

Dynamic Diversification.

Only a fool goes into a meeting with just one scenario. For over 20 years, this site has focused on active investing, based on a momentum framework known as Decisionmoose. Index Moose was extremely successful at beating the benchmark S&P 500 for 15 of those 20 years, but the Moose has struggled in the last five.

Investors who visit this site are looking for a practical investment strategy. If our active momentum strategy isn't optimal at the moment, it might be useful to identify the next best option. Last week, we began by discussing passive investment strategies. This week, we look at dynamic diversification.

Dynamic Diversification

Instead of a traditional passive diversified portfolio, in which the percentage attributed to each asset is fixed, Dynamic Diversification applies active management principles to the portfolio in real time to reduce exposure to the weakest assets while maintaining exposure to the strongest. It is an amalgam of active and passive strategies.

Institutional money managers and hedge funds use this strategy, and the black box solutions they employ to implement it are far more sophisticated than anything a do-it-yourselfer can accomplish on a PC at home. Sophistication, however, is not necessarily synonymous with success. Institutional money managers and hedge funds have found themselves in the same difficult investment environment that the rest of us have.

My intention here is not to create a recommended black box solution. It is to provide several highly simplified examples of dynamic diversification in order to discuss its pros and cons relative to passive diversification and relative to momentum.

Dynamic diversification essentially takes a passively diversified portfolio, like the one below, and applies one or more technical filters to it. The most prevalent technical filters are moving averages. Using the most common growth portfolio (discussed here last week-- diversified 60% equity and 40% income), what can we learn by applying several moving averages, one at a time?

Portfolio	SPY	IWM	IEV	EWJ	AXJL	ILF	GLD	EDV	CASH
Growth—60-40	20%	15%	5%	5%	5%	5%	5%	30%	10%

Probably the most basic filter is the 200-day (40-week) moving average, which sets the traditional intermediate-term boundary between bull and bear markets. Another basic filter is the 50-day (10-week) moving average, which sets the traditional short-term boundary between bull and bear markets. And finally the 90-day (18-week) is also a widely used filter.

One way to reduce exposure to the weakest assets in a diversified portfolio, while maintaining exposure to the strongest, is to set a rule that sells any asset when its price falls below its moving average, putting the proceeds in cash. (For example, if the price of SPY in the above portfolio falls below its 200-day average, its allocation goes from 20% to 0% and cash goes from 10% to 30%.)

Like last week, I'm going to cut to the chase. Plugging in the model ETF data, calculating performance according to each of the three moving average filters, and comparing that with Index Moose and the benchmark, leads to a number of observations. (Notice I don't say "conclusions", since these calculations are theoretical in that they don't reflect a true account, and don't include dividends earned or trading expenses paid.)

Portfolio (12/30/16)	1 year	5 year	10 year	15 year	3-year Sharpe
S&P (SPY)	+10%	+73%	+59%	+94%	2.08
Index Moose	-6%	-12%	+39%	+576%	-1.85
Growth—60-40x200	+8%	+16%	+56%	+112%	2.59
Growth—60-40x90	+7%	+12%	+57%	+125%	0.74
Growth—60-40x50	+8%	+13%	+38%	+99%	0.88

As the table above shows, dynamic diversification strategies have begun to compare favorably with the momentum model. Timing is everything when it comes to measuring performance. It is also everything when

it comes to picking a strategy. The economic and financial environment has a deep impact on the effectiveness of one's investment strategy.

Until the current environment-- in effect for 8 years and essentially known as Fed financial engineering—ends, dynamic diversification provides a reasonable alternative to traditional momentum strategies. The trick, of course, is to know when the “current” environment has passed. (More on that later.)