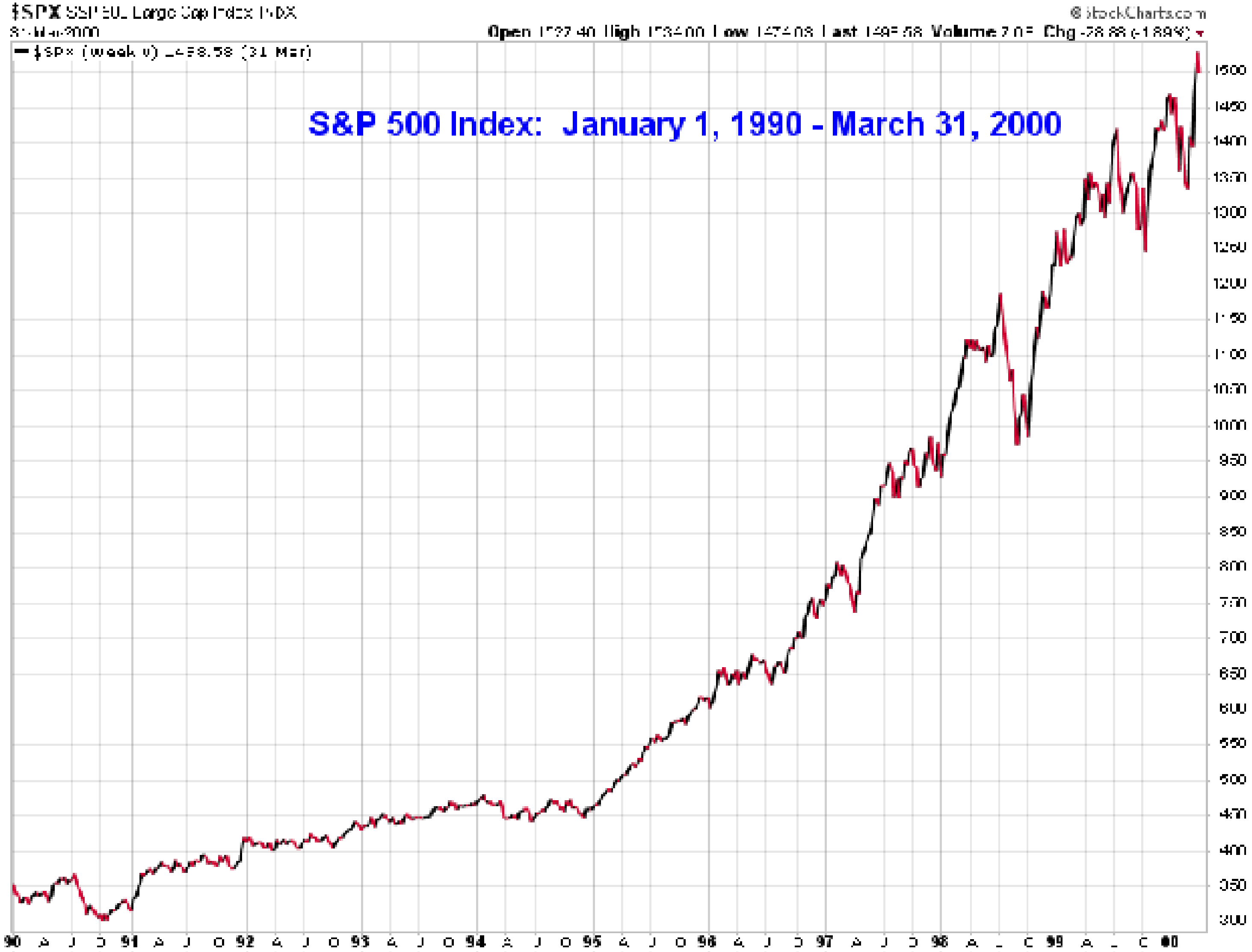
What is risk?

A Bull Market: January, 1990 – March, 2000

- S&P 500 experiences almost uninterrupted growth 1/1/1990 – 03/01/2000
  - 455% Return*
  - Initial investment of $100,000 grows to $455,000**
- Huge expansion in the number of individual shareholders
  - Ownership Grows from 15% to 55%
  - Direct, Indirect: 401(k)s, Mutual Funds

*Source: www.standardandpoors.com
**Past Performance is no assurance of a future result

The Standard & Poor's Stock Index (S&P 500) is an unmanaged index generally representative of the U.S. stock market without regard for company size and cannot be invested in directly.
The market for all securities is subject to fluctuation, such that upon sale, an investor may lose their principal.


$SPX S&P 500 Large Cap Index INDX
© StockCharts.com
S&P 500 Index: January 1, 1990 - March 31, 2000
1500
1450
1400
1350
1300
1250
1200
1150
1100
1050
1000
950
900
850
800
750
700
650
600
550
500
450
400
350
300
90 A J O 91 A J O 92 A J O 93 A J O 94 A J O 95 A J O 96 A J O 97 A J O 98 A J O 99 A J O 00

A Bear Market: March 10, 2000 – October 9, 2002

- Market loses $9 trillion in 31 months*
  - Dow Jones Industrial Average Index loses 37%
  - NASDAQ 100 Index loses 79%
  - S&P 500 Index loses 49%
- Impact on average investor
  - Average loss of 47.4%
  - $455,000 becomes $239,330 during this time period**

*Source: www.standardandpoors.com
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$SPX S&P 500 Large Cap Index INDX
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S&P 500 Index: March 1, 2000 - October 31, 2002

The Stakes

- If you retired March 2000, you walked into a 47.4% decline!
- Is "Buy and Hold" the answer for the long term?
- It took the S&P 500 index 7- years and 2- months to recover to its pre-bear market peak! (3/24/2000-5/30/2007)

Another Bull Market: October 9, 2002 – October 9, 2007

- S&P 500 experiences almost uninterrupted growth 10/9/2002 – 10/9/2007
  - 102% Return*
  - Initial investment of $100,000 grows to $202,000**
- Larger expansion in the number of individual shareholders
  - Direct, Indirect: 401(k)s, Mutual Funds

*Source: www.dorseywright.com
**Past Performance is no assurance of a future result


$SPX S&P 500 Large Cap Index INDX
© StockCharts.com
S&P 500 Index: October 1, 2002 - October 31, 2007
Oct
03
Apr
Jul
Oct
04
Apr
Jul
Oct
05
Apr
Jul
Oct
06
Apr
Jul
Oct
07
Apr
Jul
Oct

Another Bear Market: October 9, 2007 - March 9, 2009
(Most recent Bear Market - #16)

- Market loses $11 trillion in 17 months*
  - Dow Jones Industrial Average Index loses 57%
  - NASDAQ 100 Index loses 52%
  - S&P 500 Index loses 57%
- Impact on average investor
  - Average loss of 56.78%
  - $202,000 becomes $87,300 during this time period**

*Source: www.marketwatch.com "US Stocks Slip as Early Rally Evaporates," 3/6/2009
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The market for all securities is subject to fluctuation, such that upon sale, an investor may lose their principal.


$SPX
© StockCharts.com
S&P 500 Index: October 1, 2007 - March 31, 2009
Oct
Nov
Dec
2008
Feb
Mar
Apr
May
Jun
Jul
Aug
Sep
Oct
Nov
Dec
2009
Feb
Mar

Reality: Bear Markets Hurt!

- The Facts:
  - Most Recent Bear Market: DJIA Index loses 57%
    - Bear Markets defined: 20% decline (or greater) in the S&P 500 Index
    - Since 1929: 16 bear markets have occurred
    - Average frequency of a new bear market since 1929: every 4.8 years
    - Average depth of a bear market: 38.2% decline
    - Average duration of a bear market: 17 months
    - Average time lost making up a bear market loss: 60 months (including last Bear #16)

Source: www.standardandpoors.com
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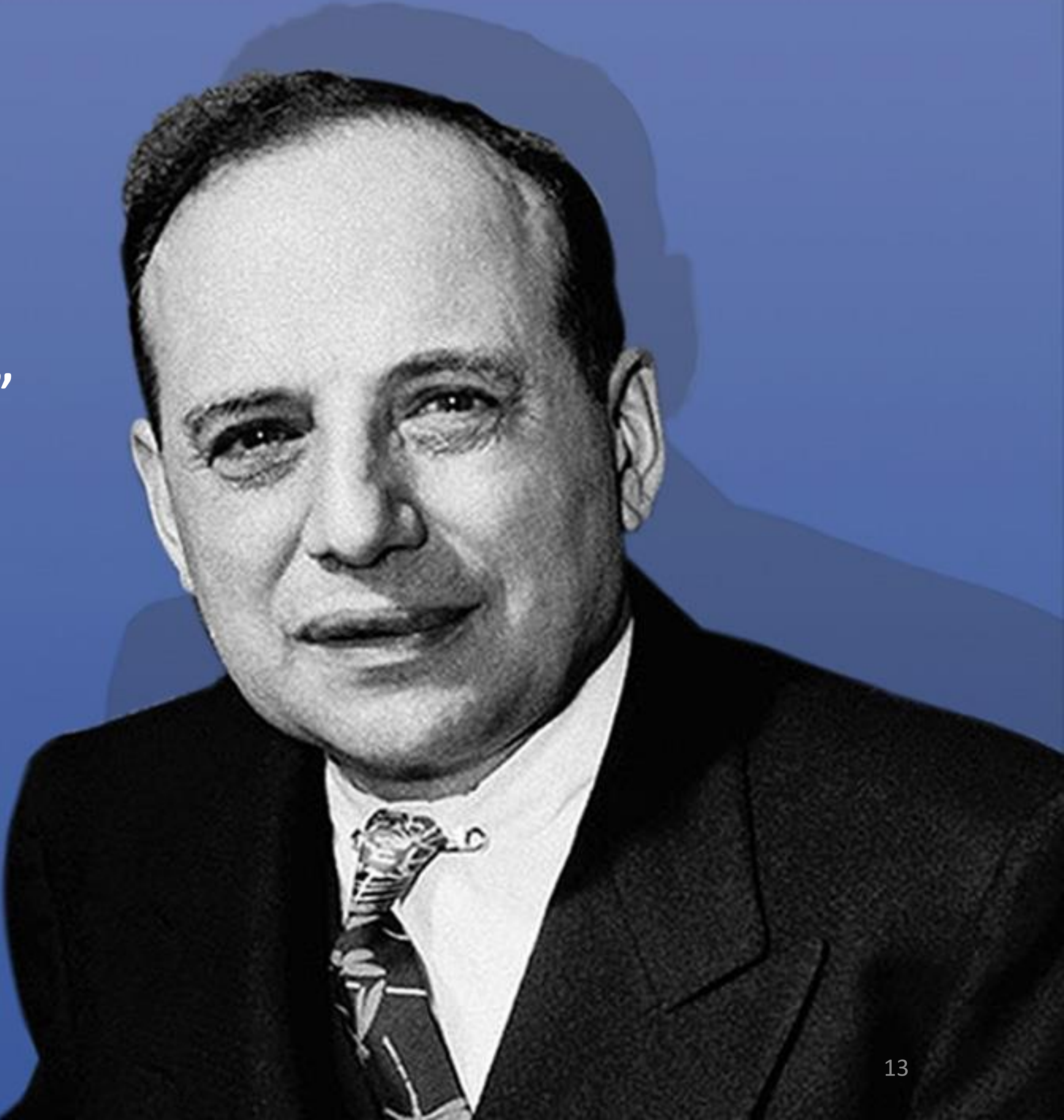
"The essence of investment management is the management of <u>risk</u>, not the management of returns."

- Benjamin Graham

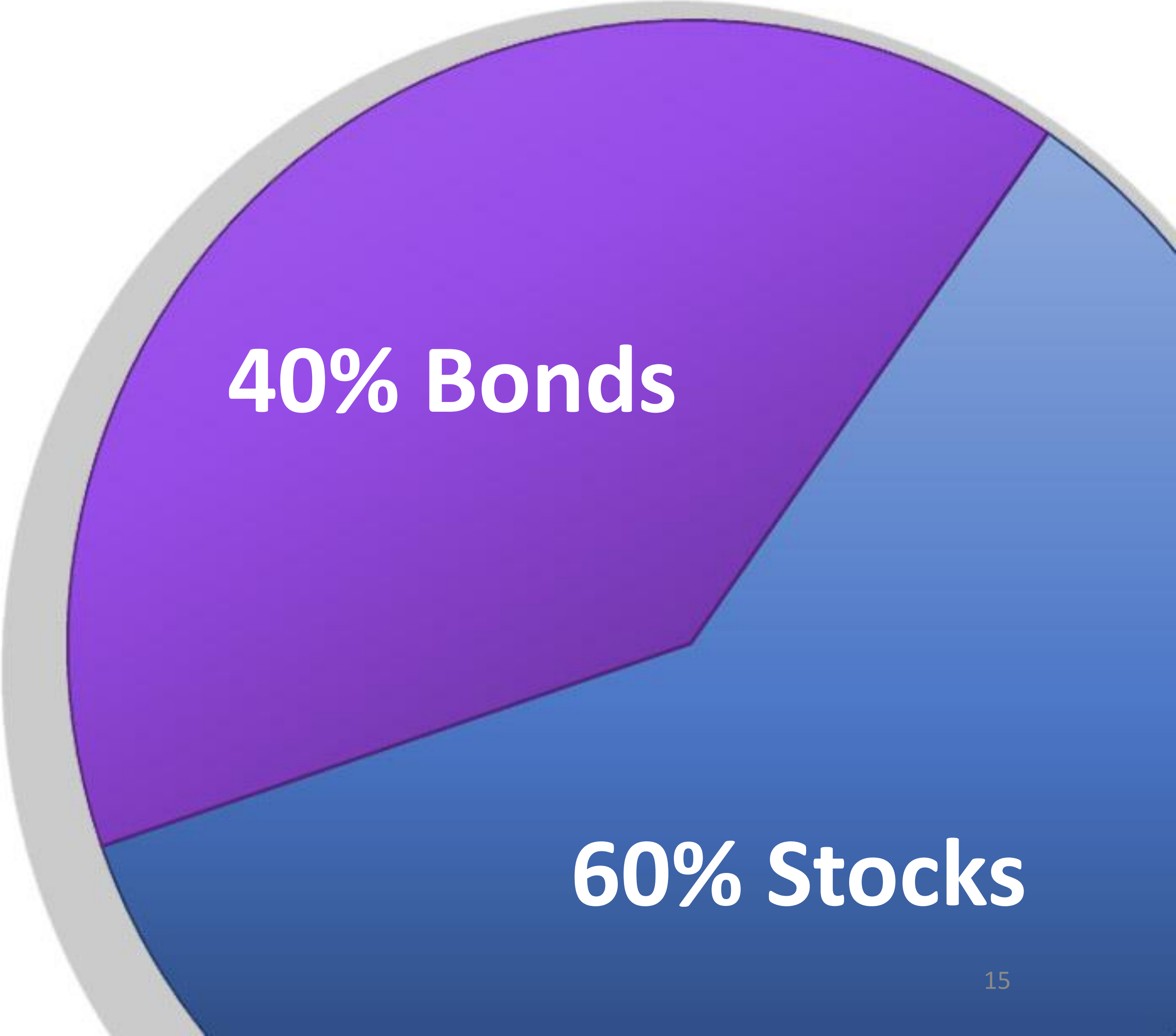
"The Dean of Wall Street"



The industry-standard method
of managing risk in an investment portfolio
is exemplified by the widely used
"60/40 portfolio."

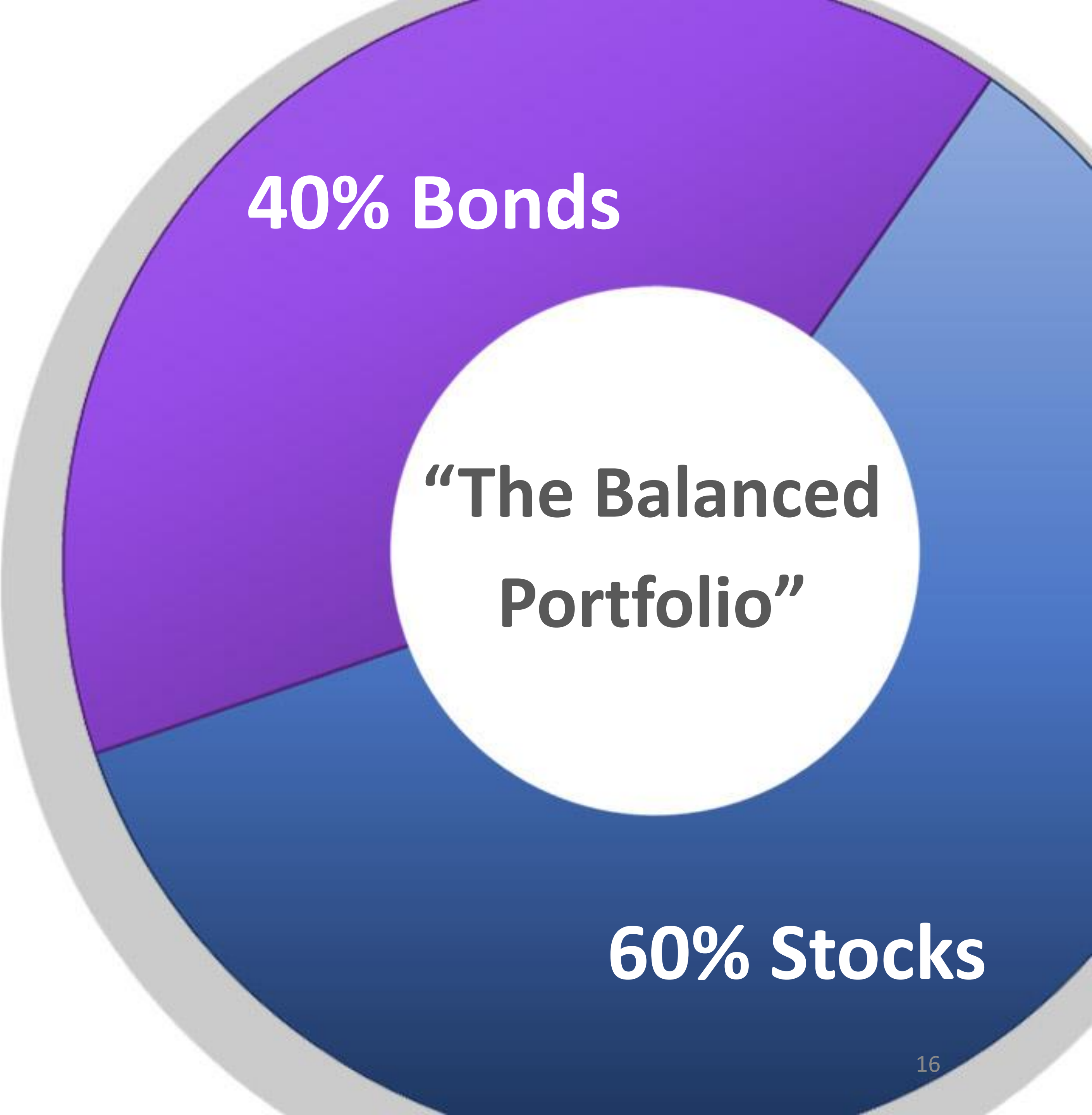
A 60/40 portfolio refers to a 60% allocation to stocks, and a 40% allocation to bonds.

The “risk management” is the 40% held in bonds, which are expected to act as a buffer to stocks during bear markets, since they tend to hold up in times of stock distress.



The 60/40 has become such an industry standard, that it is commonly referred to as:

"The Balanced Portfolio"



The 60/40 portfolio is so common that an investor can find a Balanced Fund by throwing a dart at the mutual funds page of their Sunday newspaper.

In fact, hundreds of Balanced Funds are now available, including many whose names you may recognize, like these:

- **Vanguard Balanced Index**
- **American Funds Balanced**
- **Dodge & Cox Balanced**
- **T. Rowe Price Balanced**
- **Fidelity Balanced**

This passive, fixed, unchanging method of risk management is called

STATIC

risk management.

But, does a **STATIC** 60/40 portfolio really provide the desired risk management?

The answer is, “<u>NO!</u>”

In a Bear Market, when risk and losses are high, it’s not enough.

But in a Bull Market, when risk is low, it’s too much.

If you think about it, a STATIC portfolio, with its constant, unchanging allocations to stocks and bonds, is a bit like preparing for any weather you might encounter by dressing in a constant, unchanging set of clothes, like this guy.

Dressed for all conditions, but prepared for none.

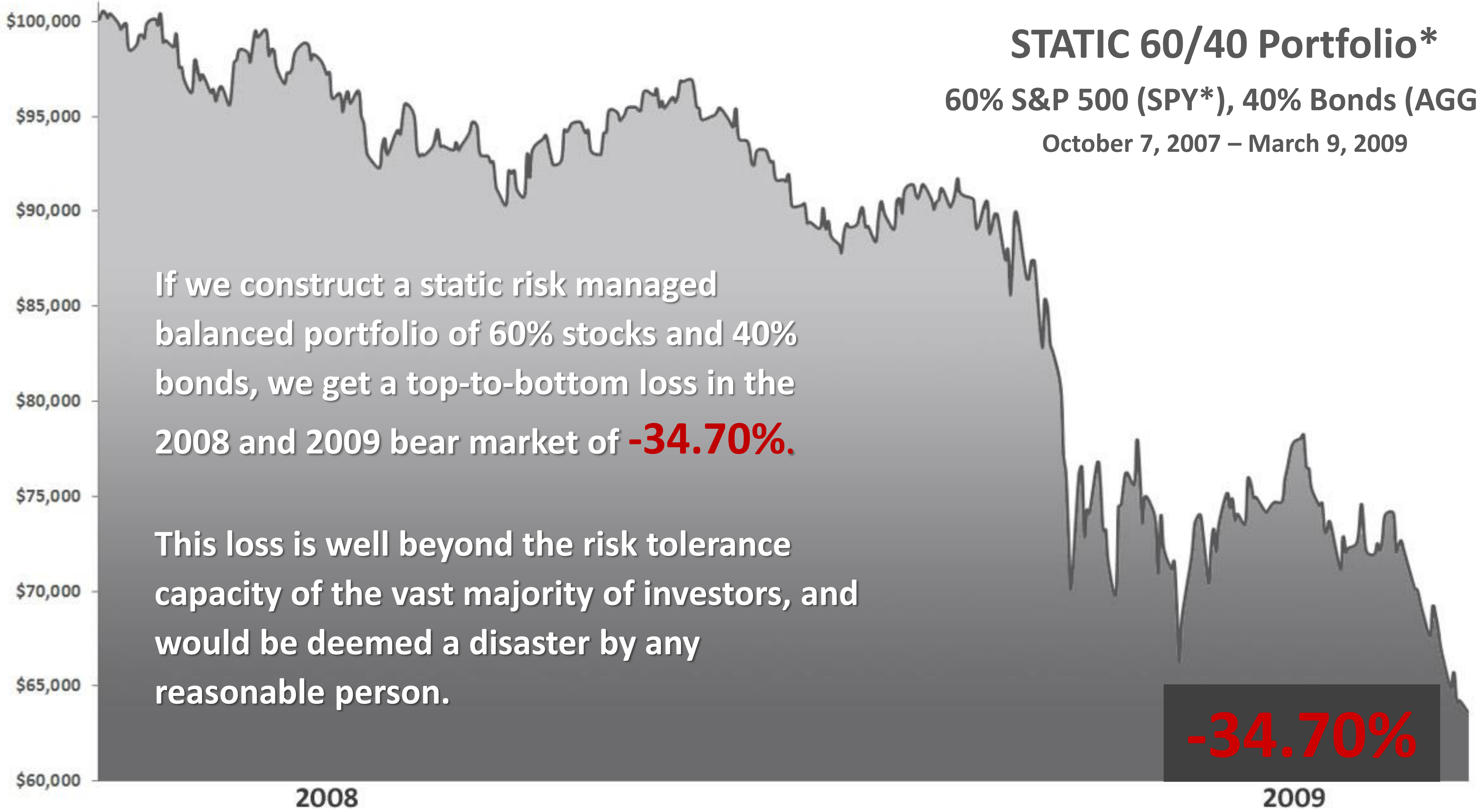
As you can see, he has allocated 60% of his wardrobe for blue skies and sunshine, and 40% for a life-threatening blizzard.

And as you can imagine, his wardrobe, in reality, is unsuitable for either condition.

STATIC 60/40 Portfolio*

60% S&P 500 (SPY*), 40% Bonds (AGG*)

October 7, 2007 – March 9, 2009

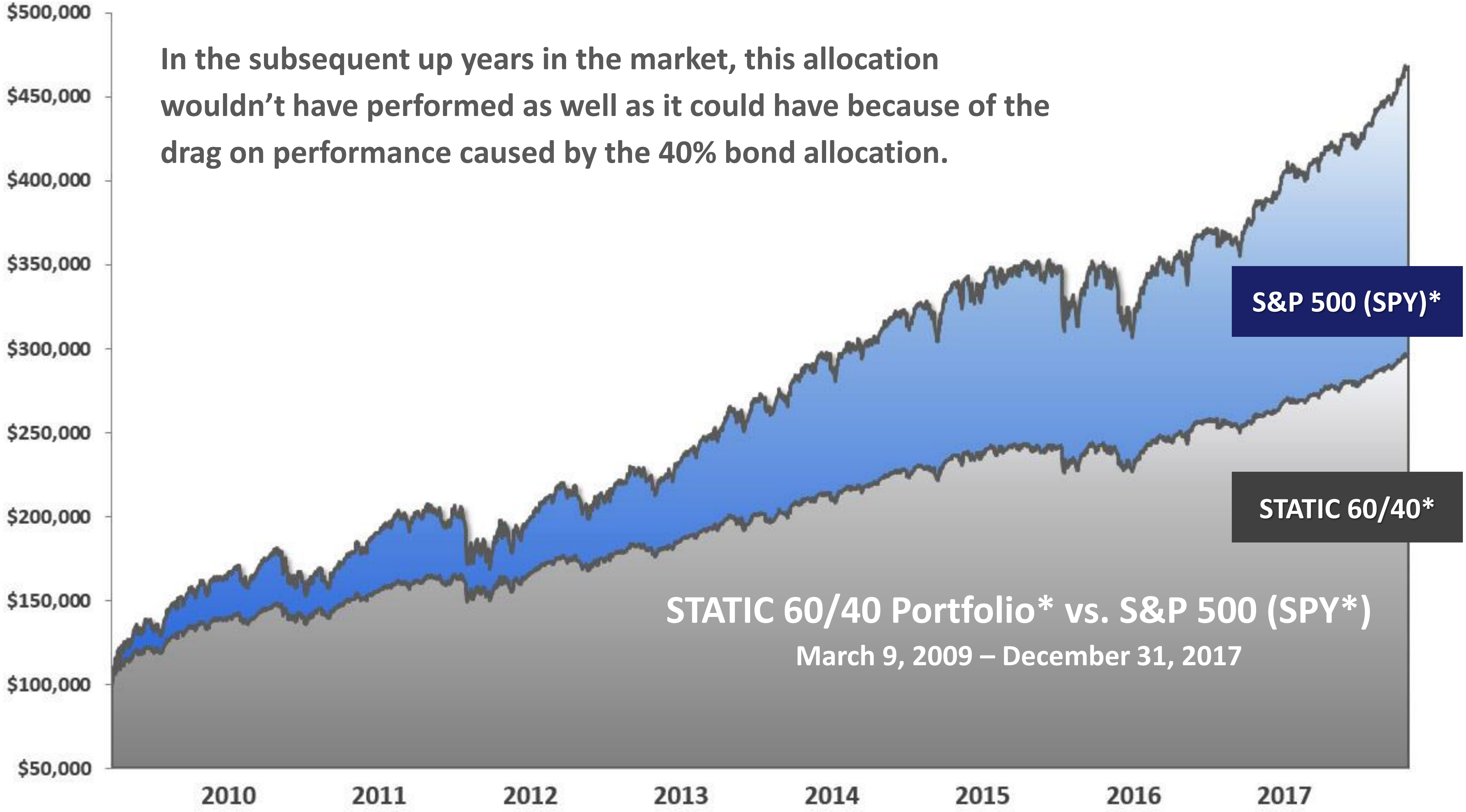


If we construct a static risk managed balanced portfolio of 60% stocks and 40% bonds, we get a top-to-bottom loss in the 2008 and 2009 bear market of -34.70%.

This loss is well beyond the risk tolerance capacity of the vast majority of investors, and would be deemed a disaster by any reasonable person.

* SPY = SPDR® S&P 500® ETF Trust. This exchange traded fund seeks to track the investment results that, before expenses, correspond generally to the price and yield performance of the S&P 500 U.S. stock market index. AGG = iShares Core U.S. Aggregate Bond ETF. This exchange traded fund seeks to track the investment results, before expenses, correspond generally to the total U.S. investment-grade bond market index. SPY and AGG dividends reinvested. STATIC 60/40 Portfolio = 60% allocation to SPY and 40% allocation to AGG. Past performance is no guarantee of future results.

In the subsequent up years in the market, this allocation wouldn't have performed as well as it could have because of the drag on performance caused by the 40% bond allocation.



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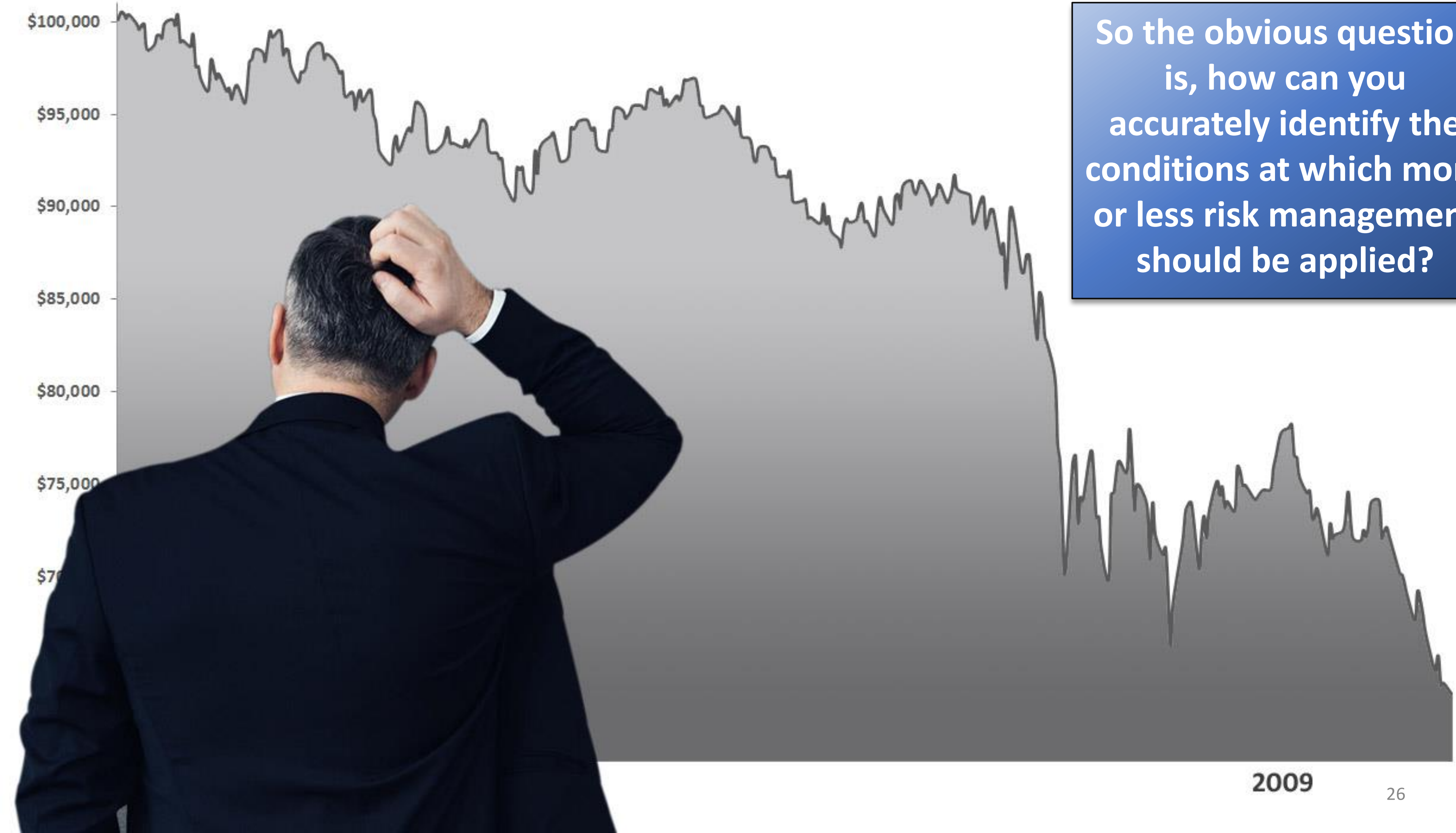


So the obvious question is, how can you accurately identify the conditions at which more or less risk management should be applied?

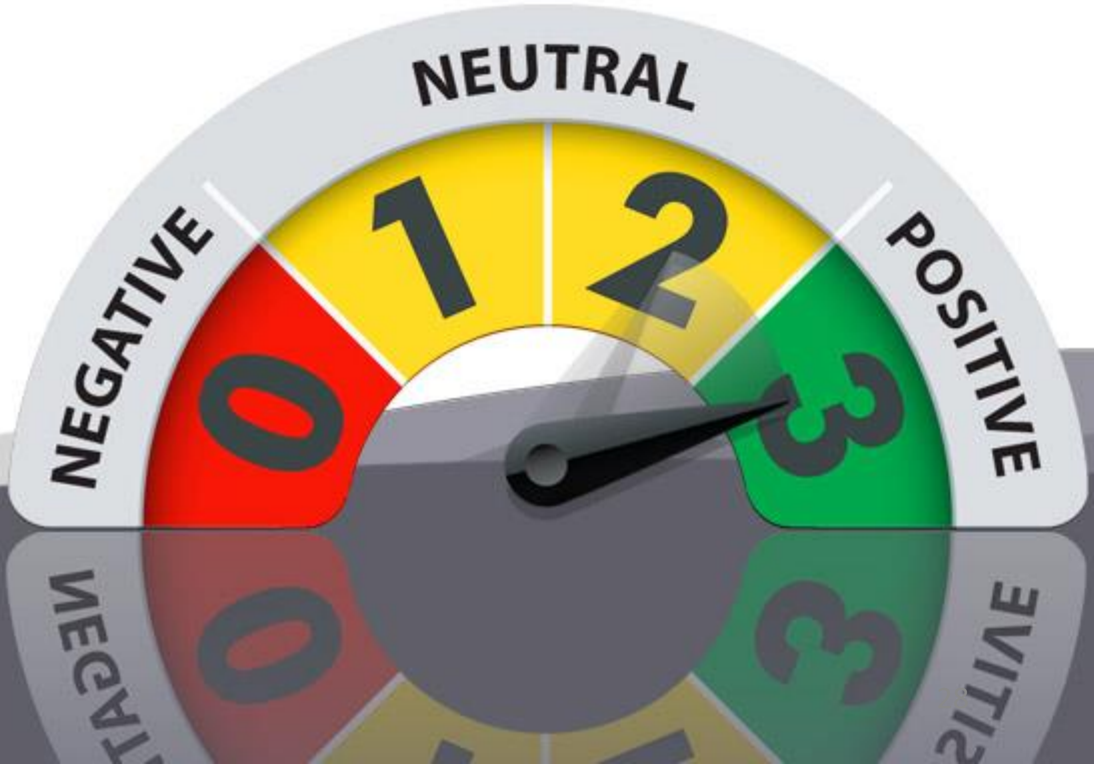
One way is the Market Condition Identification method.

This method combines a quantitative, fact-based assessment of three different market time frames to determine overall market health.

- **Short-term (weeks-to-months)**
- **Intermediate-term (quarter-by-quarter)**
- **Long-term (months-to-years)**

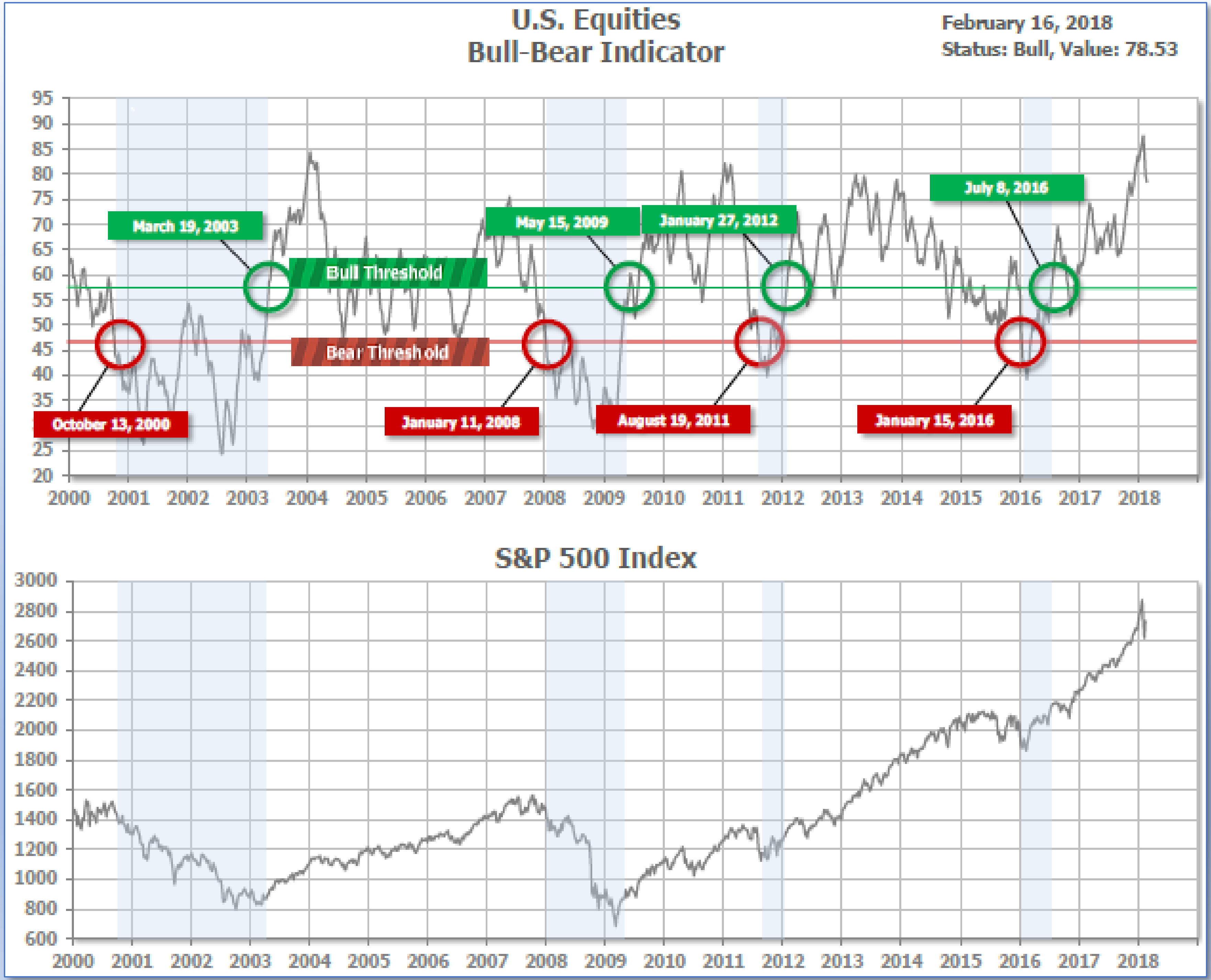
The sum of positive time frames determines a market condition reading of:

NEGATIVE, NEUTRAL or POSITIVE

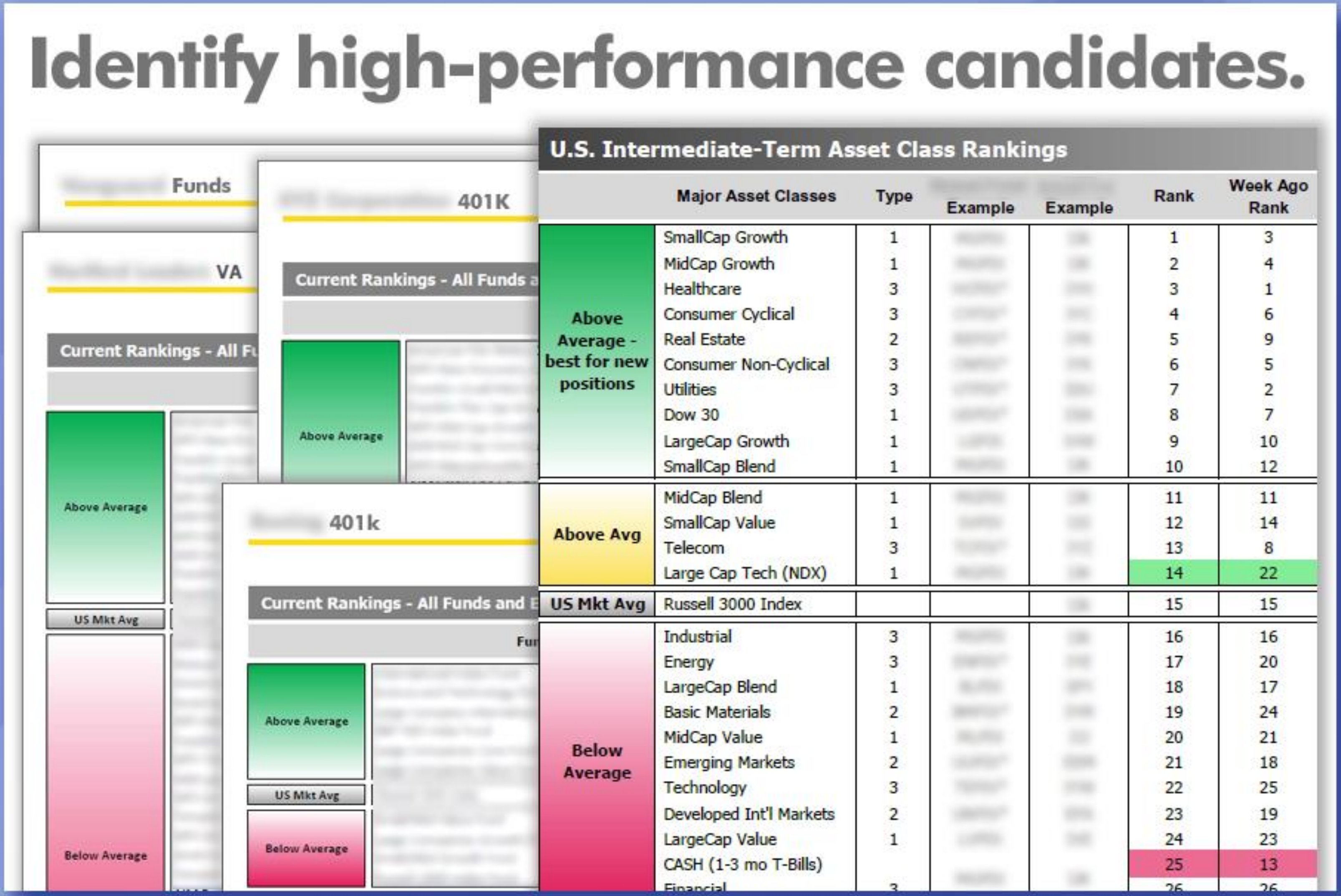


Implementing A Market Turmoil Strategy

First, Identify the Market Condition



Implementing A Market Turmoil Strategy



Identify high-performance candidates.

U.S. Intermediate-Term Asset Class Rankings

	Major Asset Classes	Type	Example	Example	Rank	Week Ago Rank
Above Average - best for new positions	SmallCap Growth	1			1	3
	MidCap Growth	1			2	4
	Healthcare	3			3	1
	Consumer Cyclical	3			4	6
	Real Estate	2			5	9
	Consumer Non-Cyclical	3			6	5
	Utilities	3			7	2
	Dow 30	1			8	7
	LargeCap Growth	1			9	10
	SmallCap Blend	1			10	12
Above Avg	MidCap Blend	1			11	11
	SmallCap Value	1			12	14
	Telecom	3			13	8
	Large Cap Tech (NDX)	1			14	22
US Mkt Avg	Russell 3000 Index				15	15
Below Average	Industrial	3			16	16
	Energy	3			17	20
	LargeCap Blend	1			18	17
	Basic Materials	2			19	24
	MidCap Value	1			20	21
	Emerging Markets	2			21	18
	Technology	3			22	25
	Developed Int'l Markets	2			23	19
	LargeCap Value	1			24	23
	CASH (1-3 mo T-Bills)				25	13
	Financial	3			26	26

Second, Identify the Best Asset Classes

Core Beliefs: A Market Turmoil Strategy

1.) We don’t know where the market will go – and neither does anyone else

2.) Wherever the market goes, it will get there by trending

3.) Along the way, there will be outperformers & underperformers

Sample Model Portfolio #1

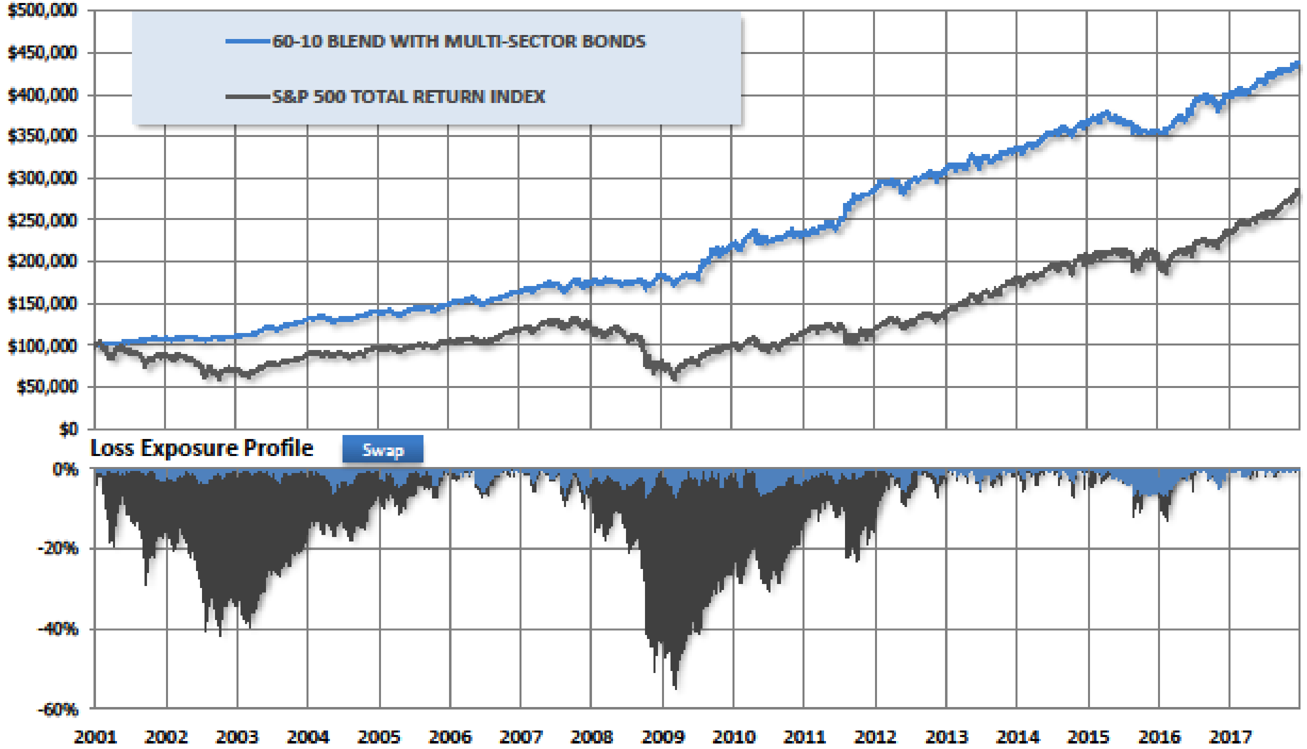
Disciplined Financial Services, Inc.

60-10 Blend with Multi-Sector Bonds

This is a sample model for illustration purposes only. This model allows a maximum equity exposure of 60% during "bull" markets. In "bear" markets, the equity weighting declines to a maximum of 10% exposure. The non-equity exposure is composed of either a separate bond model or cash.

Historical Data*

* for Date range 1/2/2001 - 12/29/2017



Ending value of initial $100,000 investment:
$437,918.32
CAGR: 9.08%
Loss Exposure Rating: 33

Ending value of initial $100,000 investment:
$283,727.00
CAGR: 6.33%
Loss Exposure Rating: 67

Difference:
$154,191.32

Maximum Drawdown

60-10 Blend with Multi-Sector Bonds

-7.4% 10/10/2008

Selected Benchmark:

S&P 500 Total Return Index

-55.2% 3/9/2009

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
60-10 Blend with Multi-Sector Bonds	7.6%	3.9%	16.9%	8.2%	4.6%	10.5%	6.2%	6.5%	18.3%	6.6%	21.7%	8.5%	8.8%	8.9%	-2.6%	11.9%	9.9%
S&P 500 Total Return Index	-11.9%	-22.1%	28.7%	10.9%	4.9%	15.8%	5.5%	-37.0%	26.5%	15.1%	2.1%	16.0%	32.4%	13.7%	1.4%	12.0%	21.8%

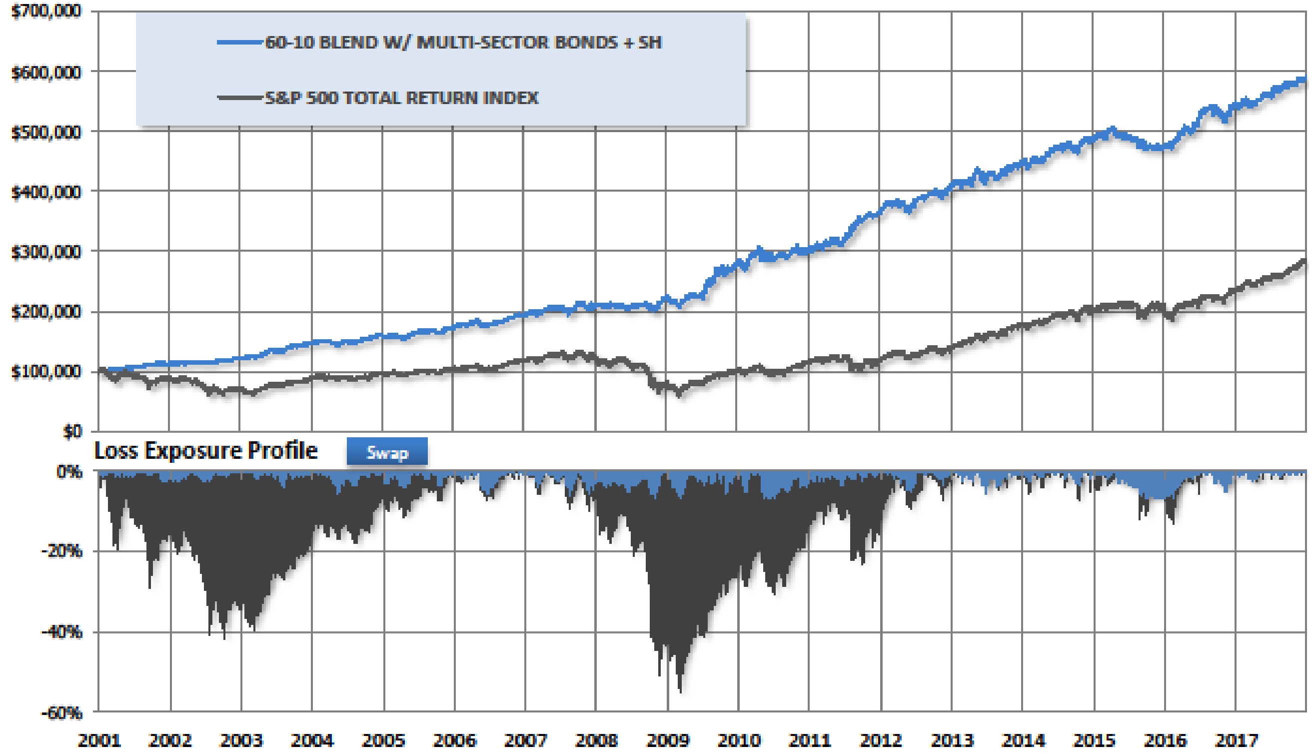
Sample Model Portfolio #2

Disciplined Financial Services, Inc

60-10 Blend w/ Multi-Sector Bonds + SH

This is a sample model for illustration purposes only. This model allows a maximum equity exposure of 60% during "bull" markets. In "bear" markets, the equity weighting declines to a maximum of 10% exposure. The non-equity exposure is composed of either a separate bond model or cash. In addition, during intermediate-term periods of market weakness, a temporary 10% position in a short ETF (SH) is added to the portfolio.

Historical Data* — * for Date range 1/2/2001 - 12/29/2017



Ending value of initial $100,000 investment:
$589,527.95
CAGR: 11.01%
Loss Exposure Rating: 33

Ending value of initial $100,000 investment:
$283,727.00
CAGR: 6.33%
Loss Exposure Rating: 67

Difference:
$305,800.95

Maximum Drawdown

60-10 Blend w/ Multi-Sector Bonds + SH
-6.9% 5/7/2010

Selected Benchmark:
S&P 500 Total Return Index
-55.2% 3/9/2009

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
60-10 Blend w/ Multi-Sector Bonds + SH	13.3%	7.8%	20.5%	10.0%	5.9%	13.2%	7.7%	7.1%	24.4%	9.0%	19.9%	11.7%	10.7%	8.1%	-2.6%	14.2%	9.0%
S&P 500 Total Return Index	-11.9%	-22.1%	28.7%	10.9%	4.9%	15.8%	5.5%	-37.0%	26.5%	15.1%	2.1%	16.0%	32.4%	13.7%	1.4%	12.0%	21.8%

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STRATEGIES TO NAVIGATE THROUGH BULL & BEAR MARKETS

Disaster Avoidance is no Accident

More than a catchy phrase, disaster avoidance requires a disciplined, structured methodology.

Our implementation of Dynamic Risk Management is that methodology.

The industry-standard 60/40 portfolio imposes losses that are unacceptably high, and gains that are unnecessarily low. Dynamic Risk Management seeks to significantly improve on both.

Q&A

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Maximum drawdown represents the greatest peak-to-trough decline over the life of an investment.

Displayed historical performance is presented gross of any management fees and gross of taxes.

Historical returns data are calculated using data provided by sources deemed to be reliable. All historical data should be considered hypothetical.

For reasons including variances in portfolio account holdings, variances in the investment management fee incurred, market fluctuation, the date of initial investment, and any account contributions or withdrawals, the performance of a specific client's account may vary from the displayed portfolio results.

Fact based investing may involve more frequent buying and selling of assets and will tend to generate higher transaction costs. Investors should consider the tax consequences of moving positions more frequently.

Registered Contact Information:

Eugene Szaj, President
Disciplined Financial Services, Inc.
19575 Janacek Ct., Suite #105
Brookfield, WI 53045
262-784-6650

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