


# Risk-O-Meter 2.0

The other week I was taking a shower.

Actually, I take a shower every day. Sometimes twice a day.

This shower was special.

I had one of those "eureka" moments during this particular shower.

You see, I do my best thinking in the shower. I suppose it's because it's just me alone with my thoughts. And the soap and shampoo.

There's no cell phone. There's no email. No laptop. There is quiet. I can think.

During this shower, I was thinking about the *Risk-O-Meter*. The *Risk-O-Meter* has served me as a helpful guide. However, there's no particular investment strategy tied to it. The *Risk-O-Meter* does not invest in a portfolio based on risks in the market.

To that end, it’s a bit wishy-washy.

I don’t like wishy-washy.

During my shower, I came up with an idea to keep the same concepts underlying the *Risk-O-Meter*, but to make it investable based on market risks.

There are two benefits to making the strategy investable. I want to invest in a system based on market risks. So, my intentions were purely selfish.

Second, an investable strategy serves *you* better. There’s nothing more that I want out of this newsletter than for you to be successful.

You don't have to invest in the strategy but given that there will be specific exchange-traded funds (ETFs) in a portfolio based on market risk, just paying attention to the system might help you in other areas of your investment portfolio.

That is a win-win.

In my head, I came up with a model to invest based on market trends, credit risk, sentiment, and volatility. These are the same factors used in the original *Risk-O-Meter* but are now expressed with specific funds that I can use to invest in the strategy.

When I finished my shower, I scribbled down a few notes. A week later, I tested out my theory. My eureka moment resulted in something I am very excited about.

An investable *Risk-O-Meter*.

I have now plowed hundreds of thousands of dollars of my own money into the portfolio just to get started. I will invest more as I move around funds and sell off other positions. I intend to invest 100% of my future 401(k) contributions into the portfolio.

Before sharing the results, I would like to make a few points.

First, the most common benchmark in the markets is the S&P 500. I do not know why. The only measure that matters is whatever amount of assets you need to accomplish your financial goals.

If you need $1 million to retire and have $8 million, who cares what the S&P 500 is doing?

In addition, most people do not invest only in stocks. The second most common benchmark is 60% stocks and 40% bonds.

I used both benchmarks in my test. A higher return than the benchmarks with lower risk is The Holy Grail.

Second, I focus on risk more than most people.

Why?

The most critical factor in investment success is sticking with the system. You need to stick with the system through thick and thin. Most people do not stick with the system. Worse, they have no plan at all. As a result, they wander aimlessly through saving and investing and waste time, money, and opportunity.

The statistics are depressing. I lay it all out in my book *Unbounded Wealth,* which you have a copy of and can see for yourself.

I would prefer not to take 50% losses. So, I focus on the risk because it's easier to rebound from more minor losses, and I am willing to earn less in return. However, in the case of *Risk-O-Meter Version 2.0*, the risks and the rewards have done better in testing than I could have expected.

The concepts are based on ideas going back decades. And I have been investing in similar strategies for a while now with success. I had just never combined them all into **one** model.

Another important reason for sticking with the system is that very few trades make up most of the returns for most investing strategies. For example, the market went straight up from the COVID lows in 2020. A huge trend formed off the bottom. If you didn't take that trade, a hugely profitable year became a losing year.

You never know when significant trends are going to emerge. The only way to deal with not knowing the future is to take **all** trades.

High probability trading systems are for losers.

If you subscribe to investment newsletters, chances are you have been bombarded by marketing that claims XYZ trading system makes money 90% of the time.

Big deal.

If you win 90% of the time, but the other 10% lose 100% of your money, you are still broke.

High probability trading systems sound good. However, these are developed by newsletter publishers and marketing professionals. In other words, people who know little about actual investing. Winning 90% of the time makes for sexy marketing. It’s even sexier if you can win 90% of the time while lounging on your couch in your bathrobe, trading options, and counting your wins before Noon.

Unsuspecting subscribers lose all of their money, and the publisher is on to the next Big Idea to sell you.

Here’s what a *real* pro experiences.

In 2003, I had the pleasure of meeting a trader considered the greatest commodity trader ever. He was profiled in the book *Market Wizards*. We had dinner, and then I spent the evening in the living room of his $20 million house overlooking one of the most beautiful lakes in the Western hemisphere.

He made all that money on less than 10% of his trades. He never knew which trade was going to be the big trade. His system was low probability but very profitable.

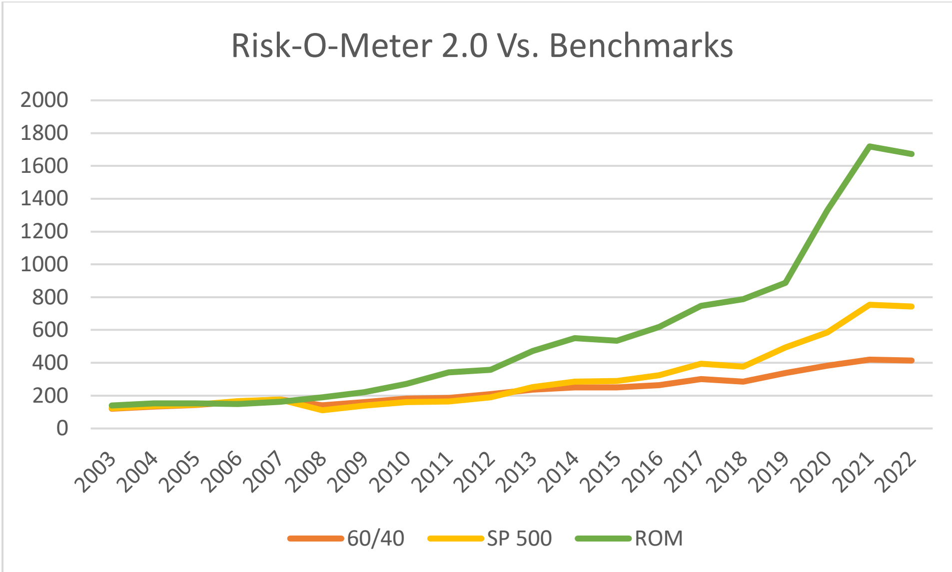
The trades in the *Risk-O-Meter* are profitable more than half the time, but a small percentage will make up the bulk of the returns.

It’s just the way it is.

As a result, the most critical factor in success will be to stick with the system.

Okay. I have preached and blabbered on enough.

Here are the results of the investable *Risk-O-Meter* since 2003 (that’s as far back as I can go with exchange-traded fund strategies even though certain aspects of this model I have tested back to the 1970s previously).




*Test through January 7, 2022

The S&P 500 returned 11.3% annually but suffered a 55.2% loss. Even the "safer" 60/40 portfolio got creamed for 35.4% while returning 7.9%.

The *Risk-O-Meter* returned 15.9% annually and suffered a 14.04% loss. I'm okay with losses in the area of 25%. So, I was extremely excited when I saw these results. Even more exciting was that the worst loss only took seven months to recover.

If you run many tests, it's not uncommon for it to take 15 *years* to recover from a significant loss. I realize it may take five years to get back to even some strategies in my portfolio. I'm okay with that since I know that going in. Seven months blew my mind. I realize that the future cannot be predicted, and it will likely take longer than seven months to recover at some point. However, I am confident it won't be 15 years or even five.

Here are some statistics you might find of interest:

| | |
|---|---|
| Percentage of Winning Periods | 70.31% |
| Percentage of Losing Periods | 29.69% |
| | |
| Percentage of Periods Outperformance of 60/40 | 60.62% |
| Percentage of Periods Underperformance of 60/40 | 39.74% |
| | |
| Percentage of Periods Outperformance of S&P 500 | 55.02% |
| Percentage of PeriodsUndperperformance of S&P 500 | 44.98% |
| | |
| Best Return in a Month | 15.14% |
| Worst Return in a Month | -13.07% |
| | |
| Median Winning Month | 2.26% |
| Median Losing Month | -1.81% |
| | |
| Draw Down | 14.04% |
| Time to Recover Draw Down and Hit New High | 7 Months |

Here are some things about the strategy to consider.

There are four components to the system.

The first component is the market trend. What are the market trends, and what asset classes have performed the best? The trend is your friend until the end when it bends.

The portfolio will be invested in top-performing equity funds when trends are favorable. When trends are unfavorable, the portfolio will be invested in top-performing fixed-income funds.

The next component is credit risk. What is the market telling us about risk by analyzing trends in the credit markets? Credit analysts tend to be better at assessing risks than equity analysts. There are clues in the credit markets that may highlight danger around the corner. Let's use that to our advantage.

If credit risk is low, the portfolio will be invested in equities. When credit risk is high, the portfolio will be invested in safe-haven U.S. government fixed-income investments.

The third factor considered is volatility. What's volatility telling us about the asset classes that are likely to perform the best?

When the volatility situation is favorable, the portfolio is bullish and will invest in equities. Safe-haven investments will be in the portfolio when volatility is in "risk-off" mode.

The last factor is sentiment. Is market sentiment too bearish? Too bullish?

The answers to those questions are my formulas. Each component can be thought of as either "risk-on" or "risk-off" mode. When the component is on "risk-on" mode, it's invested inequities. In "risk-off" mode, it's invested in fixed income or a safe-haven asset.

**There are no short positions.**

The volatility and credit risk components use a small percentage (5% total) in levered ETFs. Generally, I am not a fan of levered ETFs. However, in this situation, a little bit of extra juice with favorable risk/reward characteristics makes me feel comfortable with a 5% allocation to levered ETFs.

I have a small portfolio of my own money in a levered ETF strategy that I developed. The results can be wild. However, I have only risked what doesn't keep me awake at night. I feel comfortable that if I stick with it, I'll continue to do well over time, and it will have a significant impact on my net worth.

In the case of the *Risk-O-Meter*, a 5% position in levered ETFs will not affect my mood or my ability to get a good night's sleep.

A 5% position might give you cold sweats. You need to do what is best for you.

If you do not like levered ETFs, that is fine. Please do not invest in them. One can always invest in the unlevered equivalent ETF.

All of the potential positions in the strategy are **huge** asset classes. It is impossible for one person to move the market in any of them or benefit in any way from being in a position before the next person. Therefore, the strategy could suit someone with $1,000 or $100 billion.

The *Risk-O-Meter* is not a personalized investment strategy. However, I will show whether each component is on "risk on" or "risk off" mode so that you can use it however it best suits you.

This portfolio trades *monthly*. There's no advantage to trading weekly. If you want more action, a trip to Las Vegas should satisfy your urge to wager money constantly.

It takes me about 10 minutes to manage my finances each month. That leaves me plenty of time to ski, golf, garden, hike, cook, take the dog for a walk, and read. Those are my favorite activities on any given day.

Watching the markets does not rank in the top 20 of my favorite activities.

The tests assume trading on the first day of the month. That's how the software works. However, due to the publication of this newsletter, I will detail the portfolio on the first Monday of the month.

There's nothing magical about investing on the first day of a given month. Again, that's just how the software works. You could easily pick a random day of the month and invest. As long as you do it *consistently*, you should be just fine over time.

Therefore, I will post the portfolio in the next issue of this newsletter, which is February 7th, the first Monday of the month.

Stay tuned next week!

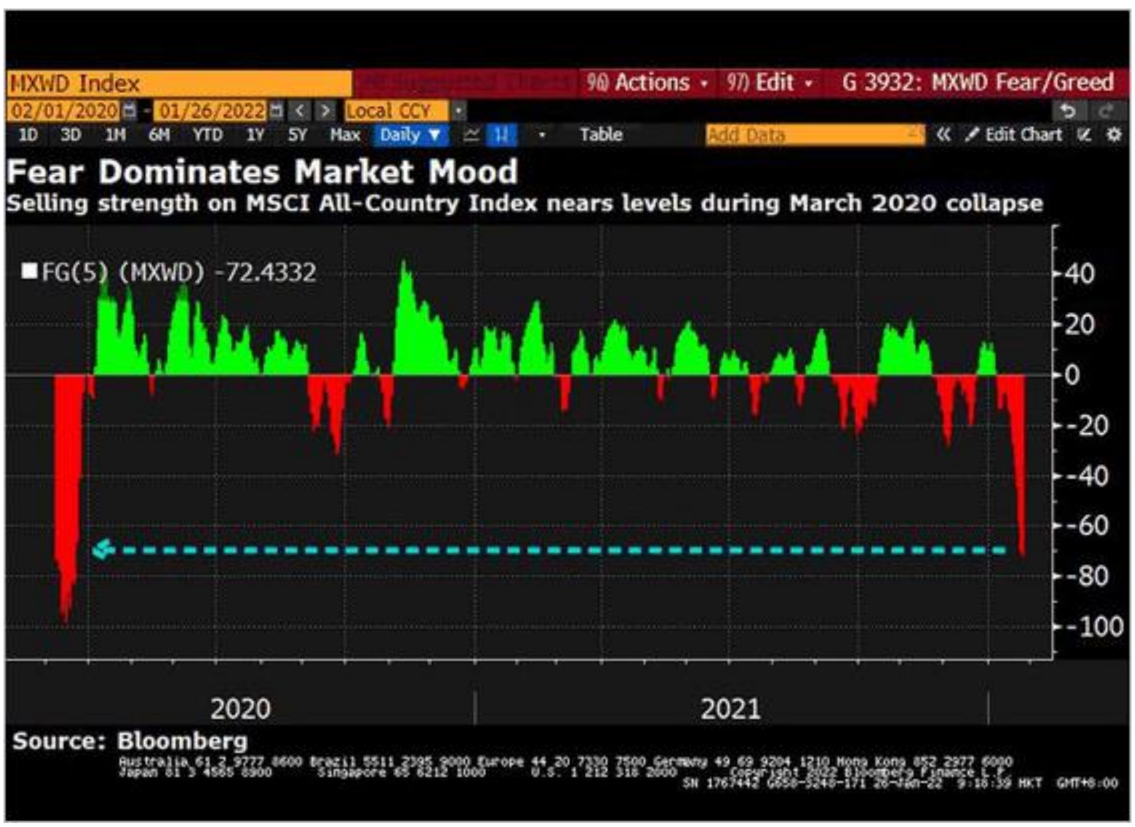
The *Risk-O-Meter* version 1.0 remains on a sell signal, indicating high risks. As I noted last week, a bounce in the market was highly probable. On Monday, the DJIA traded off more than 1,000 points before finishing the day in the green. A similar price action occurred on Tuesday, with the indexes opening down significantly and many stocks rebounding into green territory. The market was up big on Friday.

When the market is oversold, and there is *that* much **fear**, the only way to go is up. Investors get margin calls, they get terrible prices, the selling ends, and the buyers swoop in to buy shares and clean up the market.

Investors did get terrible prices. The 1,000 point loss in the DJIA coincided with the timing of margin call selling for retail investors on Monday.

And, boy, was there ***fear***. Last week's fear was close to what we saw during the COVID smash.

Take a look at the chart below.

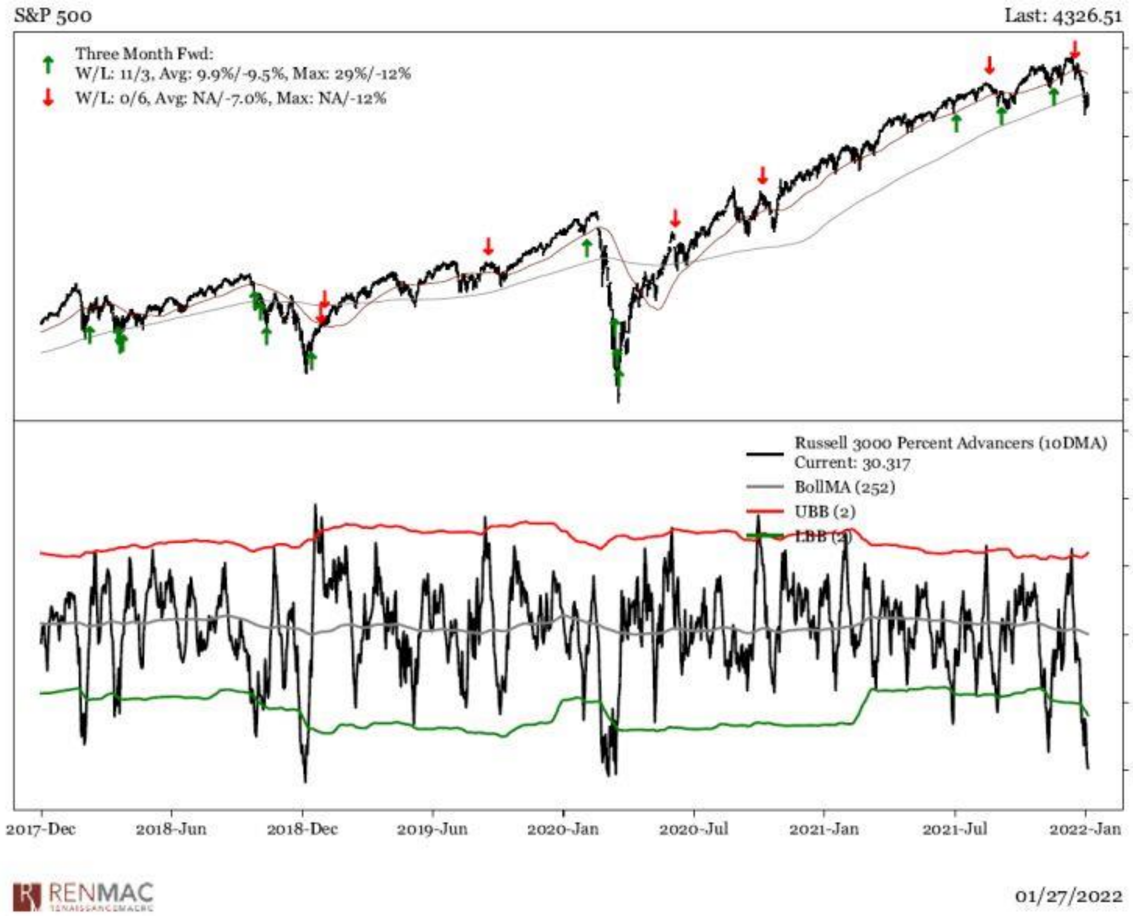



**UGLY!**

That's *a lot* of selling pressure.

The market was not just oversold coming into the week. The market was ***OVERSOLD!!!***

Here is another chart that shows that the level of selling has been broad-based and that the level of selling has entered the realm of the COVID crisis in 2020.




We also learned that the narrative that cryptocurrencies are an inflation hedge is false.

At least, not in a panic.

The cryptocurrencies fell sharply, then rebounded tremendously and mimicked the price action of technology stocks but in an extreme manner.

My conclusion is that the cryptos are just levered technology bets.

I still maintain that they are *not* currencies. That's not a bad thing. It's just that the market is trading like a commodity that is highly levered to an underlying asset. There's no difference between cryptos and soybeans.

Once the oversold condition is worked off, the quality of the move higher will determine whether risks are still elevated or not.

An example of the quality of the rally would be to see what percentage of stocks are participating in any move higher. Is it just the usual suspects like Apple, Tesla, and Microsoft?

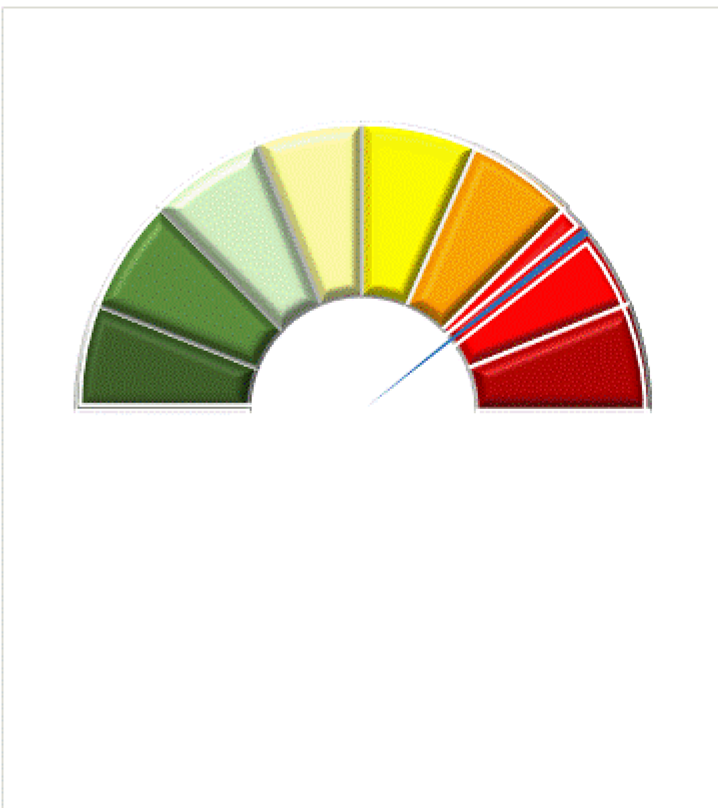
Are smaller stocks picking up steam at a greater rate than S&P 500 stocks?

That would be beneficial to the market.

Are companies buying back stock? The prohibition against buying back stock due to quiet periods is ending, and there's a clear path in the next seven weeks for companies to buy back stock if management feels the beaten-down prices represent good value.

Given that risks are elevated, I did not add to any positions (other than my initial investments into the new *Risk-O-Meter*, which I will detail next issue). However, because the market was deeply oversold, I didn't sell anything either.

Sometimes doing nothing is the best action to take.



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