

WCM-Investing - Rules Of Engagement & The QDI

by Steve Selengut

Crash! The 2007 thru 2008 financial crisis halved 401(k), IRA, and Mutual Fund values in a matter of months. For many, retirement dates had to be pushed back; for others, new jobs had to be found. The tragic flaw? No income allocation in the investment program. Market value builds egos; income pays the bills.

Few employers cautioned Savings Plan participants that 401(k)s are just not defined benefit programs. Few mutual fund distributors suggested to benefit departments that their programs were missing something of critical importance.

Throughout the meltdown, all investment securities fell in market value. But the vast majority of income securities, including closed end income funds (CEFs), have continued to pay interest and dividends. Market value builds over-confidence; income pays the bills.

The Working Capital Model (WCM) is a comprehensive system for investment management that is based on uncompromising rules of engagement. The investor's focus must remain centered on the development of dependable cash flow and the creation of an expanding number of houses and hotels on his game board.

With a reasonable amount of effort, and a lot of self-discipline, anyone can use it to build a portfolio, slowly and sanely, benefiting from the cycles we all expect to continue indefinitely. All cycles have two components; the WCM helps you deal with each.

Every portfolio holding must generate regular income of some kind and each must have profit potential--- at least at the time of purchase. The planned balance between income producers and growth providers (equities) must be maintained throughout the process, even though there may be no immediate need for the income. Have you learned that unrealized gains are not growth?

Year to year, we want to see reasonable growth in both Working Capital (the total cost basis of the cash and securities in the portfolio) and base income (interest and dividend income produced by the securities in the portfolio). But more importantly, we want to produce this growth in a lower-than-usual risk environment, made up of properly diversified investment grade securities.

The first steps in the investment process are Management Functions: Planning, Organizing, Leading, and Controlling

Planning involves the identification/definition of Investment Goals and Objectives. They should be long-term but flexible over time. They should include parameters and rules that are well thought out--- at the personal level. They should be reasonable and realistic historically.

Goals and objectives are essential, but they need to be laid-up on a foundation that reduces the risk of loss at various stages in the life cycle of the investment program. Asset allocation is a planning/organizing tool used to design the portfolio in a way that will balance the need for growth in Working Capital with the age-dependent risk tolerance of the investor.

Asset allocation decisions should implement and support the Investment Plan. Under normal circumstances, the securities in the income "bucket" of the portfolio (bonds, government securities, mortgages, preferred stocks, REITs, etc.) are all much safer than any of those in the equity "bucket".

An asset allocation with 50% in each bucket is much more conservative than one with 80% directed toward equities--- regardless of the quality ratings we require for the equity securities. Asset allocation decisions must be made using the cost basis of the securities in each bucket.

Beyond asset allocation itself, organizing involves selecting actual securities that fit into the two investment buckets in a properly diversified manner. It may involve several separate portfolios, but must be easy to direct and control. Diversification rules (also based on security cost basis) will guide the portfolio into a variety of issues and sectors.

Proper diversification assures that the overall risk of loss is spread around companies, countries, businesses, and geographical areas. Market capitalization issues, and global representation are dealt with behind the scenes, in the quality determination phase of the security selection process.

Leading, most simply, is personal decision-making. You must direct the activities of others (brokers/managers/accountants/etc.) who may be offering you investment advice. The investment manager (you are the primary investment manager) must create the quality, diversification, and income generation rules (the QDI) that govern the day-to-day operations of all portfolios.

Why would anyone accept a portfolio that was not designed for his or her own unique situation and needs? Laziness, confusion, brainwashing, ignorance of the markets--- all of the above?

The Principles of Investing (the QDI) are superimposed in, on, and around the management functions. They control the security selection process to help reduce portfolio risk. They help set the targets for profit taking and provide mind-set controls that enforce the rules. They assure that every security within the portfolio contributes to base income.

It is imperative that you lead your portfolio into strict guidelines for security quality, cost-based diversification, income generation, and profit taking. Rules for disposing of downgraded or weakening positions must also be codified.

Profit taking is the most satisfying of all portfolio decision-making functions--- and possibly the least popular! Most of the reasons are ego centered, until the WCM shows clearly the opportunities that are available for the newly created working capital.

Reasonable targets must be set (between seven and ten percent dependent on the amount of smart cash available), and triggers pulled insensitively when targets are reached--- no hindsight at all can be tolerated. A monthly brokerage statement with unrealized gains is a sign of poor management.

Controlling involves realistic performance evaluation, and monitoring to assure that you are following your own rules and guidelines. Comparing your annual change in market value with the DJIA or S & P is not performance evaluation.

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