PRING TURNER
Investment Management

PRING TURNER APPROACH TO BUSINESS CYCLE INVESTING

Essentially, an investor needs two game plans; one for defense to protect assets in difficult periods, and one for offense, to grow wealth during favorable conditions.

The heart of our investment approach focuses on business cycle associated trends for bonds, stocks and commodities and is based on two observations. First, there is a rhythm to typical business activity that has repeated continuously since the beginning of the industrial revolution over 150 years ago. Second, the ideal asset allocation and sector rotation for investment portfolios can be adjusted based on the stage of the business cycle in an effort to increase returns while reducing risks. The calendar year rotates through four seasons, the knowledge of which empowers farmers to plant in the spring, harvest in the fall and avoid the problematic cold of winter. Like the seasons of the year, the environment for bonds, stocks, and commodities also changes in a repeatable and sequential fashion. Rather than being victimized by inevitable cyclical declines, investors can prepare for the ever-changing financial market seasons and stand to benefit from understanding the progress of the business cycle.

WHAT IS THE BUSINESS CYCLE?

Always being alert and anticipating the next inflection point in the business cycle creates a dynamically managed portfolio that takes advantage of emerging profit opportunities and also protects one's wealth from the inevitable cyclical declines.

The business cycle is the normal, sequential, and repeated ups and downs of the economy. This continuous sequence has repeated over and over since the U.S. became an industrialized nation in the 18th century. A bell shaped curve provides the best illustration of the business cycle. The shape is simple, elegant and implies continuous change, with one cycle leading into the next (figure 1).

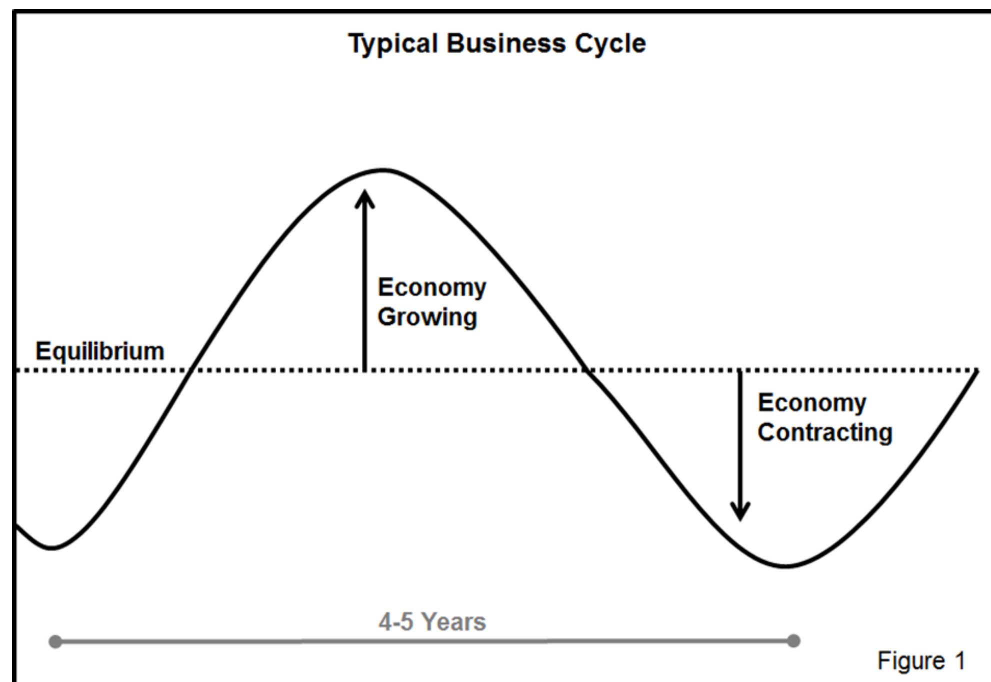


Figure 1

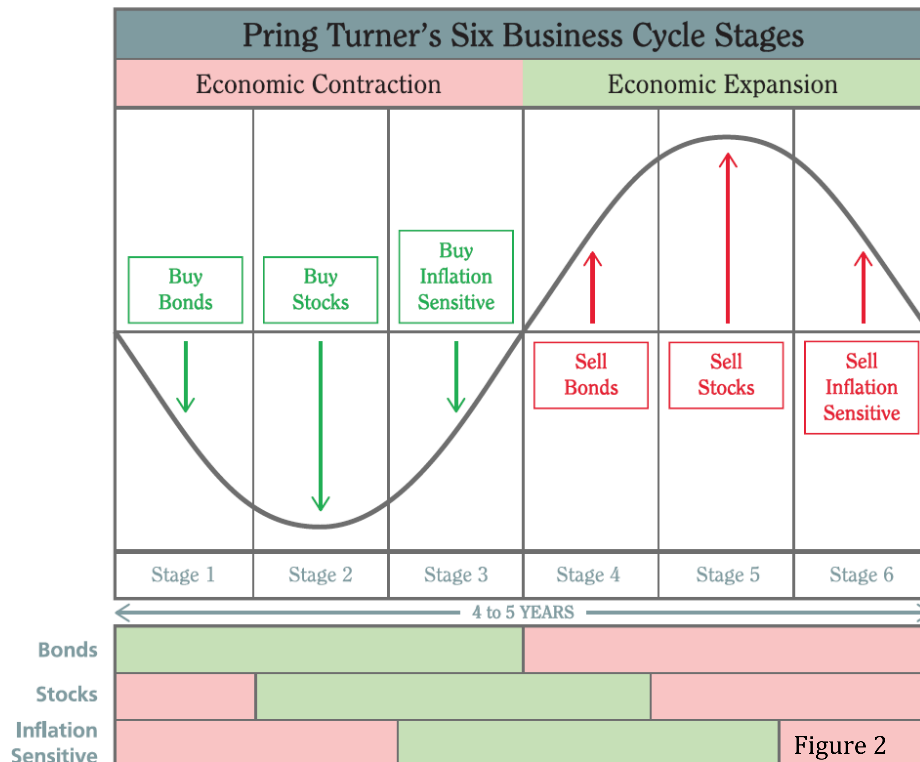
Since 2000, the stock market has experienced two vicious declines of greater than 50%, providing an excellent benchmark to gauge performance. During this time, our all-season strategy outperformed the S&P 500 while taking roughly half the risk

The uphill (above the dotted line) half of the curve implies the growth or expansion phase of the economy. This is a profitable time for companies and the employment picture is bright. The downhill (bottom) half of the bell-shaped curve, or contraction phase, is commonly referred to as a recession. A recession sees business activity shrinking. Sales and profits decline for corporations. As companies lay off employees, the unemployment rate rises and household

income declines. The stock market suffers declines, often substantial losses, associated with recessions. Over the last century three out of every four bear markets for stocks (-20% or greater declines) have occurred during recessions. The real value of understanding the business cycle is that it helps us look ahead and anticipate economic turning points without extrapolating current financial market conditions indefinitely into the future. In simple terms, it helps investors identify whether it is an appropriate time to play offense (grow wealth) or defense (protect wealth) in portfolios.

INTRODUCING THE SIX STAGES

Anyone with gardening experience understands that it is difficult to plant in the winter because nothing grows. The same is true for the financial seasons in the business cycle, where investors can use knowledge of the chronological bond, stock and commodity sequence to create a financial market calendar. By better understanding these financial seasons and using the correct forecasting tools, investors can make well-informed decisions and dramatically improve their chances for investment success. Each asset class has two turning points in a given business cycle—a top and a bottom. This means that a typical cycle has a total of six junctures—three buys and three sells. We call these the *Six Stages*. The calendar year has four seasons, each of which has its own characteristics. The same can be said for the business cycle, except we have organized it into six stages.



The six-stage model can help investors dynamically adjust asset allocations around the typical business cycle sequence. Certain asset classes are favored (green) or de-emphasized (red) during specific times in the cycle.

The stages are illustrated in Figure 2 (above) and begin with a slowing economy, when bond prices are bottoming, and continue all the way through until the eventual peak in commodity prices. The implication from the diagram is that each stage is equal in duration, but in reality this is not the case. Our research indicates that the six stages move sequentially a majority of the time, which may offer an edge for investors by signaling when to reduce or emphasize a specific asset class.

HOW DO WE KNOW WHICH STAGE WE ARE IN?

The stage of the business cycle is identified through models or "barometers" for each of the three asset classes (Bonds, Stocks and Commodities). Our barometers are constructed from proprietary technical, and inter-market relationships that have

been researched all the way back to 1955 by Dow Jones Indexes. When a majority of the components within a barometer are on a "buy" signal then that asset class is considered "bullish," and when a majority are on a "sell" signal then that asset class is considered "bearish." The barometer performance has been stress-tested under all kinds of geopolitical turmoil, wars, economic distress, monetary conditions, and embraces periods of inflation, deflation, crashes, booms and busts. We determine the prevailing stage of the business cycle by looking at each of these barometers. Stage I occurs when bonds are bullish and stocks/commodities are bearish. Stage II occurs when bonds and stocks are bullish while commodities remain bearish. Stage III reflects when bonds, stocks and commodities are all bullish. Stages IV, V and VI inverse of this sequence. We use this stage information to establish our broad tactical asset allocations guidelines.

APPLYING BUSINESS-CYCLE STAGE SHIFTS TO TACTICAL ASSET ALLOCATION

Doesn't it make sense to reduce your exposure to stocks in anticipation of a recession and to purchase more stocks when the economy is expected to accelerate into a growth mode? For instance, during a recession in Stage 1, our asset allocation guideline includes a healthy mix of bonds and cash to stabilize portfolios. The opposite is true in Stage II and III, when the economy is moving up to full throttle and maximum exposure to stocks is recommended. We believe that our six-stage framework is an ideal way to construct an active allocation discipline, especially because it also serves as a critical risk-management tool.

BROAD BUSINESS CYCLE ASSET ALLOCATIONS GUIDELINE

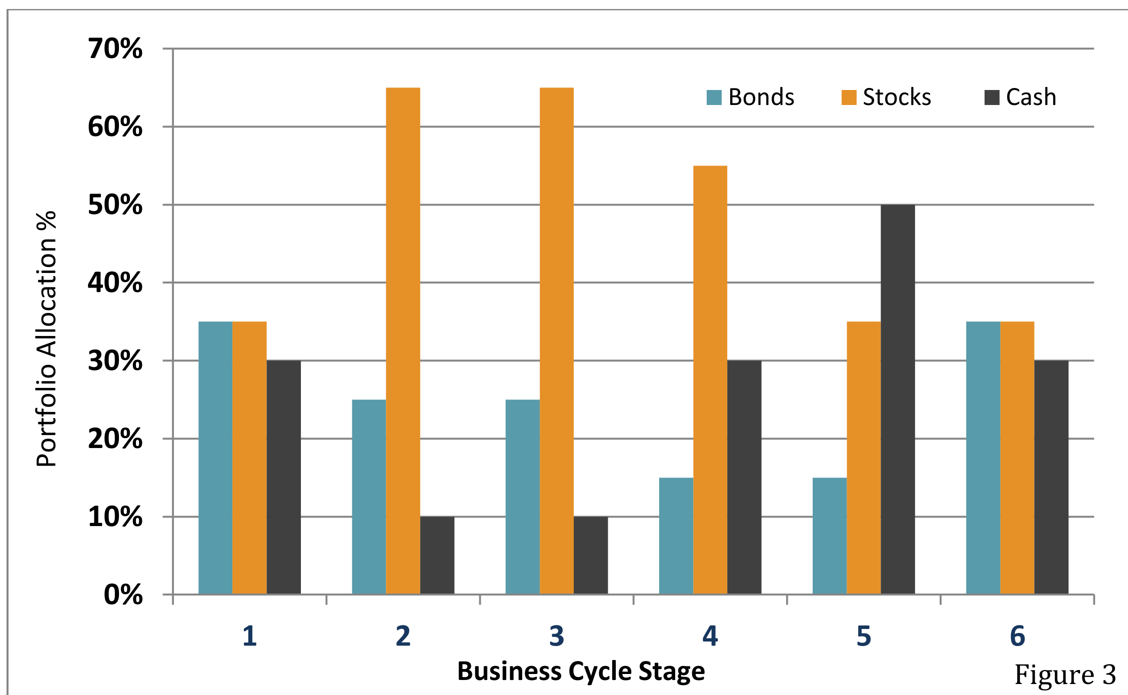


Figure 3

This broad asset allocation guideline can serve as an important starting point for actively managing portfolios throughout the business cycle. The graph serves as a general guideline but should not be mistaken as a precise model, simply an illustration.

Keep in mind that no strategy or discipline is perfect and each has its own shortcomings. In the case of economic fluctuations, not all cycles will experience every stage, and stages occasionally diverge from the expected sequential order. Sometimes the cycle will skip a stage or even two. In fact, a cycle may also retrograde to a previous phase. This is why changes to portfolio allocations should be gradual. Larger allocation switches can be justified only when the evidence of a change in the environment is overwhelming and markets have not already gone too far in factoring this into prices. For investors, the beauty of following the repetitious nature of the business cycle is an investment methodology that never goes out of style, an "All Season" approach if you will.

PERFORMANCE

In 2012, analysts at Dow Jones Indexes were intrigued with the research, and thoroughly tested the barometer data and business cycle theory going back to 1955. The results were strong enough to justify the construction of an index designed to track the strategy. The result was the *Dow Jones Pring Business Cycle Index*, the first proactively managed business cycle index for Dow Jones. The index incorporated a rules based system that identified the six stages and best allocated according to how each asset class and equity sector traditionally performed in every business cycle phase. Their thorough analysis found the strategy offered solid returns with less volatility for investors.

HOW HAS OUR ALL-SEASON STRATEGY PERFORMED FOR CLIENTS?

"How have you performed?" is only half the question! "How much risk did you take to generate that return?" is an equally important question. One of the best ways to judge risk-adjusted returns is to examine how well an advisor handles difficult market environments. Since 2000, the stock market has experienced two vicious declines of greater than 50%, providing an excellent benchmark to gauge performance. During this time, our all-season strategy outperformed the S&P 500 while taking roughly half the risk. Visit the "How We Invest" page of our website to examine our real life performance results. We claim compliance with the Global Investment Performance Standards (GIPS®), the industry gold-standard for performance reporting. We are proud of our performance and transparency. Unlike the majority of investment advisors, we openly share and regularly update our performance figures directly on our website.

FINAL THOUGHTS

The business cycle investment process, similar to the continually changing seasons, follows a logical sequence to make active asset allocation decisions. The approach marries our conservative investment philosophy to a disciplined decision process. Since the 1970's, our repetitive decision making discipline has been used to profitably manage portfolios for conservative investors.

Our performance, in tandem with research provided by the folks at the Dow Jones Index organization, demonstrates that our philosophy and business cycle investment discipline provides attractive risk-adjusted returns over many cycles and years. Always being alert and anticipating the next inflection point in the business cycle creates a dynamically managed portfolio that takes advantage of emerging profit opportunities and also protects one's wealth from the inevitable cyclical declines. Our research and investment performance are time tested and proven to benefit the "All Season" conservative investor.

"Essentially, an investor needs two game plans; one for defense to protect assets in difficult periods, and one for offense, to grow wealth during favorable conditions."

-- Martin J. Pring, Investment Strategist – Pring Turner Capital Group

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