



FINANCIAL SENSE ONLINE

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GUEST EDITORIALS

A Simple Portfolio For Serious Investors

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FOREWORD

For the benefit of new readers, we will explain what our goal has been in writing a series of essays on selecting key asset classes and managing a portfolio for turbulent markets. From the very start, our goal has been to teach the principles of successful investing, to emphasize the importance of picking the right asset classes for the expected market environment, but never to give readers a cookbook recipe to be followed blindly.

However, when we choose an asset class that has only one readily available security, we must of necessity name that security. In all other cases we identify the asset class by name, but do not give individual security names. We have a strong feeling that each individual investor will work harder to achieve success, if they pick most of the securities in their portfolio. So please do not write and ask us for our preferences. Our goal is to teach the principles involved in picking a sound portfolio and let you do the work to make it a success.

WHAT IS A SIMPLE PORTFOLIO?

In the early days of the aerospace industry, design engineers were very concerned about failure of critical equipment. A new branch of engineering called reliability engineering was created to keep failure rates at an acceptable small level. Experience taught them that the best way to reduce failures and assure success was to strive for simplicity, not complexity, in design. They created and followed a design philosophy called KISS for "Keep it Simple Stupid." This slogan succeeded in reminding the design engineers to eliminate all items that were not essential to the success of the mission.

We define a Simple Portfolio as one that includes the smallest number of asset classes to meet the investor's goal in the anticipated environment. It might have as little as 3 major asset classes, each of which may have one or more subclasses for diversification and better returns. For the main discussion below, we have selected 4 quite different asset classes, 2 of which have 2 sub classes. We could easily have selected 5 major classes each with 3 or more sub classes, but this would not



have been in keeping with the KISS philosophy.

Many undisciplined investors may have a so-called "diversified" portfolio with 20 securities all in the same asset class. That is in direct violation to the principles that we recommend. A Simple Portfolio is essential for good management over time. It makes it easy to follow the performance, do scheduled re-balancing and making on-course modifications if needed.

ANTICIPATED MARKET ENVIRONMENT

Although we now have three years of bear market experience, only a tiny fraction of investors have learned its many lessons. Followers of the Elliott Wave Principle understand that this bear market has much farther to go in both time and distance to reach even an initial bottom. Our more than 62 years of market experience have placed us clearly in the bearish minority.

It is now possible to select those asset classes which have done well in the past 3 bearish years.

We will start by listing the circumstances that may occur in the next twenty years:

1. Bear market declines and bullish rallies will exist for the full period.
2. Interest rates may rise and the value of the dollar may fall.
3. Basic industries such as oil, gas, timber and health care will survive.
4. Precious metals in various forms will be volatile and in demand.
5. A permanent short hedge should be maintained at all times.
6. Cash reserves shall be in the form of short to medium U.S. Treasury and carefully chosen Foreign Government bond funds.

Our regular readers already understand our strong views on selecting a group of basically different asset classes and rebalancing their dollar amount periodically to achieve a slow steady growth in the portfolio. New readers should read our other essays for additional background information on [Financial Sense](#). Our complete archive can be found on www.freebuck.com

PROFITING FROM EXPECTED VOLATILITY IN DIFFERENT ASSET CLASSES

The Simple Portfolio is designed to grow assets in turbulent markets by taking advantage of these characteristics:

1. Careful selection of asset classes known to react differently to expected market conditions.
2. Profits are shifted periodically from rising asset classes to other classes that are lagging.
3. Often this means profits are transferred to more stable asset classes and are protected from downturns in the more volatile class.
4. Periodic rebalancing as above, provides slow and steady growth; while continually protecting assets from downturns in volatile classes.

SELECTED ASSET CLASSES

For our Simple Portfolio we have chosen 4 major asset classes each of which "marches to a different drummer." For stability in difficult environments, we have given a 30% weighting to highest quality U.S. and foreign government bonds. Next, we allocate 30% to precious metal funds and 15% to a diversified energy fund holding stocks with large coal, oil and gas reserves.

We complete the portfolio with a 25% position in a managed short fund to provide gains in the bearish phases for transfer to other asset classes

PORTFOLIO COMPOSITION TO BE MAINTAINED BY PERIODIC REBALANCING

Government Bonds	15%	Zero coupon U.S. Bond Fund maturing in 2010
	15%	Foreign Gov't Bond Fund of short to medium maturity
Precious Metals	20%	ASA Closed End Gold Fund (NYSE)
	10%	CEF Closed End Gold & Silver Bullion Fund (AMEX)
Energy Stocks	15%	Diversified Natural Resource Fund
Short Position	25%	Fully Managed Short Fund
	100%	

Please note that we pick these asset classes, not only on the basis of past performance, but on their expected differences under future market conditions. The stripped treasuries will slowly rise to their maturity value and be a source of capital for shifting into other asset classes when and if needed. The precious metals class will provide expected long-term gains from gold and silver bullion and gold stocks plus further gains by transfers to and from other asset classes resulting from gold and silver's volatility.

We strongly favor the use of the ASA closed end fund because it will probably retain its present small size in the expected mad rush into open end funds when gold rises above \$400 per oz. Large funds will be unable to buy meaningful amounts of small mining companies which will gain the most in price. Vanguard has already closed its fund in the gold rally of last year.

The natural resource fund holds dwindling assets in the ground that will retain or enhance value for the foreseeable future. The allocation to the short fund is based on our best guess from experience and—due to its expected volatility—will both contribute and receive assets during rebalancing actions.

BUILDING THE PORTFOLIO

A tax-free portfolio could be started with an initial investment of under \$10,000. In such a portfolio, further cash additions could be used to maintain the recommended percentages of each asset class as a means of doing a rebalancing.

Once the portfolio size reaches about \$50,000, the portfolio composition can be maintained by shifting assets from the gaining asset classes to those with less than the desired percent. Holding all the assets together in one brokerage account makes it both feasible and easy to accomplish rebalancing with minimum paperwork.

This portfolio anticipates a volatile market environment with price swings in every asset class except the short-term zero coupon bond fund. We expect that there will be many opportunities to shift gains from rising to falling asset classes within each major class and also between asset classes. The simple portfolio is designed to take advantage of price fluctuations in any asset class by shifting capital from rising portfolio segments to others that are gaining less or actually sustaining losses. Let's look at some possible examples.

Precious Metals

With rising gold prices, ASA will gain faster than CEF and a transfer of money would be made to CEF. Later, with gold dropping from a price peak, transfers would be made from CEF to ASA. Each of the transfers will eventually create a very meaningful rate of growth for the overall portfolio. In a major top in gold, money would be transferred to other asset classes to maintain

their percentage in the portfolio.

The natural resource fund is expected to show growth in every bull rally phase and to resist a severe decline in bearish conditions.

The 25% allocation to the managed short fund will provide profits to be redistributed under bearish conditions. Such additions will be made to the other classes at favorable prices.

This portfolio will need to be modified to be either more bearish or bullish, if market conditions undergo a major change.

ANNUALIZED GAIN FROM BULL MARKET LOW FOR EACH ASSET CLASS

TOTAL GAIN FROM LOW DATE TO 07/03/2003

Asset Class	Bull Mkt. Low Date	Annualized % Gain
2010 Zero Coupon Bond Fund	01/03/2000	14.71%
Foreign Gov't Bond Fund	10/31/2000	16.01%
Gas, Oil, Coal Energy Fund	08/26/1998	12.63%
ASA Closed End Gold Fund	08/04/2000	43.20%
CEF Closed End Bullion Fund	11/01/2000	16.69%
Fully Managed Short Fund	08/30/2000	31.23%

The average annual portfolio gain during this period, weighted by the percentage of each security, was 24.7%. The chances are quite good that rebalancing this diverse portfolio on a 6 or 12-month basis would have improved the performance to some small degree, or if not, would have helped improve the future performance by keeping the intended asset balance.

DISCUSSION

Readers of my 70-odd essays over the past 2 years will recognize some of my favorite asset classes. Our favorites come from keeping things simple and favoring those with promise for the future. Our fifty-plus years of experience with stocks, bonds and mutual fund tells us not to look back, but to look ahead. This is of course directly opposite to most conventional wisdom.

According to the experts I read, the United States and the entire developed world is facing a financial crisis of huge magnitude, possibly the greatest ever in complexity and size. Preserving assets over the next decades may be very difficult. Here is how our Simple Portfolio handles some of the foreseeable problems. The number of dollars will be safely maintained in the Zero Coupon Bond fund. Purchasing power of the dollars will be maintained, at least in part, by holding an equal weighting of Foreign Government bonds. Added protection from loss of purchasing power through inflation will be achieved through funds owning physical gold and silver and an excellent fund holding mining stocks. Finally the large short position will offer substantial protection from losses in a continuing bear market.

Under expected market conditions, our Simple Portfolio will not do any major shifts in any asset class. It will simply spread assets from the fastest gaining classes to those classes which are below their specified percentage in the portfolio. Many of these asset changes will normally occur after a sharp price run up in one class, and thereby automatically protecting the transferred assets from any subsequent price losses after the transfer.

SIMPLE PORTFOLIOS FOR THE MORE RISK-ORIENTED INVESTOR

The portfolio described above with 6 asset classes in 4 categories should meet the needs of many investors. However we know from our e-mail there are many investors who have chosen a much riskier position for their assets with large positions in a single asset class such as precious metals. Before closing this essay, I would like to offer suggestions on ways to reduce the risk with your money in only two major asset classes. The first example uses five asset classes compared to six in our portfolio above, but in only two major classes.

Investors wishing to hold a large and diversified precious metals portfolio might consider the following:

Sample Large & Diversified Precious Metals Portfolio

Government Bonds	30%	Zero coupon U.S. Bond Fund maturing in 2010
	30%	Foreign Gov't Bond Fund of short to medium maturity
Precious Metals	10%	ASA Closed End Gold Fund (NYSE)
	10%	CEF Closed End Gold & Silver Bullion Fund (AMEX)
	20%	Small Unhedged Gold & Silver Mining Stocks
	100%	

Investors could own a very diversified precious metals portfolio as above and build their capital slowly and surely by transferring profits from the rapidly rising asset classes to the more stable bond classes. Portfolio rebalancing by periodically returning each asset class to its original desired percentage of the total assets does this simply and relatively easy.

For a second example of a portfolio with just two major asset classes, we shall substitute 40% of three classes of short funds as presented below:

Sample Large & Diversified Precious Metals Portfolio

Government Bonds	30%	Zero coupon U.S. Bond Fund maturing in 2010
	30%	Foreign Gov't Bond Fund of short to medium maturity
Short Funds	10%	Reverse S & P 500 Short Fund
	10%	Reverse NASDAQ Short Fund
	20%	Fully Managed Short Fund
	100%	

This example will function in a similar manner to that above. In bearish cycles, it will create variable amounts of gains in the 3 classes of short funds. Periodically, or by another method described below, the short fund gains will be redistributed within their group and also to the bond funds. Then, in the next bull market rally (and lower prices of the short funds), asset moves will go back to the short funds and predominantly to the most volatile fund.

WAYS TO ACCOMPLISH TRUE REBALANCING

We define "true" rebalancing as returning the portfolio, periodically or irregularly when price peaks and valleys occur in any of the asset types, to its original desired composition. We have no idea what Wall Street advertisements mean when they plead with investors of all ages and types to submit their losing portfolio for "rebalancing" advice. Moderately volatile portfolios, like

our Simple Portfolio, need rebalancing by either method mentioned above perhaps once a year. The two volatile portfolios would perhaps do better with more frequent rebalancing, say every 6 months. However, investors fortunate to have a computerized charting program like FastTrack would get truly astonishing results from switching at price peaks and bottoms in the volatile asset classes.

WILL USING THE "KISS" SYSTEM HELP INVESTORS?

Unfortunately this question is not answerable since we lack information on the portfolios of reliability engineers. It is worthy of note, that the KISS practices have spread far from their aerospace source. In 1971, I introduced them to the electric utility industry.

No person with this background has identified himself or herself in E-mail correspondence to me. Perhaps one will write. It is not a secret that many individuals have not done a brilliant job of managing their personal investments. But their failure in this respect is not as deplorable as the general incompetence of professional advisors and money managers who have been responsible for the loss of trillions of dollars of other people's money.

ADDITIONAL INFORMATION

I have written a number of essays that provide more information on gold stocks and funds, government bond funds and short funds. I have also written extensively on the benefits of portfolio re-balancing, giving specific examples. More recent essays are in the [FSO archive](#) of my work; while a complete list of essays can be found in the archives of www.freebuck.com.

Although I am still recovering from a serious illness, I will be pleased to answer general questions of a non-personal type. I hope to continue writing, but at a slower pace than before.

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