The Art of War
by: John Burns
April 2012

"If you seek peace, prepare for war."

This statement dates back to the Roman Empire, where it was assumed to have been adopted from The Art of War, an ancient Chinese classic on military strategy. It suggests the key to success is to anticipate and prepare defenses before they are needed.

The message also applies well to investment management and, more specifically, to rebalancing portfolios in certain market conditions. The environment we found ourselves in last month represents a great example.

Favorable market conditions have a way of soothing investors. Moods and expectations rise along with the stock market, and each successive step higher makes it incrementally easier to convince ourselves the upward march will persist for the foreseeable future. We lull ourselves into a state of comfort and inaction at the precise time we should be making preparations for the inevitable downturn. We let our guard down.

This is a classic strategic mistake. Stocks produce great gains for our portfolios when the market grows, but we can be sure no rally will last forever and must consider retaining some of that wealth if we anticipate income needs in the coming years. A great market run that leaves stocks valued at fair prices represents an opportunity for investors to commit some gains to safekeeping.

Our war chest, the part of the portfolio invested in high quality bonds and other low volatility-low return securities, helps us build time into our plans. It allows us to withstand the rigors of an inevitable future market downturn that could last several years. We look for favorable market conditions to sell stocks in order to fill the war chest.

If there is hesitation to shift assets to safekeeping during these periods and the market begins a sharp descent, the benefit of committing funds to the war chest at that point would diminish greatly. The best time to act is when conditions are good.

We do not seek to forecast market peaks, only to receive fair prices for the stocks we decide to sell. The greatest feature of maintaining war chest reserves is arguably that we do not have to make predictions for the strategy to work. There is no way to know whether the stock market has reached its high point, but with discipline we can limit stock sales to periods when they will be valued fairly.

The central concept is to store enough war chest reserves to sustain our needs during a drawn out market drop. We want to avoid selling too many stocks – only enough to meet our income expectations – because while the war chest addresses our needs over the next few years, our long term well being depends on maintaining stock exposure. We would be forsaking future growth by storing too much more in safekeeping than we could possibly need.

We saw reason to grow our reserves over the last several weeks. Better to do so at prices we can live with today than at fire sale prices when our portfolios are under siege tomorrow.