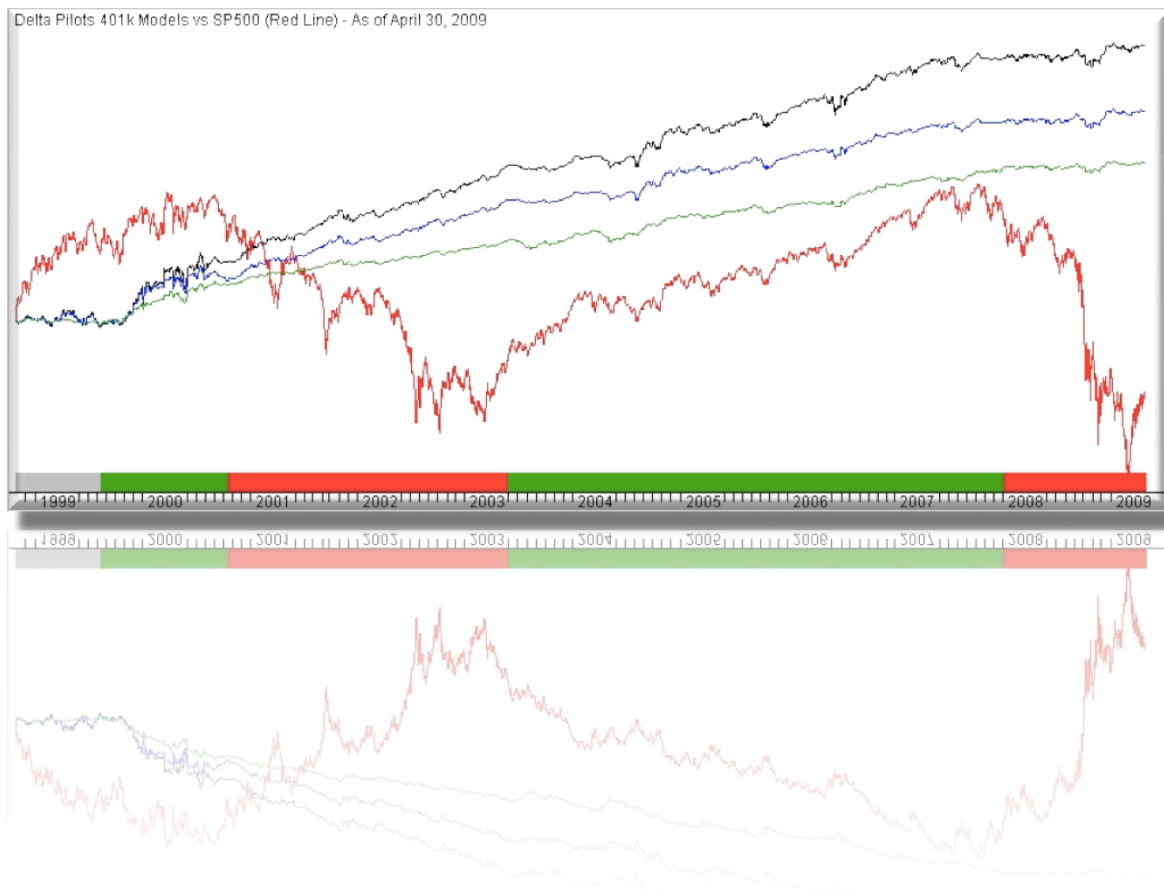


# Fast Start Guide to Understanding the Advisor 401k Investment Process



## **Introduction**

Every investor should understand the process used to make investment decisions in any system he or she is considering following. This white paper lays out the major components of the process used by The Advisor 401k Newsletters.

There are constraints on this investment process that must be addressed:

- Required hold times (if any) of investments that are purchased
- Limited investment selections
- Balancing the required holding times against the optimum holding time for best results historically
- Investment selection
- Systematically upgrading investment choices to deal with changing market leadership
- Market risk levels and how they affect allocation to stock market investments
- Limited access to market information as you travel

Each of these issues can be addressed in multiple ways to achieve differing goals. It is important for you to understand the goal of the Advisor 401k Investment process:

**THE GOAL OF THE ADVISOR 401K NEWSLETTERS IS TO  
BALANCE GROWTH AND SAFETY**

Our goal *is not* to get every ounce of potential return without regard to the amount of risk taken. If your goal is to get every ounce of return and every ounce of risk, you are better off in an index fund. You will capture 100% of every market rally and 100% of every decline. Believe it or not, some investors can live with that – or simply don't care about loss.

We *do* care passionately about losses. While you cannot avoid 100% of the short-term losses in the stock market, you can certainly miss most of the major risks. If you capture most of the return on the way up and avoid most of the major losses on the way down, you will come out far ahead – and sometimes save the fruit of decades of investing.

This brings up a second principle of our approach that you should understand. It does you no good to have great returns on the way up only to see them shrivel up and die on the vine on the way down. To succeed on a long-term basis, you must keep your gains.

**OUR FOCUS IS ON MAKING MONEY AND KEEPING IT**

Everyone talks about making money in the stock market. We want to make money too. What differentiates our process from that of others is that we talk about the one thing that no one ever talks about – KEEPING IT.

The way we do this, though, is *very* different than what you get with a standard “asset allocation program” (think Financial Engines, or your local financial planner). Most of these programs *own* a variety of market indexes and “rebalance” them quarterly or annually.

They too, have transactions – they don't buy and hold forever. Their view is that they should "buy the market" and hold through whatever comes.

Our approach is based on a different view of reality. The best way to explain this is visually. This is a picture (same one as on the cover) of the 10-year results of the S&P 500 (in red) versus the three portfolio models in our system. Take a hard look at the difference and then we'll continue.



Figure 1 - S&P 500 (in red) versus the Airways Models

The stock market, here represented by the S&P 500, is like the weather you are flying through. Sometimes it helps you, sometimes it hurts you and sometimes it creates a serious risk to you. The approach of the typical asset allocation program is to *own* the weather.

**OUR APPROACH IS TO FLY THROUGH THE WEATHER AND AVOID  
EXTREME WEATHER - NOT TO OWN THE WEATHER**

We don't believe "owning the weather" makes sense for several reasons:

1. The "financial weather" doesn't know your goals any more than the real weather knows the destination of your aircraft. Why would you forfeit control of your financial future to the vagaries of the market weather any more than you would rely on the actual weather to cause your flight to arrive at the correct destination? Weather has no intelligence. It just is. Weather isn't on your team.
2. The "weather" often includes risks that are a real danger to your financial health, just like real weather can be a danger to your physical health. When you use the asset allocation approach, you are slightly modifying your results from owning just the S&P 500, but when the market goes down, they all go down. If you "own the weather", you will experience the blow off tops as well as the crushing declines. You will be held hostage to events you have no control over and your future will depend on those events. We would ask, why do you want to do that?
3. If asset allocation was the best way to invest, why are pension plans underfunded as a

result of their losses? They are the largest users of asset allocation strategy and they failed to protect the money of their clients.

You can see (in the chart above) the Airways system flies *through* the weather. Does this approach work? Look at the chart. Does it outperform the “weather” in every instance? No. But why would you care? Is it ever your goal to out-fly the wind? Or is your goal to arrive at your chosen destination safely and on time?

## **I. Identify the Type of Market You are In Today**

The single largest factor that determines your total return in the stock market will be the movement of the stock market itself! The expression “a rising tide raises all ships” is a great picture of what happens in the stock market. It could also be said, “a falling tide lowers all ships.” Specific investments you make will go up when the market goes up and go down when the market goes down.

Rising markets are often referred to as Bull Markets. Falling Markets are referred to as Bear Markets. Being able to define what kind of market we are currently investing in is the chief cornerstone of our approach. We do not anticipate what kind of market we are in. We have a quantitative approach that *measures* what kind of market we are investing in today. As such, we don’t invest based on feelings, premonitions, hunches, beliefs or hopes. We invest fully in markets that are quantitatively identified as Bull Markets. We reduce or eliminate exposure in markets that are quantitatively defined as Bear Markets.

That there are different types of markets is easy to verify by simple observation. To have the same approach in both markets is to us, foolish. The past 10 years has been a lost decade for buy and hold, asset allocation investors. Events like that occur more frequently than most investors realize.

Here is a chart of the S&P 500 Index from 1998 through the end of 2008. Take a look and you can easily see that there are good markets and bad markets.



Figure 2 - S&P 500 Index 1995-2009

It's important to recognize that there are different kinds of markets, but to make that observation useful to us as investors, we have to be able to quantify which is a rising market and which is a falling market. It is easy to see which is which in retrospect, but as investors we want to know what to do now, before the trend is completely drawn. Here's the first step in accomplishing this and why it is so important to be able to know what kind of market you are investing in now.

## DIFFERENT MARKETS REQUIRE DIFFERENT APPROACHES

Rather than rely on simple observation, which can be influenced by human emotion, we use a quantitative model to identify Bull and Bear Markets. Here is the same chart again, but I've now imposed an indicator on the S&P 500 to define when a Bull Market begins and when a Bear Market begins. Take a look again:



Figure 3 - S&P 500 with added indicator to identify Bull versus Bear markets

It is now much easier to see that there are periods of time that stretch for *years*, where it just doesn't pay to be fully invested. There are also periods of time that can stretch for years where you absolutely want to be invested. There must be a way to tell them apart. We do this using several custom indicators that give a similar picture to what you see in Figure 3.

Because the type of market will influence your returns more than any other factor, this is always our first step in the investment process.

***As a side note here, we do not believe in nor do we practice market timing*** – We do not believe *anyone* can time the market and certainly not close to perfectly. The interesting thing about the term “market timing” is that everyone uses it, but no one defines what it means. To us, it means anticipating future movements. We do not do this. We believe it is impossible to accurately anticipate future movements. There are no market crystal balls. The Advisor 401k system looks at *actual data* that exists in the market now and evaluates risk, position sizing, investment selection, etc. based on that data. It does not anticipate movement. It simply adjusts risk and exposure based on the available data.

Most people in the media and most financial planners who are quoted in the media explain market timing as “jumping in and out of the market” based on human feelings or perceptions. We agree that relying on emotion is a poor way to invest.

Unfortunately, most financial planners do not have a good alternative other than to experience the full devastation every time the market goes down. You need to look back no farther than 2000-2008 to see the devastation this “asset allocation” approach brought to investors portfolios as well as pension funds that are now underfunded.

Retirees were particularly hard hit by following the advice of these practitioners of a pseudo science. Harsh words? Yes. And fully deserved. Ask any retiree who lost 30-50% of their retirement money. The cold comfort the financial planners gave them was that these things happen and to continue to hold on the way down.

## **II. How Much to Invest**

Now that we know the most important thing – which kind of market we are investing in, we can ask and answer the second most important question: How much should I invest now? Investment managers refer to this as, “money management”. This answers the question, “how much of your money are you going to put at risk in this environment?”

### **WE INVEST DIFFERENTLY IN BEAR MARKETS THAN IN BULL MARKETS**

**Bear Markets:** In order to balance growth and safety, ideally we want to have no exposure to the stock market during Bear Markets. For this reason, the Airways 401k models have the following allocations when in a Bear Market:

**Conservative:** 50% Money Market/50% Short-term Bond Funds  
**Moderate:** 20% Money Market/80% Short-term Bond Funds  
**Aggressive:** 0% Money Market/100% Short-term Bond Funds

The models will *remain* invested in these allocations until the market switches from defined Bear Market to defined Bull Market. This waiting period is often the most difficult for investors who are easily influenced emotionally by daily market events. Bear Markets can last a long time. Bottoming and switching from a Bear Market to a Bull Market takes longer than most investors realize.

**Bull Markets:** Once the system identifies a switch from a long-term Bear Market to a long-term Bull Market, it *begins* to allocate funds to stock mutual funds. This is *not* a total 100% switch (also very different than market timing). The bottoming of stock markets can take months. This bottoming process is often volatile, with false rallies that fail, sometimes dramatically.

As a new Bull Market rises from the ashes, it will gradually gain strength and eventually emerge as a confirmed, long-term, rising trend. The system recognizes that this is a

process, not an event. For this reason, as risk exposure declines, it begins to allocate a larger and larger percentage of the portfolio to the stock market.

This transition period allocation will contain some percentages in money market funds and or bond funds and some percentage allocated to the stock market. The system is fine tuned enough to make these decisions in 1% increments.

Once a *confirmed* major Bull Market Trend is fully formed, the Bull Market allocations is as follows:

**Conservative:** 50% Short-term Bond Funds/50% Top 4 Stock Funds  
**Moderate:** 30% Short-term Bond Funds/70% Top 4 Stock Funds  
**Aggressive:** 100% Top 3 Stock Funds

[NOTE: You can customize this system to meet your needs. See Section V.]

Next, we will examine how the system chooses which funds to invest in during Bull Markets.

### **III. Investment Selection**

One popular “mutual fund upgrading” approach originated with a newsletter decades ago. Today, that same company has mutual funds based on the same concept. This approach averages fund performance over 4 time periods and “upgrades” the portfolio based on these rankings. This same approach was taken by other newsletter publishing firms and applied to some airline 401k funds. There are two or three such firms we know of writing newsletters for pilots that use this approach.

There are some downsides to using this approach. First, you are typically “switching to the fastest horse” by choosing high momentum funds. Sounds appealing, doesn’t it? “Riding the fast horse!” Unfortunately, some horses fall, some horses go off the track, and sometimes you switch to a horse right before it begins to stumble. When there are market losses, they are often *more severe* because you were riding the highest momentum horse.

You would be better off to choose funds which have high velocity, but which are still in the earliest stage of beginning a new up-trend. The Airways technology does just that by using two components to choose investments:

- 1. Velocity Fund Upgrading , which identifies top performing funds relative to all possible fund choices *and***
- 2. Buy-Point-Technology, which identifies how close a fund is to the *beginning* of an early up-trend**

These two factors are combined into one composite score, which is used in identifying and ranking the Top Funds. After these funds are identified, the system calculates the appropriate position size. This will vary, as mentioned above, as the new Bull Market trend becomes firmly established. Eventually, the full allocation is moved into the Top Funds.

## **IV. Investment Upgrading**

No matter which sectors of the market are the leaders at the beginning of a Bull Market, that leadership will rotate as the market develops and matures. This system regularly updates the fund selection to move to new leadership.

The upgrading interval depends on two factors: 1) whether your company's 401k Plan has a required holding period and 2) the results of holding funds for differing periods of time, as measured historically.

In our research, the sweet spot for holding period is *about* 30 days. Unfortunately, some 401k Plans require a 60-day hold, which limits upgrading to 6 times per year. In that case, no matter which approach you use to managing your 401k account, you have the same rules to deal with. And this system produces very good results in a historical look back over 10 years with 60-day holding periods. If your company's 401k Plan has no holding period requirement, the system will upgrade the investment holdings once every 30 days. We plan to do this in the first issue of the newsletter each month.

[NOTE: The mid-month newsletter will be strictly a market update and no changes will be made to the models in these mid-month issues.]

The system uses the same technology to evaluate the fund choices for upgrading that it uses to initially choose funds when a Bull Market commences. If a fund still ranks in the top 3 or 4 among its peers, it will continue to be held. If it drops lower in the rankings, it will be replaced at these upgrading opportunities.

## **V. Stop-loss prices. Customizing the System. Etc.**

As described under section III, the Airways 401k system uses a combination of two methods to identify *which* investments to purchase and *when* to purchase them. This differs significantly from competing fund upgrading systems, which often buy the highest momentum funds as they approach a market top, only to hold them while they fall. The highest momentum funds are typically the funds that fall the most in a market decline. The Airways system is sophisticated enough to choose investments when they are beginning positive moves after a pullback or recent decline. This avoids buying a fund right at the top and then suffering a severe decline.

**A. Stop-loss Prices** – In the original version of our 401k system, we introduced the pilot world to stop-loss prices in order to protect them between issues of the newsletter. For a time, this has served us pretty well.

**On the positive side**, these stop-loss prices sometimes protected pilots from much, much larger declines when the market failed. Generally, this stop-loss price was set as 5% below the original purchase price.

**On the negative side:** When you use a stop-loss value, you frequently experience a whipsaw, where the market *declines just enough to get you out* before it turns and rises



again! In this case, all it took was for the fund price to drop 6% and then reverse course and head upwards. When this happens, you end up on the sidelines, watching the fund value rise without you.

**In other words, there is no free lunch in the investment world.** For every positive, there is a potential negative stalking you. The reduction of risk also led, at times to a reduction of total return. Any volatile market has the potential to take well-meaning stop-loss prices and use them *against* you.

There is also the issue of keeping track of stop-loss prices while on trips and away from your computer. We often received phone calls or emails asking if there was some way we could notify pilots when the stop-loss values were violated. This signaled us that a large number of readers were not following the stock markets on a daily basis, which makes perfect sense, but makes the stop-loss approach less valuable.

**The positive aspect of using stop-loss prices – avoiding major market declines – will be continued and automated through a different mechanism (actually two separate mechanisms):**

- 1. There is an ongoing analysis of the markets to determine when a long-term Bull Market is switching to a long-term Bear Market.** When this switch occurs, the system moves the allocations into money markets and or bonds. Remember, this is THE MAJOR determinant of total return in the long run and the major way of preserving your gains on a long-term basis. The long-term market shifts mean you will be invested (largely) during rising markets, and out of harms way (largely) during long-term market declines. Never in a perfect way, but that is the nature of investing in equities.
- 2. The ongoing upgrading of investments works to move your portfolio to new market leaders as they break out and begin trends.** Over the course of a Bull Market, leadership continues to change and the system will evaluate and follow these changes – again in an automated way. Because it will buy these positions much closer to their recent pullbacks or declines, there is less risk when a decline happens – especially compared to a momentum based system like some other newsletters use.

These two mechanisms work well together and dramatically reduce the need for the stop loss prices. If you doubt this, please look at the 10-year chart of the system performance on the cover of this white paper. Would you have been satisfied with this performance? With this risk level? Almost everyone would immediately say yes, they would have loved to have this performance. Ultimately, the test of whether a system is effective is the results. Note that this performance did not depend on a single stop-loss price, but relied on the two mechanisms listed above. By giving the system just a bit of freedom, long-term results exceed those of using the stop-loss price strategy.

[NOTE: if you still prefer to make your own stop-loss prices and suffer the downside, which is your right. It will be up to you to keep track of holding periods and to figure out when to buy back in, and to calculate your own returns.]

There are hundreds if not thousands of hours of analysis and decades of experience from multiple investment firms all wrapped up into this one package of intellectual capital. *We all recognize that there is no perfect way to invest.* If there were, everyone would be doing it – especially larger money management firms. There are, however, great ways to invest that protect the downside and deliver returns on the upside, while staying within the constraints of your 401k Plan. This is one great one in our opinion.

**B. Customizing the System to Fit You** – The newsletter offers three model portfolios – Conservative, Moderate, Aggressive – for you to use as *guides* in your own investing. They are not personal investment advice, since only you know your own situation. For that reason, you are acting as your own investment advisor. *Nothing in this document should be taken to imply that investments do not have risk. There is always risk of investment loss when you are investing. Always.*

What if you want to take what you find in the newsletter and then do your own thing? Many people do just that. There are numerous ways to do that.

The *easiest* way to modify this system to fit you is to vary the amount of money the system allocates to money markets and or short-term bond funds during Bull Markets. For instance, what if you are less than Aggressive, but more than Moderate? You could follow the top fund recommendations of the Aggressive model portfolio, but only with 80% of your money or 75% or 65%. What if you are somewhere between Conservative and Moderate? By decreasing the amount held in short-term bond funds during Bull Markets, and allocating those funds to the Top 4 mutual fund choices, you can take a measured amount of additional risk and end up with a “Conservative-Plus” model of your own. For instance, 40% Bonds, 60% Top 4 funds. You can adjust the models in 1% or 5% or 10% increments - either up or down based what percent of your portfolio is held in short-term bond funds – and create any risk level that is appropriate for your situation. Many pilots do just that.

## VI. FAQs

### **Q: Will I *always* outperform the S&P 500?**

No. This would be totally unrealistic. Nothing always outperforms everything else all the time. Even the S&P 500 does not outperform every other choice in all time periods. If you are a long-term investor, we encourage you to follow a system you can 1) live with through good and bad markets, 2) feel comfortable with the level of risk exposure and 3) that produces long-term results that get you to your destination. Focus on the 10-year chart and not the daily market.

### **Q: Can I avoid all losses on a short-term basis?**

Again, no. The only way to accomplish that is to cease being an investor and become a saver, using guaranteed interest savings accounts. You will always experience some declines as a true investor. This system focuses on avoiding devastating declines, while capturing major trends. While every way of investing will involve some losses over short periods of time, this system has minimized those losses in look back periods. One of the truisms of investing is that past performance does not guarantee future success. The world is constantly changing, as investors learned in 2008. Events can change suddenly and dramatically. In the final analysis, *you are responsible for the choices you make*. By making this system available, we are not giving individual investment advice. You are making your own decision as to how this strategy may or may not fit into your individual situation.

### **Q: When should I make the recommended trades?**

Any time from the day the newsletter is published until 8 days following. This system is stable enough to deliver results whether you buy on day 1 or day 8. What if you are on an extended overseas trip, or just forget to read the newsletter until much later? If you fail to make the trades before day 10, you have a decision to make. If your version of the system trades every 30 days, we would suggest waiting for the next trade. If your version of the system trades every 60 days, we suggest you make the trade – just realize you will have to hold for 60 days or sell when the system traded the next time and get a warning letter from the Plan administrator. The best first choice is to make the trades in the original time window.

### **Q: Do I need to keep track of holding periods?**

If your plan has holding periods, for example 60 days, and you strictly are following one of these models, the system will operate in a way that stays within these restrictions – assuming you trade on the same day each time. Ultimately, you have to hold for the amount of time your plan requires. For some plans, there are no holding periods at all (although try to trade every day and you will quickly learn there are indeed unwritten rules).

### **Q: Will this system produce identical results in every 401k Plan?**

No. Each 401k Plan has different funds, different numbers of funds, and different qualities of funds, different restrictions on holding periods, etc. These variables will produce differing results. The results will vary, but will be very consistent.

### **Q: Have these performance results been examined by a third party?**

Yes. Theta Investment Research has examined the results and examines them on an ongoing basis. (Theta Investment Research tracks manager performance and provides independent

third party verification of performance and risk measures).

**Q: Where should I put my future contributions?**

We believe the easiest thing to do is to direct your future contributions into the Money Market fund and then invest them during regular fund upgrading periods. If you do not do this, you will have the problem of moving them from funds that are not being used and may be inferior or in decline.

If you have additional questions, please feel free to email us at [airways@dejazzd.com](mailto:airways@dejazzd.com)  
Put the word "Question" in the subject line.