

THE RELAXED INVESTOR

**How to Transform Yourself
from Struggling Speculator
to World-Class Fund Manager
Starting Today**



Dan Murphy

Dan Murphy

The Relaxed Investor

With very special thanks to these generous individuals:

Allen Bese

Ronald Hitzfield

James Hill

Eddie Moody

Tracy Gordy

Alba Cornish

Rhett Wolff

Arthur Allen

Gunnar Solheim

Richard Campbell

B W Bowers

Ruben Luevano

Jules Coleman

Michael Nally

INTRODUCTION	ERROR! BOOKMARK NOT DEFINED.
Finding an Edge	9
ELIMINATING THE NOISE: THE FOUNDING PRINCIPLES OF AN EXCITING NEW WAY OF TRADING	9
The House <i>Almost</i> Always Wins	9
Leaving Nothing to Chance	10
The World's Greatest Investor	10
Playing the Long Game	11
Eliminating the Noise	11
Since When Is the Path to Prosperity Found by Taking <u>EVERY</u> Path?	13
Theories and Proverbs Banging Pots and Pans	14
Even Solomon Would Be Impressed	15
Taking a Good, Hard, Objective Look at Markets	16
PART ONE WRAP UP	17
THE STRATEGY THAT HAS BEATEN THE MARKET SINCE 1926	18
The Law of Errors...And Bean Counting	19
The Law of Errors in a Social Environment	20
Seeing the Market Through a Glass Jar	20
The Paradox of Investing	21
What Goes Up, Keeps Going Up	22
Rotational Investing with a Twist	22
How to Invest in a Rotational Investment Model	23
Part Two Wrap Up	26
THE REXLAXED INVESTOR STRATEGY EXPLAINED	28
The Bitcoin Bubble	29
The Magic Forgotten Formula	29

The Relaxed Investor

THE Six Major Asset Classes	30
WARREN CAN TAKE A BIG ONE, CAN YOU?	32
Top One or Top None?	35
The Risk-Free Filter	36
Four Major Ideas	38
Mystery Ingredient X	39
The Final Touches to a World-Class Strategy	40
Part Three Wrap Up	42
There's a Relaxed Investor in You, Too!	42

Introduction

I wouldn't call myself a gambler, but it was gambling, and more specifically horseracing, that led to the biggest breakthrough in my trading career.

My Great Uncle Clarence was a legendary speculator of horseraces. That's not quite right. What I meant was he was a strategist. He was a legendary strategist of horseraces.

Handicap horseracing to him wasn't a pastime, it was a business. While all the other spectators were losing their money, their shirts and their sanity, he was making tens of thousands of dollars "gambling" at the track. I never heard him call it gambling. He was much too thrifty to throw his money to chance.

In our line of work, we have our own set of legendary figures. Names like Warren Buffett, Ed Seykota, Bill Eckhard, Jim Simons and Edward Thorp are well known throughout the finance world. Legendary figures managing to make hundreds of millions—if not billions—of dollars even as other hardworking Wall Street types crash and burn into namelessness.

We've heard it before and we've asked ourselves on countless occasions: how do they do it? If the market is nothing but a gamble, if it's too efficient to be bested, then how the hell do these guys come out on top? Not just once mind you—but throughout their careers. Could it be insider knowledge? An overlooked market theory? Blind chance? Somebody has to win the lottery, right?

Finding an Edge

Traders will spend their whole careers looking for an edge that they can apply to the market. Most of the time they think the edge comes from having knowledge that another trader doesn't. They're looking for an opportunity, theory, or pattern that will explain the market and give them the upper hand. Finding that silver bullet is all that stands between them and untold millions.

But let's look into this idea a bit further, and see if there's anything to it. If a silver bullet did indeed exist, and people had known of it for decades, we should be able to follow the money trail. More than a handful of people should know of it. If it's been around for that long, we would see evidence of it all around us.

The fact is we don't. The facts actually point to the complete opposite:

- In 2010, between 72% and 79% of Forex clients investing through brokerage firms FXCM and Gain Capital Holdings faced quarterly losses which, over the course of the entire year, led to 99.6% of clients losing money

- According to a study done by Thomas A. Hieronymous, 92% of traders saw their trading accounts devastated within the set timeframe and quit trading soon after
- In a survey done by the NFA, 92% of new traders had hit rock bottom on their trading accounts in a period of six months
- A research project by Ronald L. Johnson estimated that upwards of 75% of the traders in the study “were headed inexorably toward failure, with a 100% risk of ruin.”
- Over the course of nearly six years, Terry Odean examined the trading accounts of over 60,000 households, with the conclusion that “trading is hazardous to your wealth.”

These abysmal numbers are spread out across the board. Whether you trade index futures, commodity ETFs or stocks of individual companies, eventually you’ll come face to face with these percentages.

Certainly those traders educated in our prestigious colleges tend to do better? After reading tome after tome of financial know-how, and covering an immense range of market theory, such “experts” would have figured out a way to defy the statistics. But if the educated few had identified a winning pattern, where is the money to prove it?

Your professor likely had you pore over price charts and wave cycles in an attempt to analyze market trends. Maybe you had to determine three wave patterns from five wave patterns. And when you were tasked with deciphering how many Fibonacci sequences there were in a yearly market cycle, you just prayed that someone—either Elliott Wave himself, or at least your professor—had a clue as to how this could be applied in real life to make you millions of dollars.

Except, when we look at the facts, we’re left with just one question:

Where are all the Elliott Wave billionaires?

Is there a single one? If not, why? Does a supernatural force recognize when you are filthy rich and about to be put on the Forbes 500...and then take away your wave counting superpowers? I think it’s safe to say that most market theories, while attractive in their ability to identify patterns in the market, are not what some experts make them out to be, and should be taken with a grain of salt as we’ll see in the coming pages.

I’m going to share a discovery with you in this report, one that I believe could change how you trade forever. This discovery is based on a proven market strategy, not a one-off trading opportunity; it’s focused on long-term portfolio growth, not short-term profits; and it uses real-world market data instead of conflicting news sources, quarterly reports, rumors and hearsay.

You don’t need to jump through hoops as a trader. Nor do you have to bend and sway with a capricious market. My report will explain what to hold and for how long. It will show you

what to buy and when to buy it. Try waiting around to identify that kind of information out of a Wave chart. Chances are you'll be waiting a long time.

By the end of this report, you'll know how to objectively gauge the market to grow your portfolio year in year out. I'll provide you with the information you need to have this strategy up and running within 90 days. After those 90 days, it is my belief that you'll be well on your way to becoming a highly skilled and successful fund manager.

My Uncle Clarence always told me to never own anything that ate while I slept. This strategy is the complete opposite: It steadily makes money while you live your life. That's what being a relaxed investor is about.

Eliminating the Noise: The Founding Principles of an Exciting New Way of Trading

Money was secondary for my Uncle Clarence. What he really loved was crunching the numbers. For him, no detail was too small, no statistic too mundane, to be ignored by his calculations. He researched the breed of each horse, the training it received, and the weights it carried. He knew the length and width and conditions of every track he went to. He turned each jockey into a living set of statistics—precise facts and figures made readily digestible through simple math equations. And he penned it all down on an old yellow notepad with a chewed up No. 2 pencil.

He went to the track to work, and at the end of the day, when everyone else walked away with the insides of their pockets hanging out of their pants, he strolled past with a fatter wallet than he had walked in with. Chance and gambling weren't in his vocabulary. And he taught me that a trader can eliminate a fair deal of chance with a proper strategy in place.

The House *Almost* Always Wins

Ed Thorp is a bit of a role model of mine. I don't think I'm the only one who's been fascinated by his life. He graduated from U.C.L.A. with a B.A. and M.A. in Physics and a PH.D in Mathematics. In 1962 he wrote *Beat the Dealer*, the first book ever published to identify a strategy for beating the game 21. Later, with the help of MIT professor Claude Shannon, he engineered the first wearable computer to beat roulette. With it, they were able to significantly improve the odds of which number the roulette ball would land on.

The gangsters that ran the casinos caught on commendably fast, as you might imagine. After what Thorp described as an attempt on his life with an alleged car tampering, he decided to change course. The casinos of Las Vegas were chumps. Instead, he would take on the biggest casino in the world: the stock market.

After some time, Thorp devised a strategy to buy and sell mispriced warrants (similar to today's stock options) which were issued by public companies. The strategy today is known as the Black-Scholes option. But before Black and Scholes had ever considered such a thing, Thorp was using it to make himself a very rich man.

Looking back on that list of great traders I mentioned earlier, the one thing that they all have in common with one another is that they have a strategy in place that allows them to outsmart the market and eliminate a great majority of chance. Most of these strategies are

for obvious reasons shrouded in a great deal of secrecy, but other facts about these men and the fruits of their trading methods are widely available.

Leaving Nothing to Chance

Let's take a quick look at Thorp's track record. While managing Princeton Newport Partners, he won 227 months out of 230. That's the most consistent track record I've ever seen. His is the track record that obliterates the efficient-market hypothesis (which states that it's not possible to time the markets).

Chance has zero to do with Thorp's portfolio growth over the years. The odds of flipping a coin and coming up with 227 heads out of 230 flips are insanely small, as in 1 out of 10^{63} small. To put that into perspective, the number of atoms in our sun is estimated at 9×10^{56} . It would be about a million times easier to randomly pick a single atom from the sun than randomly generate Thorp's track record.

If that doesn't convince you that the markets can be beat, I don't know what will.

The World's Greatest Investor

For me, there is one particular investor that sticks out. No, it's not Warren Buffett. In fact, his fund has returned double that of Buffett's. He's a recluse, but will occasionally surface for charity work for causes such as autism prevention. His name is Jim Simons, the founder of the hedge fund Renaissance Technologies and the greatest trader who's ever lived. Jim is currently worth \$11.7 billion and climbing. His fund has returned a record 35% per year since 1989 *after* fees. He will likely pass Buffett in wealth in six years. An amazing feat considering Buffett had a 20-year head start.

If you dig a bit deeper into the secrets of his fund, you will see that they use mathematical models to analyze and execute trades. On their website, they are looking to hire programmers to join their group, namely people with Ph.Ds. in scientific disciplines. They are out to recruit a very small subset of the population—people that use evidence to prove or disprove their theories. They aren't out to recruit economists or psychics. They want to hire those with scientific minds.

Hardly anything is known about the strategies that Renaissance uses, other than the fact that they do indeed use strategies that are rigorously tested via computer before applying them to markets around the globe. Even if we did know, the average trader likely doesn't have the raw computing power necessary to identify market trends like Renaissance does.

Thorp and Simons are analytically minded individuals. We simply cannot write off their success as blind luck. Nor is it believable that these men had access to insider knowledge throughout their entire careers. Were that the case, their portfolio's wouldn't be nearly as vast as they are. These men explore a universe of potential asset classes and stock sectors, which is a fact that, as we'll see in the coming chapter, is essential to my own unique market strategy.

Playing the Long Game

Gamblers and traders share a compulsion with one another, and that is to seek out the opportunities that will make them the most amount of money in the least amount of time possible. This tendency isn't endemic to gambling and trading of course—it's human nature to consider the short term over the long term.

For most gamblers and traders, the mantra is "just one big play is all it takes," or "one lucky stroke is all I need to make it big." Frantic day traders think like this *every single day*, and I know this because *I was one of them*. When I started out I was the biggest opportunity seeker in the trading world. A taxi cab driver convinced me I could make a quick fortune selling naked calls on E*Trade. As a matter of fact he sold me my first trading book.

And of course, not once did I think to myself that this book wasn't the real deal. Not once did it dawn on me to ask him why, if this book was really that great, why *he* wasn't in the trading business for himself. If it were that easy, why the hell was he playing taxi driver when he had the golden goose of trade secrets sitting right there underneath all the candy bar wrappers and stale McDonald's fries? No, ladies and gentlemen, not once did I step back and wonder why this guy wasn't a filthy rich millionaire.

Had my Uncle Clarence still been around to hear me tell that little gem of a story, I'm certain he would've died from the subsequent heart attack that it gave him. I hadn't yet figured out the power of the long game. It's the long game that all successful traders look toward. Do you think Warren Buffett made billions of dollars gambling on a few random stock trades? I don't think so. It took him decades to amass the kind of wealth that he has now.

My uncle was an anomaly when he walked into a track full of short-term-minded gamblers. For traders like Thorp and Simons, stepping onto the New York Stock Exchange would produce similar results. But this is exactly how you need to think for my strategy to work. You can't play for the short game anymore. In fact, as we'll see in the next part of this book, my strategy won't even work unless you can back away from the markets and look at them from an objective angle.

Unfortunately, if I had felt like this was an easy thing to do, I would've skipped this entire segment. But all of my previous experience says that the complete opposite is true. I know how hard it is to break out of the habit of trading opportunistically, especially when your money is on the line, and when vast riches seem to hide behind every trade you make.

But breaking the habit is exactly what we have to do. And the only way to do it is to show these opportunities for what they really are: a lot of useless noise.

Eliminating the Noise

The investing world is full of blind alleys and dead ends. The closest comparison to it would be dieting fads, but even that doesn't come close to matching the sheer extent of it. The vast majority of everything you hear in a given day has the shrill ring of coins being poured down a thousand different sink drains. If you had just known this, if you had only heard of

that, if you had just talked to that guy you hate in the office next door, you would have ended the day on a good note.

Diversions are everywhere. Commodity experts blare out stories of riches to be made with shale oil. The “Death of America” mantra seems to seal the fate of gold going to \$10,000. 3D printing is supposed to make China obsolete. Those supposedly in the know will tell you to pay close attention to macroeconomic indicators such as debt to GDP, manufacturing and retail numbers, and quarterly reports. Then there are the chart readers and technicians with thousands of indicators; more than you could spend a lifetime studying. MACD, 52-week new highs, VIX, put/call ratios, cup and handle, short interest, odd-lot selling, insider buying, advancing vs. declining issues.

Make no mistake: most of what you hear will have some truth to it, making your urge to act that much more dramatic.

And that’s just some of what you’ll see on CNBC and Fox Business every morning before the opening bell. In today’s world, the flood of news has reached Biblical proportions. So much is happening so fast you have no choice but to rely on blind instinct. You’d have just as much luck lifting your index finger and singing Eenie Meenie Miney Mo as you would by watching Cramer and the other talking heads.

Behind the scenes, sometimes spilling out into the open, seemingly intelligent people spew forth hogwash about planetary cycles, sun spots, and gravity’s effect on mankind. Biblical codes are cracked, displaying for all the world (for the small price of \$9.99) the entire past, present and future of the U.S. stock market from its inception to Doom’s Day.

How in the world is someone supposed to make sense of it all? How does anyone make any money around here?



Look at the previous graphic. Is this you? Are you like a deer caught in the headlights, unsure of which path to take? Are you feeling like you're over-whelmed by all these competing ideas? Do you go down one path only to have it lead to a dead end? Then you try another...and another...and another? Each resulting in yet another failure?

Since when is the Path to Prosperity Found by Taking **EVERY** Path?

I want you to look at the chart again and tell me something: which of these competing ideas is an actual strategy? Which one will last a lifetime of investing? Which one tells you what you should be doing at all times? Which one answers the question "how much" to invest? Aren't most of them just some fleeting opportunity that once it's done and over, you're back to square one looking for a new opportunity?

From the beginning of your career, you've been led to believe that you that in order to become rich, you must jump on some *opportunity* such as the next breakthrough in medical technology, or the next big tech stock. You've been led to believe that becoming rich is done in lottery-like fashion. That you have to know some trick or secret and get in from the very beginning.

Getting rich is a process, not a one-time event. The most successful investors did not make billions by jumping in early on Microsoft...or by using astrology or gravity to tell them when it was safe to buy. They did it by using *repeatable* processes over a period of decades. None of them – not one – made insane gains like those touted by unscrupulous marketers or misguided dreamers and their 1000%+ gains over a period of weeks and months. But over time, they all went from *average* members of society to extremely *wealthy* individuals. The kind of people that can afford to buy islands, fly in private planes, drive a new foreign sports car each day of the week, and never worry about balancing a checkbook.

When you limit your intake of market news and market chatter, great things are not far behind. First, it clears up your mind and allows you to focus on what matters most: your strategy. Second, it gives you more time to do things that don't involve trading. The great thing about a strategy is that it will do all the work for you. It will tell you what to trade, how much to trade, and when to trade it. A trusted strategy requires an immense amount of thought to develop and test, but once you have it, it's there for a lifetime.

That's a lot of noise we just eliminated, but it wasn't the whole of it. Before we move on into the core strategy, I want to address one more issue that is rampant among traders, and that is their fascination with market theory and market proverbs. We run into this stuff on a daily basis, and it has the tendency to raise decibel levels painfully high. We're going to change that.

Bring your earmuffs. The below section can get pretty rowdy.

Theories and Proverbs Banging Pots and Pans

A few pages ago during the introduction to this book, I pointed out that market theory isn't all that it's cracked up to be. Believers of certain theories can display a level of zeal often associated with religious converts. To these individuals, even if the theory has led them down blind alleyways again and again, they will simply look at the data in a different way to ensure the theory stays "true."

Unfortunately, Economy professors take great pleasure in teaching us all about these theories, and almost no pleasure at all in helping us acquire the critical thinking skills we need to think outside of them.

Case in point: I find it amusing that my economics professor never told me about Ed Thorp while discussing the efficient-market hypothesis. It just goes to show you that a large portion of economists – even those with Ph.D.'s and other initials behind their name – are more engaged with the dogma of the day than they are with providing future traders with tools and strategies that they can use *in the real world*.

Beware looking too deeply into market theory. The patterns that they demonstrate, while sometimes amazingly accurate, are not great candidates for predicting the market. Let me rephrase that: they aren't accurate *enough* predictors of the market. Taking Elliott Wave

Theory into consideration, we can identify a pattern is taking place, but we don't know *when* it will happen or *what stocks and commodities* it will happen to.

Elliott Wave Theory will never make for a solid investment strategy. How do you define the top of a wave count? What is the bottom? How can we apply it to the markets on a daily basis to improve our returns?

The mathematician Benoit Mandelbrot remained skeptical of the Elliott Wave theory throughout his career. "It is an art to which the subjective judgment of the chartists matters more than the objective, replicable verdict of the numbers," he said. "The record of this, as of most technical analysis, is at best mixed."

Even Solomon Would Be Impressed

Market proverbs are another problem entirely. Over decades of trading, investors have coined a number of adages and wise sayings that are supposed to improve our trading game and grant us vast amounts of wealth. Or at least, that's what we imagine they're supposed to do.

Here are a few of my favorites:

"You can't go broke taking profits."

That's baloney, and is responsible for thousands of irresponsible actions. According to a study done by the NASAA, most traders end up taking quick profits like the mantra says, but then they end up taking even larger losses.

"Buy the rumor, sell on the news."

In the information overload digital age, there are just too many rumors floating around for anyone to keep up with.

"The market is a discounting mechanism."

That would assume the markets are rational. People are not rational, therefore markets are not rational. A person's view of the future is often viewed through rose colored glasses. Markets simply reflect human behavior.

"You should be diversified over many industries."

As you will soon see in the coming pages, diversity = mediocrity. All assets can't possibly outperform each other.

"Buy when you can't find a bull."

Sounds like sound advice, especially in a country like the U.S. People thought the same thing about Japan after it crashed.

Problem was it just kept crashing.

“In a bear market, the winner is the man who loses the least.”

Cute, but not if you’re looking at more than just the stock market. Bond traders made fortunes during the 2008 stock market collapse.

That’s an extremely small sample of what I hear on a daily basis. As with any speculative trade, people come up with hundreds of them, and most of them just plain don’t work. A bit of skepticism goes a long way here. And besides, with a proper strategy implemented, you don’t even need them.

Taking a Good, Hard, Objective Look at the Markets

Objectivity matters. And theories and proverbs don’t always lend themselves to objective analysis. Both can be great at capturing our fascination and attention, but, and here’s the main point I’m trying to make, *they don’t make good strategies*.

Strategies don’t try to explain *why* something is happening in the market. They simply take advantage of it. A strategy tells you what to do and when to do it. When we improve strategies, we improve results. On the other hand, when we improve a theory, we only get more theory. Great theories don’t just answer questions, they create all new ones.

Look at it like this: no one stopped asking questions about physics once Einstein’s theory of relativity superseded Newton’s theories of the laws of motion and universal gravitation. As soon as someone figures out a better way to describe the universe, Einstein’s theory will be about as relevant as Newton’s is today.

Your job as a trader isn’t to philosophize about chart patterns. Your job is to throw real-world data into finely crafted strategies and churn out results that you and your clients can actually use. A strategy isn’t going to force more questions on you. It’s going to tell you what to do with all of that data. It’s infinitely better than some professor’s theory or some anonymous proverb when it comes to making you money, which is why I’m telling you right now that *for you, the expert trader*, that kind of stuff is *noise* and you’re doing yourself a huge favor by *eliminating it from your trading game*.

Part One Wrap Up

Part One explained the founding principles for my market strategy. Actually, they explain the founding principles for *every market strategy that has ever made anyone any money period*. You can choose to embrace or ignore my ideas on the coming pages, but no matter what you decide, never ignore what you’ve learned from part 1 of this report. It explains the most common mistakes that new and even expert traders make. Ignore it at your own risk!

Here are the core takeaways for Part One:

- You can eliminate the lion's share of chance from the market by putting in place the proper strategy.
- All of the great traders living today made their millions by crunching the numbers and testing variations of their strategies.
- Great strategies tell you what to trade, how much to trade and when to trade it.
- Trading opportunistically will force you to look at every gleaming object, every press release, and every quarterly report for that elusive "get rich quick" tipoff. If great traders know one thing, it's that there is no "get rich quick" tipoff. It's a fantasy that the average trader wants to believe as true even though it isn't.
- A relaxed investor will always have a strategy in place which allows him or her to "step away" from the market without the dire fear of missing out on the next great trade of the century. The relaxed investor isn't thinking about the market all the time. He's letting the strategy go to work for him.
- Theories, while capable of explaining market phenomenon in a general sense, do not function as true strategies, and should therefore be ignored. Most educated traders are no better off from following these strategies as you are.

Part Two will dive into the core strategy of the report. It will explain what the greatest indicator of the market is, and why that indicator is necessary for the strategy to work. Later on, we'll look at how rotational investing is a trader's saving grace, and why its demise following the 2001 bear market may have been a bit premature.

The Strategy That Has Beaten the Market Since 1926

Back in Part One, we learned that Renaissance Trading uses algorithms and software programs in their strategies to help them identify what to invest in and when to invest in it. While we don't know much about that strategy, we can make a few assumptions. First, we can assume that highly efficient programming is more capable than any human is of rapidly sifting through market data. Secondly, we can assume that such software can pick up on specific signals within the market which help traders decide on when to buy and when to sell.

The techniques used by Renaissance Trading bear a striking resemblance to how the National Surveillance Agency (NSA) gathers data here in the U.S. and across the globe. With its massive computing capability, the NSA can collect and store a nearly infinite set of telephony and internet data. Programs are run across the aggregated data, picking up on patterns that are then used to identify potential terrorist threats. If Renaissance Trading had this kind of computing power behind them, they could very well find the market's golden goose.

The goal of the trader is different than that of the NSA of course. The trader's goal is to understand the collective "mind" behind the market. If you knew the combined minds of every single individual trading in the market right now, you would not only know what the state of the market currently is, you would know exactly where the market *was going to go*.

Unfortunately we can't yet hook up our brains to a mind-reading super computer, so that's out. I don't know many people that have the funds hanging around to hire 150 programmers like Renaissance Trading does, so for all respective purposes that's out too. Nor do I know anyone that has a googol (that would be 10^{100} if you were wondering) worth of hard drive space to store data on like the NSA does. Does that make us helpless in the face of the markets?

Not by a long shot.

The great thing about the strategy that I'm about to show to you is that the only indicator you need to listen to is the market itself. To understand why, you need to think of the market in terms of millions of different individuals, all attempting to outsmart each other with their best guesses. Maybe that best guess came from a quarterly report claiming solid retail numbers. Maybe that best guess was due to so-and-so having insider information which then passed to somebody who knew someone who told Martha Stewart. Maybe Miss Cleo from those psychic hotlines back in the 1990's convinced some poor shmuck to invest his entire life savings into Acai berries. The millions of reasons behind these trades are

limitless, which is why even Renaissance Trading can't produce an army of minute-millionaires.

You may have laughed at some of those trader "investment strategies" I mentioned in the previous paragraph. If you're wondering how you can trust the market to tell you what to do when there are investors that will literally ask their cats for trading advice, you're not alone. Not everyone is going to be close to the true sentiment of the entire market with every trade they make. With such a varied number of attempts, you'd figure that even if we were able to identify the market's "mind", too many weirdoes would have thrown off the average.

But that couldn't be further from the truth.

The Law of Errors...And Bean Counting

In 1987, economist Jack Treynor held a jellybean counting contest for his students. He asked his undergraduates to guess the number of jellybeans in a clear glass jar he had placed on his desk.

At first glance, you'd think that these novice jellybean counters would be way off the mark with their guesses. And you'd be right. In fact, while a few guesses came close to the mark, most were wildly far flung from the real number of beans in the jar. Out of a total of 850 beans, the guesses ranged from 500 to 1300. Perhaps it would have been best to hire a professional jelly bean counter to do the work for the students.

But as it turns out, a professional didn't have to be called in. When Professor Treynor averaged up the student's guesses, the number came out to 871, just 2.5% from the actual answer of 850. Despite so many guesses being completely off the mark, the combined average of all guesses came extremely close to the true answer.

More experiments were undertaken to see whether expanding the pool of participants would improve the average. Sure enough, that's exactly what it did. With each and every new guess, the chances increased that the combined average would get closer to the true number of jellybeans.

As for those experts, a few people showed off a serious natural ability as bean counters. However, not a single person could consistently beat the average guess over more than a few experiments.

The above experiment is another example demonstrating what is known as the law of errors, which, some 200 years prior, was established in the field of astronomy as a means to account for the diverse number of observations by different people of the same star. On averaging out these observations, it was found that the most precise location of a star took into account not one star gazer, but many.

As Louis Menand put it in *The Metaphysical Club*, "the law of errors quantified subjectivity."

The Law of Errors in a Social Environment

In Scott Page's book *The Difference: How the Power of Diversity Creates Better Groups, Firms, Schools, and Societies*, the central idea revolves around what he calls the diversity prediction theorem. The theorem states:

Collective Error = Average Individual Error – Prediction Diversity

Page went on to state with numerous examples that the more diverse a group in their guesses, the closer to the actual answer they would come. A diverse crowd would predict better than any one individual in it.

As we already know, the social ecosystem that is the market should be looked at as the sum total of all the guesses of every trade throughout the day. But as you might have already noticed, there's a problem with using jelly beans (and on a similar note, stars) as a comparison to the market, and that is that a bunch of jellybeans in a jar is a static number with a single right answer. Markets, on the other hand, have a trajectory that is constantly on the move. Unless we can apply our law of errors to a moving market, it's of no use to us.

Seeing the Market through a Glass Jar

Imagine you're a father and you take your little girl to a state fair. She's practically pulling your arm out of its socket. She's begging you to take her over to the ring toss. She wants to shoot BBs at a line of moving ducks. She's itching to throw a baseball at a pyramid-shaped stack of cans. And the whole time you're telling yourself "these games are *rigged* by a bunch of dirty *conmen*. At best they're all luck and no skill."

But it's your little girl, so you (a little grudgingly) appease her. Conmen 1. Dad 0.

And then you see it. Some clown lifts up a sheet that was covering a giant jar of jellybeans. The crowd swells. Everyone's itching to have a go at it. Every man, woman and child there believes, by some trick of the mind, that they have better jellybean counting abilities than anyone else. And they're about to prove it.

You and your little girl find a spot near the table where fair-goers are taking turns writing down their name and their guess. At the same time, you pull up the calculator on your smartphone and start furiously adding up the numbers, making sure to keep track of how many people are guessing. The crowd is so big it takes half an hour before everyone has placed their bet. Of course, you're the last to go, and as you write down your number, not even the clown's painted-on smile can rival your own.

The crowd quiets down while the clown goes through the list. His finger points at one number, then a different one, then another, until finally, at the very end, that clownish index finger rests right there at the bottom.

He calls your little girl's name.

She squeals with delight. Hell, you squeal with delight! You've never won a fair game in your life. As that clown comes up to you with the grand prize, you feel like you're being crowned king of the state fair.

Well played, you sly dog you! I bet you feel like Ed Thorp pocketing thousands at a Vegas blackjack table. You just pulled a fast one on the guys that were trying to pull a fast one on you! Hell, you pulled a fast one on the entire crowd! Now you get to haul around a six-foot-tall stuffed panda bear for the next hour. But you could care less, you're all pride.

The Paradox of Investing

Back in Part One, I briefly mentioned how taking a step back from the market and looking at it from an objective angle is essential for my strategy to work. This is easier said than done when our passions get in the way. Money acts a lot like a drug, and if you're still jumping at every opportunity, the strategy will fall apart.

The fictional dad in the story above was doing something very different from everyone else. He remained an observer until the very end. He understood that the crowd would tell him everything he needed to know. And he was right.

The same idea applies to the market, only in our case, the aggregate guesses are dynamic and on the move, and we're observing them as they move along an unknown trajectory. However, we can make educated guesses about that trajectory simply by observing what everyone else is doing.

Let's put it this way: as more information flows into the market, the average guess of the crowd will either be to buy what is going up, or sell what is going down. It stands to reason that if I want to be in a stock that will go up over the next month, it will already be going up.

We all digest information differently, and none of us digests the same exact information in any given day, but by observing the aggregate total of all guesses, we can quickly identify everything we need to know about what to buy. I'll prove this later in the report with an experiment going back to 1926, but I want to say it right now: Buying what is already going up is the key to successful investing. But the reason you can trade this way is an incredible paradox.

In order to beat the crowd, you must first excuse yourself from what the crowd is telling you to do, and then turn back around and let the crowd tell you what it's *actually* doing. By objectively measuring price behavior, the crowd will tell you everything you need to know about where you should actually be investing your money. Strange as it might sound, in order to beat the crowd, you must analyze the crowd. You just need the proper tools to listen.

If you were to think this through step by step, the implications are pretty clear cut. A stock, or a commodity, or a bond, or real estate, or whatever is traded by human beings will already be going up on its way to going even higher. In William O'Neal's book *How to Make Money in Stocks*, he talks about the fact that the largest winning stocks all had to rise in order to get to their peak levels. A stock that went to 100 had to cross 50, right? This is a

self-evident fact that is easily overlooked, but to beat the markets, it's essential to keep in mind.

What Goes Up, Keeps Going Up

Imagine if we applied our new-found knowledge to the stock market. We would only invest in those stocks going up. But there are thousands of stocks that could potentially be going up. We can't simply invest in thousands of stocks. We have to come up with some sort of a filter that tells us *what* stocks to buy out of the thousands of upward-trending stocks.

To make this example as simple as possible, let's assume we would invest in the one stock going up the most, and we would place our "bet" in this stock over the next month. For better or worse, you would hold the stock until the start of the next month where you would again calculate which stock was the highest percent gainer.

If this strategy sounds familiar, keep reading. I'll go into much more detail about what it is in the next segment. For now, just understand that we're always pinpointing the highest percent gainer and holding for a set period of time.

In this simplified example, that one month holding period is important. A period of a month is long enough to take advantage of a strong market trend, but not so long that it would drag down our portfolios in a downswing. I've experimented with a number of different holding periods, and you should too. However, once you settle on a holding period, it's important to keep to it. We're no longer trading in a reactionary, opportunistic way. If what you're holding hits a bump midway through your holding period, stay the course. *This is essential for my core strategy to work.*

Rotational Investing, with a Twist

At the very start of this report, I said that my dear Uncle Clarence had introduced me to the biggest breakthrough in my career. I can sum it up with an analogy:



Imagine if you were able to keep betting on the lead horse as it goes around the race track. As one horse takes the lead, you move your bet from the old leader to the new one. You do this over and over as the horses round the track. You would win every time.

No race track in the world is going to let you have such a lopsided edge over them. They would be dead broke in no time. Yet the markets of the world have allowed it to happen for decades. After going back 87 years, I believe that the edge I'm going to reveal to you today

has possibly been there since the dawn of markets...of which evidence I will show you later in this report.

What I'm describing to you here is rotational investing, and no, I'm not the first person to come up with the idea. In fact, I remember hearing about it in a newsletter designed to switch from sector to sector in Fidelity sector funds each month, using the equivalent of the horse racing strategy I just outlined. You would simply track which sector was in the lead by its recent return over the past few months and *viola*: reliable, steady returns.

Back then, it was easy to place your money with Fidelity or another mutual fund company, and they wouldn't even charge you commissions. They made their money from charging a management fee.

You could invest in everything from auto companies to real estate to software companies. It seemed like a really neat idea to me, and it made a lot of sense. The problem was that the strategy was fundamentally flawed. Due to lack of sufficient testing and a glaring hole in the model, it lost a great deal of money in the 2000-2002 bear market. I'm sure it would have been worse in 2008, but that newsletter no longer exists. Like many others, it's ended up in the scrapheap of newsletter despair.

The original idea of rotational investing failed because it was an incomplete strategy. It misled people into thinking they were safe in stocks alone. As you're about to see, rotational investing is the key to incredible rates of return throughout your trading career. But first, it's important to understand where it works, and where it doesn't work.

How to Invest with a Rotational Investment Model

In an earlier, simplified example of rotational investing, we looked at replacing a stock with the highest gains in one month with a stock that had the highest gains in the next month. Now let's take that step further because as you know, holding one stock is mighty dangerous. A couple of large shareholders could snap that stock's back in an instant if there were a sudden change in what they deemed important about the company. If you're holding Enron and Enron alone when the crap hits the fan, your portfolio is toast.

In order to understand how to invest with a rotational investment model, we need to look beyond rotating just a few stocks. This of course brings up the question: what *do* we look at? Dozens of options exist in the U.S. market alone, a few of which seem viable for our rotational investment strategy. Mutual funds, ETFs, stock options, forex...does one outdo all the others?

For our decision to make sense, we need to look at these options by considering three critical factors: freedom, diversity and ROI. We already discussed the first factor. If the fund option is too expensive to make changes to every month, or there are restraints on how often we can move our assets, it isn't going to do us any good.

The second factor, diversity, is important for reasons that we'll be discussing in Part Three. For now it's simply important to consider what fund options allow for a diverse set of asset holdings such as stocks, bonds, commodities and foreign assets.

We'll go into details about the third factor in Part Three as well. To paraphrase, we need to find a fund option that brings in great returns by outperforming the market month after month, all while avoiding heavy volatility and unnecessary risk.

Let's take a look:

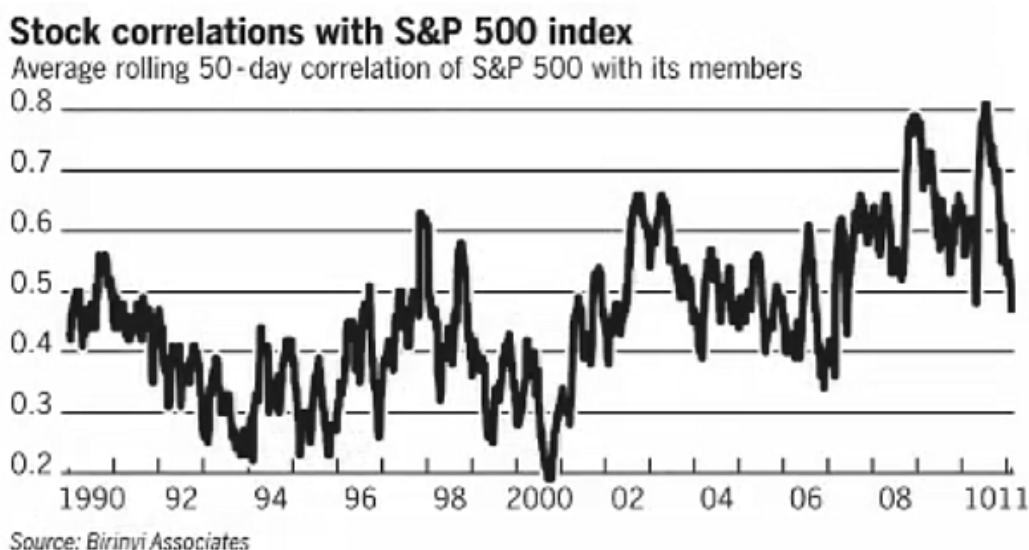
- **Mutual funds:** I don't like mutual funds for trading in 401Ks because most people can't trade more than every 90-days. In other cases they have your money locked up tighter than an inmate at Ft. Knox. Some mutual funds allow trading slightly more often, but who knows if their restrictions will get worse.

Even low-fee mutual funds such as Fidelity are a no-go for me. I don't recommend them because crooked investors that came before you already spoiled the party. There was a time when you could make a trade without any fees. Then came the bribes and the front running and an act of Congress. Again, most funds only let you switch between funds once every 90-days. They will charge you a huge fee if you trade more often. The Relaxed Investor strategy and its rotational investment model doesn't work with 90-day switching. It's too long a holding period.

As far as returns go, mutual funds aren't amazing. At best 401Ks are going to make you average. They were created to make it as easy as possible to get started with investing. Most employees are simply handed a piece of paper and sign their name. Little if any thought goes into choosing even the few options in a 401K. For most, this means they are paying have someone split their money 60% in stocks, 40% in bonds. This keeps Average Joe's retirement safe and sound, but we want more out of our strategy.

- **Options on ETFs or stocks:** Don't do it! I know everyone wants to get wealthy fast, but you'll just end up blowing out your tiny little account. We're no longer opportunistic traders jumping at the first sign of rising stocks and bonds. Besides, most of the supposed gains here are all smoke and mirrors. This is not the way to go if you want to be a relaxed investor.
- **Futures:** I trade futures. I have no problem with them at all. They do require much larger accounts to trade the relaxed investor method. A high 6-figure portfolio would be required because you don't want to maximize your use of leverage. You would also lose the diversity of trading sector funds, which would lead to a lower return to drawdown ratio (MAR). Not to mention the fact that you have to roll your contract into a new one every so often.
- **Forex:** Don't even go there. It's the Wild West. The brokers are out to get you. They often trade against their clients' accounts. Avoid. By the way, the relaxed investor strategy does not work with currencies.
- **Stocks:** Stocks are great. They allow plenty of freedom and can provide great returns. The problem is that they aren't diversified enough. If you've been trading over the past decade, you've seen your fair share of bear markets. You might have noticed that when things are getting really bad, all stocks seem to go down together. Looking at a universe of stock sectors might seem like a robust strategy, but not when they all move together

in sync. As you can see from the chart below, stocks in the S&P 500 were 80% correlated to each other at the height of the 2008 bear market. Holding just about any basket of stocks would have murdered your account.



It's for this very reason that we need to be careful of investing in stocks alone. I'll go into even more detail about this in Part Three.

- **ETFs:** ETFs trade just like a stock, so you can simply setup a brokerage account to trade them. You can trade them in a margin account, tax deferred account, or a simple cash account just like you can with stocks. They pay dividends most of the time. ETFs are amazing these days because you can also buy a basket of stocks just about anywhere in the world. For example, if I wanted to buy a basket of stocks in the Philippines, I would simply buy the ETF with symbol **EPHE**.

There are two drawbacks to trading ETFs. First, they are managed by a team of people, so they charge an expense ratio. Most are in the 0.15%-0.6% rate per year, so they are extremely competitive with mutual funds. The expense accrues on a daily basis, and is deducted from the fund's average net assets.

Here are the expense ratios of the ETFs I discussed in the 19 ETF portfolio of U.S only ETFs.

ETF Symbol	Description	Expense Ratio
IBB	Biotech	0.48%
IEF	7-10 year U.S treasuries	0.15%
IYR	U.S Real Estate	0.48%
JNK	Junk bonds	0.40%
SHY	Short-term U.S bonds	0.15%

SMH	Semiconductors	0.35%
TLT	Long-term U.S bonds	0.15%
XHB	Homebuilders	0.35%
XLB	Materials	0.18%
XLE	Energy	0.18%
XLF	Financials	0.18%
XLI	Industrials	0.18%
XLP	Consumer staples	0.18%
XLU	Utilities	0.18%
XLV	Health Care	0.18%
XLY	Consumer Discretionary	0.18%
XME	Metals and Mining	0.35%
XOP	Oil and gas Exploration	0.35%
XRT	Retail	0.35%

The stock ETFs are made up of a basket of stocks. For example, the metals and mining ETF, XME, holds 40 stocks such as AK Steel, Alcoa, Nucor, Newmont Mining, and Royal Gold.

The bonds ETFs are made up of baskets of bonds of varying expirations. If you were to try to replicate these ETFs, you would need to have a much larger account. I am very thankful that we live in an age where it's so easy to allocate capital around the globe.

I said there were two drawbacks to ETFs. The second is not a problem for those with smaller accounts, but it does affect larger fund managers: Liquidity. Some ETFs have very low trading volume. Just trading a few hundred shares could cause you to get bad fills, which is called slippage. As a budding fund manager, it's your job to reduce slippage as much as possible. With each ETF you trade, take note of the size of the bid and ask. When your account becomes larger, you might have to split up your orders a few seconds or minutes apart. Again, this is not a big deal for those with less than \$500,000 usually.

Trading tip: If you're trading on the open of every new month, you should aim for getting filled on the order first thing. Markets DO go straight up. Those waiting with their hands in their pockets are often rewarded with bad fill prices. To facilitate things, I hired a programmer to come up with trading signals which look for those big moves early in the morning, and then hop on in anticipation of even higher highs. It takes advantage of those waiting around for a pullback because they eventually take the market higher and higher. Never forget that. Sure, you'll often be rewarded with patients, but those little gains will be sacrifices in one fell swoop when you get a runaway market.

Still, even accounting for their drawbacks, investing with ETFs is one of the best options available for the strategy that we're using, as you'll see in the coming pages.

Part Two Wrap Up

My goal for Part Two was to lay the groundwork for the relaxed investor strategy. As investors, we should be able to explain, at least to ourselves, why we've chosen one strategy over another. It's only by having a strong understanding of our methods that we can improve and optimize them.

Here are the core takeaways for Part Two:

- By using the law of errors to our advantage, we can engineer a strategy that uses a single key indicator, the market itself, to tell us everything we need to know about the market.
- Buying what is already going up is the key to great investing. However, unlike other investors that buy what is going up because of a piece of information or a hunch, we're buying it because we know that the market will bring it up for us. The average guess of the market will be to buy what is going up and sell what is going down.
- Since the asset with the strongest showing won't stay strong forever, we need to rotate our assets so that we're always invested in the highest percent gainer. This is called rotational investing.
- A proper holding period for a rotational investment strategy is essential for it to work. If it's too short, we're not taking advantage of the crowd's buying wave. If it's too long, we risk a downturn that could wreak havoc on our portfolio. A period of about one month has worked very well for me, but I invite you to test out other options.
- Understanding what kind of fund option to use will greatly increase your chances of producing great results with a rotational investing strategy. Some options, such as Forex, doesn't work at all with such a strategy. Others, such as mutual funds, force us into holding periods that are too long. And while stocks and potentially options may give us great earning potential in theory, if the market tanks we're out of the game. ETFs on the other hand allow for solid returns, diverse holdings and enough freedom to enter and exit when we need to.

I mentioned before that a rotational investment model failed because it was looking only at one asset group: stocks. In Part Three, I'm going to explain how this strategy, with the proper additions in place, could have saved investors hundreds of millions of dollars in the 2001 and 2008 bear markets.

The Relaxed Investor Strategy Explained



Figure 1: Black Monday on the New York Stock Exchange

History is rampant with speculative bubbles and their subsequent corrections. As more opportunity seekers watch prices climb every higher, they too pile on in a bid to cash in on prosperity. This goes on until inevitably...

Crash.

When speculation is rampant, so is passion. Traders see money for the taking and dive in, expecting to become filthy rich. When the correction happens, the mood can turn hysterical, and objectivity flies out the window.

The history of bubbles is an amazing story in and of itself, and unfortunately I can't go into any great depth on the topic without turning this report into a text book. But a couple of examples seem worth mentioning here, starting with my favorite of all time, the infamous Tulip Mania of the 1630s.

As the popularity of tulips and their varieties exploded in the Netherlands, the demand for tulip bulbs began to skyrocket. The fact that prices on such bulbs were rising was enough to fuel the original speculative bubble. Eventually people realized that tulips were plants and that supply was practically unlimited, hence the rather severe bust cycle.

As a reminder of human being's opportunistic behavior, I acquired this painting of a chart of tulip prices. You might have seen it in Gordon Gecko's apartment in the movie *Wall Street: Money Never Sleeps*.

The Bitcoin Bubble

As I write this, I suspect the next bubble will be in Bitcoin, an alternative and internet-based worldwide currency that is known for its wild price fluctuations. Instead of being seen as a currency, schemers and opportunistic traders constantly follow it in hopes of getting rich quick. Human nature, and human gullibility for that matter, hasn't changed a bit since 1637.



It goes without saying, but as traders that aren't dealing in fast opportunities and get-rich-quick schemes, we can't risk being caught up in a bubble. But then, that's easier said than done, right? Haven't I just told you to always buy what's going up? How can we avoid the ultimate pop when we're the ones buying into it?

The Magic Forgotten Formula

I mentioned before that the great flaw of rotational investing was that it didn't look other potential assets outside of the U.S. stock market. If we look back to my original example of horseracing, if you choose the "lead horse" in stocks, and the stock market takes a major tumble, you're going down with it no matter what you do.

But what would happen if we included not only stocks, but commodities like gold, oil and grains? What about adding treasury bonds, junk bonds and t-bills? Heck, why stop there? Why not include stocks and bonds from outside the country?

Imagine for a second that the world had just one very big market, and that market acted like a giant balloon. If you press on one part of the balloon, the air inside simply goes to another part of the balloon. Money never sleeps. It goes where it's most welcome, and when it disappears in a flash from one area, it's always somewhere else.

Our metaphors regarding market bubbles "popping" are entirely misplaced. When speculation drives up prices, and an ensuing bubble implodes, the entire world market doesn't implode with it. The only reason we have to fear a bubble is if we aren't looking at a wide enough range of assets. Taking the assets of the entire world into account, even if a serious depression hit, there would be safe havens to invest in around the globe.

This, to me, was a concept that had all the makings of an incredible strategy. But before I could just blindly trust my judgment, I had to test my theories. I decided to go back as far as I possibly could with data that not only included stock indexes, but t-bonds, corporate bonds, and the "risk-free" rate as Ed Thorp and Black and Scholes all described it—T-bills.

I'll get back to T-bills in a bit because they are the glue that holds this strategy together, even with baskets of stocks as you'll soon discover.

The Six Major Asset Classes

While I could find a great deal of data on commodities and stocks going back to the 1970's, I was not happy. I wanted to go back further than any other study I had ever seen on this unique strategy. Plus, as you'll see, I wanted to add my own unique twists. As it turned out, there was a book available on eBay for a tidy sum that had quotes all the way back to 1926 for six major asset classes.

- 1) Large cap stocks
- 2) Small cap stocks
- 3) Long-term government bonds
- 4) Intermediate-term government bonds
- 5) Long-term corporate bonds
- 6) U.S. Treasury bills

I felt like I had both won the lottery and taken a baseball bat to my head when I won the thick tome on eBay. I realized not only that I had paid a small fortune for this book, but that there was no data CD for all those quotes. I would have to transcribe nearly 90 years of data by hand. Luckily, I learned years ago that there is no shame in hiring someone else to do the hard work, and my assistant did a great job turning the printed data into a spreadsheet. After two rounds of error checking, we were all set for the test.

In this first experiment, I simply looked back at the past performance of each of the six asset classes over the past 12 months. Whichever asset was up the highest percent in that amount of time would be the asset we invested in over the next month. We would buy at the start of the new month, and then we would repeat that process every month throughout the entire experiment to see what to invest in next. No trading frictions were assumed for the tests. Profits are reinvested. Here are the results:

The Relaxed Investor

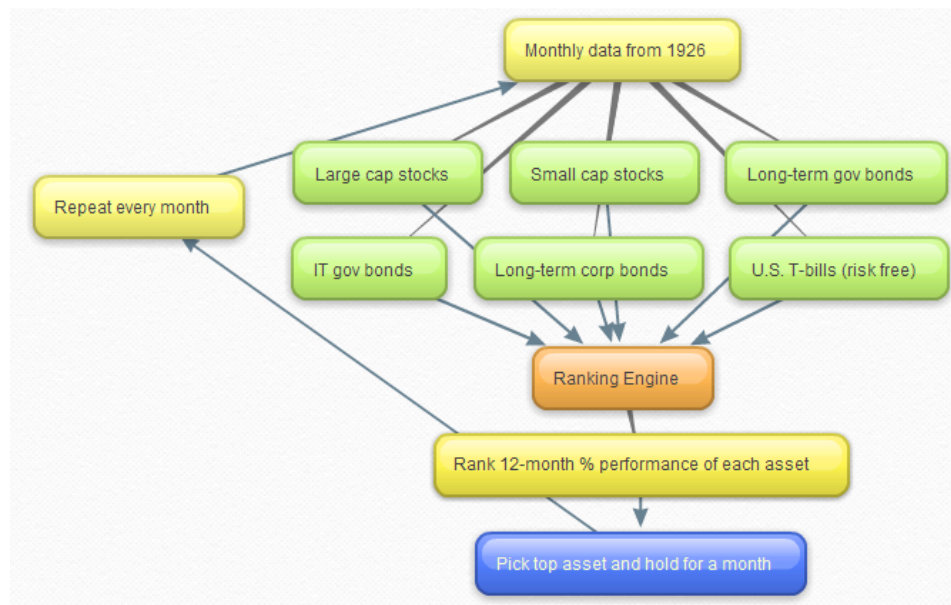
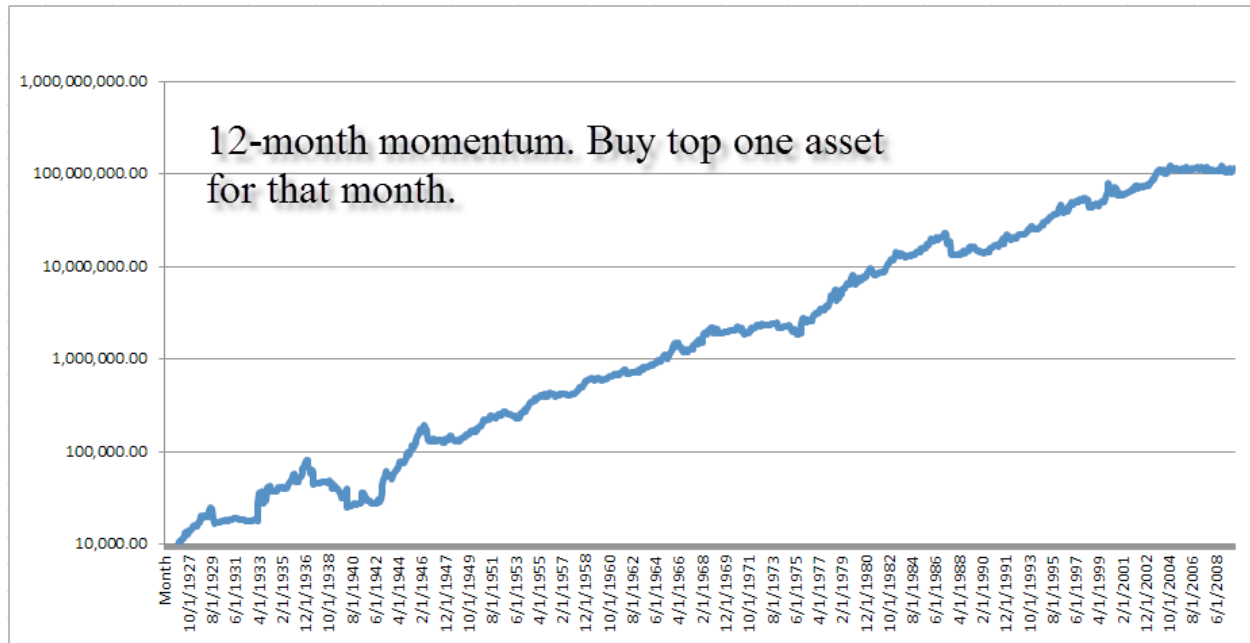


Figure 2: Mind-map of simple asset rotation model

This simple, yet effective strategy appears to have great merit as \$10,000 turns into \$112 million—an 11,200 fold increase. That's an 11.3% year-over-year growth rate for 87 years. It doesn't take a high rate of return to generate amazing growth. Those that want to make all those gains at once will never make it past seven figures. I will tell you this to entice you. I will show you how to double those gains in the pages ahead.

Warren Can Take a Big One, Can You?

Now it would be a big mistake to look at only the raw profits from this strategy. What is even more important than how much the strategy makes is how much it loses. I want to know the worst drawdown in the experiment's history. A drawdown is how much a portfolio goes down from its peak to trough. If you're Warren Buffett, you can stand a 60% drawdown like he took in 2008. I however get really stressed if my portfolio is down more than 25% these days.

Our experiment shows a 68% drawdown in the deflationary 1930's. However, one thing I must point out is that using "12 months" as the test's only input was completely arbitrary. I could run the numbers and perhaps find a better month.

In the next experiment I decided to try to smooth the data even more by buying into the top two performing assets, along with weighting two different time periods – one month and six months as you can see from this mind-map:

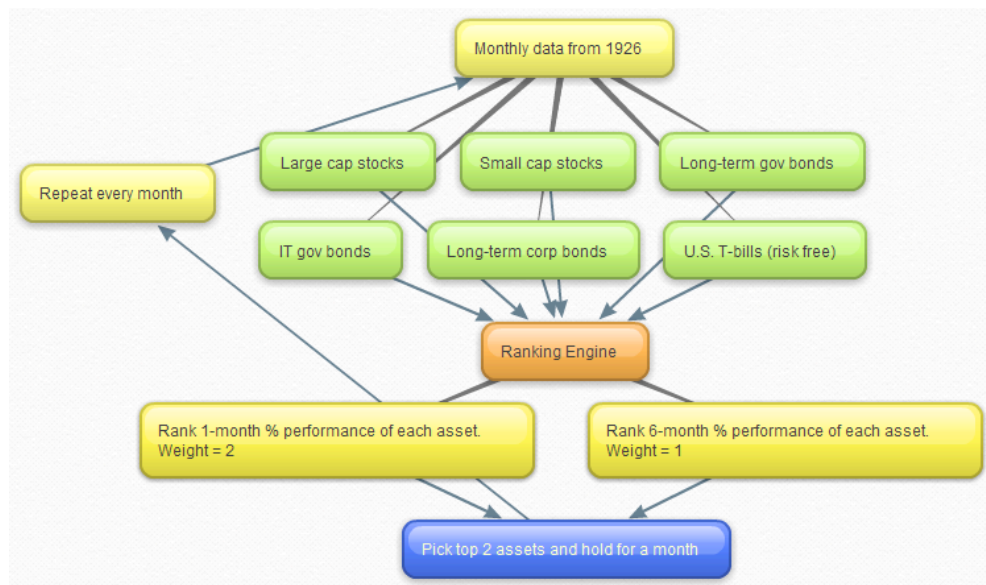
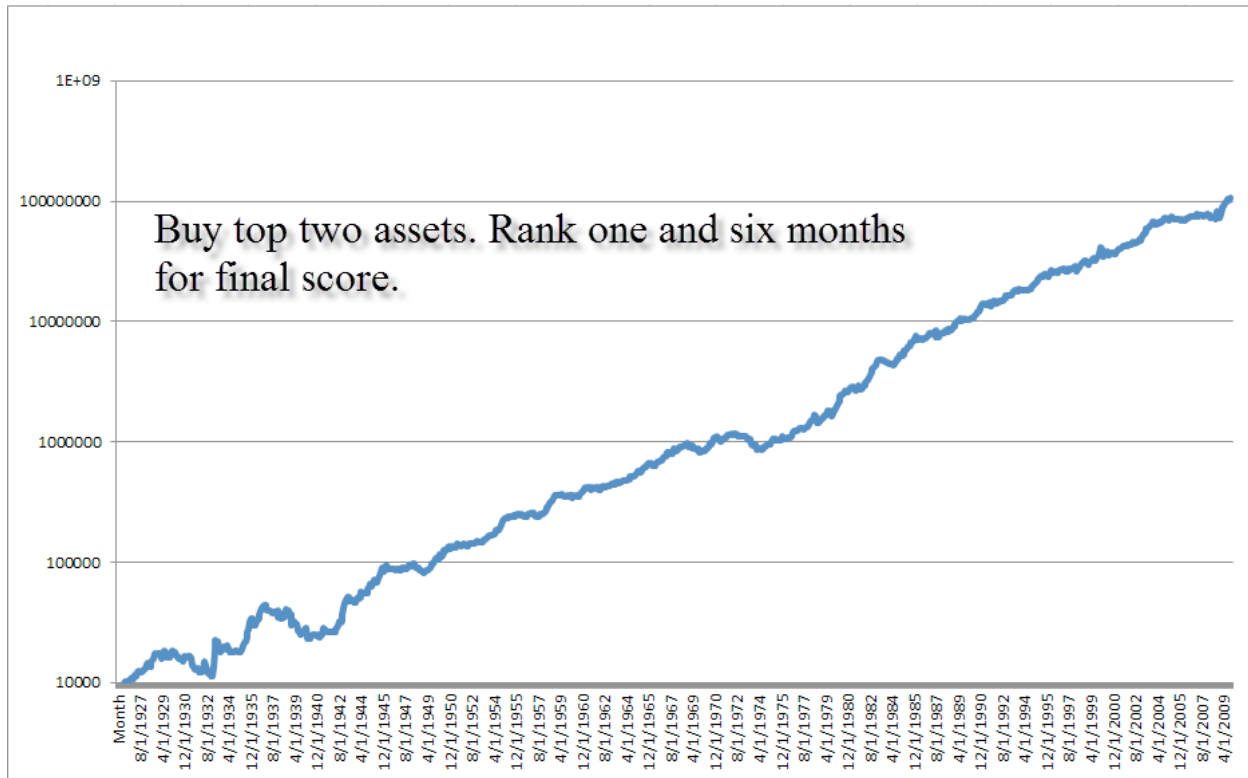


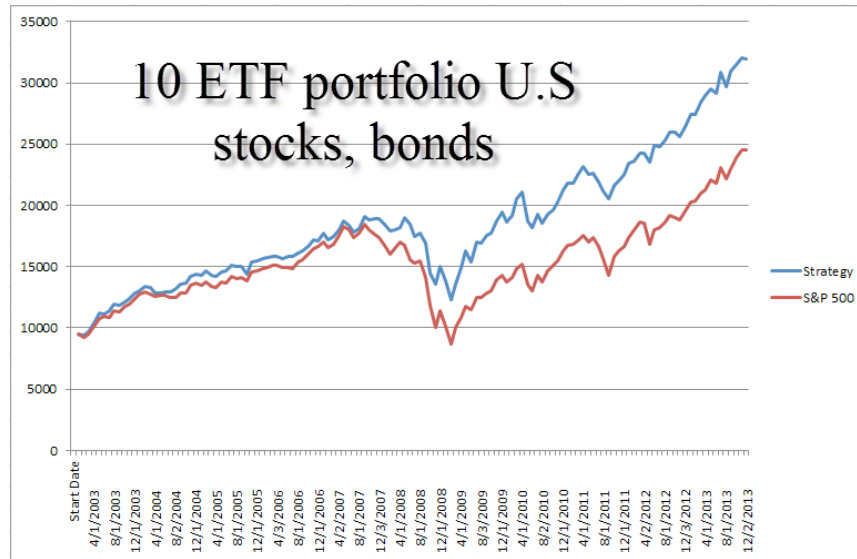
Figure 3: Mind-map of rotational model with top two assets



As you can see by the chart above, the equity curve is considerably closer to a straight line with the added diversification and performance weights.

Diversification is a fine line however. Most traders and the “experts” that teach them say that you should be as diversified as possible. Entire television shows are dedicated to telling their audience whether or not they’re diversified enough. I would argue that *the universe of assets that you look at should be as diverse as possible, but what you actually own should be only minimally diverse*. Combining those details with the fact we’re only investing in what has already gone up is about as polar opposite as you can get from Cramer and the other talking heads.

Here’s a great case in point:



The chart above trades **19** U.S. stock sector and U.S. bonds using exchange traded funds (ETFs) holding a “diverse” basket of the top ten ETFs. The strategy performs significantly better than buying and holding the S&P 500, which is a broad measure of the top 500 stocks in the United States.

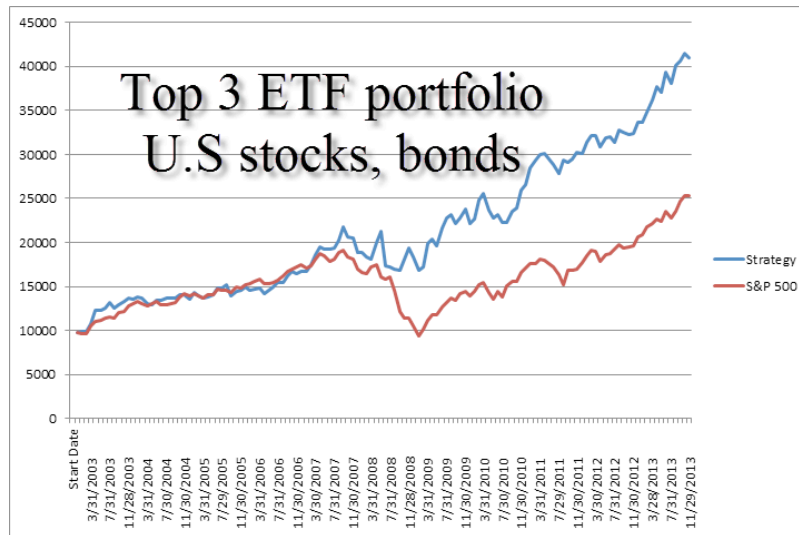
Here’s is a list of the 19 ETFs used in the tests:

ETF Symbol	Description
IBB	Biotech
IEF	7-10 year U.S treasuries
IYR	U.S Real Estate
JNK	Junk bonds
SHY	Short-term U.S bonds
SMH	Semiconductors
TLT	Long-term U.S bonds
XHB	Homebuilders
XLB	Materials
XLE	Energy
XLF	Financials
XLI	Industrials
XLP	Consumer staples
XLU	Utilities
XLV	Health Care
XLY	Consumer Discretionary
XME	Metals and Mining
XOP	Oil and gas Exploration

XRT	Retail
-----	--------

Top 3

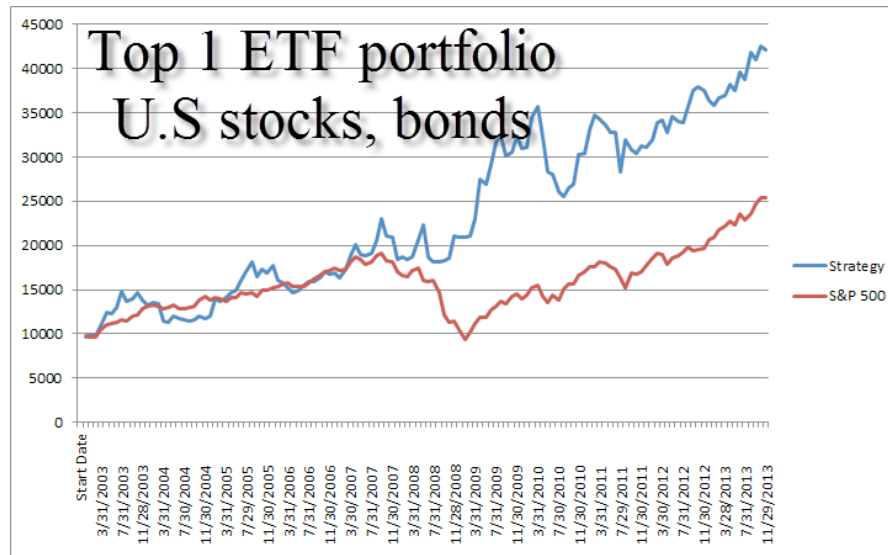
For the next study, let's go contrary to conventional wisdom and test the same strategy with only the top three ETFs:



Now we see significant outperformance of the S&P 500 benchmark, as well as significantly smaller drawdown as compared to the ten ETF portfolio. Clearly theory and reality are colliding here, with reality taking the winning spot.

Top One or Top None?

There does appear to be a conundrum of sorts. Because if you use only the “top one” strategy, the results are very erratic, yet profitable on every test I’ve done involving a broad set of ETFs. It’s as if there is a Goldilocks scenario where too many assets result in lower returns and higher drawdowns, and too few assets result in sometimes higher returns with higher drawdowns. But a certain percentage of the universe of assets you’re looking to invest in is “just right.”



Let's now go back to how I originally introduced this strategy. I had heard about something similar being used on Fidelity sector funds. At first, the strategy was very successful, but it fell apart during its first look at a major bear market. I will now explain the secret ingredient it needed in order to survive. This strategy would have likely saved investor hundreds of millions.

As you now know, selecting the top stock sector and holding for a month is not a savvy strategy. When the stock market falls apart, the entire house of cards tends to crumble. The best stocks turn into the worst stocks, and the worst stocks perform even worse. It's often a race to the bottom.

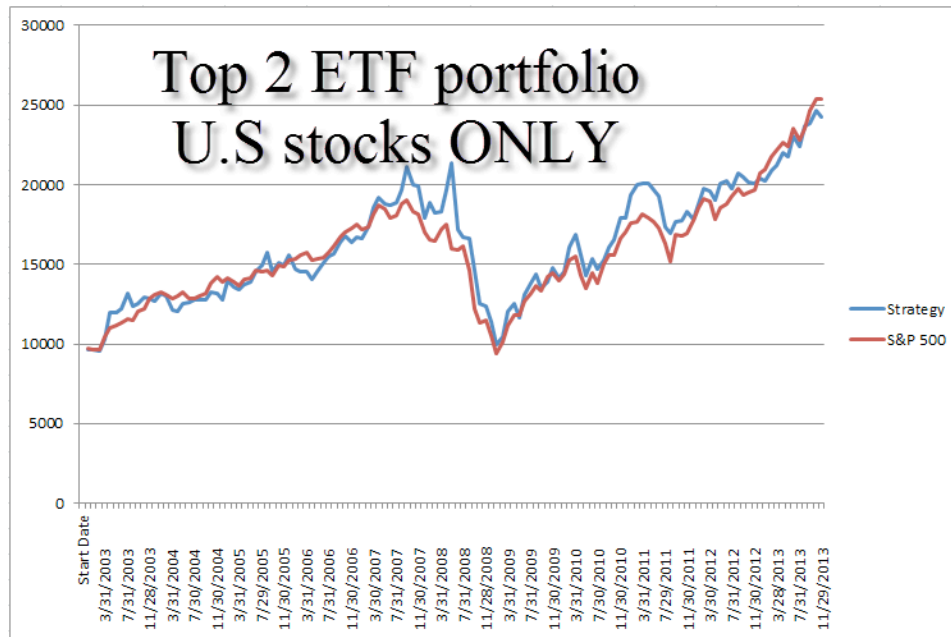
The Risk-Free Filter

Let's come full circle with our discussion of famed hedge fund manager and my neighbor here in Newport Beach, California, Ed Thorp, who originally discovered the Black-Scholes option trading model years before they published their work. He was busy making money with the formula while the academics were trying to make a name for themselves. Well, to each his own!

In the formula, it is assumed that stocks grow at a risk-free rate of return of the 13-week U.S T-bill. As I write this, the T-bill is the least risky asset in the entire world. If the U.S should lose its prized hegemony, then the risk-free rate would likely be calculated by the next superpower's short-term T-bill rate.

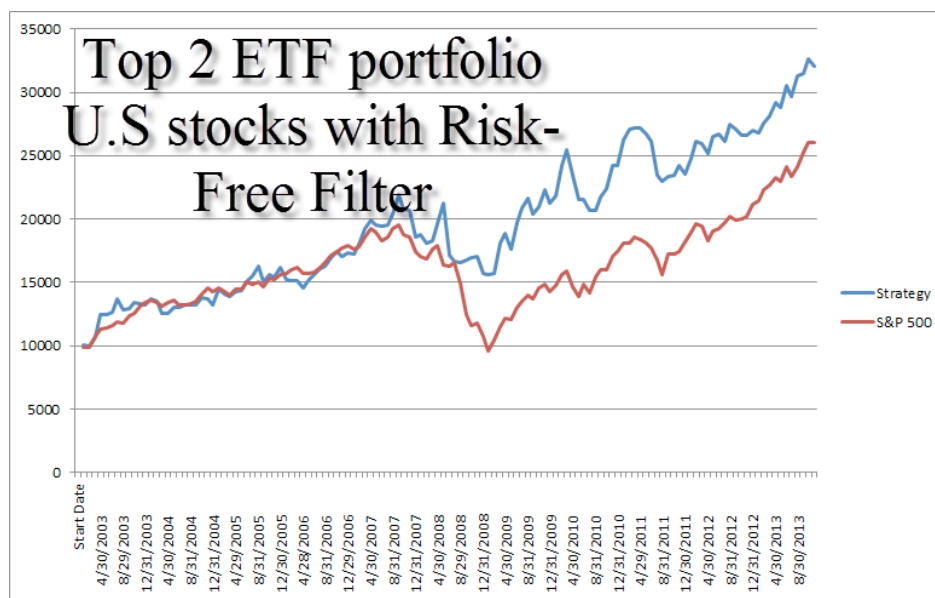
T-bills have hardly fluctuated since the 2008 bear market. If you look at its volatility over the past 87 years, it is by far the lowest of any other asset class. When times get tough, you want to be in safety. When happy days are here again, you want to be invested in more risky assets like stocks.

In the following chart, I show the “top 2” strategy of investing in the U.S stock sectors only. Fifteen of the nineteen ETFs I showed earlier are stock sectors. Here are the results:



Suddenly, the edge disappears. The total drawdown is on par with the diversified S&P 500 at the depths of the 2007-2009 bear market – 56%! A strategy without an edge is like a car with no breaks.

Now let’s throw out a life preserver and save this strategy. What if we include the performance of U.S T-bills every month to the mix? If the stock sector doesn’t outperform T-bills, we invest in the safety of T-bills instead. Here is what we end up with:



We now see a higher rate of return and worst drawdown cut nearly in half! Clearly this is the one step that could have saved all those investors who myopically chose to invest in stocks and stock sectors instead of the safety of the risk-free rate of return when times became more desperate and 80% of stocks began to sink lower in unison.

I hope your wheels are spinning here, because I just gave you the perfect filter for getting out of the stock market when your positions are misbehaving. Even if you don't choose to use this particular strategy (although I don't know why you wouldn't considering the rigor of testing), you can still draw your line in the sand.

If your stocks are performing worse than T-bills over a period of time (such as one month and six months as used in the previous examples), sell 'em and get into T-bills. The added benefit of this kind of approach will be that you only buy into stocks or sectors that are already going up. The edge there is tremendous. Use it.

Here's an example for die-hard stock trading fans: You can use a basket of stocks such as the NASDAQ 100 from which to trade the top 5 stocks. You rank them as I've described, then rotate into the new top 5 each month. Use the Risk-Free Filter to get out of your stocks and into T-bills when your stocks are ranked worse than T-bills.

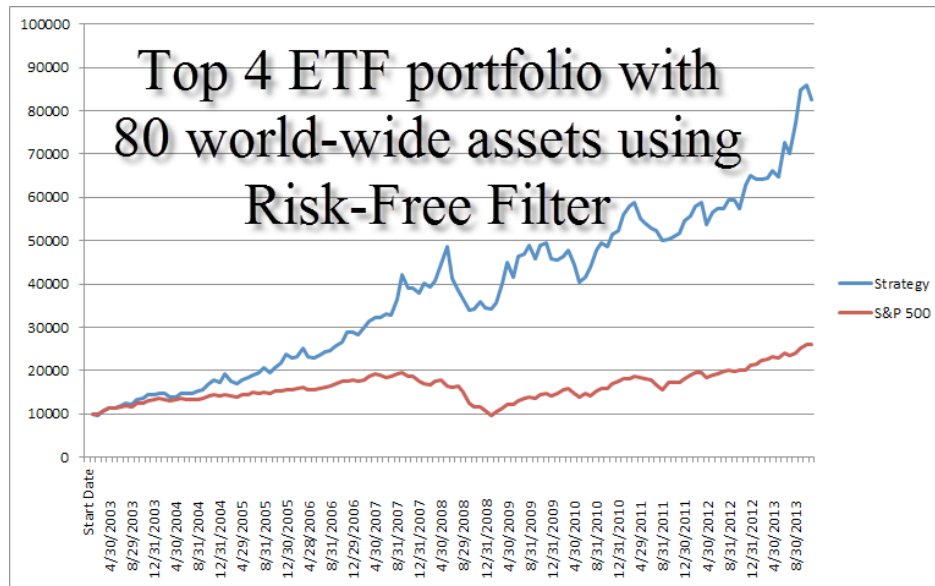
As you know, using such a trading method for stocks is not the route I went by, nor do I suggest it because there are many more options for trading profits when you look around the entire globe. The gains – and more importantly the losses – are more stable.

Four Major Ideas

Now as I mentioned earlier, the larger your universe of assets, such as bonds, stock sectors, foreign stock markets, commodities such as gold, oil, or even uranium...the higher your returns and the lower your drawdowns will be. I've run hundreds of experiments, and they all point towards four major ideas:

- 1) Use a large universe of global assets. Don't just invest in the United States or the country you reside in.
- 2) Invest in a small portion of those assets, but not too small (such as one).
- 3) When an asset is performing worse than T-bills, replace it with T-bills.
- 4) Hold the assets over a fixed period of time, such as one month before replacing them with better performers. So you don't have constant turn-over in your portfolio...which leads to higher fees and trading frictions such as slippage (bad fills).

In the next example, I use a basket of 80 ETFs world-wide to narrow down to four positions every month. The results show a world-class 21.5% compound annual growth rate, which turns \$10,000 into \$82,638 over a ten year period. The worst drawdown is 33.5%, which is much better than the S&P 500's massive 55.2% drop, but still needs improvement.

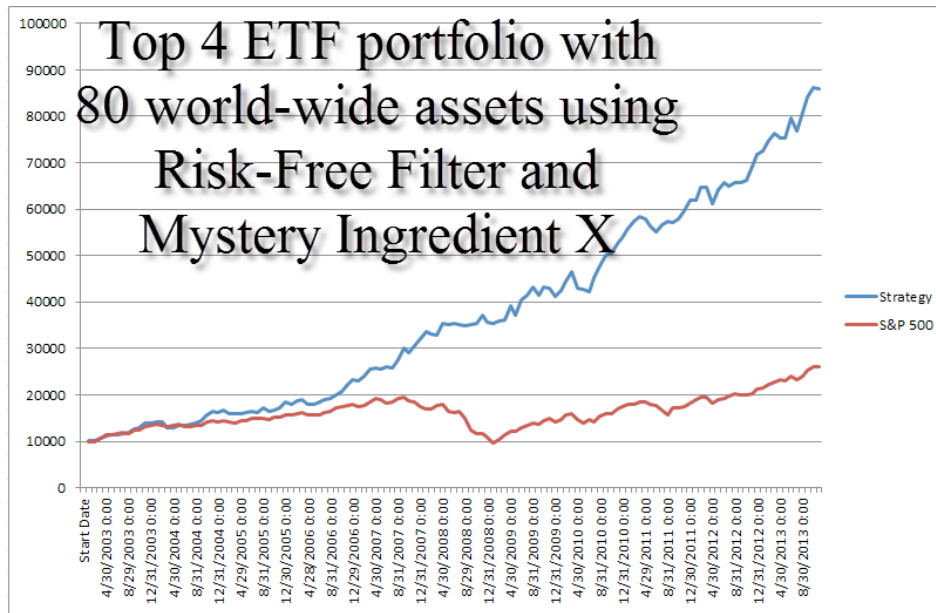


Mystery Ingredient X

A strategy is never perfect, and I'll be the first to admit it. A lot of work needs to be done maximize returns and stabilize losses. As you can tell from the above chart, there's work to be done still.

That work, for me, is Mystery Ingredient X, a kind of experimental tweaking of my strategy that I'm proud to say is showing some fantastic results. In every attempt I've made, Mystery Ingredient X significantly reduces my portfolio's volatility.

I won't reveal Ingredient X in this report, as it would take yet another report of significant length to discuss why this simple filter works amazingly well – especially when looking at a large universe of ETFs around the globe. I have tested this added strategy back to 1926, and it lowers volatility significantly. Now I would have loved to test a basket of 80 assets all the way back to 1926, but the data just doesn't exist much to my chagrin.



By adding one more piece to the puzzle, Ingredient X is able to do a much better job of picking the top four ETFs that are far less likely to cause large drawdowns. The return was nearly identical to the previous experiment, but the drawdown was cut in half at 15.6%. Creating opportunities for high growth and small drawdowns are the goals of every world-class fund manager, and as Mystery Ingredient X shows, it is possible with the proper strategy in place.

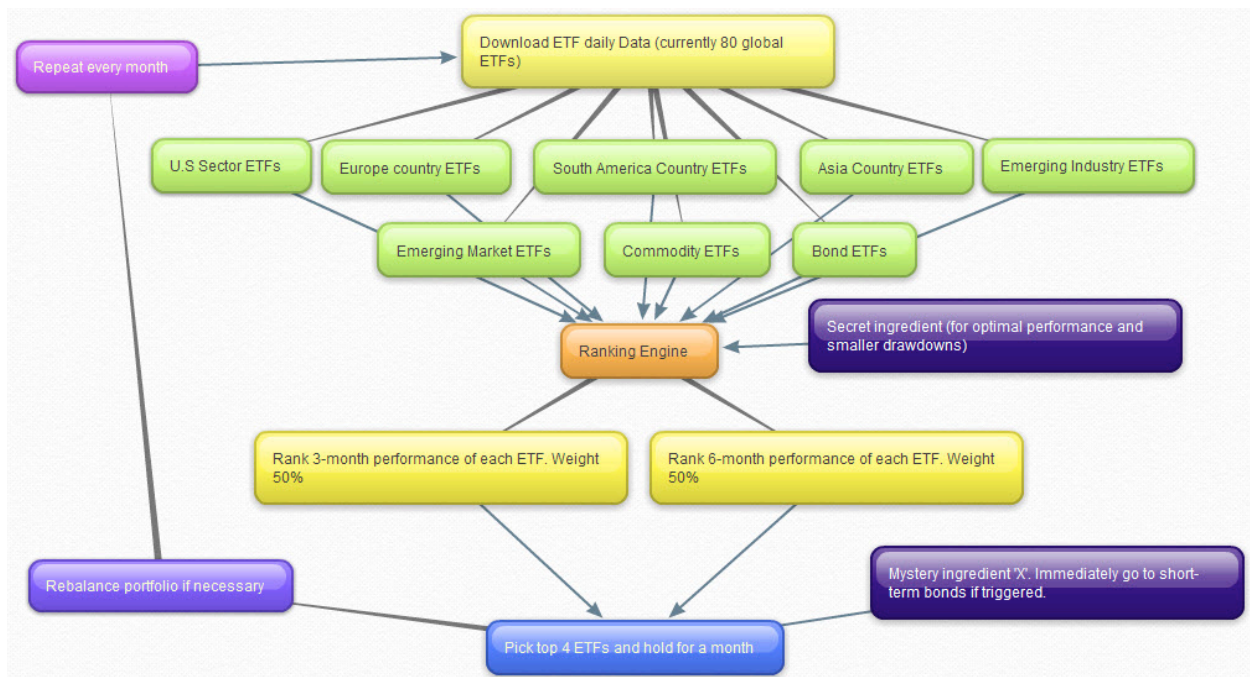
Many would think I was crazy for sharing this much information with you because of the possibility of too many people trading it. I don't believe that to be the case because few, very few will ever willingly go out of their comfort zones and look for new trading strategies. For most people, that's probably for the best. I've found that most who do look outside the "tried and true" investment strategies get caught up in a web of unscrupulous marketers who love to take your money and give you worse than nothing in return. The most expensive information is bad information, which is why I've gone to great lengths to show you a strategy that has survived the test of time.

The Final Touches to a World-Class Trading Strategy

We've come a long way with our strategy, but one question remains to be answered. As we look at the huge range of worldwide assets that one could potentially invest in, how do we know for sure which ones will yield the highest returns? As we've mentioned prior, that's a lot of assets to look at all at once.

The most optimal route is to set up trading signals, which is exactly what I did. You'll need to hire a programmer to download quotes for your ETFs and then sort them based on recent performance. I know this because I hired a darn good programmer. Cost me \$47,000 for version 1.0 (and still adding up since I'm always testing the new ideas that pop in my head.)

Ideally, you would want to create something that does this:



This is the mind map I made for creating the backbone of the Atlas Order.

The strategy chooses the top four assets from a huge world-wide basket of 80 ETFs. I've also implemented Mystery Ingredient X into these signals to help choose the assets that are least likely to fall flat that month.

Part Three Wrap Up

Part Three is the third and final part to this trading report. It covers the core strategy as well as the experiment that I used to prove it. We covered a lot of ground, so let's revisit what we've learned so far.

Here are the core takeaways for Part Three:

- Bubbles at first seem like a major concern for our strategy due to our buying up assets that are rising up the fastest. However, we can avoid going down with the ship if we actively consider a worldwide bundle of assets to invest in.
- Holding the top gainer out of six U.S. asset classes over an 86-year period can be used to produce steady and reliable growth year in year out. When stocks take a tumble, we have other options to turn to that are safer during a downturn.
- The wider our range of potential assets, the more prepared we are to weather a market meltdown.

- ETFs prove their merit time and again by offering a solid diversity of stocks and bonds. After experimenting with different numbers of ETFs, it's safe to say that the universe of assets you invest in should be more than one, but less than five. This is contrary to what we've heard before that greater investment diversity yields better results.
- By using our Risk-Free Filter, T-bills, we have a safe haven from market downturns. Had the original strategy of rotational investing used this filter, it would have saved people millions of dollars over the last decade and a half.
- Trading signals are important in order to keep track of all the potential assets that we should invest in. Hiring a programmer to set up such trading signals is a good place to start.

There's a Relaxed Investor in You, Too!

That's a wrap for this report. I hope you found it informative! It's taken me a long time to come to these conclusions, but like all things, you need to put in the work to see results. The good news is of course that by putting in the right *kind* of work, life gets a whole lot easier. It's all about working smarter, not harder!

I'd now like to point you towards additional free training to pick up where this report left off. You see, teaching you that "what's going up tends to keep going up" is only part of the picture. Yes, the gains you can make trading ETFs are superb, but how would you like to double or even triple those returns?

Now before you dismiss this as hyperbole, I'd like to do something few people ever do in public -- show you my audited track record, not a hypothetical back test:



Alpha Performance Verification Services

1913 Stuart Avenue
Richmond, VA 23220
(804) 677-4343
www.alphaverification.com

Independent Verifier's Report on Performance Record

Joshua Tree Financial Inc.:

We have examined the accompanying Statement of Investment Performance and Notes to Statement of Investment Performance for the Joshua Tree Financial Inc. **Generational Wealth Strategy** for the period May 1, 2014 through April 30, 2015. Joshua Tree Financial Inc. is responsible for the Statement of Investment Performance and Notes to Statement of Investment Performance. Our responsibility is to express an opinion on this performance presentation based on our examination.

Scope of Work

Our examination included examining evidence supporting the Statement of Investment Performance and Notes to Statement of Investment Performance for the **Generational Wealth Strategy** and performing other procedures, as we considered necessary in the circumstances. Our examination included procedures to obtain assurance that performance results reflected in the Statement of Investment Performance were calculated using criteria as outlined in the Notes to Statement of Investment Performance. We believe our examination provides a reasonable basis for our opinion.

Opinion

In our opinion, the Statements referred to above present, in all material respects, the performance record of the **Generational Wealth Strategy** for the period May 1, 2014 through April 30, 2015 based on the criteria set forth in the Notes to Statement of Investment Performance. The Statement of Investment Performance and Notes to Statement of Investment Performance are an integral part of this opinion.

Alpha Performance Verification Services
Michael W. Hultzapple, CPA, CFA, CIPM
May 15, 2015

Joshua Tree Generational Wealth Strategy Gross Performance															
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD	S&P 500	
2015	-2.44%	13.56%	-2.57%	0.12%	-	-	-	-	-	-	-	-	8.07%	1.93%	
2014	-	-	-	-	4.05%	10.93%	-9.12%	12.50%	-3.69%	-1.98%	5.95%	2.29%	20.75%	10.86%	
Cumulative - 1 year														30.50%	13.00%

The account that was audited was setup with \$100,000 (real money) to demonstrate the amazing results that occur when two powerful opposing forces collide in the stock market. I've been able to stocks like Tesla for 18.5% off. Or ALNY for a whopping 24% discount (audited and verified).

I've executed 112 of these rare 'DB Transactions' and counting over the past year. I'd like to invite you to a complimentary online workshop I'm holding and reveal to you exactly how I've been buying up stocks at massive discounts, month and month.

Because you've read all the way through this report, it tells me something: You are a person that is highly interested in becoming a better investor and trader. You are highly motivated. If you're anything like me, I became motivated by the temptation of freedom that trading offers: Trade anywhere in the world. Be your own boss. No commute to a j-o-b where you help make someone else rich.

Along the way to riches, I veered off the path a number of times. I listened to the siren song of quacks, crackpots, and outright thieves. It took me years to get back into the fast lane to consistent wealth generation. Looking back on those dark days is painful and sometimes humiliating. That's one of the biggest motivators I have for teaching other trades. I don't want them to suffer the sleepless night and constant self-doubt I had as a trader drowning in a sea of red.

So my next gift to you will be meeting (virtually) face to face online.

As an added bonus for downloading and reading this report, I'd like to invite you to a free demonstration to watch me build another "weird" strategy LIVE with The Boss "SuperAi."

Just follow this link and register for this live training event:

<https://portfolioboss.com/go/superaid>

Trade smart,

Dan Murphy

P.S. I'm planning on building a strategy for trading the VIX index.

The VIX makes money when stocks go down, so it's a perfect strategy to add to your arsenal.

Imagine not just making money in down markets, but absolutely cleaning up! Join me at this link...seating is limited so show up early:

<https://portfolioboss.com/go/superaid>

Government Required Disclaimer: The results listed herein are based on hypothetical trades. Plainly speaking, these trades were not actually executed. Hypothetical or simulated performance results have certain inherent limitations. Unlike an actual performance record, simulated results do not represent actual trading. Also, since the trades have not actually been executed, the results may have been under (or over) compensated for the impact, if any, of certain market factors such as lack of liquidity. You may have done better or worse than the results portrayed.