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Portfolio Diversification: Truth Versus Myth

by: Sam Seiden

Are you like the millions of Americans who go to sleep each night feeling safe and secure because their investment portfolios are properly diversified? Conventional diversification attempts to decrease risk and offer more opportunity for the average investor.

However, when we observe conventional diversification protocol through the objective eyes of pure supply and demand, it becomes quite clear that conventional diversification actually increases risk and decreases opportunity. With retirement around the corner for the most populous and wealthy generation in history, this is an issue that can't be ignored. In this article, we will learn how to assess the markets through the laws of supply and demand, explore an alarming reality of conventional diversification, and provide a framework and foundation from which average investors can properly diversify their own portfolios.

The Foundation: Quantify Supply and Demand

The movement of price in any and all free markets is a function of the laws of pure supply and demand. Low risk/high reward buying and selling opportunities emerge when this simple and straightforward relationship is out of balance. Let's review Figure 1 to understand how and why we quantify supply and demand, as this will lead us to our objective opportunities for low risk gains.

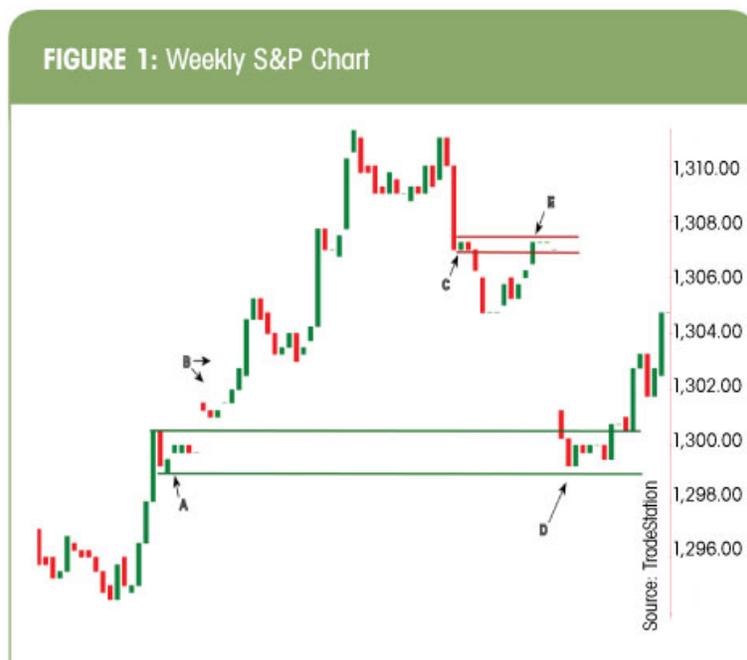


Figure 1 is weekly chart of the S&P 500. Notice price level "A." For a period of time, price was stable, suggesting supply and demand is in balance (equilibrium) at that level. Once price moves higher "B," it is clear that there was no equilibrium at "A." In fact, we can now say that price level "A" represents a major supply and demand imbalance. We know this to be true because the only reason price moves higher from "A" is because there were many more willing buyers than sellers at "A." It simply took time for this unbalanced equation to play out. You don't need a technical indicator or some professional to tell you this, its simple logic. "D" represents the first decline in price to the objective demand level, which is where we find our lowest risk/highest reward buying opportunity. For diversification purposes, this would be the ideal time to buy into the S&P 500.

"C" is just the opposite. It is a price level where objectively, supply exceeds demand. For a period of time, price was stable at level "C," and then there was a sharp decline. The decline tells us that there is much more supply than demand at "C." "E" represents the first time price revisits the objective supply level, which is where we want to sell or sell short. Note that we are only focused on the first time price revisits of these demand and supply levels. The reason is simple. Each time price revisits a demand or supply level, the imbalance within that price level is decreasing as demand or supply is being absorbed. The lowest risk/highest reward opportunity for the astute speculator is when the first time price revisits a demand or supply level.

The Simplicity of Markets

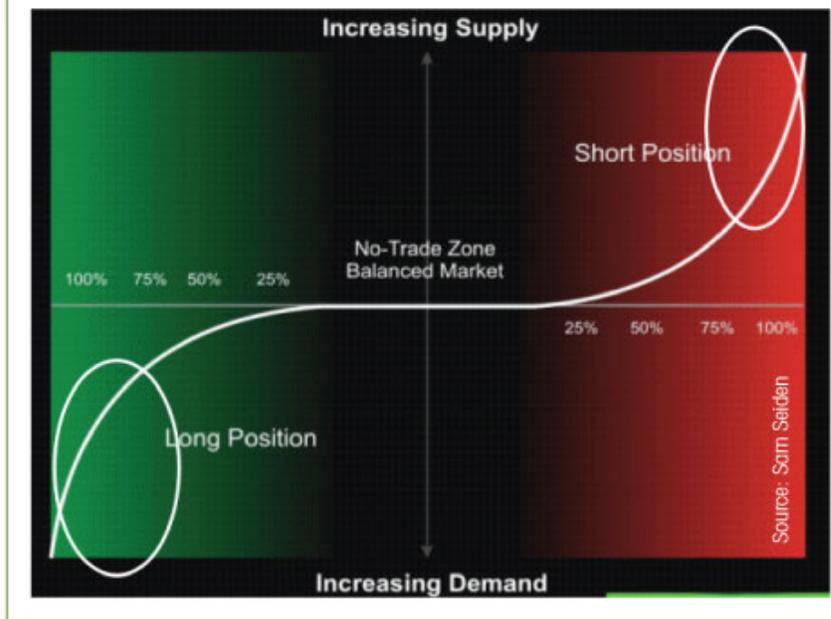
Put simply, a trading and investing market is made up of three components: buyers, sellers and a widget being bought or sold. These widgets may be shares of a stock, S&P futures, foreign currencies, bonds and many more tangible and intangible widgets. For example, let's say the widget is a stock. This stock has some value. That value or price as we call it is determined simply by the supply and demand for the stock, which is the ongoing interaction of all the buyers and sellers taking action with regard to that particular stock. A market is always in one of three states:

- A state where demand exceeds supply which means there is competition to buy and that leads to higher prices.
- A state where supply exceeds demand, which means there is competition to sell, and this leads to declining prices.
- A state of equilibrium. At equilibrium, there is no competition to buy or sell because the market is at a price where everyone can buy or sell as much as they want. However, as the market moves away from equilibrium, competition increases which forces price back to equilibrium. In other words, competition eliminates itself by forcing markets back to equilibrium.

A Fundamental Truism

The greater the supply and demand imbalance, the greater the opportunity. This is true when buying and selling anything, not just with investments. While many "professionals" would have you diversify your portfolio by buying many different stocks or a "ladder" of bonds for example, a much more efficient, lower risk/higher reward approach is to identify the markets with the greatest supply/demand imbalance and risk your hard-earned capital there. Figure 2 represents how we quantify the objective and ideal risk/reward opportunity we are looking for.

FIGURE 2: Risk/Reward Curve



It's Quantifiable

I have always believed that if what I say works, and if what I preach is based on a mechanical set of objective criteria, there has to be a mathematical formula that quantifies it. This curve represents that equation. This curve is a cubic parabola, $Y = X$ cubed (The "Y" axis (vertical line) represents price levels at which demand is increasing and supply is decreasing as you move down the curve. Conversely, it represents price levels at which supply is increasing and demand is decreasing as you move up the curve. The "X" axis (horizontal line) represents the amount of your investment capital you will put at risk. Obviously, we would never risk anything close to the numbers shown above but for a mathematical model, the numbers shown on the graph are appropriate. The bottom line is, the greater the supply and demand imbalance, the more investment capital we should put at risk because objectively, risk is lowest and potential reward is highest.

The flat part of the curve represents a price level where supply and demand is in balance (equilibrium); for every buyer, there is a seller. At equilibrium, there is no opportunity. When opportunity is not present, you certainly don't want any of your capital at risk. As price moves away from equilibrium, it is moving closer to price levels where supply and demand are out of balance, which is where we find opportunity. As price moves out to the levels where the supply/demand imbalance is increasing, the amount of capital at risk should increase. The circled areas on the graph are where the prime turning points in the markets are present. To understand this better, think of corporate profit margins. The circled areas on the curve represent the largest profit margins. In trading and investing, we are always in search of large profit margins. This is not all that different from stretching a rubber band. The more you stretch it, the more potential energy is stored, waiting until it reaches a threshold where that energy is released and it snaps back. The thresholds in markets where prices turn are the price levels where supply and demand are out of balance.

Seeing the Curve on a Price Chart

How do we know when we are at these levels, far from equilibrium? Please refer back to Figure 1. Price levels "A" and "C" represent the boundaries of this curve. All you have to do is look at a larger time frame chart (or smaller if you're an active trader) and do the following:

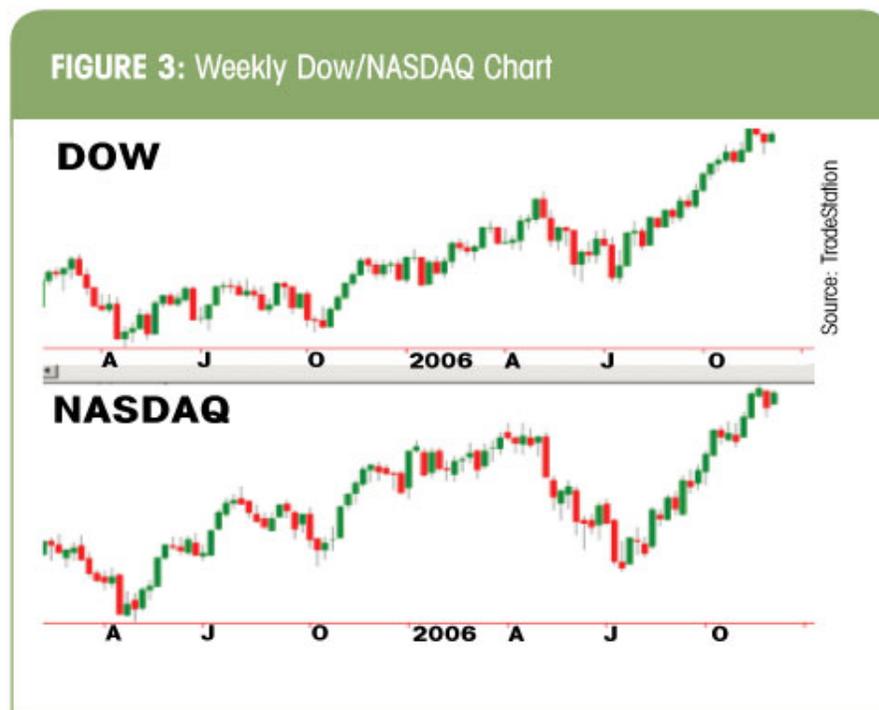
1. Identify current price.
2. Identify the demand level below the current price that has not been revisited it yet. This level represents the lower boundary of the supply and demand curve.
3. Identify the supply level above current price that has not been revisited yet. This level represents the upper boundary of the supply and demand curve.

The Problems with Conventional Portfolio Diversification

For most investors, your portfolio is split between stocks and bonds. Whatever the split is, have you ever realized that almost every investment in a typical portfolio appreciates only when prices go up? What happens if these markets go down for a significant period like they did in Japan for over ten years? And worse, what happens if this decline in price begins when you are near retirement?

When we break down portfolio diversification in stocks, there is another issue to be aware of. An average investor will typically be told to reduce risk by investing portions of his or her portfolio in different stock sectors and markets. An example would be to have a portion of your stock portfolio in Dow stocks which are typically large cap stocks, and a portion in the tech heavy NASDAQ market.

Consider Figure 3.

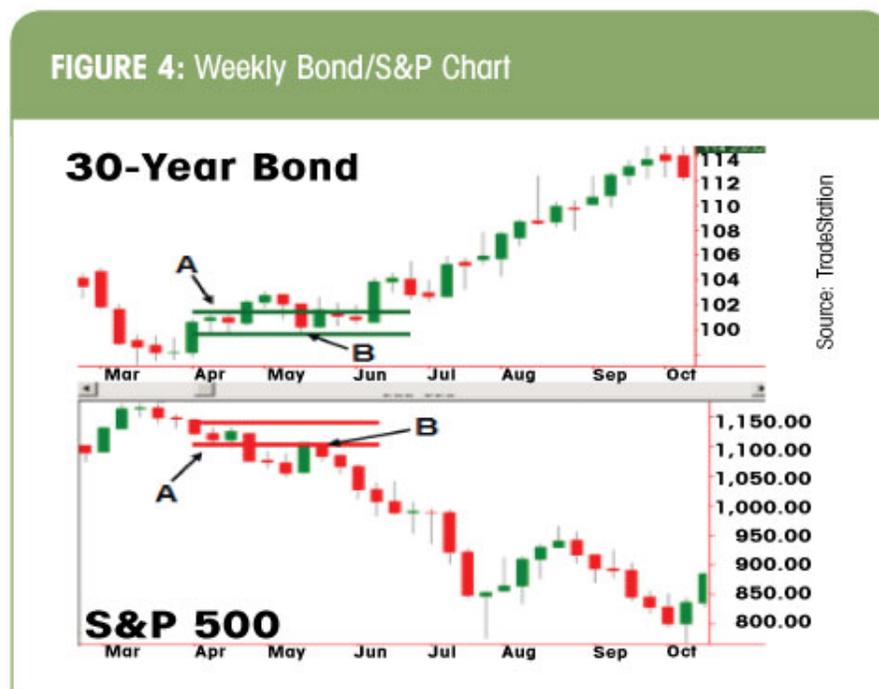


At first glance, these two charts appear to be the same. During almost any period in time, equity markets move in the same general direction. As you can see here, diversifying in these two markets is really not decreasing risk, it is actually increasing risk. The average investor thinks his or her hard-earned capital is diversified properly between two semi-uncorrelated markets, but the truth is, the risk is actually doubled as these markets almost always move in the same direction. Again,

conventional diversification is typically risk disguised as opportunity for the ill-informed investor. These days, it is also very uncommon for a foreign equity market to move in the opposite direction of the major U.S. markets for any sustained period of time.

Proper Diversification According to the Laws of Supply and Demand

Ok, enough questions and alarming issues, let's use pure supply and demand and learn how to properly diversify your portfolio. See Figure 4. Here, we are looking at the same period of time in the S&P 500 and the 30-year bond. Area "A" in the S&P chart represents a major supply level for reasons mentioned earlier in this piece. "B" is the first time price revisits that area of imbalance, which is where we would want to sell for profits or initiate a short position. Let's take a look at the 30-year bond chart. Area "A" represents a major demand level, again, for reasons discussed earlier in this piece. "B" represents the low risk/high reward time to buy into the bond market.



The Bottom Line

Traders need to take action when risk is lowest and reward is highest. As you can see, at the exact same period of time, the S&P begins its huge decline and the bonds begin their enormous rise. The proper play for the astute diversifier is to take profits (sell) on much if not all of your stock holdings and buy into the bond market. This is how we diversify our portfolio based on the laws of supply and demand. No matter how diverse your stock holdings were during that decline in the S&P, you likely lost plenty of your investment capital. Had you listened to the whispers of Adam Smith and focused on pure supply and demand, the move from stocks to bonds would have been very clear. Don't let the illusions of conventional thought obscure what is truly a simple reality that anyone can understand and apply.

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