saltydoginvestor

How to beat the market using trend investing

"I noticed that in advances as well as declines, stock prices were apt to show certain habits."

Jesse Livermore (1877 – 1940)

Members' Guide

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PART 3 “How Saltydog began & other stories”

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A very warm welcome to Saltydog Investor

Dear Investor

Douglas Chadwick

I'm Douglas Chadwick, the creator and founder of Saltydog Investor.

Thank you very much for subscribing.

Trend investing – also known as 'trend following' or 'momentum investing' – is a proven method of making money in the stock market, going back over one hundred years.

One of its most famous adherents was Jesse Livermore, an investor and 'speculator' (as traders were then known) on the US markets at the end of the nineteenth and beginning of the twentieth century. I refer to some of Livermore's nuggets of wisdom in this guide, and there's a quotation from him on the cover.†

With Saltydog Investor, I've taken the timeless principles of trend investing and applied them in my own way, using the data and investment technology available to us in the twenty-first century. And very successful it has been too.

I know the Saltydog system works. It's made me mountains more money than my IFA and pension company ever did when they managed my investments. And I know it's helped a lot of other people improve upon their investing in a way they never imagined possible.

I'm confident that Saltydog will help you make more money too.

For many investors, coming to Saltydog is a completely new departure. If you have been a 'passive' investor up to now – simply buying funds or shares and holding on to them for the long term, through thick and thin – you might feel a little daunted by the thought of managing your money more actively. This is doubly true if you've always left your investments in the hands of someone else altogether, such as an IFA. It's perfectly understandable to feel nervous about taking on that responsibility yourself. You might well be thinking: What if it all goes wrong?

Let me assure you – if you follow our basic guidelines, it won't go wrong. The worst that could happen is that you lose a little money as you learn the ropes. But if you follow our rules you can't possibly have a disaster. And I'm very confident that you'll do well. If you feel uncertain, just follow one of our two demonstration portfolios to start with.

I have complete confidence in the Saltydog system, which I've used to invest my own money, very successfully, for the past fifteen years. If you're an averagely calm, intelligent person, with a bit of confidence and self-discipline, and you enjoy learning new skills, you'll be fine. More than that, you'll probably enjoy it!

Take it easy, take time to read the instructions, read our weekly emails, become familiar with the system and the data, and then start gently with just a small proportion of your money. You can gradually increase the amount you're investing as you gain more experience and confidence, in both the system and in yourself.

There's a lot of helpful material to get you on board. You have this in-depth Members' Guide. On our website there are a number of explanatory videos, along with the crucial Saltydog data, which is updated weekly. And there are two demonstration portfolios that you can follow.

Every Wednesday my colleague and Managing Director of Saltydog, Richard Webb, will send you two email updates, explaining the movements in the markets, and telling you which changes we're making to the demonstration portfolios. And every month Richard will also send you our monthly newsletter. So there's a lot of guidance for you.

In addition, if you do get stuck with anything or have a question, please do get in contact with us. We'll be pleased to hear from you, and only too happy to help. Richard is on hand to answer all your queries.

I'm sure you're keen to get stuck in. So without further ado - and using appropriately nautical terminology - let's get under way. I'll hand over to Richard to explain how the Saltydog system works, and how to use it to make money… and protect it.

Warm regards, and the very best of luck with your investments.

Douglas Chadwick

Founder and Chairman, Saltydog Investor

† Livermore's fascinating life story can be found in a marvellous book, "Reminiscences of a Stock Operator" by Edwin Lefevre. I thoroughly recommend it.

Why you've made a good decision: 11 advantages of the Saltydog system

Hello, Richard Webb, Managing Director of Saltydog here.

Richard Webb

Just before I begin explaining how the Saltydog system works, let me first highlight to you all the reasons why it's such an effective approach to investing… and why I'd say you've definitely made the right decision to be here.

Let's start at the top…

ADVANTAGE No. 1: The potential for market-beating gains.

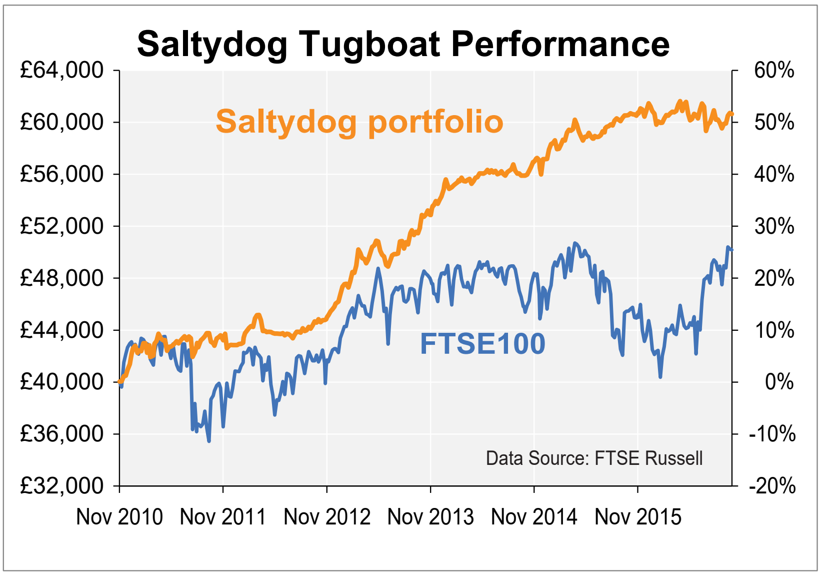
With the Saltydog system, it's perfectly possible for you to beat the market.

We know this, because we've done it ourselves. Douglas has used the Saltydog system for over 15 years, beating the market every one of those years. And we have proven it publicly over the past five.

As at the time of writing in October 2016, the Saltydog test portfolio (called the "Tugboat") has achieved an average of over 7% gains per year over the past five years, and has significantly outperformed the FTSE100.

Not bad at all, and we're very proud of that. Especially since this is our most cautious, lowest-risk portfolio.

Here's the chart of our performance as of October 2016



Of course the past is no guide to future performance, as you know. And how well the Saltydog system works for you depends on how you apply it – whether more cautiously or more adventurously.

But we are very confident that – as long as you follow the rules of our system – you can do just as well as our Tugboat portfolio, if not better.

ADVANTAGE No. 2: Avoid every investor's biggest fear: a cataclysmic drop in the market.

Over the last 15 years, there have been two enormous crashes in the market: the dotcom bust of the early 2000's, and the global financial crisis of 2008.

In 2000-03 the market plummeted by almost 50%. In 2007-09 it dropped by 48%. That's very scary.

Imagine you were about to retire and - due to a market crash at just the wrong time - your invested wealth nearly halved in value. You wouldn't recover from a setback like that. It would clearly have a very, very serious impact on your quality of life. The markets could do that to your money. And you never know when.

Not surprisingly, this is every investor's greatest fear – losing a huge amount of money, out of the blue.

Here at Saltydog, we share that fear. We don't want it to happen to us. And here's the thing: our system practically eliminates it.

That might sound like a ridiculously bold claim, but once you've come to understand the Saltydog system, I think you'll agree with me.

Many investors take a 'passive' approach to investing, and simply 'buy and hold'. (Or they leave their investments in the hands of an IFA or pension company, who operate a buy-and-hold strategy for them). When the market goes up, their investments go up. And of course when the market goes down, their investments follow suit.

Saltydog takes an active approach to investing. Our aim is to *enhance your gains* on the way up, and to actively *minimise your losses* when the market is going down. You don't just have to sit and watch when the FTSE starts to take a dive – you can control your exposure to the market.

As you can see from the chart on page 5, we have avoided the worst of all the drops in the market over the past five years - which I'd say proves my point. And consequently our Tugboat portfolio has significantly outperformed the FTSE over that period.

When the Saltydog system is applied effectively, you benefit from the upside and avoid the worst of the downside.

Wouldn't you want to do that?

ADVANTAGE No. 3: <u>It's simple and straightforward to use</u>.

Once you've understood the basic Saltydog principles (which I explain in detail below), it's quite straightforward to use the system.

You don't need to be a highly experienced investor. Any moderately intelligent person with a modicum of confidence and the desire to control their own money can use it. And it takes about fifteen minutes to one hour a week.

ADVANTAGE No. 4: <u>Be as cautious or adventurous as you wish</u>.

The Saltydog system is equally useful for cautious and adventurous investors – and everyone in between.

Our **data** covers every investment sector – with ten thousand funds offering exposure to every kind of market across the globe. And our **method** tells you how to interpret that data, according to our principles of trend investing. So it's entirely up to you how you use it.

You can stick to nice, safe, steady investments, with a history of very low volatility and with a much lower chance of losing money. Or you can put your money into much more adventurous sectors, with the possibility of bigger and quicker returns (and of course a higher risk of losses). Or you can do something in between: whatever combination you feel like.

Whatever your risk profile, you can apply the Saltydog system according to your own requirements.

ADVANTAGE No. 5: <u>Make money from rising trends anywhere in the world</u>.

The Saltydog system monitors around 10,000 funds, covering markets and sectors around the globe. (But using only UK-listed funds).

So there's no need to confine yourself to the UK market – if, for example, Chinese property, American small companies, or the Nikkei (Japanese stock market) are making good gains, you can join in.

Or, if you prefer to stick to the UK, you can do that too.

ADVANTAGE No. 6: <u>No need to follow financial news</u>

The Saltydog system is "self-contained". The charts and numbers we provide every week give you all the information you need to become a successful trend investor. You don't need to be following the ins and outs of the financial news.

Of course, you may want to combine your view of the markets with the Saltydog data to make decisions that you feel more comfortable with. But you don't have to – you can just use the information that we provide.

ADVANTAGE No. 7: <u>You don't need to predict the future</u>

The Saltydog system doesn't require you to have a view of where the market is going. You don't need to have any special insights or smart predictions about the future.

Using the Saltydog charts, numbers and system, you simply watch what is going on – and when you see a trend you like, you invest accordingly.

ADVANTAGE No. 8: <u>A simple, effective way of managing risk</u>

The Saltydog system has a simple, clear way of analysing global markets. It's very easy to see trends and opportunities, and – just as importantly - to evaluate the risks involved in them.

You can make clear decisions about how safe or adventurous you want your portfolio to be.

Whilst we want to take advantage of positive trends and bull markets wherever possible, one of the key principles of the Saltydog system is *not taking any unnecessary risks*.

ADVANTAGE No. 9: <u>Avoid the inherent danger of investing in individual companies</u>.

The Saltydog system is not about buying and selling individual company shares. So there's no risk of one particular share movement having a big impact upon your portfolio.

By focussing on *sectors* of the market, and by buying funds (which invest across a range of companies in a particular sector), essentially you are diversifying your money.

There's an additional advantage of buying funds too. You get to 'use' the expertise of experienced fund managers who specialise in their field, and who have teams of analysts covering their particular sector – all far more knowledgeable about individual companies than the average private investor.

ADVANTAGE No. 10: <u>It's not expensive to run</u>.

There are quite a few popular misconceptions about the cost of buying and selling funds. Many investors think that this is an extremely expensive way to invest, especially if you buy and sell funds frequently.

This is simply not true. Yes, there are costs involved, as there are with any kind of investing. But buying and selling funds isn't really expensive. And we believe that the advantages – the potential higher returns from applying the Saltydog system – far outweigh the costs.

ADVANTAGE No. 11: <u>Learn an enjoyable and satisfying new skill</u>.

Saltydog investing is fun!

Many of our subscribers find that they actively enjoy and find great satisfaction in managing their investment portfolios more actively, using the Saltydog system.

As you become more familiar with it, and more experienced, you'll find it a rewarding new skill – one that gives you many insights into the financial world and what's going on in markets all around the globe.

What Saltydog members say…

About trend investing, using the Saltydog system:

“I have long given up trying to understand the stock markets from a fundamentals point of view. There's no obvious correlation and I see it more of a herd mentality. So therefore I like the Salty system… My annualised return since I started is 8.5% .” **R.L.**

“Value investing, which I had been trying to apply, is not for one in his late 70s. You have to stomach long periods when key holdings are deeply under water. Back the horse that IS running fast, not one that just might run fast… In 2015 I made 8.8%.” **D.E.**

“I like being able to quickly react to changes in the market. My other investments which are supposed to be actively managed by an IFA hardly seem to change from one year to the next and I keep being told "it's for the long term", which seems lazy to me.” **O.K.**

“The advice makes sense. The whole idea makes sense... I made 8.5% in 2015 which is no mean feat and largely thanks to you pointing me towards funds that I had no idea existed.” **R.W.**

“Excellent service... Very impressed with downside protection… A perfect foil to ‘buy and hold’ of the mainstream press.” **Simon Payne**

About the gains they’ve made with Saltydog:

“It's easy to understand and lets you know the sectors which are doing well at present. I'm up 25% in 18 months… It's worth every penny.” **David Moody**

“Beautifully simple to follow. About 9% increase over the last 12 months.” **J.D.**

“It's easy to follow and I'm gaining in confidence. My initial investment has grown 30% in under 3 years. Delighted.” **Christine Corner**

“33% in 3yrs since subscribing.” **Andrew Ashworth**

"Since October 2010 I have made an annualised 9.69%... I base decisions on the data used in Saltydog, which is very good." **M.I.**

"[I] like the fact that the work is done for me re. trend analysis of performance. Returns in three full years: 16% (2013), 7.5% (2014) and 10.5% (2015)." **P.W.**

"About 25% in 3 years. It clearly beats other 'systems'." **Alan Ashton**

"9% over the past 12 months... Very respectable!" **Stuart Hatton**

"Trending to around 12% annualised, even with all the trauma of the past few months." **David Gauld**

"I like the concise structure of how funds performance is measured and displayed. Performance 2015: 16%." **R.F.**

"I have averaged 12% using a blend of my own choices and Saltydog. I find it a thoughtful, professional and productive system that does 'everything it says on the tin'." **Mike Jamieson**

About using the Saltydog system:

"Simple, easy to use system. Very pleased." **S.L.**

"Very simple to follow, has given me an 8% return annually. Allows me to draw a better income from my pension than otherwise." **M.K.**

"Easy to follow, consistently performs. Made about 7-8% in the last year." **N.M.**

"I feel safe and in full control using your advice. No unnecessary risk taken. Easy to understand and simple to follow. **Doug Jordan**

"The system is easy to use and update. I have used it successfully over the past two years making 15% and 7%." **S.H.**

"I love the fact that it gives me the confidence to invest my own money with sensible guidance plus the information to enable me to make rational decisions." **Fran Sharp**

What is Saltydog investing?
- a 1-minute summary

- Saltydog is **trend investing**. (Also known as 'momentum' investing). That means we only invest when we see a clear trend in the market. If there isn't a positive upward trend, we don't invest. And if the trend is downward, we get out.

- We use **funds** to invest our money. We don't buy individual company shares. We identify particular sectors showing a positive trend, and use funds to invest in those sectors.

- We are **active investors**. We don't buy and hold investments indefinitely. And we certainly don't hold on to investments when they start falling. Our aim is to ride the uptrends, and get out of the downtrends.

- We may **invest anywhere in the world**. With the thousands of funds available, you can use our system to invest in any sector or market in the world. (Though if you don't want to, you don't have to).

- It takes about **15 minutes to 1 hour per week**. The Saltydog data is updated every Wednesday, and that's when you need to review what's happened and decide how to respond. Or you can follow the Saltydog demonstration portfolios.

  If you simply follow one of our demonstration portfolios, then making the necessary changes to your investments will take you about fifteen minutes per week.

  If you want to be more active and make your own independent decisions, then it will probably take you about one hour.

  And just to say – most of our subscribers actively look forward to it!

2 key principles: (The opposite of everything you've ever been told)

Let's get something clear from the start.

If you're an average private investor, then what I'm going to say is going to contradict almost everything you've read or heard about how to be a sensible investor.

Compared with mainstream investment advice, what I'm going to say is not just different. It's the complete opposite.

I'll be telling you things that the majority of investment advisors, professionals, gurus and financial journalists will say are unwise, misguided, deluded, foolhardy, costly, dangerous or impossible.

So it'll probably take you a little while to adjust.

Please be patient. Don't jump to any hasty conclusions. Please stick with me as I explain, because I believe you'll find it incredibly worthwhile.

Though you might well say to yourself, "At last! Something that finally makes sense!"

That's what *I* felt when I got the Saltydog system to work, and proved to myself that it did make money – and *far more* money than anything my financial advisors had ever achieved.

I'd like to begin with two key principles which underlie the whole Saltydog system.

According to our approach, to *make more money safely*:

1. **You actively respond to market trends, identifying the best sectors in the market and moving your money into them, and**

2. **You actively manage your level of risk.**

These two principles differ enormously from the way that most private investors – especially passive investors – think about the stock market.

First, market trends.

Most investors are absolutely helpless in the face of the ups and downs of the market.

They don't think they can do anything about them except passively sit them out – even if the market drops by more than 45%, which has happened *twice* in the last fifteen years. The majority of investors assume you just have to sit and take it, watching your wealth shrinking by the day.

From this point of view, to try and take advantage of **market trends** would be "timing the market" – something that only whizz-kid traders can attempt. For anyone else it's seen as impossible and not worth contemplating.

Essentially passive investors are trusting in the fact that over the *very* long-term - i.e. decades - the market has always gone upwards… and hopefully will do so again.

Not very comforting if you don't have decades ahead of you, is it?

There's a very similar type of attitude towards managing the **risks** of investing – which is what our second Saltydog principle addresses.

The most common approach investors use to manage the risks of the market is also very 'static'. In other words, they have a rough idea of which investments are more or less risky – e.g. small cap shares (risky), blue chip stocks (less risky), bonds (safer), cash (safest) - and they keep a certain percentage in each category, which probably never changes very much. Or if the percentages do change, it's not for any particularly well thought-out reason.

The Saltydog approach is a complete contrast to this. There's nothing passive or static about it. The practicalities will become clear soon. But what's important to understand now is:

Saltydog is all about **actively responding to market trends**, in two main ways:

a) You can ride upward market movements, and also get out of the downturns, and

b) At any one time, there are some market sectors doing well and others doing less well or badly – and you can move in and out of these.

The Saltydog system is also about **actively managing the level of risk** in your portfolio, in response to changing circumstances – and according to clear, rigorous guidelines. (It's not random, or based on personal whim).

Here at Saltydog, we believe this will <u>make you more money</u>. Our demonstration portfolio has proved it.

And it will do so <u>without exposing you to unnecessary risks</u>. In fact, we're confident it will keep your money much safer.

PART 1: How to use the Saltydog system

Quick Start Guide: how to get going right away

We really recommend that you read this Saltydog guide in full before you get started, so that you fully understand the system, the methods and the principles.

But if you're of an impatient disposition, here's the "Quick Start" version:

1. Make sure you have your investment money with a broker or "fund supermarket" that allows you to easily buy and sell funds. **See our Guide to Getting Started**

2. Decide how much risk you're prepared to take, and pick the appropriate portfolio model for deciding where to allocate your money: Tugboat (lower risk), Ocean Liner (medium risk) or Speedboat (higher risk). **See below pp. 35-36**

3. Look at the weekly data on the Saltydog website – www.saltydoginvestor.com - and find the best-performing sectors over the past 4 weeks. **See below pp. 18-19, 21-24**

4. Pick the best fund(s) in these sector(s), and buy it/them. **pp. 33-34**

5. Watch the trends, week by week, and then decide when to sell. **pp. 34-35**

Or, copy what we do…

Alternatively, you can simply follow one of the two Saltydog demonstration portfolios – the Tugboat and the Ocean Liner – where we select specific funds, and I provide you with weekly email updates on all our buying and selling decisions.

Our website: weekly data, portfolio information and newsletters

Our website has a members-only section where you can access:

- All the data (numbers and charts) on sectors and funds, updated every week.
- The details of our two demonstration portfolios: Tugboat and Ocean Liner.

- Back issues of all our monthly newsletters.

Go to: www.saltydoginvestor.com and click on the Login button at the top right.

Any questions?

And if you’ve got any questions at all, please contact me, Richard Webb, at info@saltydoginvestor.com

Why we use funds, and why it's a good idea

The Saltydog system is based upon investing in <u>funds</u>, not purchasing individual company shares.

The reason for this is very simple: when Douglas Chadwick (Saltydog founder) started investing it was using funds, and he developed the system from there.

However, despite that quirk of personal history, there are three definite advantages of using funds for your investment portfolio:

1. **Easy access to all sectors and markets**

   Buying individual company shares in some markets can be tricky. On the other hand, UK-based funds are easy to buy, and provide us with exposure to all markets and sectors across the globe – allowing us to take advantage of uptrends wherever they occur.

2. **Spreading your risk**

   If you buy an individual company share, you run the risk of that company performing badly or going bust. Whereas a fund will have, say, 20-30 companies in its portfolio, and your investment is spread across all of them. Thus with a fund your risk is much more diversified – which is a lot safer.

   Of course you still need to pick the right *sector* of the market to invest in – but that's what the Saltydog system is all about, and we'll get on to that in a minute.

3. **Smart people pick the shares for you**

   Picking individual company shares successfully is a difficult job. If you're going to do it properly, you need to do a lot of analysis and have a good understanding of the market and the company's competitors. Do you have the time, inclination or expertise for that?

   On the other hand, a fund manager is a smart person who specialises in their area of the market and spends their entire working week trying to understand it better. Plus they have a team of analysts poring over the companies in this sector. Can we pick individual shares as effectively as them? Probably not. Let's have the professionals do the job for us.

Of course, some people want to pick individual company shares. That's fine, but it's not what the Saltydog system is about.

Other people will object to using funds for a very practical reason: the cost.

I won't go into this in detail right here. (For a full explanation of the costs involved in funds, and how they compare with buying individual shares, please see our Guide to

Getting Started). But suffice it to say that fund costs have dropped significantly in recent years, and contrary to popular belief it can actually be as cheap or cheaper to trade in funds as it is in shares.

Sectors: a nice, simple way to understand 10,000 funds

Believe it or not, the weekly data that Saltydog uses provides us with information on 100,000 funds.

Yes, you read that right. One hundred thousand!

OK, in reality we can cut that number down quite a bit.

60,000 of those funds are offshore i.e. managed outside the UK. Here at Saltydog system we only use UK-registered funds, so if we deduct the 60,000 offshore funds that immediately brings the number down to 40,000.

Then there are some technical variations in funds, where a particular fund has a few different 'classes' for different customers e.g. one version for institutional (professional) investors, and another for retail investors. There are a couple of other variations too.

Taking account of these fund variations means we can divide the total number by 4, which brings us down from 40,000 to 10,000 funds we can actually consider investing in.

Ten thousand. Yes, that's still an enormous number.

So how on earth do we begin to make sense of them?

In fact it's very easy.

The trade body for the investment management industry, the Investment Association (IA), has conveniently defined 33 different sectors of the market.

Each sector has a clear definition, stipulating which investments can and can't be included, and if a fund wants to be listed in that sector it has to stick to the rules.

For example, a fund listed in the Tech and Telecomms sector can't start putting some of its money into property – because that's not what it was set up to do.

Here are a few examples of the 33 sectors specified by the Investment Association, just to give you flavour of how our 10,000 funds are categorised:

- UK Gilts
- Property
- UK Equity Income

- Global Equity Income
- European Small Companies
- North America
- Tech and Telecomms
- China/Greater China

The 33 IA sectors give the average investor more than enough ways of targetting specific areas of the markets. Whether you like UK small caps, Japan, America, property, global bonds or whatever, there's a fund sector that covers it.

And within each sector, there are hundreds of different funds to choose from. (We'll come to how we pick individual funds a bit later).

So that's one key element of our analysis of all the funds: sub-dividing them into the 33 sectors.

All of the Saltydog data uses these sectors for making the most important decisions, and picking the right sector is the key to getting the best returns with the Saltydog system.

Making it easy to follow the different sectors: the Saltydog 'groups'

When we started analysing all the fund and sector data in the early days of the Saltydog system, we gradually realised that some of the 33 sectors behaved in a similar fashion to other sectors. They would go up and down together - not precisely, but enough to think of them as related.

N.B. If you'd like to understand this in more detail, please see Part 2, Chapters 15 & 16, " From dull to unpredictable: how sectors behave", and "Revealed: the powerful effect of volatility on your investments in four simple charts". See pp. 42-47

So we decided to combine the 33 sectors into just five Saltydog 'groups', to make it easier for us to do top-level analysis.

As I'm sure you know, different sectors of the market behave in very different ways.

Some sectors are very reliable and dependable… and a bit dull. They plod along and nothing much happens. Historically, this means things like cash – the safest, most predictable asset of all - and government bonds from well-established economies. Generally speaking (although not always, especially after the effect of QE on bond markets), your money is safe here, but it's never going to grow very much.

Then at the other end of the scale are sectors of the market which are very unpredictable. When they go up, they really shoot up. And when they go down, they really drop down. Here we find things like small companies, emerging markets, tech and telecomms, and China. You might make a lot of money in these areas, but you might lose a lot too.

To use a more technical term, we can say that the more predictable, reliable investments have *low volatility*. They don't move up and down very much.

And the more unpredictable, 'excitable' sectors have *high volatility*. They move up and down a lot.

The five Saltydog groups represent different levels of volatility, from the lowest to the highest. And in the spirit of Douglas's early work in the merchant navy, we gave them nautical names that reflect the degree of risk involved.

Here are the five Saltydog groups - from the least to the most volatile - along with examples of the sectors included within them:

Most volatile

5. **Full Steam Ahead (Emerging Markets)** – China, Asia/Pacific, Global emerging markets

4. **Full Steam Ahead (Developed Markets)** – UK All companies, UK small companies, America, Japan

3. **Steady As She Goes** – UK equity income, Equity & bond income, flexible investment, Global.

2. **Slow Ahead** – UK gilts, UK corporate bonds, Absolute Return funds, Global bonds

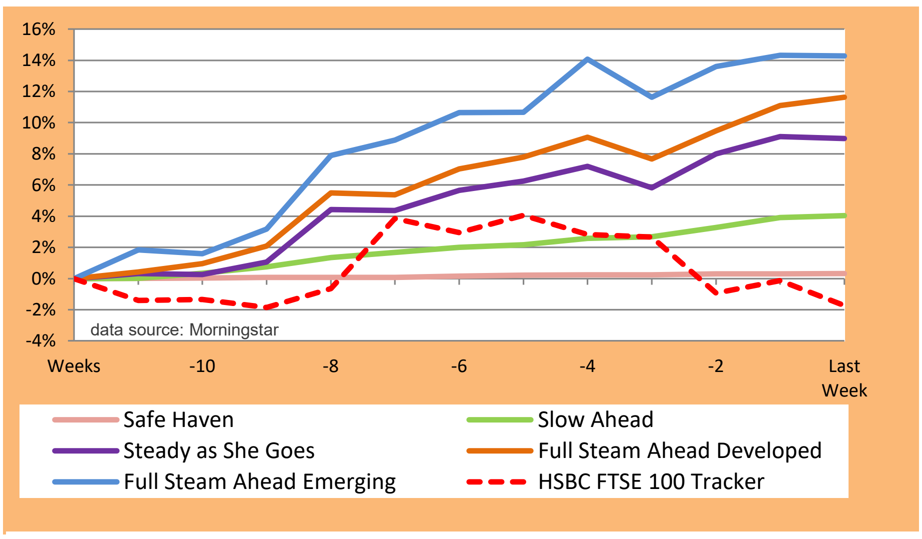
1. **Safe Haven** – Money Markets

Least volatile

To give you a taste of how we use these groups in practice, have a look at the chart below. It's the first chart that we give you with each weekly update of the Saltydog data.

It tracks the performance of each Saltydog group over the previous 12 weeks, and allows you to instantly compare them.

Saltydog Group Comparison



As you can see, the least volatile group – Safe Haven (pink line) – is at the bottom, with the smoothest profile and the lowest return. (Practically zero).

And the most volatile group – Full Steam Ahead, Emerging (blue line) – is at the top, with the choppiest profile and the highest return.

In other words, this particular chart (from 8th December 2015) shows the five Saltydog groups in “perfect order” – with the lowest volatility group showing the smallest return, and the highest volatility group showing the biggest return.

Of course the relative behaviour of the groups doesn’t always look like this. It depends entirely upon the overall market conditions and investor sentiment.

In very uncertain times – e.g. war, financial crisis, political turmoil - the more volatile groups can be at the bottom, with the least volatile groups outperforming them, as investors pull their money from riskier assets and put them in safer places.

The “Safe Haven” group: how do we use it?

Most of the time we will be invested in four groups: Slow Ahead, Steady As She Goes, and the two Full Steam Ahead groups (Developed & Emerging).

What about the Safe Haven group - what’s that for? Essentially the Safe Haven group is like having your money in cash. These sectors are near-cash equivalents. They are the least volatile sectors by far, but also give the lowest returns – especially during a time of very low interest rates. Essentially, moving to Safe Haven is getting out of the stock market completely.

So we would only move our money into the Safe Haven group if *all* the other groups were showing a negative performance. Safe Haven is exactly what it sounds like: a retreat from the market, and into cash (or near-cash).

This situation only arises in the most extreme circumstances – so most of the time we don’t include Safe Haven in the weekly analysis of our demo portfolios.

Why moving your money between sectors makes perfect sense

Before we move on to how we identify trends, let’s just look at why it makes perfect sense to move your money between market sectors.

The simple reason is: at any one time, some sectors are doing better than others.

And here’s the evidence. This is a table of the average performance of each fund sector (grouped into the five Saltydog groups) over the past seven years:

IA Sector	Annual Returns (%)						
	2009	2010	2011	2012	2013	2014	2015
Safe Haven							
Money Market	0.95	0.32	0.03	0.49	0.23	0.29	0.24
Short Term Money Market	0.62	0.17	0.28	0.23	0.14	0.06	0.14
Slow Ahead							
£ Strategic Bond	22.66	8.71	3.91	14.39	3.52	6.92	0.38
£ Corporate Bond	14.67	7.89	5.33	14.29	1.34	10.63	0.22
£ High Yield	47.92	12.29	-1.82	20.39	8.02	2.02	0.02
UK Gilts	-2.65	6.42	16.16	2.04	-4.90	14.92	0.00
Global Bonds	6.66	8.89	2.44	7.98	-2.54	4.87	-1.14
UK Index Linked Gilts	5.69	8.09	21.60	0.35	0.05	18.66	-1.26
Global Emerging Markets Bond	13.93	16.03	0.53	12.58	-9.21	3.42	-5.15
Steady as She Goes							
UK Equity Income	23.06	14.52	-2.43	14.78	25.79	3.62	6.65
UK Equity & Bond Income	18.90	12.30	-0.81	12.75	17.32	4.55	3.99
Global	23.04	15.85	-9.34	9.66	21.79	7.05	2.87
Mixed Investment 40-85% Shares	20.40	12.45	-5.42	10.16	14.77	4.99	2.83
Global Equity Income	18.10	15.35	-1.97	11.03	20.27	7.07	2.57
Flexible Investment	24.75	14.86	-8.53	10.34	14.82	4.83	2.09
Mixed Investment 20-60% Shares	16.32	9.08	-1.62	8.69	9.21	5.04	1.51
Mixed Investment 0-35% Shares	11.82	7.76	1.38	7.02	4.81	5.31	0.86
Full Steam Ahead - Developed							
European Smaller Companies	36.15	25.96	-18.37	22.20	30.72	-1.08	19.15
Japanese Smaller Companies	2.66	22.74	-6.77	5.57	35.78	5.18	17.22
Japan	-3.50	19.17	-11.32	3.29	26.11	0.43	16.10
UK Smaller Companies	51.60	30.90	-8.89	22.70	37.59	-1.58	14.94
Europe Excluding UK	19.46	8.83	-15.41	19.40	26.30	-0.94	9.37
Europe Including UK	22.73	12.26	-12.98	17.98	25.94	0.28	8.31
Property	14.43	12.63	-5.26	12.82	5.64	13.08	5.55
UK All Companies	30.55	17.51	-6.79	15.39	26.45	0.86	5.01
North America	18.53	17.25	-2.03	7.46	30.61	17.77	4.60
North American Smaller Companies	24.52	32.85	-4.15	8.64	36.67	9.83	1.39
Full Steam Ahead - Emerging							
Technology & Telecommunications	45.19	23.28	-3.63	8.61	27.51	12.82	8.00
Asia Pacific Including Japan	28.84	20.96	-16.02	11.04	10.17	5.33	5.21
China/Greater China	56.52	15.09	-21.83	13.66	9.26	9.40	1.48
Asia Pacific Excluding Japan	53.83	22.42	-16.31	16.64	1.89	9.73	-2.81
Global Emerging Markets	60.27	23.68	-19.12	13.60	-3.76	3.43	-9.35

Data Source:Morningstar

As you can see, there is an enormous variation in performance.

Amongst all the different sectors and years, the highest individual gain was Global Emerging Markets in 2009, which went up 60% in one year.

And the biggest loss was China/Greater China, which dropped by -22% in 2011.

Not surprisingly, both these sectors are in our most volatile group: Full Steam Ahead, Emerging Markets.

With the least volatile group, Safe Haven, the gains have been very consistent (and positive), but tiny.

But the main point to draw from this table is that a sector that does well one year may then perform not so well or badly the following year – especially in the more volatile groups.

In other words, if you want to optimise your investment performance, you want to move your money into the best-performing sectors at any one time.

The two indicators for moving your money: a *significant trend*, and *out-performance*

Since the market is moving around all the time, the critical question is:

How do we know when to make a move? – i.e. when to shift our money into the sectors that will perform best?

There are two key indicators:

1. We need to see a *significant trend* in a sector, and
2. We need to see that *this particular sector is significantly out-performing* other sectors.

As regards the first point – obviously we can't be reacting to every little move in the market. We are active investors, but we aren't day traders. So we need a way of filtering out the 'noise' – all the smaller ups and downs – and focussing only on the significant trends.

From all our research and years of experience using the Saltydog system, we have established that **a significant trend consists of 4 consecutive weeks of consistent data**.

Anything less than four weeks' worth of data isn't enough to reveal a trend. With our research we analysed the trend patterns from many different time periods, and four weeks was the most significant.

One proviso: a four-week trend is no *guarantee* that a positive move will continue. A market trend that's been running for four weeks could easily fizzle out in week five.

But four weeks is the best starting point for us… and, most importantly, it has been proven to work – as the results of our demonstration portfolio have shown, significantly beating the FTSE 100 over the past five years.

So four weeks is the key time-period we use for deciding whether a trend *is* a trend.

As regards the second point, the principle here is: **you never invest in a *more* volatile sector, unless it's showing significant out-performance compared to the *less* volatile sectors**.

This is a crucial aspect of the Saltydog approach to risk management.

To put it very simply: Why take on extra risk unless you're getting something worthwhile in return?

The more volatile sectors definitely offer the prospect of bigger gains, when the market is heading up. But they're also *riskier.* You can lose a lot more money in the more volatile sectors too, when the market situation changes. So you only move into them when they are clearly worth it.

(And, as I mentioned earlier, the *extent* to which you increase your exposure to more volatile sectors is entirely up to you – depending upon the level of risk you want to take. We'll come back to this in more detail later. See pp. 35-36).

Here's what you do:

- You look at the four-week performance of the sectors in the various groups: Slow Ahead, Steady As She Goes, Full Steam Ahead (Developed Markets) and Full Steam Ahead (Emerging Markets).

- You ask yourself: Are the returns from the sectors in the Steady As She Goes and Full Steam Ahead groups (higher volatility) significantly better than those from the Slow Ahead group (lower volatility)?

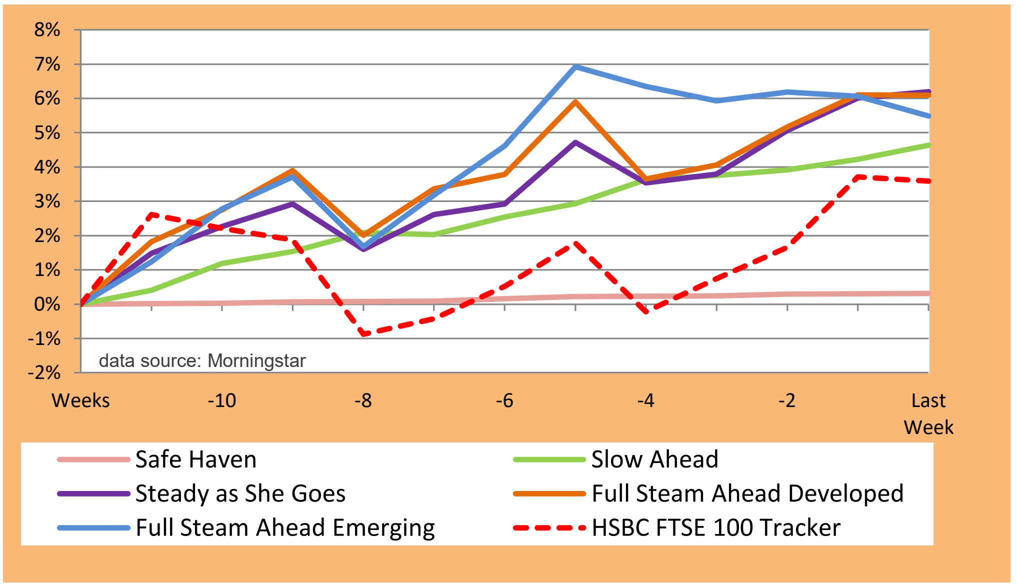
- If the answer is No, then you should simply stick with sectors in the Slow Ahead group.

- And if the answer is Yes, then you can consider investing in sectors in the Steady As She Goes or Full Steam Ahead groups.

A simple example (no. 1)

Let's look at a simple example, using the Saltydog data from one week in May 2014 :

First, if we look at the *top three* Saltydog groups in the chart below, we can see that the most volatile group – Full Steam Ahead, Emerging Markets (light blue line) is performing worse than Full Steam Ahead, Developed Markets (orange line) and Steady As She Goes (purple line).



And particularly over the last 4 weeks (look at the 4-week mark on the bottom axis), Full Steam Ahead, Emerging Markets (blue) has dropped, whereas Full Steam Ahead Developed (orange) and Steady As She Goes (purple) have gone up.

So in this scenario, why would we invest in Full Steam Ahead, Emerging Markets? We wouldn't. It's a more volatile group, it's more risky, and it's <u>under</u>performing.

We can get actually get a *better* return from *less risky* groups, so there's absolutely no point in investing in the most risky group (Full Steam Ahead, Emerging).

To look at this in more detail, let's consider the fund sectors within these groups.

Here are the Saltydog numbers for the top sectors in these three groups. (Listed in order of volatility, with the least volatile at the bottom).

FULL STEAM AHEAD - Emerging Group

Sector	4wks
Gbl Emerging Markets	-0.1%
Tech & Telecomms	-0.1%
Asia Pacific inc/ex Japan	-1.0%
China/Greater China	-5.8%
Average:	*-1.7%*

FULL STEAM AHEAD - DEVELOPED Group

Sector	4wks
UK All Companies	3.3%
Property	2.8%
Japan inc Sm COs	1.9%
Europe Inc/Ex UK	1.6%
N America inc Sm COs	1.4%
European Small COs	1.0%
UK Small COs	0.3%
Average:	*2%*

STEADY AS SHE GOES Group

Sector	4wks
UK Equity Income	3.8%
UK Equity & Bond Inc	3.4%
Global Equity Income	2.2%
Mxd Inv 40-85% Shares	1.4%
Mxd Inv 0-60% Shares	1.3%
Global	1.3%
Flexible Investment	0.9%
Average:	*2.0%*

If you look at the bottom figure in each column – the *Average* for each group – you can see that they simply reflect what's shown on the chart. Over the last four weeks, FSA Emerging has gone down -1.7%, whilst FSA Developed and Steady As She Goes have both gone up 2%.

But what's also key is the highest-performing sector. As you can see, over the last four weeks the highest return is 3.8% from the UK Equity Income sector. And which group is this sector in? It's in Steady As She Goes, which is the *least* volatile group of the three.
So… let me summarise what we've learnt here.

From the chart, the group analysis shows us that FSA Emerging is doing worse than FSA Developed and Steady As She Goes. From this we obviously conclude that FSA Emerging is *not* the group we want to invest in. At this point we could also conclude that investing in *either* the FSA Developed or Steady As She Goes groups would be equally worthwhile – since they both show the same average return over the last four weeks.

However, when we look closer at the sector analysis, it's clear that the best - performing sector (UK Equity Income) is in Steady As She Goes – the *least* volatile group.

And our 'default' position is always to revert to the *least* volatile groups, if the more volatile groups are not significantly out-performing them. So here we would invest in the UK Equity Income sector.

With this example it's easy to see how we apply the second principle outlined above:

You never invest in a *more* volatile sector, unless it's showing significant out **- performance relative to the *less* volatile sectors**.

Let's consider the possibility that a higher volatility sector *was* out-performing UK Equity Income. What sort of out-performance would we need to see, to justify taking on the higher volatility? Compared with the 3.8% return from UK Equity Income – in the relatively low risk Steady As She Goes group – we'd need to see a return of something like 4.5% or more in a higher volatility group. Otherwise it would simply not be worth taking on the extra risk.

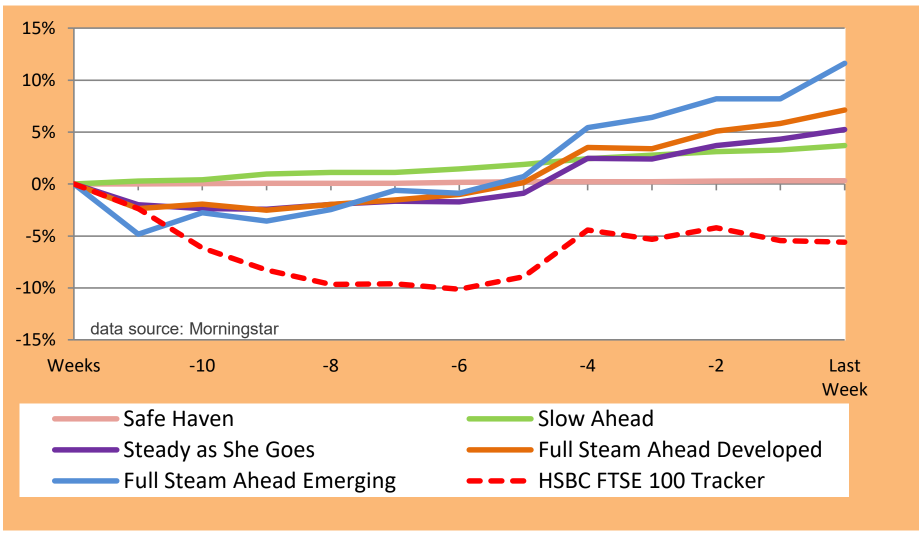
N.B. This example doesn't take into account *all* the factors we'd probably consider before deciding on a sector to invest in. But it gives you a good idea of the key points.

A simple example (no. 2)

Just for the sake of clarity, let's consider another example where the situation is different.

Here we are using some Saltydog data from a week in November 2015.

Here's the group chart. And we can see here that Full Steam Ahead, Emerging Markets (the blue line) – the most volatile group - is clearly performing the best, particularly over the last four weeks:



Now let's look at the sector numbers, to see whether they confirm the group snapshot or not.

FULL STEAM AHEAD - Emerging Group

Sector	4wks
Tech & Telecomms	7.8%
China/Greater China	7.2%
Asia Pacific inc/ex Japan	3.2%
Gbl Emerging Markets	2.8%
Average:	*5.3%*

FULL STEAM AHEAD - DEVELOPED Group

Sector	4wks
N America inc Sm COs	6.0%
Japan inc J Small COs	4.2%
Property	1.8%
Europe inc/ex UK	1.8%
European Small COs	1.6%
UK Small COs	1.4%
UK All Companies	1.1%
Average:	*3%*

STEADY AS SHE GOES Group

Sector	4wks
Global	4.1%
Global Equity Income	2.8%
Flexible Investment	2.5%
Mxd Inv 40-85% Shares	1.9%
Mxd Inv 0-60% Shares	1.3%
UK Equity Income	0.7%
UK Equity & Bond Inc	0.5%
Average:	*2.0%*

SLOW AHEAD Group

Sector	4wks
£ High Yield	1.9%
Targeted Abs Return	1.5%
Global & GEM Bonds	0.9%
£ Strategic Bond	0.8%
Slow Property	0.7%
£ Corporate Bond	0.2%
UK Gilts & I-Lnkd Gilts	-0.9%
Average:	*0.7%*

If we look at the *Average* figure for each group (at the bottom of each column), here you can see that as the volatility of the groups increases, so do the returns. In this example the most volatile group – FSA Emerging - has got by far the best average return.

Most volatile	FSA Emerging	5.3%
	FSA Developed	3.0%
	Steady As She Goes	2.0%
Least volatile	Slow Ahead	0.7%

And the same is true of the sectors. The best-performing sector – Tech & Telecomms – is in the *most* volatile group (FSA Emerging), with a four-week return of 7.8%.

If we go down to the *next lower*-volatility group, FSA Developed, the best-performing sector here – N America incl Small Companies – has a four-week return of 6%.

In other words, the higher-volatility sector – Tech & Telecomms – is showing significant out-performance relative to the lower volatility sectors. In fact it's out-performing by 1.8%, which is a big difference over four weeks.

And therefore, in this case, we *would* want to increase our exposure to the higher-volatility sector, because the much higher performance does justify it.

Two 'odd' sectors

Tech & Telecomms, and Property: how they fit into the Saltydog groups

Most of the IA fund sectors fit nicely into the Saltydog groups in a way that is self-evident.

However with two sectors this isn't true: Tech & Telecomms, and Property.

How do we assign them to the appropriate Saltydog groups? By carefully analysing their volatility. Tech & Telecomms is very volatile, so it fits in with the "Full Steam Ahead, Emerging Markets" group – the most volatile one.

With the Property sector, we've taken the official IA sector and sub-divided it into two. (These two 'sub-sectors' are our own invention, and not part of the IA scheme). Again this is based on our analysis of the volatility of the funds within it.

"Slow Property" goes in the Slow Ahead group. And "Property" goes in the Full Steam Ahead, Developed Markets group.

How you identify a worthwhile trend

We've already talked briefly about trends, and how – in order to consider investing in a particular sector - we need to see *four consecutive weeks* of consistent data. (See pp. 23-24).

But it's also useful to look at a couple of other time periods: 12 weeks, and 26 weeks.

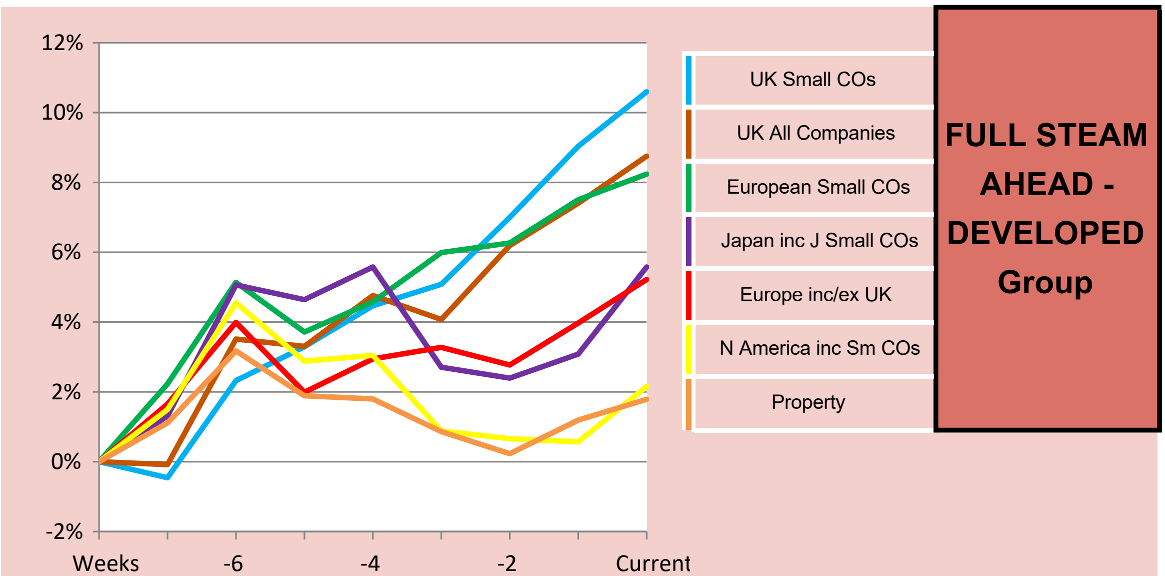
Just to reiterate, four weeks is the key period that we consider. **Our primary decision-making comes from the 4-week numbers**.

Having said that, if we've identified a 4-week trend and we see that it also has a positive 12-week trend, this is nice confirmation of the 4-week trend. It's not essential that the 12-week trend is also present, but it gives added weight to the significance of the trend.

Finally, the 26-week trend – if it's present – is even further confirmation that the 4-week trend is part of a longer-term movement. It's not often that we see a 26-week trend in one particular sector, but when we do it's a real money-making opportunity.

For example, here's an example of weekly data for the Full Steam Ahead Developed group, from May 2015.

Look at the performance of the top sector - UK Small Companies:



Sector	4wks	12wks	26wks	Wk -1	Wk -2	Wk -3	Wk -4	Wk -5	Wk -6	Wk -7	Wk -8
	Percentage Return Data										
UK Small COs	**5.0%**	8.6%	18.2%	1.6%	2.0%	1.9%	0.6%	1.2%	1.0%	2.8%	-0.5%
UK All Companies	**3.0%**	6.6%	15.3%	1.3%	1.2%	2.1%	-0.7%	1.5%	-0.2%	3.6%	-0.1%
European Small COs	**2.5%**	9.2%	19.1%	0.7%	1.2%	0.3%	1.4%	0.9%	-1.4%	2.9%	2.2%
Europe inc/ex UK	**1.2%**	6.6%	13.6%	1.2%	1.2%	-0.5%	0.3%	1.0%	-2.0%	2.3%	1.6%
Japan inc J Small COs	**-1.1%**	7.7%	19.3%	2.5%	0.7%	-0.3%	-2.9%	0.9%	-0.4%	3.8%	1.3%
Property	**-1.1%**	1.4%	10.9%	0.6%	1.0%	-0.6%	-0.9%	-0.1%	-1.3%	2.1%	1.1%
N America inc Sm COs	**-2.1%**	1.2%	7.3%	1.6%	-0.1%	-0.2%	-2.2%	0.2%	-1.7%	3.1%	1.5%
Average:	*1%*	*5.9%*	*14.8%*	*1.4%*	*1.0%*	*0.4%*	*-0.6%*	*0.8%*	*-0.9%*	*2.9%*	*1%*

The UK Small Companies sector stays top of the tree and a 5% return over the last 4 weeks is very impressive.

The combined Japanese sectors did well last week with a 2.5% gain, but its 4 week return is still negative.

As you can see, the 4-week data is the first column of the table, outlined in black. UK Small Companies are way out ahead of the other sectors, with a 5% return over the last 4 weeks.

Then look to the next two columns to the right: 12 weeks and 26 weeks. Here you can see that the positive trend is confirmed – with a 12 week return of 8.6%, and a 26 week return of 18.2%.

Admittedly with the 12-week and 26-week returns there are other sectors in the top position. If you look down the 12-week column, you'll see that European Small Companies have outperformed UK Small Companies over this period, with a 9.2% return. And over 26 weeks Japan incl. Japanese Small Companies has the highest gain, with 19.3%.

This is where some people may want to take slightly different approaches.

If you prefer to stick to trends which have been established over longer time periods (12 weeks or 26 weeks), then you might choose to invest in the European Small Companies or the Japanese Small Companies sector.

But if you're happy investing in trends that have emerged over a shorter time period (4 weeks), then you'd invest in the UK Small Companies sector – as that's the largest return over the most recent 4-week period.

From our perspective, the key period is 4 weeks (which is why it's outlined in black), and it's clear from this table that UK Small Companies are way out in front. The 12-week and 26-week numbers just serve to confirm the positive trend over longer periods – giving us extra confidence that this is a good sector to invest in.

There are also other situations where the 12-week and 26-week data is useful.

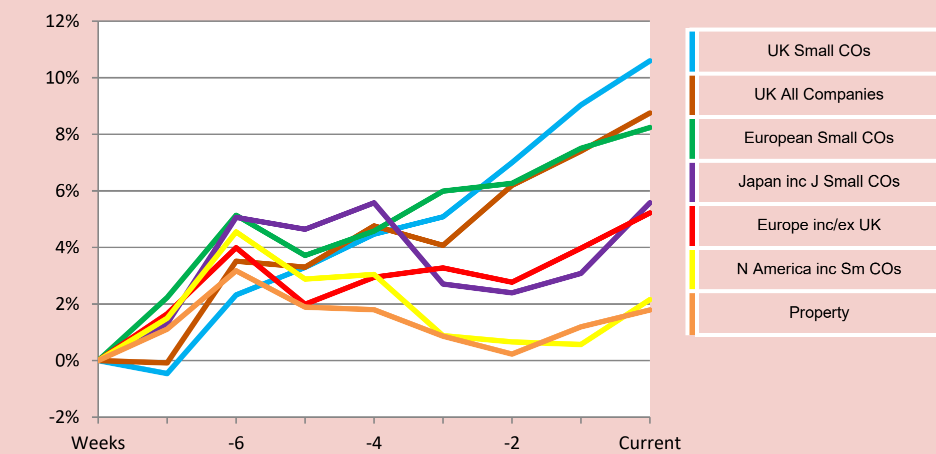
One is when you are wondering whether to stay in a sector. For example, you may be invested in the UK Small Companies sector and then one week you see, from the 4-week data, that the Japan incl. Japan Small Companies sector has jumped ahead of it. Do you immediately sell your UK Small Companies fund and buy a Japanese fund?

Not necessarily. If the sector you're already invested in has got a stronger performance over 12 and/or 26 weeks, then it's best to stick with the one you've got.

Also when it comes to choosing between different funds in a sector – if you're trying to decide between two funds with similar short-term (4-week) performance, then if one of the funds has a better longer-term trend over 12 or 26 weeks, that would tip the balance.

There are two other pieces of information from the Saltydog data that can help you ascertain trends. These are the week-by-week numbers over the last eight weeks, and the corresponding 8-week chart.

Let's take the same example of weekly data that we just looked at:



FULL STEAM AHEAD - DEVELOPED Group

Sector	Percentage Return Data										
	4wks	12wks	26wks	Wk -1	Wk -2	Wk -3	Wk -4	Wk -5	Wk -6	Wk -7	Wk -8
UK Small COs	**5.0%**	8.6%	18.2%	1.6%	2.0%	1.9%	0.6%	1.2%	1.0%	2.8%	-0.5%
UK All Companies	**3.0%**	6.6%	15.3%	1.3%	1.2%	2.1%	-0.7%	1.5%	-0.2%	3.6%	-0.1%
European Small COs	**2.5%**	9.2%	19.1%	0.7%	1.2%	0.3%	1.4%	0.9%	-1.4%	2.9%	2.2%
Europe inc/ex UK	**1.2%**	6.6%	13.6%	1.2%	1.2%	-0.5%	0.3%	1.0%	-2.0%	2.3%	1.6%
Japan inc J Small COs	**-1.1%**	7.7%	19.3%	2.5%	0.7%	-0.3%	-2.9%	0.9%	-0.4%	3.8%	1.3%
Property	**-1.1%**	1.4%	10.9%	0.6%	1.0%	-0.6%	-0.9%	-0.1%	-1.3%	2.1%	1.1%
N America inc Sm COs	**-2.1%**	1.2%	7.3%	1.6%	-0.1%	-0.2%	-2.2%	0.2%	-1.7%	3.1%	1.5%
Average:	*1%*	*5.9%*	*14.8%*	*1.4%*	*1.0%*	*0.4%*	*-0.6%*	*0.8%*	*-0.9%*	*2.9%*	*1%*

The UK Small Companies sector stays top of the tree and a 5% return over the last 4 weeks is very impressive.

The combined Japanese sectors did well last week with a 2.5% gain, but its 4 week return is still negative.

The last eight weeks' numbers are on the right of the table, after the 4-week, 12-week and 26-week numbers. They are presented in reverse chronological order, with the most recent week's performance, "Wk -1", coming first, all the way down to Wk - 8.

What these weekly numbers enable to us to do is see how strongly a trend is performing, and whether new trends are emerging. The corresponding chart gives a more visual representation of the same data.

For example, in the data above we can see that UK Small Companies have had a positive gain in seven out of the past eight weeks. It's only the Wk -8 figure that is negative. So that is a very strong trend. Obviously you can also see that visually from the chart, where the light blue line representing UK Small Companies is soaring upwards.

But what we can also see from the weekly data is Japan incl. Japan Small Companies is the best-performing sector in the past week (Wk -1), with a 2.5% gain, compared with the 1.6% gain for UK Small Companies.

Although we certainly wouldn't be investing in the Japanese sector this week – as it's the 4-week data that's crucial, and over four weeks this sector is showing a negative return of -1.1%. However the strong movement over the last week gives us something to look out for over the next few weeks, to see whether a new trend is starting to emerge.

Another factor you can see from the chart is the relative volatility of the different trends. If you want to avoid fluctuations in your investments, then you want to choose the nice, smooth, upward-moving trends, rather than more 'choppy' ones. If you can live with the volatility, it doesn't matter so much.

In the chart above we can see that not only are UK Small Companies (light blue line) out-performing all the other sectors, but that this sector also has the smoothest upward trend.

The final investment decision: picking funds

Now we come to the final decision we need to make about where to put our money: which fund to buy?

There's one thing to remember here…

When it comes to getting the best investment performance from the Saltydog system, the most important question is: Which sector is performing the best?

In other words, if you *pick the right sector*, but don't necessarily choose the 'perfect' fund in that sector, you're going to do well.

But on the other hand, if you pick a good fund without considering which is the best sector, you're not going to do so well overall.

It's getting in and out of the right sectors that's the key to good performance.

So… our first step is always to pick the best-performing sector. As we've already covered, that means we need to:

- Identify a genuine trend – primarily using the 4-week numbers.
- Find a sector that is out-performing other sectors.
- Only pick a sector in a *more* volatile group if it's significantly out-performing sectors in *less* volatile groups.

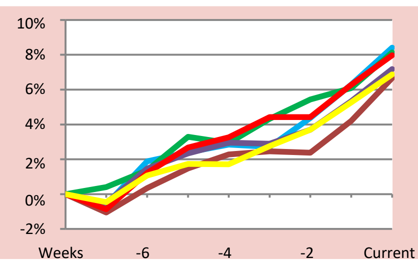
Once we've identified the specific sector we want to be in, then we have to pick a fund within that sector to buy.

How do we do that?

Let's return to the example we just looked at, from May 2015, where we identified the UK Small Companies as the best-performing sector (pp. 30-31).

We can now move on from the *sector* data, and look specifically at the Saltydog *fund* data for the UK Small Companies sector. The fund table looks like this:

Full Steam Ahead Developed Group - 4 Week Data



UK Small COs	4 Week		12 Week		26 Week		Recent Weekly Deciles							
	Dec	**Ret**	Dec	Ret	Dec	Ret	-1	-2	-3	-4	-5	-6	-7	-8
Franklin UK Sm Cos	**1**	**5.7%**	1	8.2%	1	20.7%	1	1	3	3	6	1	6	8
Ignis Small COs	**1**	**4.4%**	3	6.8%	4	13.7%	1	1	6	2	5	1	10	10
MFM Techinvest Special Situ	**1**	**5.2%**	4	5.8%	5	12.1%	1	5	4	1	9	1	10	5
Schroder UK Small COs	**1**	**4.3%**	1	10.6%	1	17.7%	2	1	5	3	6	1	9	8
Cavendish AIM	**1**	**4.8%**	4	6.0%	9	7.4%	2	1	6	1	6	1	8	10
Liontrust UK Smaller COs	**1**	**5.3%**	3	6.8%	6	11.1%	2	2	5	1	8	1	10	8

As you can see, with each sector we show the top 6 best-performing funds.

And just like the sector data, we have a breakdown into 4-week, 12-week and 26-week performance.

Plus we have a week-by-week analysis of the last 8 weeks' performance.

Though there is one important difference compared with the sector data – and that is that we use *deciles* as a way of measuring fund performance.

What are 'deciles'?

A decile (pronounced "dess-ile") is a method of indicating the performance of an investment fund over a period of time compared to its peer group (i.e. compared to all other funds within that particular Saltydog group), rated on a scale of 1-10. Number 1 indicates that the fund is in the top 10% of funds being compared, whilst 10 indicates that the fund is in the bottom 10%. We use decile ranking instead of the more common quartile ranking because it more accurately pinpoints the leading funds.

Detailed decile performance. With the weekly Saltydog data, we provide a separate data sheet which shows the decile performance for the last 12 weeks for all the top-performing funds.

When we're picking a fund within a sector, the principle is essentially the same as when picking sectors:

- Which fund (in the chosen sector) has a strong 4-week trend?
- Is this fund in the top half of the sector i.e. not lower than deciles 1-5 ?
- Looking at the 8-week performance, does it consistently have a high decile ranking, or is it jumping up and down a lot?

Looking at the example table above, we can see that the Franklin UK Small Companies fund does pretty well on all these criteria:

- It has the highest 4-week return, of 5.7%
- It is in decile 1, and
- It's been in decile 1 for three of the past eight weeks, and has been in the top half (deciles 1-5) for the past four weeks.

So within the UK Small Companies sector, which is where we want to invest, we would pick the Franklin UK Small Companies fund as our chosen vehicle – and put our money into that.

How do you decide when to sell?

Once you've invested in a particular sector, by buying a particular fund, you have a different question to deal with: How do you decide when to sell?

With the Saltydog system we have different guidelines for when you're buying and when you're selling.

When you're buying, you're looking to identify the best fund, in the best sector, in the best group.

Then, when you own a particular fund, you have to decide what to do with it. Of course if it keeps performing well, you hold on to it or even invest more money in it.

But what if things aren't going so well?

Essentially we want to see a fund in the top half of decile performance i.e. in deciles 1-5. If it starts dropping off, we give it three weeks' grace. Although we are active investors, we don't want to be buying and selling literally all the time. We give it the benefit of the doubt for three weeks.

So we will keep hold of a fund, even if it's decile ranking is dropping, for a few weeks. But if we see that it's dropped out of the top half of the decile rankings for three weeks in a row – i.e. its decile ranking is 6 or worse – then we will sell it.

If you're feeling more cautious, you could be more pro-active than this. For example, if a fund has been in decile 6 or lower for two weeks, you could halve your allocation to it. And then if it stays in decile 6 or lower for the third week, then you would sell completely. So you can either do things more gradually, or simply wait until you see three bad weeks in a row (decile 6 or lower) and then sell all at once.

Another situation to consider is where the fund you hold is doing fine, but another fund overtakes it. What do we do here?

The answer is that we'll tend to keep the fund we already hold over the short term i.e. 4 weeks or so. But if we see that the other fund is out-performing over a longer period – i.e. 6-8 weeks – then we will replace the one we own with the better-performing one.

Cautious or adventurous? Deciding how much risk you want to take

You probably have a good sense of how much risk you want to take on.

Maybe you are adventurous, hoping to make some really big gains, and prepared for the losses that might come your way.

Maybe you're more cautious, preferring to know that your money isn't at too much risk, and hoping for steady but less spectacular returns.

Or maybe you're something in between.

Whatever your attitude to risk, the Saltydog system can work perfectly for you. And to help you with your risk management, we've set up some easy-to-use guidelines.

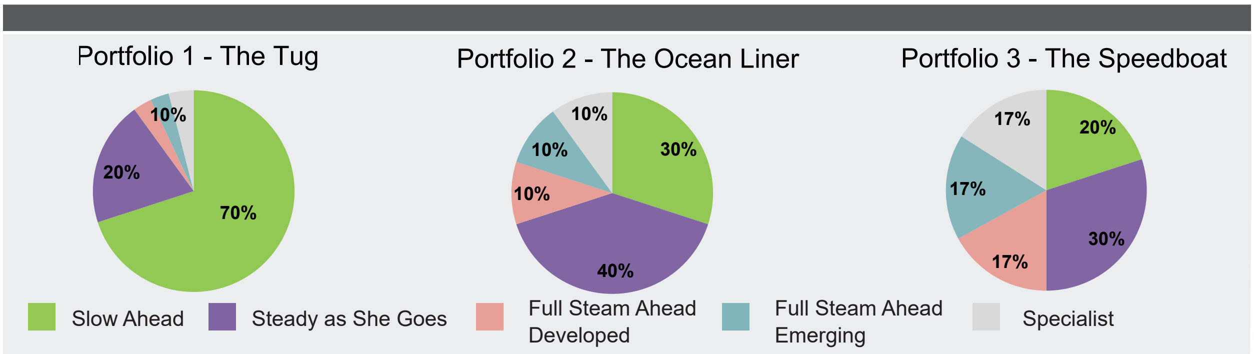
As you know from the different Saltydog groups, the more you invest in the Safe Haven and Slow Ahead groups (lowest volatility), the better you will sleep at night.

Conversely, the more you invest in Steady As She Goes (medium volatility) and the two Full Steam Ahead groups (high volatility), the more exciting, and also turbulent, life becomes.

In order to make it easy for you, we've created three model portfolios – low risk, medium risk and high risk – which specify what proportion of your money you should allocate to each of the Saltydog groups.

These three model portfolios are called the **Tugboat** (low risk/volatility), **Ocean Liner** (medium risk/volatility) and **Speedboat** (high risk/volatility).

Here they are:



By choosing the model that matches your level of risk tolerance, you ensure that your portfolio maintains the right balance of investments. (Otherwise known as 'asset allocation').

As you can see straight away, the Tug (lowest risk) has a very *large* percentage allocated to the low volatility Slow Ahead group: 70%. And it only has a *small* percentage allocated to the three high volatility groups – Full Steam Ahead Developed, Full Steam Ahead Emerging, and the 'Specialist' sector: just 10% for all three combined. This is what keeps it safer and more stable.

With the high risk Speedboat portfolio, the emphasis is the other way round. The Speedboat has a much higher proportion (50%) in the three high volatility groups, and a lower proportion in the low volatility groups (only 20% in Slow Ahead).

What is the "Specialist" sector?

The Specialist sector is one of the official Investment Association (IA) fund sectors. In the words of the IA, it contains funds that "are not accommodated by the mainstream sectors". And we don't assign it to any of our Saltydog groups – we consider it separately.

The Specialist sector includes funds that invest in areas such as gold, natural resources, agriculture, Latin America, Russia & Eastern Europe.

From the Saltydog perspective, the Specialist sector is risky and highly volatile, but it does provide some very interesting opportunities from time to time.

But what's also very important to understand is that the percentage of our portfolio allocated to each of these groups is not fixed – it depends on the market situation.

Let me explain.

In a static asset allocation model, you would decide – for example – that you'd have 40% of your portfolio in UK shares, 40% in bonds, and 20% in cash. And these percentages would be fixed. You'd try to maintain them all the time, whatever the market was doing.

But with the Saltydog system, we are always responding to what the market is telling us – via our data. Nothing is static.

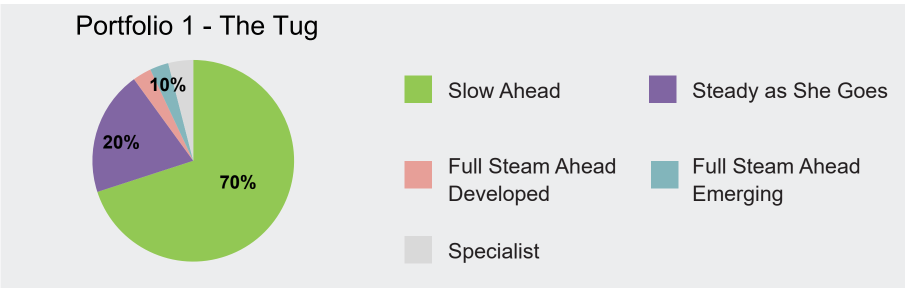
With each of the three model portfolios above, we have shown them in their most 'adventurous' states. These are the percentage allocations for when the market is in *optimum* conditions, with everything going smoothly and heading nicely upwards – meaning that the higher volatility groups will be clearly out-performing the lower volatility ones.

On the other hand, if market conditions become uncertain or more risky – i.e. the higher volatility groups are no longer out-performing - then the portfolio allocations become more conservative. We shift our money out of the more volatile, and into the less volatile groups.

Remember the key Saltydog principle that we explained on page 24:

You never invest in a *more* volatile sector, unless it's showing significant out-performance relative to the *less* volatile sectors.

With the model portfolios, it works like this. Let's take the Tugboat as our example.



Tugboat portfolio: group allocations in *optimum* market conditions

These are the group allocations for the Tugboat portfolio *in optimum market conditions*:

- 70% in Slow Ahead
- 20% in Steady As She Goes, and
- 10% across the three most volatile groups – Full Steam Ahead Developed, Full Steam Ahead Emerging, and the Specialist sector.

(a) Markets doing badly

But let's say that we're not in optimum market conditions. We look at the Saltydog data and we see that – based on the 4-week trends - the sectors in the Slow Ahead group (the least volatile) are doing better than any of the other (more volatile) groups. Or, to put it the other way round, the more volatile groups are not outperforming the Slow Ahead group. What do we do now?

We certainly won't be investing in the *more* volatile groups, because they're not outperforming. So, as long as there is a decent performance to be achieved from the Slow Ahead group, we'll put all our money into Slow Ahead:

How does this follow from the optimum version of the Tugboat pie chart?

As we've seen from the previous pie chart above, the Tugboat allocation in *optimum* market conditions allows us to invest 30% of our money in groups that are *more* volatile than Slow Ahead - with 20% of our money in Steady As She Goes, and a further 10% in the three most volatile groups (Full Steam Ahead Developed, Full Steam Ahead Emerging, and the Specialist sector).

We are always happy to *reduce* our exposure to the more volatile sectors – because that means less risk, and our money being relatively safer. So if the more volatile sectors aren't out-performing, it makes perfect sense to take the money allocated to them and invest it in *less* volatile sectors instead.

Therefore, in this instance, we take the 30% we could put in to the more volatile sectors, and allocate all of it to Slow Ahead sectors.

(b) Markets pick up

If the market starts to pick up and we begin to see *out*-performance by the more volatile sectors, then we will start to move our money into them.

Let's assume that the sectors in the Steady As She Goes group are now outperforming the Slow Ahead group. Let's also assume that the three most volatile Groups are *not* outperforming Steady As She Goes.

In this case we could allocate up to 30% of our money into Steady As She Goes:

Since the three highest volatility groups are not out-performing Steady As She Goes, we can take the 10% allocated to them and assign it to Steady As She Goes, because it's a lower volatility group. So 20% (the allocation to Steady As She Goes in optimum conditions) plus 10% equals 30%.

(c) Markets pick up further: optimum conditions

If the market picks up even further, and we see significant out-performance in the *most* volatile groups, we can then put some of our money into those. And thus we would end up with our money in the most aggressive arrangement of the Tugboat portfolio, like this:

Here there's 70% allocated to Slow Ahead, 20% allocated to Steady As She Goes, and 10% allocated across the three most volatile groups.

The key thing is that you never exceed the maximum allocations allowed for your exposure to more volatile groups.

For example, if you adopt the Tugboat portfolio, you will *never* allocate more than 10% of your money to the three most volatile groups – however well they are doing. If you're only happy with the lower level of risk, which is what the Tugboat is designed for, you simply don't want to take on more than 10% exposure to the groups with the highest levels of volatility.

With Steady As She Goes, here you could go up to a maximum of 30% exposure. (As we saw above). Never more than that, with the Tugboat, however well these sectors are performing.

And with Slow Ahead, as we've seen, you could be in a situation where 100% of your money is in this group.

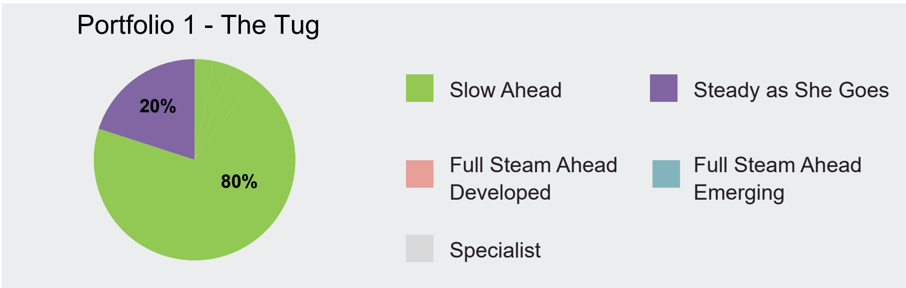
(d) Other possible allocations

The examples I've given above show the ideal, logical progression. In other words, as the market picks up, the more volatile groups gradually start to out-perform – so we move from the Slow Ahead group, to the Steady As She Goes group, and finally to the three most volatile groups.

But, depending on how the various sectors are performing, it doesn't always go in a perfectly neat progression – going up step-by-step through the more volatile groups.

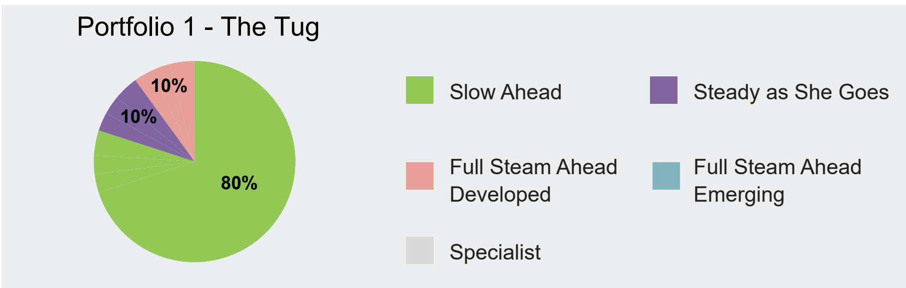
Here's another possibility.

Let's say we have 80% of our money allocated to Slow Ahead, and 20% allocated to Steady As She Goes, like this:



Now if the market picks up further, the next logical thing to do – based on the principles I've just explained - would be to increase our exposure to Steady As She Goes, up to the maximum of 30% that the Tugboat allows.

But let's say that the higher volatility Full Steam Ahead group is flying along, and far out-performing the Steady As She Goes group. In this situation you could actually decide to move money into the Full Steam Ahead group *before* filling up the full Steady As She Goes allocation, like this:



Here, because it's out-performing so strongly, we've put 10% of our money into Full Steam Ahead Developed - even though we still have 'only' 10% of our money allocated to Steady As She Goes.

The key points are that:

(a) You only move into more volatile groups when their out-performance merits it, and

(b) Whichever portfolio you pick, you never exceed the maximum allocations for your exposure to the more volatile groups.

Exactly the same principles apply to the other portfolios - Ocean Liner and Speedboat – but just using different percentages, giving you more exposure to the volatile groups.

(e) A complete market melt-down

Last of all, if there is a major crisis and the markets totally collapse – where even the Slow Ahead group is not showing a positive performance – then we would move our money into the Safe Haven group.

This is the equivalent of getting out of the stock market completely – effectively moving into cash. (See the note on Safe Haven on p.21).

PART 2: The principles – how Saltydog works

From dull to unpredictable: how sectors behave

Different sectors of the market behave in very different ways.

As I explained earlier (see p. 19), some sectors are very reliable and dependable… and a bit dull. They plod along and nothing much happens. Historically, this means things like cash – the safest, most predictable asset of all - and government bonds from well-established economies. Generally speaking (although not always, especially after the effect of QE on bond markets), your money is safe here, but it's never going to grow very much.

Then at the other end of the scale are sectors of the market which are very unpredictable. When they go up, they really shoot up. And when they go down, they really drop down. Here we find things like small companies, emerging markets, tech and telecomms, and China. You might make a lot of money in these areas, but you might lose a lot too.

To use a more technical term, we can say that the more predictable, reliable investments have *low volatility*. They don't move up and down very much.

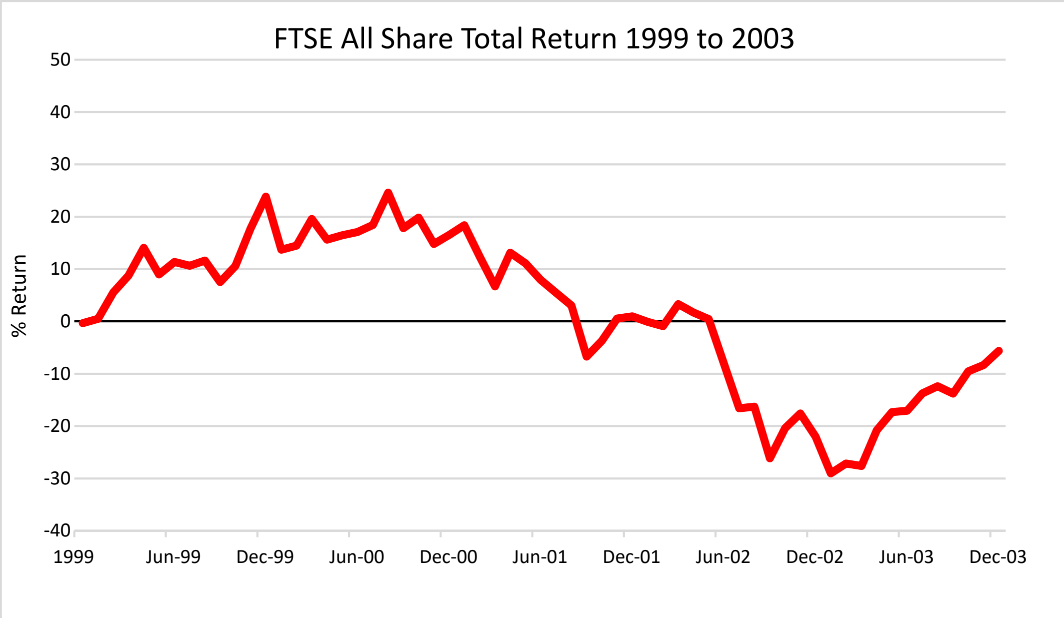
And the more unpredictable, 'excitable' sectors have *high volatility*. They move up and down a lot.

This is crucial to our investing, and especially to the Saltydog system.

So I'd now like to show you what different levels of volatility actually look like in the markets, and how this can have a practical, profitable effect on our investing. It will just take four simple charts.

Revealed: the powerful effect of volatility on your investments, in four simple charts

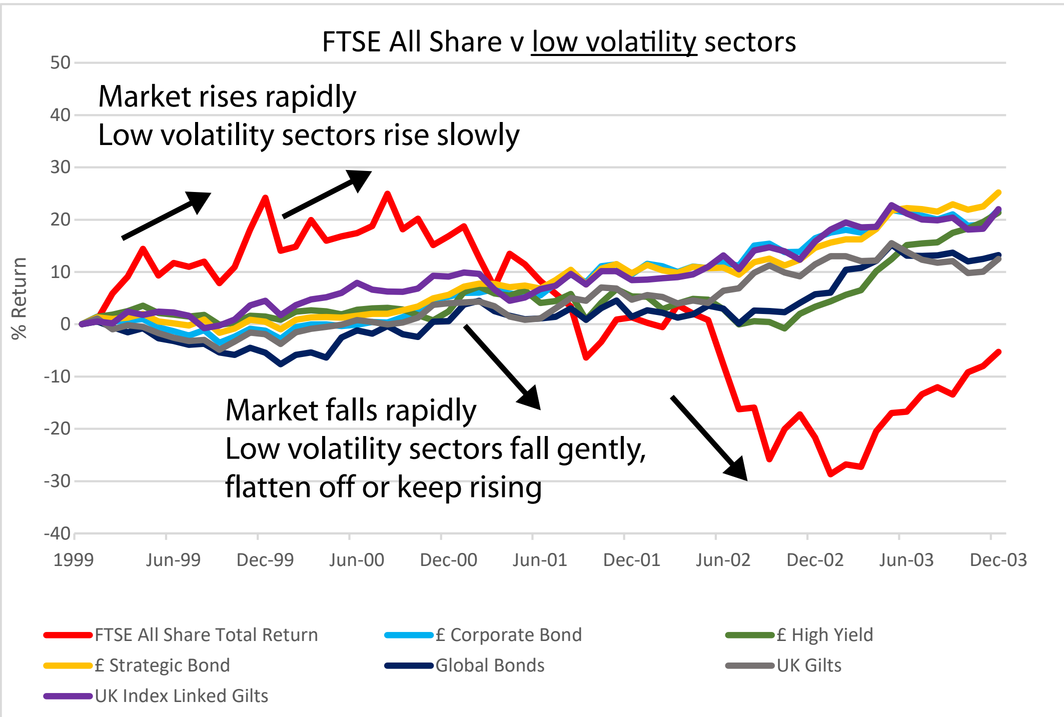
Take a look at this. It's a chart of the FTSE All Share index over four years from 1999 - 2003.



Using this chart as a baseline, let's see how some of the <u>low</u> volatility sectors compare with it.

Here's the same chart of the FTSE All Share again (in red), but this time with the performance of various low volatility sectors superimposed on it.

The crucial thing to notice is the relationship between the FTSE All Share (red line), and the low volatility sectors.

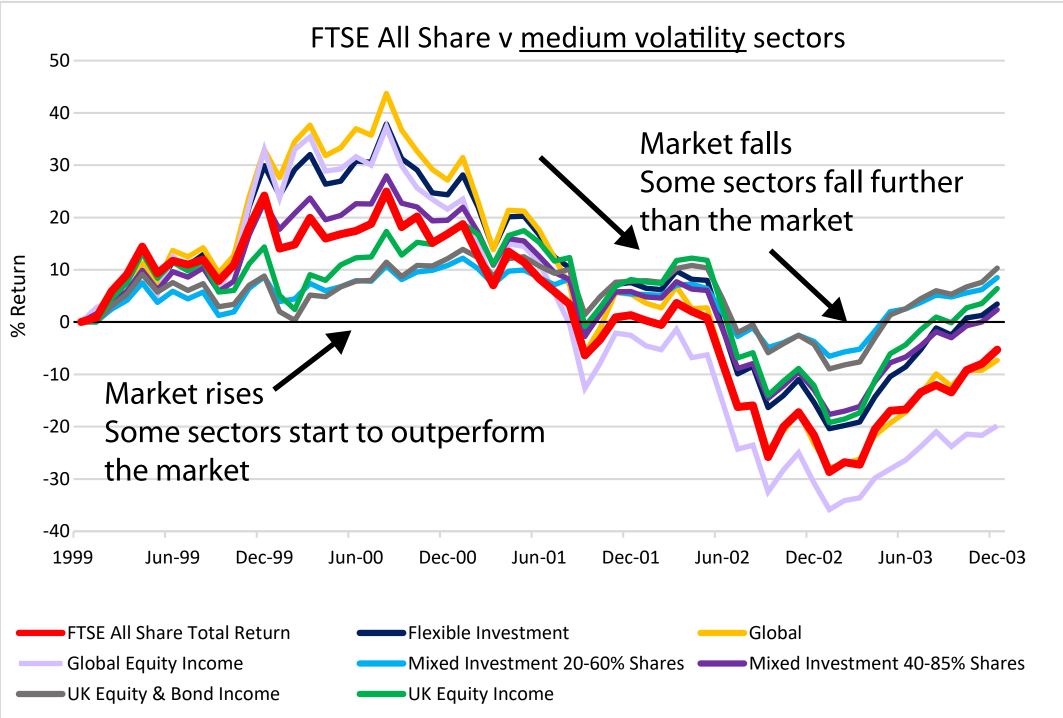


As you can see, when the All Share (red line) rises rapidly in the first third of the chart, the low volatility sectors also rise, but much more slowly and gently.

And in the second third of the chart, when the FTSE All Share (red line) drops sharply, some of the low volatility sectors also drop down – e.g. the green line – but not very much. The other low volatility sectors simply flatten off, or even keep gently rising.

This is a graphic illustration of what "low volatility" means. The ups and downs are less. Compared with the overall market (red line), the low volatility sectors move in a much smoother, more dependable trajectory. For us, as investors, that means if we're invested in these sectors we can sleep more soundly.

Now let's have a look some sectors that are more volatile.



Here you can see a quite different situation.

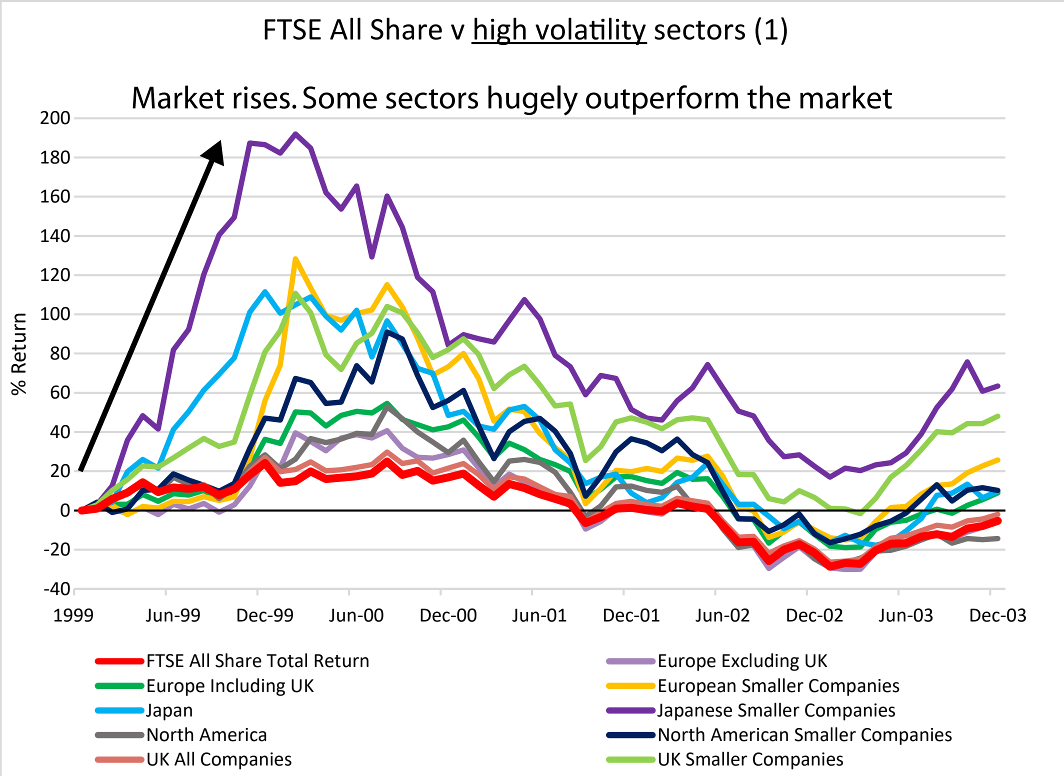
As the FTSE All Share (red line) moves up, all these sectors are moving up much more strongly, compared with the first chart above.

In fact some of these sectors are out-performing the market. The top 4 lines – yellow, pink, blue and purple – are actually *above* the rising red line, during the up-trend. This didn't happen with any of the sectors in the first chart.

Similarly, when we come to the second third of the chart, as the market (red line) drops down, all the sectors also move down sharply – particularly the pink line, which has now clearly done *worse* than the market.

Compared with the flatter lines of the sectors in the first chart, there's a lot more movement here – in both directions, up and down. This is what higher volatility looks like.

Now, to complete our understanding, let's go one stage further and look at the *most* volatile sectors of the market – the high volatility ones.



As you can see, this time round the effect is even more pronounced.

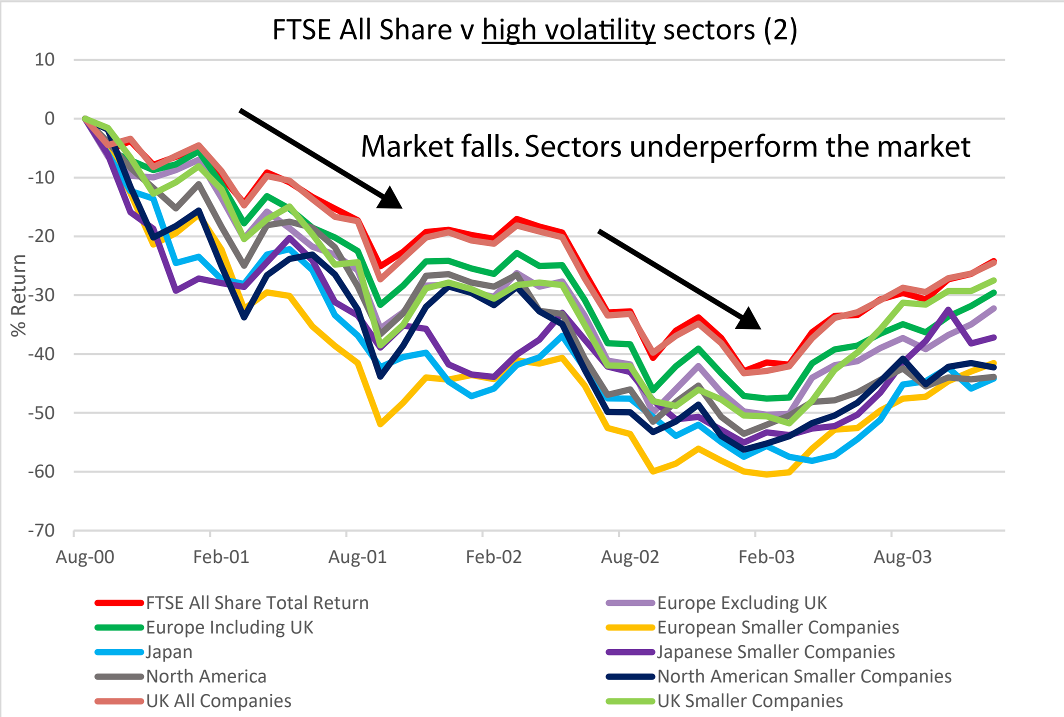
(N.B. The red line looks slightly flatter in this chart because the scale has been altered to accommodate the much bigger movements of some of the sectors).

As the FTSE All Share (red line) moves upwards, you can see that some of the high volatility sectors really rocket up into the stratosphere. Compared to what looks like a sedate, plodding All Share, they're on steroids.

As the FTSE All Share moves up from 0 to around 20, the best-performing sector (in this case, the purple line - Japanese Smaller Companies) has gone from 0 to 180. Nine times higher!

Similarly, an exaggerated movement also happens on the way down – though in this particular instance it's not nearly as dramatic as the upward movement.

To make it easier to see, here's a chart from the beginning of the downward trend, starting in August 2000, with all the sectors rebased to start from zero.



As you can see, the FTSE All Share (red line) drops about 42%.

At the same time almost all the high volatility sectors exaggerate this downward movement. And one of them, European Smaller Companies (yellow line) drops by 60% - nearly one and a half times more.

Of course this is not of the same magnitude as the upward movement, where Japanese Smaller Companies beat the market by nine times.

But that's just what happened on this occasion. In general, the high volatility sectors are just as likely to dramatically amplify *downward* movements too.

The principle remains the same:

Low volatility sectors *dampen* the market movement, both up and down. High volatility sectors *exaggerate* the market movement.

Now that you've seen the charts, I can explain the practical conclusions we can draw from these patterns – and how they can help us make more money from our investments, with less risk.

Sector volatility: the 10-year proof

In case you're wondering, our conclusions about sector volatility aren't based on 4-year charts.

When we first thought about launching the Saltydog system, we did extensive research into the volatility of the 33 different sectors.

We plotted every sector's weekly returns and calculated their standard deviation in detail over a 10-year period. That means that we can prove mathematically that certain sectors tend to move in similar ways, and have certain consistent levels of volatility.

How to use volatility to <u>maximise your gains</u> and <u>minimise your losses</u>

We've just seen what 'volatility' means in practice.

As the market rises and falls, the most volatile sectors go up and down the most – *exaggerating* the market movement. The least volatile sectors go up and down the least – *dampening* the market movement.

So how do we practically apply this knowledge to make more money from the markets?

Here we come to <u>one of the key Saltydog concepts</u>:

When the market is rising, you want to be in the sectors that are the MOST volatile.

And when the market is going down, you want to be in the sectors that are the LEAST volatile.

> N.B. We are "long-only" investors, and so when the market is heading down we don't concern ourselves with trying to short it – we simply reduce our exposure to the downtrend as much as possible.

Why is this?

Since you've just seen the charts demonstrating the effect of volatility, this concept should now be easy to understand.

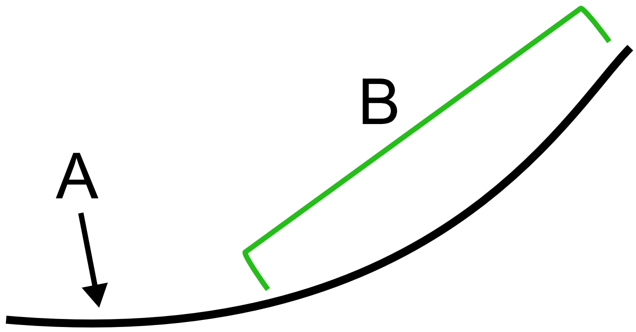
When the markets are going up, you want to be in sectors which *exaggerate that upward movement,* for bigger gains i.e. the high volatility ones.

And when the markets are going down, you want to be in sectors where that *downward movement is minimised,* for smaller losses i.e. the low volatility ones. Or even, in extreme cases, out of the market entirely (in cash).

Obvious really, isn't it?

How you can actively respond to the market and make more money

Let's look at what happens when a market starts to trend upwards.



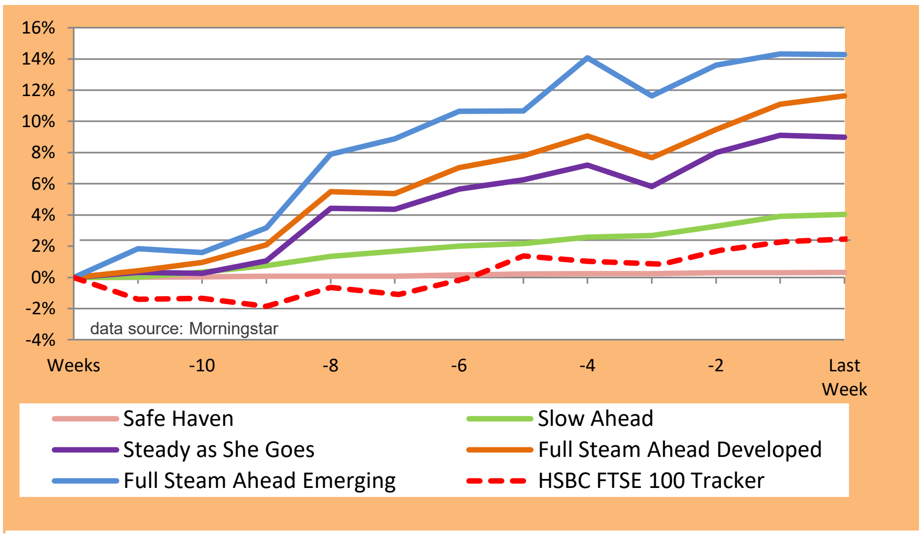
A strong uptrend

As the market starts to rise (point A), the upward gradient of the slope starts to increase.

As we know, the more volatile sectors will *exaggerate* this upward movement, and the less volatile sectors will *dampen* it.

The more the gradient of the upward slope increases, the more pronounced this difference between the sectors becomes. So as the upward slope gets steeper and steeper (B), the most volatile sectors will be outperforming the least volatile ones by a greater and greater degree.

If we took a snapshot of the performance of the various Saltydog groups in the latter part of stage B, it would look like this:



Strong uptrend: the *most* volatile sectors significantly out-perform the *least* volatile ones

In this instance of a strongly rising market, the most volatile group - Full Steam Ahead, Emerging Markets (the blue line) - is storming ahead. It has produced a 14% gain in just 12 weeks.

But at the other end of the scale, the least volatile groups – Safe Haven (pink line) and Slow Ahead (green line) - have only gone up by about zero and 4% respectively, over the same period.

In other words, the most volatile group is outperforming the least volatile groups by at least 3x. That's a huge difference.

In this kind of situation we want to *maximise our gains,* and we do this by **increasing our exposure to the more volatile sectors**. In other words, we put more of our money into funds in these sectors.

Let me re-emphasise: this is a key feature of the Saltydog method, and completely different from passive, buy-and-hold investing. In other words, we're not just sitting and watching the market. Instead we're picking the best sectors to be in at any particular time, week by week.

Now there is the important question of how much risk you personally want to take on. And it's entirely up to you how far you want to increase your exposure to the more volatile sectors.

If you're a *cautious* investor, in this uptrend situation you probably want only a *small* additional exposure to the more volatile sectors of the market – leaving most of your money in the safer, less volatile sectors. On the other hand, if you're a more *adventurous* investor, you will want a much *bigger* exposure to the more volatile sectors.

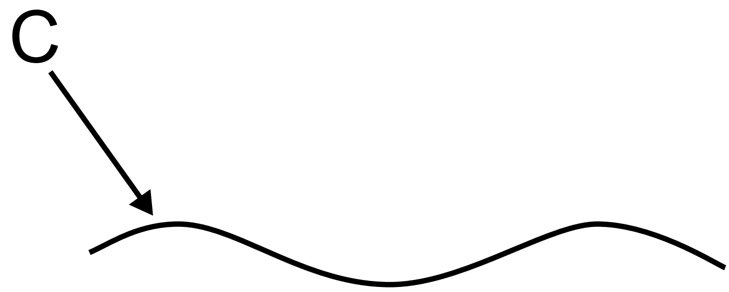
It's your choice. This question is covered in Part 1, Chapter 14. (See p.35). It's very straightforward, and we have set up some simple rules for you to follow, depending on how cautious or adventurous you want to be.

Either way, whatever sort of investor you are, the key points remains the same:

- When the market is trending upwards, **the more volatile sectors will start to outperform** the less volatile sectors.
- In this situation, to increase your gains, you want to **increase your exposure to the more volatile sectors**.

What happens when the market flattens off?

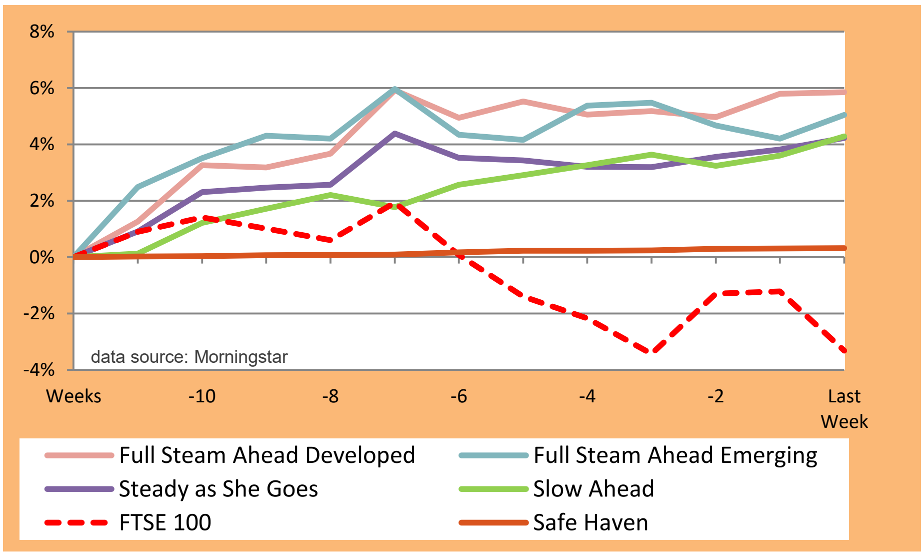
Now let's look at the charts and data for when the market flattens off and goes sideways.



Market flattening off & going sideways

As the market starts to flatten off after an uptrend (point C), the first thing we see is that the out-performance of the most volatile sectors starts to decline. The relative performance of all the different groups starts to close up. There's no longer such a big difference between the high volatility and low volatility groups.

Why? Because the overall direction of the market is flatter, there isn't a clear movement to be exaggerated by the higher-volatility sectors. They've got "less to work with", as it were. And so the chart of the different groups starts to bunch up, like this:



In this chart we can see two things. Firstly, after the first four weeks the overall trend is pretty much flat for three of the groups – although Slow Ahead (green line) keeps trending upwards.

And secondly, as I just mentioned, the performance of all the groups is bunching together. At the far right of the chart, the four groups (apart from Safe Haven) are all in the 4% - 6% range. This is very different from the previous group chart that we looked at, on p.48, where there's a much wider 'spread' of performance.

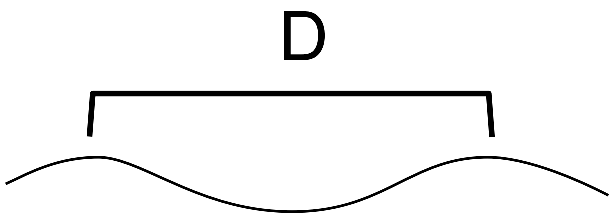
At the top of the market, when it's flattening off, this kind of pattern provides us with all the information we need to manage our risks – so that we aren't highly exposed if a downturn then ensues.

The gap between the performance of the different groups – high volatility and low volatility – narrows. And therefore it no longer makes sense to be so heavily invested in the high volatility sectors, because they aren't out-performing the low volatility sectors as much as before. In fact they may not be out-performing at all.

So at this point you start to withdraw your money from the high volatility sectors, and switch it into the lower volatility, safer sectors.

Of course, the thing about a sideways market is that we don't know which way things are going to go next. Is this a market top, with a downturn coming? Or will the market head upwards? We don't know.

A small uptrend may be the beginnings of something bigger. Or it may just fizzle out. Similarly with a small downtrend.



Sideways market

So if a sideways market pattern (D) continues for a while, we just have to keep testing the water.

We use our 4-week minimum period to decide whether a trend is worth putting our money in. We start with a small amount, and if the trend continues, then we can increase our exposure. If it begins to die out, then we simply reduce our exposure or get out and wait for the beginnings of another trend to emerge.

So we play the market – in and out, in and out – until it goes in one direction or the other.

In a sideways market everything we do is a bit tentative. We're never really committing to anything and it's difficult for us to make much money, if any. But the fact is, unless we're continually testing, we're not going to be in the right place when the big movement up or down comes.

If we're *over*-exposed in a sideways market, and it turns into a big downturn, then we'll lose much more money than we need to. And if we're *under*-exposed, and it turns into a big upturn, then we won't make as much money as we could. We need to keep the right balance.

This is the way we protect ourselves, and are always ready for the next move – by continually adjusting our exposure.

And this is how you really can keep yourself relatively immune from all investors' greatest fear – a cataclysmic 40% - 50% plunge in the market.

Let's now investigate big plunges in the market more closely.

Why a 50% plunge in the market needn't scare you

Huge bear markets are scary.

Everybody panics. News bulletins are filled with dramatic stories. Share prices can drop dramatically in the space of a day. And all you're thinking is, "I'm losing money, and I want it to stop".

You're torn between wanting to sell, to keep the rest of your money safe (though then your paper losses become real losses), and hanging on in the hope that the market will recover, but leaving your money at risk. It's not nice.

Fortunately, I have two pieces of good news for you.

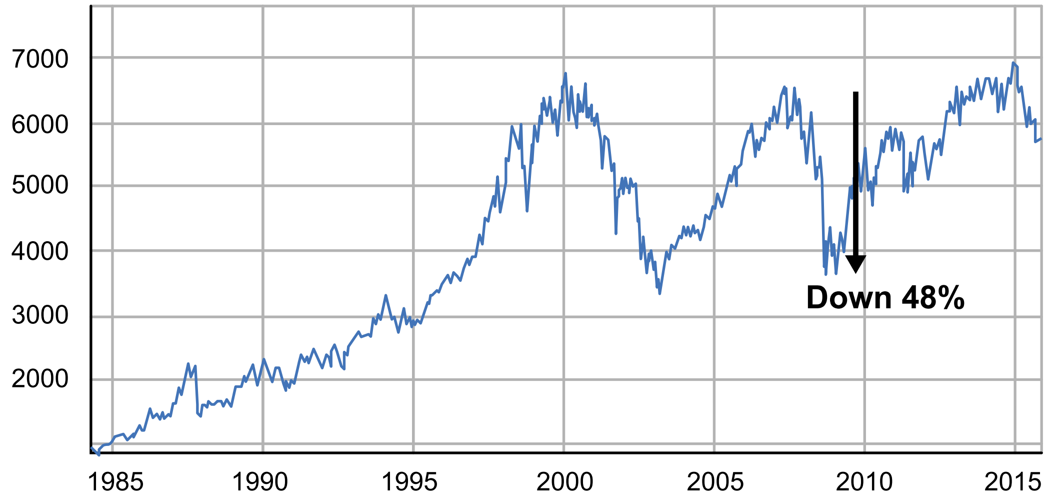
The first is, from the Saltydog point of view, huge 50% bear markets are not that dramatic. (I will explain this in a moment.)

And the second piece of good news is that, using the Saltydog method, you can very easily protect yourself from the worst of a huge bear market. Yes, you'll still lose some money. You can't be totally immune. But you won't lose nearly as much as if you just passively sit out the collapse, waiting for the market to hit bottom and then recover again.

So… what do I mean when I say that huge bear markets are not that dramatic?

Let's have a look at the global financial crisis of 2008.

The overall drop in the market for that period – which was actually from October 2007 to March 2009 – was 48%. Here's the very long-term chart:



The global financial crisis of 2008: the market almost halved

Now there's no denying that that is a horrific picture for any investor. Losing just about half of your stock market investments in one fell swoop.

And the worst of it is that the markets dropped off a cliff. After the strong four-year bull market of 2003 – 2007 the markets reversed abruptly, and plummeted downwards. There was no flat market at the top, and so there was almost no time for any investor to prepare. The turnaround was swift and brutal. Nor was there any indication that the fall in the market would be quite so severe.

All in all, it was every investor's nightmare.

Except that… this explanation isn't true at all.

The first misconception we need to dispel is that huge market crashes (40% - 50%) are very sudden and occur in a very short period of time. This is just wrong.

The crash in the market due to the global financial crisis does look horrifically quick in the chart above. But that's because it's a very long-term chart, showing 30 years of the FTSE.

Let's take a different perspective. Here's a 5-year chart, where the details of the crash are clearer.

From this it's obvious that the 48% drop wasn't a sheer precipice, but was actually a number of distinct steps downwards to the bottom – taking place over the course of an entire year:

The global financial crisis of 2008: in distinct steps

In July-August 2007 there was a 10% drop from the market peak.

The markets recovered briefly, regaining the previous high, and then there was a long and bumpy 18% drop over six months, all the way from October 2007 to March 2008.

There was another recovery, followed by another two-month drop of 17% from May to July of 2008.

Following another short recovery, there was a very dramatic one-month drop of 30% after Lehman Brothers collapsed in September 2008.

So what's my point?

My point is this. The full peak-to-trough drop of 48% happened over the course of an entire year. And even the biggest drop within that year – 30% - happened over the duration of a month.

With the Saltydog system we are reviewing our data *every single week*, and adjusting our portfolios accordingly.

The fact is, there is no way that we would continue to invest heavily in a market that was falling like this, over such a sustained period of time. It would be against every single principle of the Saltydog system!

Now I'm certainly not claiming that you can avoid making any losses whatsoever. That would be foolish.

The reality is that trend investing is always working "after the event". So if a market starts falling, we can't react to it until it's actually started falling – which means we will lose some money initially. We can't help that. But once we've moved our money out of the riskiest sectors and into safer sectors, we are definitely going to protect ourselves from any really huge losses that ensue afterwards. As the market continues to fall, the data will be telling us that things are not good - and so we'll only be allocating our money very defensively.

Look at it this way… If the entire market goes down 50%, and you lose only 20%, that would be quite an achievement in itself. It would mean you'd saved a third of your invested wealth from disappearing. Yes, it's still a loss – but it's a much more manageable one. And I think that protecting yourself like this is more than achievable by anyone using the Saltydog system intelligently and diligently.

PART 3: "How Saltydog began & other stories" (Douglas)

A tale of foolishness: what not to do with £150,000

In the mid-1970s I set up my own flat-pack furniture manufacturing business. Ten years later, in 1985, I successfully sold it.

Using some of the proceeds of the sale I invested in two investment bonds, together worth £150,000. This was a not-inconsiderable sum, equivalent to around £450,000 in today's money.

Douglas Chadwick, founder of Saltydog Investor

I purchased these two bonds via an Independent Financial Advisor (IFA), as the investment company concerned did not deal directly with the public.

Like so many people I had been sold the illusion that financial advisors actually advise, that wealth managers actually manage, and that the financial industry has individual investor's interests at heart. This was foolish of me.

Unfortunately, or perhaps stupidly, I only began taking an active interest in the performance of these two bonds 15 years later. It is no excuse, but I had been busy building another manufacturing business.

When I eventually did look, I had two unpleasant surprises. First, there had been very little capital growth. And second, I was astounded to discover that my money was still in the same market sectors as at the outset. No-one had been managing it at all. It had just been sitting there, forgotten, throughout the 15 years, regardless of the dramatic changes occurring in the investment landscape.

Enough is enough, I thought. It's time to take control of this myself.

And thus began the road that led to the Saltydog trend investing system, and to me now explaining it to you.

I'll come back to that journey and what I discovered in a moment. But first, a bit of background.

Trend versus value investing - and how Warren Buffet came a cropper

There are many different types of investing styles all of which will have their advocates and enthusiasts.

For me there are only three that merit any attention. There is “value investing”. There is “small company investing”. And finally there is “trend investing”.

At Saltydog Investor we believe unashamedly in trend investing.

Provided that you have access to accurate up-to-date information, in my opinion **trend investing is the only method that makes long-term sense** and lends itself to the understanding of the DIY investor.

Value investing is represented very clearly and ably by its most famous advocate, Warren Buffet, one of the wealthiest men in the world.

Value investing means that you are looking for good companies that are trading in unloved sectors or are just simply overlooked and undervalued. You buy their shares cheaply and sell a long time in the future at a very much higher price - or at least that is what you hope to achieve.

There are some fund managers who specialise in this technique of value investing. To be successful, this requires much scrutiny of the company’s balance sheet, sales plans and accounts, and having done all of this it can all go horribly wrong due to totally unforeseen circumstances.

If you are going down the route of value investing it is well worth remembering the expression “Man plans and God laughs”. Warren Buffet came a cropper by buying into Tesco, and then a couple of years later being forced to write-off nearly a billion pounds. And he is an investing genius!

Small company investing is exactly what it says on the tin, i.e. you don’t invest in large companies.

The theory is that companies start small and gain value as they become larger. That is fine and dandy provided that you have selected a company to invest in that does not fall by the wayside. And be assured, there are many of them that will exit stage left never to be seen again.

Another reason this style is popular with some managers is because when a company is small it is less well researched. Price anomalies may exist, and there is a bargain to be bought by the fund manager that does this research. So at the end of the day, it turns out that this is really just another form of value investing, but with small companies as opposed to large. The evidence does seem to show that small company funds outperform large company funds if you look over a long enough period of time.

In my book, trend investing has much more logic to its approach and makes more sense.

Share price ‘momentum’ and the legendary Jesse Livermore

With trend investing you are reducing the element of gambling on a potential future result. Instead you are living and making your investment in ‘real time’.

The basic idea is that **once a trend is established either upwards or downwards for a fund or sector, it is more likely to continue in that direction than to move against the trend.**

In other words, the price of an asset gains a certain ‘momentum’.

In physics, momentum is the force possessed by matter in motion. It’s the product of the mass and velocity of a body. And we can make an analogy with investing.

The greater the money that is being invested into a fund or sector, the quicker its value will rise and the greater impetus it will acquire as it attracts more and more investors. For a time its rise will become self-fulfilling. Obviously the opposite applies when a fund or sector loses investors, and the momentum is downwards and the price falls.

Jesse Livermore, the legendary trader from the US in the late nineteenth and early twentieth century, explained it as follows:

> **“**When a stock is going up, no elaborate explanation is needed as to why it is going up. It takes continuous buying to make a stock keep going up; as long as it does so with only small and natural reactions from time to time, then it is a buy.
>
> After a steady rise this stock levels off and turns down with only occasional rallies; it is obvious that the line of least resistance has changed from upwards to downwards. There is no need for explanations. Now is the time to sell.**”**

I liken trend investing to going to a horse race and being able to switch to the leading horse as the race progresses. You are in the best possible position throughout, and you will win at the end. In other words your money is always earning the best return that prevailing conditions will allow.

In summary, value investors will try to buy low and anticipate selling high. The trend investor will buy high and sell higher whilst riding with the herd.

Personally I would rather be buying something that is *working today* rather than *the hope that it will work tomorrow!*

A $1 million real-life experiment

A real life experiment was set up by Richard Dennis in the 1980s to show the merits of trend trading. It became known as the "Turtle Traders".

The purpose of the experiment was to settle an argument that Dennis was having with his long-time friend Bill Eckhardt. The issue was: *Are great traders born or made?* Eckhardt thought that trading was an ability embedded in your DNA. Dennis was convinced it could be taught.

Richard Dennis was born in Chicago in 1949 and began trading commodities in the early 1970s. He started with a small loan from his family and by 1973 his capital had risen to $100,000.

At the end of the following year he was a millionaire. By the early 1980s he was reportedly worth over $100 million.

To set up the trading experiment, Dennis and Eckhardt advertised for apprentices in Barron's, the Wall Street Journal and the New York Times. The ad stated that after a brief training session, the trainees would be supplied with an account to trade.

Dennis selected 21 men and 2 women and invited them to Chicago for a two week training course. They were then given small trading accounts and asked to trade for one month. After this trial period he then gave the ones who traded successfully $1 million of his own money to invest.

The outcome? In the next five years they are said to have made an aggregate profit of $175 million. Not bad.

Dennis clearly won the argument. The experiment showed that trend trading works, and that it can be successfully taught.

Passive investing: a pointless exercise

Now to the question of active versus passive investing.

It's time to scrape the barnacles off this particular boat, as I do not believe that you can do both. You know what happens to people who stay in the middle of the road - they get run over!

One quick point before we start.

My starting point as an investor was using funds, and that's what I've stuck with throughout my investing career, and when developing the Saltydog system. Funds are the investment vehicle we use with Saltydog.

So when I talk about active versus passive investing here, I'm referring to funds. Having said that, the principles apply equally to investing in individual shares.

The experts and advisors who advocate passive investing all tend to repeat the same thing: *active investing is too difficult and time-consuming for the average investor.*

They would have you believe that successfully controlling and running your own investments requires the expertise of Warren Buffett, the cunning of Nick Leeson and a tall skyscraper in the City of London full of analysts leafing through reams of investment data.

Is this true? No, it isn't. At least not for an averagely intelligent, motivated person, prepared to devote a little time to it.

As an amateur I have proved this to be the case. And I hope you will come to the same conclusion.

But let's give the passive (fund) investing experts their say. What they will tell you to do is choose a good fund manager in a growing sector of the market, and then stick to him through thick and thin.

That sounds all well and good. But the fact of the matter is that sectors that are performing well don't conveniently go on performing well indefinitely. At some point they go out of fashion and become loss making. And then what do you do?

The passive investor will say that a good fund manager will recover his losses when his sector returns back into fashion, and what goes around comes around. (Whatever that means).

But in my view this is just silly. If you really believed that, why on earth would you want to see your investment lose some of its previous gains, even if it was going to recover them back sometime in the future? **To me that is a pointless exercise, when my money could be elsewhere making a positive return during that time.**

Common sense surely dictates that you would go elsewhere whilst the fund was on the slide and return back to the fold later, when it started to recover again.

"Fine", I can hear you saying, "but how do you know when to make these changes?"

Yes, this is the vital question, and most people have no idea how to answer it. But successful trend investors *have* answered it. With the Saltydog system I have answered it. And the market-beating performance of the Saltydog portfolio proves that I'm not deluding myself. (As does the feedback from other private investors using it).

The critical thing is to have *a constant supply of up-to-date information* on the performance of the funds from which you choose your investments.

Since I started out investing in this way in the year 2000 my portfolios have <u>never had less than double digit growth</u>, whilst taking very little risk.

If I can do this, so can you.

Though I will repeat: **you must have access to continuous, up-to-date, accurate information.** Your decisions cannot be based on rumour, hearsay or vague hunches.

An example of the importance of this goes back to the days of sail. Clipper ships returning from the Far East before proceeding up the English Channel to London, would call in at the port of Falmouth at the western end of England. From here they would send coded messages by horseman to the ship's owners in London, this being the fastest method at the time.

These messages not only gave the details of the ship's cargo of spices, teas and exotic goods, but also international news. The traders with this information then had a head-start on their competitors, and would be making their decisions and fortunes based on facts.

In my earlier working life I had a similar experience of how important up-to-date information can be.

Fifty years ago I was the navigator on a Jamaican Banana boat plying between London and Kingston Jamaica.

During the hurricane season, if we were unlucky enough to be caught out by one of these tropical storms, the most important thing was to have accurate information on the storm's size, speed and direction. This was supplied to us by the brave men of the American Coastguard who flew their planes into the eye of the storm and kept us informed of its progress.

Armed with this information we would then alter direction, slow down, even turn around and do anything within our powers to keep the ship in the South West quadrant of the storm. This is the safest sector, as the hurricane should in theory move off to the North leaving us able to continue to our destination.

This was an early salutatory lesson in the importance of good information.

All at sea: how I got started with trend investing

So let's return to the story of my £150,000 – with me now determined not to let my money do nothing for another fifteen years.

To start with, I decided to go down to my investment company's office and see what help and information they were prepared to offer me. Given the woeful service they had provided up to this point, they could hardly refuse. I knew exactly what I wanted: the most up-to-date data available on all the unit trust funds on their investment platform. I asked for it and to their credit they agreed, and an employee was instructed to supply me with the data on a regular basis.

This company provided access to about seventy funds. Compared with the number of funds on investment platforms today, with thousands upon thousands available at the click of a mouse, this was a pitifully small selection. But back then (it was the year

2000) this was all that was on offer, and I didn't know any better anyway. For my purposes it was a good start.

The data I was supplied consisted of the one-year, three-year and five-year performance figures for each fund, updated every month. And it was accompanied by the bid and offer (buy and sell) prices for these same funds.

By keeping a long-hand record of these fund numbers, I was able to establish and graph the movements of these funds on a *monthly* basis. This was critical. It meant I was free from the nonsense of decision-making based on one-year, three-year and five-year performance that the financial establishment dictated.

I was learning as I went. And after a while one particular thing became very obvious.

I began to notice that some funds would move together in the same direction, be it up or down, as if in tandem. This is when it started to dawn on me that there must be some outside control at work – something that caused those different individual funds, run by different individual managers, to move in alignment.

What could that be? I made some enquiries and eventually found out the answer.

A vital key: the power of market sectors

It turned out that this control over funds' performance was exerted by the Investment Association (IA).

As Richard explained in Part 1 (p. 18), the IA is the trade body for the investment management industry. And, as part of its function of regulating funds, it has designated 33 different sectors of the market into which all funds are categorised.

Each of these 33 fund sectors has a clear definition, with the IA stipulating which investments can and can't be included. If a fund is listed in a particular sector, it has to stick by these constraints.

This is only common sense. If you are placing your savings into a fund, you want to know which area of the investment world it's going to be operating in.

Will it be investing into high-risk specialist businesses or lower-risk gilts? What percentage of the total fund would be invested into which arena? Geographically, will it be investing in the United Kingdom, Japan or any other region in the world?

This is essential information for you, and is a control on the flights of fancy that the fund manager may have from time to time. They sometimes need reminding that regardless of how much they might like it to be, "Grimsby, unlike Hong Kong, does not translate into Fragrant Harbour"!

For example, a fund listed in the Tech and Telecomms sector can't start putting some of its money into bonds or property, because that's not what it was set up to do.

The 33 sector definitions are mainly based on *assets* such as equities, fixed income and commodities. Others have a *geographical* basis – for example Europe, Japan or North America. Then there are a few other sectors that are focused on *strategy*, such as Targeted Absolute Return funds.

With this new-found knowledge about the different IA fund sectors, I now understood what was happening with the funds that moved together.

If a particular *sector* was performing well, then the various funds in that sector would all tend to perform well. Within that sector, it was a question of a rising tide floating all the boats.

However, it was also apparent to me that not all the funds within a sector floated to the same height. Clearly some managers were better at selecting performing shares for their funds than other managers in the same sector.

The light also dawned on me that the various sectors performed differently as economic and political circumstances changed.

Looking back, this all seems perfectly obvious and straightforward. And it may well be so to you. But it wasn't to me at the time. It was quite a revelation as the build-up of my numbers gradually revealed these fascinating traits and patterns.

Nearly doubling my money in five years

Now that I had this understanding of sectors and funds, along with access to the monthly performance data, my investment decisions improved enormously. And, very gratifyingly, my returns improved in a corresponding fashion.

During the remaining four or five years that my two investment bonds had to run before reaching maturity, I was able to nearly double their value. That's right. They went up nearly 100% in five years.

And that was even with enormous costs I had to pay. At that time it was costing me from 4% to 5% to switch from one fund to another. Yes, 5% ! Even so, with my up-to-date fund performance numbers it was still possible for me to make these very substantial gains. This level of success would certainly not have been possible if I had only been able to use the finance industry's standard one-year, three-year and five year fund performance numbers to make my decisions.

The fact is most trends come and go in periods much shorter than the timespan of the finance industry's standard figures. Some trends last maybe six months. Others, if you are fortunate, longer. My monthly numbers allowed me to take advantage of these trends. The industry's very long term numbers did not.

For the DIY investor many things have changed for the better since I started in the early 2000s. Trading costs have come down, fund supermarkets have multiplied, and dealing using the internet has made life much easier all-round.

Last but by no means least, with the Saltydog system we can now provide *weekly* performance data, automated and beautifully presented for easy analysis, on *ten thousand* funds. Quite an improvement on the *monthly* data, handwritten by me, on *seventy* funds, which is what I started out with!

One thing has not changed, however, and that is that **you want your money to be invested in a rising sector.** The order of importance is still: sector first, and fund second.

Lessons from a stockmarket legend

For some final words of investment wisdom, let's return to the legendary American investor Jesse Livermore.

Livermore is one of the most remarkable investors in history, making and consequently losing four fortunes through not adhering to his own maxims. He was a trend investor or "momentum trader", and was born in 1877.

In 1929, at the height of the American stock market collapse, he was worth over $100 million - equivalent to $4 billion in today's terms.

Livermore established and left us a set of trend investing operating rules that are as relevant today as they were at the turn of the 19th century. Here are four of his sayings that reinforce what I have already written:

> **"**The game of financial speculation is the most uniformly fascinating game in the world. It is not for the stupid, the mentally lazy or the get-rich adventurer. They will all die poor.**"**
>
> **"**The only thing to do when a man is wrong is to be right by ceasing to be wrong.**"**
>
> **"**A stock operator has to fight a lot of expensive enemies within himself.**"**
>
> **"**Losing money is the least of my troubles. A loss never bothers me after I take it. I forget it overnight. But being wrong – not taking the loss – that is what does the damage to the pocket book and the soul.**"**

You can see that his message - and the lesson for us - is that it is important to recognise a loss-making situation and step away.

He is also saying that it is not necessary to get rich quickly. After all, what is so bad about getting rich slowly?

Also, you do not have to be super clever to make a good investor, you just must not be greedy and you must be prepared to leave your mistakes behind and move on.

I wish you a fair voyage

So there we have it. That's how Saltydog Investor came about, and I hope my various stories, observations and the lessons I've learned have been useful for you.

As I said at the start, do get in contact with us if you have any questions, comments or feedback about the Saltydog system.

You can contact Richard (who will also pass on any messages for me) at info@saltydoginvestor.com

I wish you the very best with trend investing, and a fair voyage!