

The Z-Series Defensive Strategy

What it is

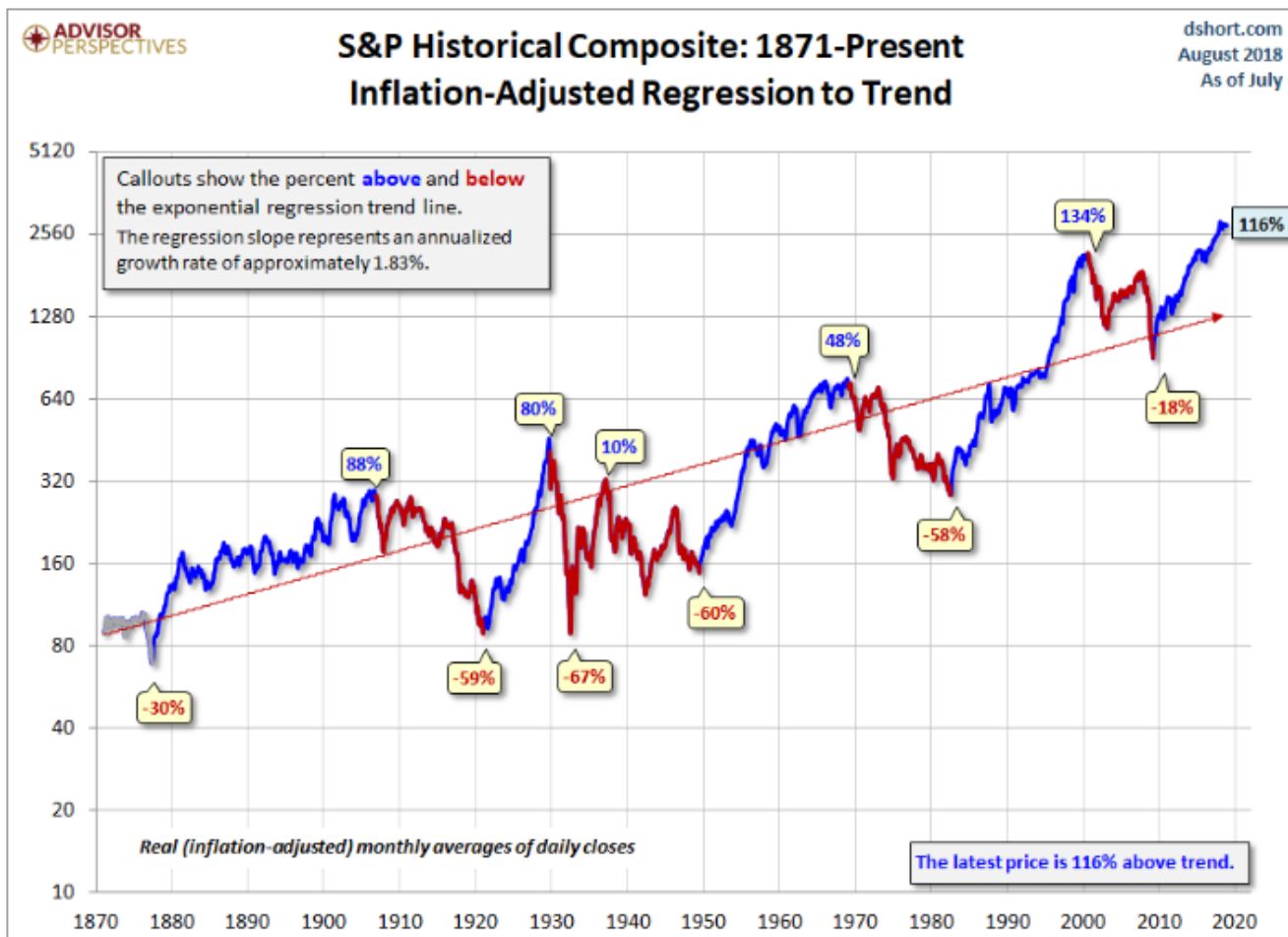
The **Z-Series Defensive Strategy** is an overlay to your existing strategy. It combines the benefits of a traditional buy & hold approach with an aggressive risk management strategy. The market is in an uptrend about two-thirds of the time, and in a downtrend during the other one-third. The **Z-Series** is designed to keep you fully invested during bull markets and protected during bear markets. It's a simple concept, but it requires a serious commitment to execute it correctly.

Why it works

The chart below shows every major bull and bear market since 1870. The straight red line that cuts diagonally through the middle of the chart is the Regression to Trend, which shows us what the market would look like if all investors had the same information at the same time and there were no surprises.

But because the market is full of surprises, both good and bad, and because of the human tendency to over-react to news, we get the long-lasting periods in the market of over-valuation and under-valuation. This feature that is hard-wired into market behavior and investor reactions, is the reason our **Z-Series** strategy works.

Chart 1. A birds-eye view of every long bull and bear market since 1870.



The most recent bull and bear markets

Looking at the right side of **Chart 1** is a good way to understand how this phenomenon works. The market had been on an historic bull run from August 1982 until the start of 2000. There were some bumps along the way, but investors who remained in the market during this 18 year stretch made out very well.

Towards the end of this magnificent bull run, things got out of hand. The market was being flooded by new startup internet companies – the dotcoms. Investors couldn't buy these stocks fast enough, and they drove the market to a level that exceeded the top of the 1929 market. There was nowhere to go but down.

A quick look at the chart reveals 6 periods of over-valuation and 6 subsequent declines to correct them. The **Z-Series** takes advantage of these large swings in the market in a way that boosts returns and lowers risk significantly.

When we look at the numbers from the above chart in Table format, a couple of interesting things pop out.

Table 1. Secular Bull & Bear Markets

Year	Market Milestone	Percent Change	Number of Years	Annualized Return, No Dividends	Annualized Return with Dividends
1877	Low	-	-	-	-
1906	High	412%	29.3	5.1%	10.1%
1921	Low	-69%	14.9	-7.5%	-2.0%
1929	High	396%	8.1	21.9%	28.4%
1932	Low	-81%	2.7	-44.9%	-41.2%
1937	High	266%	4.7	32.1%	38.7%
1949	Low	-54%	12.3	-6.2%	-0.8%
1968	High	413%	19.5	8.8%	13.3%
1982	Low	-63%	13.6	-7.0%	-3.0%
2000	High	666%	18.1	11.9%	15.3%
2009	Low	-59%	8.5	-9.8%	-8.1%
Now	-	211%	9.3	N/A	N/A

Based on inflation-adjusted S&P Composite monthly averages of daily closes.

According to Jill Mislinski and Doug Short of Advisor Perspectives, since 1871 we can see that:

- Secular bull markets gained a total of 2,075% for an average of 415%.
- Secular bear markets lost a total of -329% for an average of -65%.
- Secular bull market years total 80 versus 52 for the bears, a 60:40 ratio.

The finance industry has conditioned investors to view every dip as a buying opportunity. If we realize that bear markets have accounted for about 40% of the entire period from 1871-2018 (147 years), we can better understand the two massive bear markets of the 21st century.

And more importantly, we can begin to appreciate the value of having a good defensive strategy in place before the next major bear market arrives. We will explain how to do exactly that, with a surprisingly simple strategy.

The over-selling of Buy & Hold

The most popular investment strategy today is, without question, buy-and-hold (hereafter **B-H**). This approach has a lot going for it. It's easy to understand, easy to set up, easy to maintain, and attractive for those who are willing to settle for passively accepting whatever rate of return the market gives them.

But many other investors would rather strive to do better than the market return. With three simple steps, anyone can set up a serviceable **B-H** strategy. The steps are:

1. Decide which asset classes you want in your portfolio.
2. Figure out how to allocate your capital among these asset classes.
3. Select a low-cost mutual fund or ETF to represent each of your asset classes.

Next, we look at an example of a **B-H** portfolio that was designed by Dr. Bernstein. This portfolio is about as simple as you can get, with money spread evenly across four index funds. (There are Vanguard ETFs available for each of these asset classes if you prefer.)

Table 2. Investment returns for a popular **B-H** strategy.

Dr. Bernstein's No Brainer					
Data as of 07/28/18					
Fund	Alloc	1-yr rtn	3-yr ann. rtns	5-yr ann. rtns	10-yr ann. rtns
Vanguard European Stock Index Fund;Investor	25%	5.62%	5.33%	5.57%	3.23%
Vanguard Small-Cap Index Fund;Investor	25%	16.35%	11.94%	11.18%	11.22%
Vanguard 500 Index Fund;Investor	25%	15.94%	13.06%	12.90%	10.62%
Vanguard Total Bond Market Index Fund;Investor	25%	-1.00%	1.32%	2.02%	3.63%
Total Portfolio		9.23%	7.91%	7.92%	7.18%
S&P 500		16.10%	13.21%	13.06%	10.76%

Source: MarketWatch

Looking at the above table, it appears that Dr. Bernstein's portfolio lagged the market by a wide margin. But that's only true if you compare its performance to the S&P 500. That's an apples-to-oranges comparison. This portfolio should be compared to a benchmark that more closely represents the asset allocations being used. In this case, the proper benchmark would be a globally diversified index that includes all 4 of the asset classes. For an approximation, Morningstar offers a Moderate Target Risk Total Return Index, which has produced the following returns:

6.88% 1-yr.

7.33% 3-yr.

6.55% 5-yr.

6.64% 10-yr.

The takeaway is that this version of a **B-H** portfolio out-performs its relevant benchmark, but significantly under-performs the S&P 500. The question you must ask yourself is, will you be satisfied with an average long-term return in the ballpark of 6.75%

with a **B-H** investment strategy? Or do you want (need?) an average return that's closer to the 10% that the S&P 500 has historically produced?

HOW TO MAKE 10%

There are several ways to get a 10% long-term return on your money. The simplest and most direct is to put all your capital into the SPY ETF, or the Vanguard S&P 500 Mutual Fund. If you do this, you will match the market every step of the way. The problem is that you will occasionally take massive hits to your wealth when the market plunges. Since the market is "under water" about one-third of the time, having to sit through these periods is a large drawback of the **B-H** strategy.

Most finance professionals will recommend that you diversify your portfolio among at least three different asset classes. If you follow their advice, you're back to something closer to Dr. Bernstein's portfolio and you will not make 10% on your money.

Another way to get a 10% return is by taking more risk. Rather than putting all your capital in the S&P 500, you could spread it around to riskier, higher-performing funds like the Vanguard Small Cap ETF (VB), or the recently launched Vanguard Momentum ETF (VFMO), or the Vanguard Growth ETF (VUG). These and other funds invest in companies with higher growth rates, but they are also riskier than the blue chips in the S&P 500.

Yet another way to get a 10% return is by employing an "active" strategy. This could be picking individual stocks that you think will rise faster than the market or making bets on which market sectors or industries are going to out-perform the broad market averages. This is a time-intensive approach, and you will be competing against professional traders who undoubtedly have better information than you. But it's still a choice.

HOW TO GET 30% HIGHER RETURNS THAN A SIMPLE B-H STRATEGY WITHOUT TAKING ANY MORE RISK

It should come as no surprise that I have developed my own suite of strategies for those who want to do better than the broad market averages. I have been using these strategies with my clients since 2000, and the results have exceeded even my own optimistic expectations. These are simple strategies that anyone with an online brokerage account can use. In a nutshell, they involve being aggressively positioned during long bull markets, and conservatively positioned during long bear markets. I have three versions of the strategies, which are part of the suite I call the **Z-Series**. I will describe them and explain how they work in a moment. But first, here's a summary of the historical performance.

3 VERSIONS OF THE Z-SERIES DEFENSIVE STRATEGY

There are currently three versions of the **Z-Series Defensive Strategy**. The most active, and highest-performing of the three versions is the **Z-100**. From 1950 to 2018 there were 725 signals given by the model - the most recent being a buy signal on June 28, 2018.

When the model gives a red light signal, all funds are moved from risky assets to safer ones. The reverse happens after a green light signal. It's not complicated, but it does take patience and vigilance. If one were to miss a signal by a day or two, it's unlikely that serious damage to overall performance would result. But neglecting the strategy for weeks or months at a time could do some real damage to returns.

HOW THE Z-SERIES DEFENSIVE STRATEGY WORKS

The strategy works as follows. The **Z-Series** model tracks the daily closing price of the S&P 500, or any other index that has a liquid tracking ETF, and generates buy and sell signals based on 3 things:

1. Proximity to the next business cycle turning point.
2. A Bayesian probability of a stock market decline of 20% within the following 12 months.
3. The shape of the Treasury yield curve.

When the model gives a buy or sell signal, subscribers get an email alert telling them what the signal is, and which trading protocols are being activated.

The subscriber then executes the trading protocol they have chosen, moving a predetermined portion of capital from risk assets (equities, for example) to safe assets (cash, T-Bills, Treasury bonds). For aggressive traders, switching from long to short using ETFs can add even more juice to the strategy but requires a higher level of risk.

TRADING ACTIVITY FOR THE Z-SERIES STRATEGIES

Table 3. Number of trades required to keep the **Z-Series Defensive Strategies** operating at maximum efficiency from 2000-2018.

Calendar Year	Z-100 # Trades	Calendar Year	Z-200 # Trades	Calendar Year	Z-300 # Trades
2018	12	2018	6	2018	4
2017	2	2017	5	2017	3
2016	12	2016	6	2016	6
2015	24	2015	13	2015	9
2014	16	2014	4	2014	4
2013	6	2013	3	2013	3
2012	16	2012	6	2012	11
2011	18	2011	11	2011	8
2010	14	2010	8	2010	6
2009	3	2009	7	2009	4
2008	6	2008	4	2008	2
2007	17	2007	17	2007	7
2006	4	2006	12	2006	8
2005	6	2005	14	2005	4
2004	18	2004	8	2004	8
2003	10	2003	7	2003	4
2002	8	2002	8	2002	7
2001	12	2001	4	2001	7
2000	14	2000	21	2000	11
Average	13	Average	9	Average	6
CAGR=Z	11.7%	CAGR=Z	10.1%	CAGR=Z	9.2%
CAGR-BH	7.5%	CAGR-BH	7.5%	CAGR-BH	7.5%
% Days OUT	33.2%	% Days OUT	29.3%	% Days OUT	22.7%

ARE THESE RESULTS TOO GOOD TO BE TRUE?

There must be a catch, right? Nothing this good can be easy to manage, and nobody beats the market return without taking a whole lot of risk. At least that's what you've been told by the professionals and the pundits. But here's the deal.

Look at the numbers for 2008 in the above table. Notice that there were only 6 trades in the Z-100, and 4 trades in the Z-200. This underscores a key driver of performance for this strategy. By getting out of harm's way, and staying out, during nasty declines like we saw in 2008, the strategy wins by not losing. It's a simple idea, but extremely powerful when executed correctly.

This strategy, as I said, is easy to understand and set up. But that doesn't mean it's easy to manage. In fact, for some it can be difficult to manage. It takes a certain kind of temperament and an organized mind to make the strategy perform at peak efficiency. That means paying attention and following the rules of the strategy faithfully. Someone who gets distracted and neglects the maintenance part for a few months may do some damage to short-term returns.

But this is not rocket science, and it doesn't require a high I.Q or a degree in math or statistics. It requires common sense, consistency, and a little discipline. That's the price one must pay in order to get the superior returns that come from the strategy.

CONCLUSIONS

There will always be a place on the investment strategy menu for **B-H**. But the claim by many in the business that a **B-H** strategy is the best choice for every retail investor is promoted by professionals who have an incentive to do so.

The **Z-Series Defensive Strategy** is actually a modified **B-H** strategy. Based on my research, which I am willing to share with anyone, the **Z-Series** is fully invested 70% of the time, and fully defensive the other 30%. The strategy is easy to understand and monitor, and anyone can maintain it at peak efficiency as long as they follow the signals. Trades are based on a simple set of rules that are tied to clear and precise buy and sell dates that the model generates.

Investors who don't have the time or interest to manage the strategy on their own can subscribe to a low-cost alert service that will tell them via email when it's time to make a trade. The investor would then execute the trade according to predefined rules put in place at inception.

I have documented its historical return of 10%, 15%, and 20% using real pricing data from Yahoo Finance. While there is no guarantee that past performance will continue into the future, the **Z-SERIES Defensive Strategy** has proven to be considerably less risky than a **B-H** approach.

Are you willing and able to stick with your current equity exposure through the next bear market?

That is one of the most crucial questions you should be asking yourself. If your answer is no, then you should take the opportunity now—with the stock market close to all-time highs—to get your ducks in a row by setting up a robust defensive strategy like the **Z-Series**. Don't wait until the middle of the next bear market to discover that you can't handle large drops in the value of your life savings.

*“The people who can truly stomach the volatility of a
100% stock portfolio are either catatonic or dead.”*

-Claude Erb, formerly of TCW Group