

The 401(k) Formula™

What Is It?

The 401(k) Formula™ is a strategy designed for investors seeking a long-term, systematic approach to risk management of equity capital. The primary objective of this strategy is to avoid large losses. The secondary objective is to deliver inflation-beating high returns over the long-term. The 401(k) Formula™ seeks to accomplish this by investing in the stock market during well-defined time periods when the odds of positive returns are significantly higher than average. These time periods are called “power zones”.

The 401(k) Formula™ uses stock and bond indexes as investment proxies for mutual funds.

The 401(k) Formula's™ long-term effectiveness as an investment strategy hinges on the assumption that the stock market exhibits cyclical regularities which “skew” the distribution of returns into clearly identifiable time-periods which can be exploited for profit.

Our research has identified two cyclical forces which profoundly and regularly affect the distribution of stock market returns. They are:

- 1) The annual earnings forecasting cycle
- 2) The four-year presidential election cycle

These cycles produce well-defined time periods when the market climate is positive; in other words, when the odds of a rising market are significantly higher than average. They also produce clearly identifiable time periods when the market climate is risky and the odds of a market decline increase substantially.

These market effects are, of course, the result of changes in investor psychology which are produced by the specific characteristics of each cyclical force.

Force One: The Annual Earnings Forecasting Cycle

Investors are constantly seeking ways to reduce uncertainty. This desire has created a world-wide industry which attempts to satisfy the demand for insight into the future. The investment forecasting industry is highly paid for its “expertise” in predicting the probable course of the economy, the stock market, and the earnings of specific companies.

Investors, like most human beings, believe in “experts”. It seems rational to believe that intelligent, dedicated, experienced, and well-paid professionals should be able to get a handle on what is likely to happen over the next 12-18 months. This expectation, however, flies in the face of the facts: expert opinion is wildly overrated.

A significant body of research exists which shows that expert forecasts of earnings tend to be substantially off the mark, with a strong bias toward overly optimistic estimates. This optimistic bias creates the annual forecasting cycle.

Toward the end of the calendar year, the forecasting industry puts out its predictions for the upcoming year. These predictions tend to be overly optimistic. Early in the year, analysts routinely increase their earnings estimates and continue to defend them until about mid-year. By late-June the first two quarters’ earnings are “in” and a more realistic appraisal of full-year earnings is called for. At this point, earnings estimates for the year begin to be revised downward. This process typically continues to year-end.

This cycle causes the annual returns of the stock market to be “skewed”. The returns of the market between late-October to early-May tend to be significantly higher than returns from June to late-October. This is caused by investors influenced by expert confidence during the first half of the forecasting cycle. As expert confidence falls and earnings are revised downward, this translates into investor concern and a desire to re-organize portfolios. This is especially true for institutional investors who are strongly influenced by calendar-year comparisons to investment benchmarks. This explains why the bulk of bear market damage and large market corrections occur between June and November.

This explanation is backed up by the long-term statistics:

From 1949 through 2009, using the Dow Industrials as a benchmark:

- The average daily gain from November to May was 27 times higher than the average daily gain of all other days.
- The annualized return of the six-month “power zone” was 17%.
- The Dow was down 43% of the time between May and November.
- The Dow was down 20% of the time between November and May.
- A \$1,000 investment only during the November – May “power zone” grew to \$73,738.
- A \$1,000 investment only during the May – November “dead zone” shrank to \$729.

The 401(k) Formula™ exploits this annual “skewing” effect using mid-cap stocks. Our benchmark is the S&P MidCap 400 Index. Our research indicates that the mid-cap index is the best performing U.S. equity index, having a 30% excess annual return premium to the S&P 500. In addition, the mid-cap index has an annual power zone of seven months, from late-October to late-May, which increases returns due to the additional low-risk month.

The Annual Forecasting Cycle

S&P MidCap 400 Index 1981 - 2010

YEAR	DEAD ZONE		POWER ZONE	
	S&P MIDCAP 400		S&P MIDCAP 400	
	% CHANGE JUNE 1 - OCT 31	INVESTING \$ 1,000	% CHANGE NOV 1 - MAY 31	INVESTING \$ 1,000
1981	-3.8%	\$ 962	-2.3%	\$ 977
1982	18.3%	\$ 1,138	35.5%	\$ 1,324
1983	-0.9%	\$ 1,128	-9.3%	\$ 1,201
1984	10.5%	\$ 1,246	20.5%	\$ 1,447
1985	4.1%	\$ 1,297	33.6%	\$ 1,933
1986	-1.2%	\$ 1,281	13.6%	\$ 2,196
1987	-17.3%	\$ 1,059	13.9%	\$ 2,501
1988	6.5%	\$ 1,128	23.5%	\$ 3,089
1989	5.8%	\$ 1,193	8.2%	\$ 3,342
1990	-20.0%	\$ 954	49.1%	\$ 4,983
1991	8.0%	\$ 1,030	7.2%	\$ 5,342
1992	3.3%	\$ 1,064	14.8%	\$ 6,133
1993	5.9%	\$ 1,127	-1.8%	\$ 6,023
1994	4.2%	\$ 1,174	8.9%	\$ 6,559
1995	11.3%	\$ 1,307	15.4%	\$ 7,569
1996	1.7%	\$ 1,329	16.2%	\$ 8,795
1997	14.2%	\$ 1,518	13.8%	\$ 10,009
1998	-6.2%	\$ 1,424	19.4%	\$ 11,951
1999	1.4%	\$ 1,444	19.8%	\$ 14,317
2000	9.9%	\$ 1,587	0.9%	\$ 14,446
2001	-13.2%	\$ 1,378	18.0%	\$ 17,046
2002	-19.3%	\$ 1,112	12.6%	\$ 19,194
2003	16.1%	\$ 1,291	9.1%	\$ 20,941
2004	1.7%	\$ 1,313	12.0%	\$ 23,454
2005	5.0%	\$ 1,379	10.1%	\$ 25,823
2006	3.1%	\$ 1,422	17.6%	\$ 30,368
2007	-0.5%	\$ 1,415	-2.0%	\$ 29,761
2008	-35.2%	\$ 917	2.6%	\$ 30,535
2009	15.3%	\$ 1,057	16.7%	\$ 35,634
2010	9.4%	\$ 1,156	TBA	TBA
Losing Periods	10		4	
Winning Periods	20		25	
30 Yr Gain / (Loss)		\$ 156.00	29 1/2 Yr Gain / (Loss)	\$ 34,634.00
Compound Annual Return		0.5%		13.3%

Note: Dividends included. Data Source: Callan Associates Database

Force Two: The Four-Year Presidential Election Cycle

The presidential election cycle causes a cyclical bias which has been operating in the U.S. market since the formation of the Federal Reserve in 1913. Specifically, the election cycle tends to skew returns into a 15-month period beginning with the mid-term elections. The five-quarter period beginning in the fourth quarter of the president's second year has not been down since 1931, generating an average return of 25.6% plus dividends (Dow Industrials, ending 2009). This 15-month period accounts for almost all of the total appreciation of the market since the Great Depression. The average daily return during this period is 7.6 times greater than the average daily return during all other months. We call this period the election cycle "power zone".

PRESIDENTIAL ELECTION CYCLE QUARTERLY % CHANGES					
Dow Jones Industrials (1933 to 2009)					
	Q1	Q2	Q3	Q4	Year
Post-Election	-0.4%	4.7%	-0.6%	1.3%	5.0%
Mid-Term	0.4%	0.9%	-1.4%	7.2%	6.7%
Pre-Election	5.8%	5.5%	3.3%	1.6%	17.1%
Election	0.6%	0.8%	1.1%	2.2%	4.8%

The mid-term elections cause the political class to focus on the next presidential election. This shift in focus is dramatic. In the first two years of the presidential term the dominant party attempts to pass legislation with significant social importance and increased governmental activism. Such changes are generally resisted by investors, who tend to be cautious during periods of uncertainty. After the mid-term elections, however, the political class becomes less aggressive and more fiscally conservative. During this period there is no mention of higher taxes, increased regulation on businesses, or large legislative agendas. The dominant party knows that economics will play a large part in determining the presidential election and they pull out all the stops to make the U.S. economy vibrant during the election year. Naturally, this plays well on Wall Street.

The 401(k) Formula™ adopts a fully invested position in the market during the 15-month "power zone". The strategy invests equally in the S&P 500 and the NASDAQ 100. The NASDAQ 100 represents the largest companies in the NASDAQ Composite Index. It is heavily tilted toward technology companies, such as Microsoft and Intel. Large growth companies tend to do very well during this optimistic period in the election cycle. A look at the last five cycles confirms this.

Election Cycle Power Zone

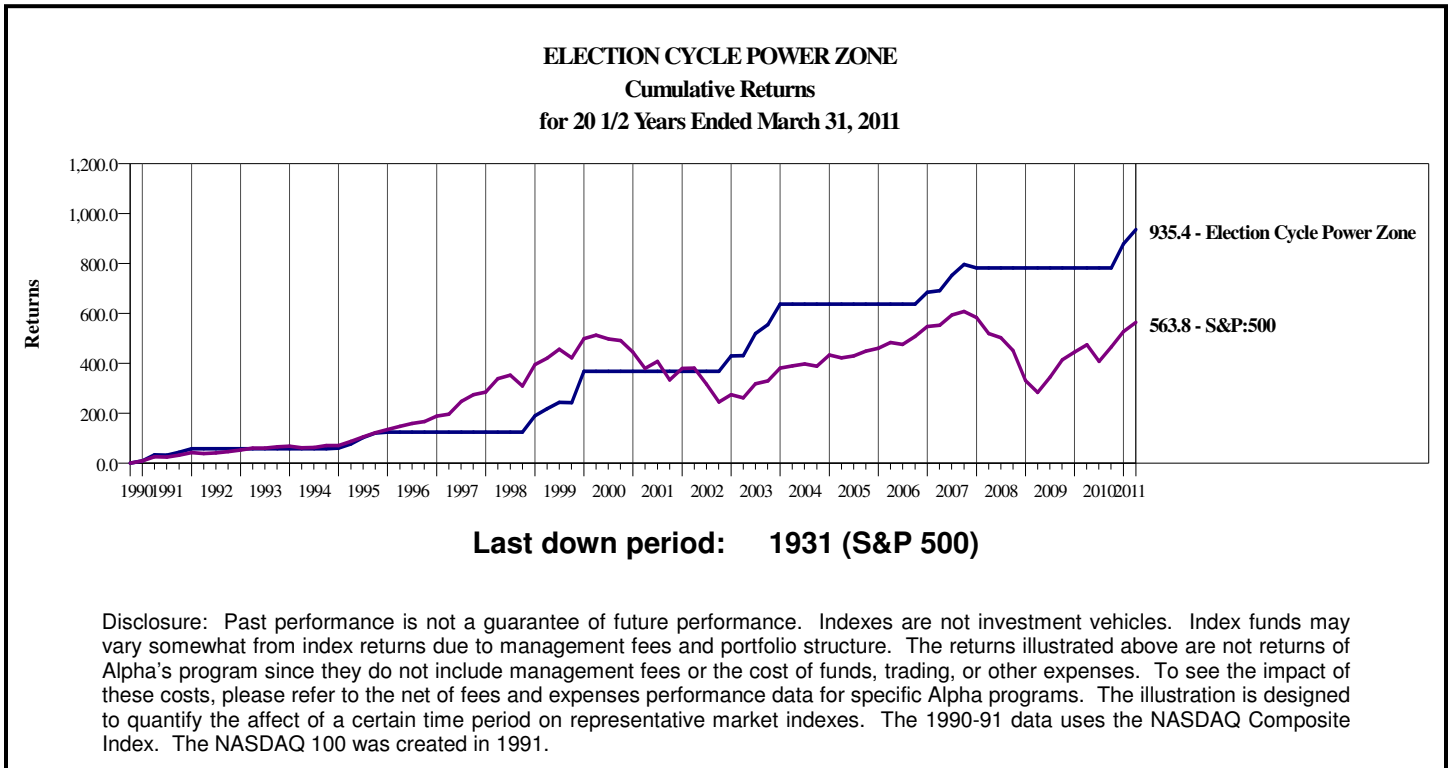
Q4 Mid-Term Year, Q1-Q4 Pre-Election Year

50% S&P 500 / 50% NASDAQ 100

1990 – Q1 2011 Cumulative Returns

Q4 1990 – Q4 1991	57.95%
Q4 1994 – Q4 1995	42.12%
Q4 1998 – Q4 1999	108.22%
Q4 2002 – Q4 2003	57.63%
Q4 2006 – Q4 2007	19.67%
Q4 2010 – Q1 2011	17.43%

Average:	50.50%
Cumulative Gain:	935.40% (as of 3/31/2011)
Cumulative Gain S&P 500:	563.80% (as of 3/31/2011)



Bonds

The 401(k) Formula™ invests in bonds when not invested in equities. Bond exposure covers 14 months every election cycle; during the five-month annual “dead zone” in years one and four, and the four-month “dead zone” in year two.

Fixed-income exposure is limited to intermediate term bonds, using the Barclays Capital Aggregate Bond Index as the model investment.

The objective of this component is to earn monthly returns in excess of money market returns with relatively low risk.

Asset Allocation Schedule

Asset Allocation Schedule			
Based on the Four-Year Election Cycle			
	JANUARY 1 → MAY 31	JUNE 1 → OCTOBER 31	NOVEMBER 1 → DECEMBER 31
Year 1 (Post-Election)	S&P MidCap 400	BC Aggregate Bond Index	S&P MidCap 400
	JANUARY 1 → MAY 31	JUNE 1 → SEPTEMBER 30	OCTOBER 1 → DECEMBER 31
Year 2 (Mid-Term)	S&P MidCap 400	BC Aggregate Bond Index	50% S&P 500 / 50% NASDAQ 100
	JANUARY 1 → DECEMBER 31		
Year 3 (Pre-Election)	50% S&P 500 / 50% NASDAQ 100		
	JANUARY 1 → MAY 31	JUNE 1 → OCTOBER 31	NOVEMBER 1 → DECEMBER 31
Year 4 (Election)	S&P MidCap 400	BC Aggregate Bond Index	S&P MidCap 400

Summary

In the end, The 401(k) Formula™ can be seen as a simple strategy for managing equity capital efficiently over time. Market risk is assumed only during periods when a positive market climate is expected. This expectation is based upon two forces which are well-defined and which reflect causal mechanisms at work on investor psychology. Decades of supporting return data provide empirical evidence for their influence on market returns.

The 401(k) Formula™ has historically exhibited lower risk with higher returns over longer time periods than equity indexes alone. The 401(k) Formula™ has also outperformed almost all diversified mutual funds, particularly in the past ten years – years containing two severe bear markets.

The 401(k) Formula™ represents a good alternative to conventional portfolios which assume a constant exposure to market risk. Buy and hold strategies, even when actively managed, remain exposed to unpredictable market risk during the market's "dead zone" which decades of return data have shown to be unproductive over the long-term and likely to suffer the most during bear markets.

The 401(k) Formula™ can be combined with conservative bond funds to create portfolios which progressively reduce market risk as an investor grows closer to retirement when income, rather than growth, becomes the principal investment objective.