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Investment Strategy

"The One Chip Rule"

Back in the early 1970s I met one of my mentors. His name was Jimmy and back then he had been a professional gambler for more than 30 years. One night over cocktails I asked him, "Hey Jim, how is it you have been able to live as a professional gambler for three decades?" His response was, "I adhere to the one chip rule." "What's that?" I questioned. "Well, I learned very early in the gambling business that every time I won 10 'chips' I needed to put one of those chips in my pocket . . . aka, the one chip rule."

I too am familiar with cards, dice, and betting in general. While in college I supplemented the monthly stipend from my parents with the winnings from playing cards. The bluffing, the betting, the showdown was all great drama to me. In my mid-twenties I began adhering to Jimmy's one chip rule. To wit, each time I won ten chips I would put one of them into my pocket, not to be used again that night. Around the same time, I found the same kind of strategy was useful in managing risk in this business. In the stock market's case, while the human natures of fear, hope, and greed still play a large role, I tended to substitute card players with the personalities of stocks, the market makers, the Fed, Washington, and politicians. Using such strategies I found that if you do your homework, and manage the risk, the odds of success in the markets are much better than a card game. When you lose in the markets at least you get most of your money back and the government shares in a portion of your losses via the capital gains/capital losses tax system. In a card game it tends to be basically all or nothing with each hand.

Subsequently, I practiced and honed my skills in the 1970s on a trading desk, chalking up my "lumps" to learning the game and paying my dues. Later, I started winning fairly consistently by sticking with well-defined rules to guide decisions and by managing the downside risk. Indeed, managing the downside risk is crucial, for I do indeed remember the movie "The Cincinnati Kid," and while Steve McQueen made the "intelligent" bet (consistent with the odds), "The Kid" made one big error . . . you do not bet the farm no matter how good the hand looks. Or as one savvy seer exclaimed, "If you're going to bet the farm, you had better have two farms!" Manifestly, in life, in cards, and in the markets, anything can happen; accordingly, you NEVER take that "bet the farm" kind of chance because occasionally "The Man" hits the long-shot and you're busted (you can read the story at the end of this missive).

As we approached the mid-July to mid-August timeframe I have once again been adhering to the "one chip rule" by raising some cash in anticipation of a decline in stock prices. So far, that strategy has been wrong-footed. Still, like flying an airplane in bad weather you have to trust your instruments, the same thing applies to the stock market. Over the last four to five weeks I have shared some of the indicators I use to determine if we should be playing "hard," or not playing so "hard." I have also shared why the seasonality suggests it is a time to be more defensive. Over the weekend I was sent yet another interesting insight from Jeff Hirsch at the *Stock Trader's Almanac* organization. He writes:

> "Second quarter corporate results have been solid and encouraging for the most part so far this earnings season, but QE taper discussions remain front page news. Following a brisk retreat from late May through June, the market has done an about face just as quickly as Fed Chairman Bernanke did when speaking about the Fed's current bond buying activities. As a result, July 2013 is on pace to rack up impressive full-month gains. In the eleven trading days through yesterday's close, DJIA had gained 3.6% so far, qualifying itself as a Hot July. At its present trajectory, DJIA could finish July with a Top 10 performance when compared to all Julys since 1950. Gains of this magnitude for July, however, have frequently been followed by a late-summer or autumn selloff and better buying opportunities than now. The [nearby] table of big July gains and subsequent declines since 1950 gives you a good look at the kind of buying opportunities that have occurred in the past following full-month July gains in excess of 3.5%."

Indeed, despite the negative weight of the evidence, like the fact that the S&P 500 (SPX/1709.67) is stretched VERY far above its 200-day moving average (DMA) at 1537.22, last week's action corrected some of those negatives. Verily, most of the indices I monitor are now back above their respective 10-DMAs. The most significant move came from the economically sensitive D-J Transportation Average (TRAN/6651.69), which gained an eye-popping 2.76% last week. Its new all-time high was confirmed by the D-J Industrial Average (INDU/15658.36) with a new all-time high of its own, thus rendering another

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Dow Theory "buy signal." In fact, most of the indexes have traded to new all-time highs. Also on a positive note is the NYSE McClellan Oscillator, which has corrected its overbought condition, but is still only neutrally configured and not yet oversold. Yet in the negative column is that the NYSE Advance/Decline Line has not confirmed the upside. So we wait, waiting to see if the weight of the evidence lines up leading to the first meaningful decline of the year. If that "call" proves wrong, it will not be the first time I have been wrong. Manifestly, in this business it is no disgrace to guess wrong, the disgrace is to stay wrong!

The call for this week: I have various short-term negative signals into the first part of this week, if the SPX can ignore those signals, then it will show an amazing resiliency during a pretty difficult period of low internal-energy readings combined with various other cautionary indicators. Personally, I believe what is shaping up is a giant false upside breakout pattern that would be confirmed by a close below 1700 on the SPX, and reinforced by a break below 1684. However, in this business stubbornness is a dangerous trait! Accordingly this week, and next, should tell us if my cautionary call, within the context of a secular bull market, is going to play. If not, it is better to lose face and save skin, which is the key to investment success as defined by Benjamin Graham in the book "The Intelligent Investor" where Dr. Graham notes, "The essences of portfolio management is the management of RISKS, not the management of Returns." He closes that thought by noting, "ALL good portfolio management begins with this premise!"

I like this story as scribed by Frederick E. "Shad" Rowe captain of Greenbrier Partners:

> "In 1965 Steve McQueen starred in *The Cincinnati Kid*, the classic poker movie of all time. This movie has so far saved me from becoming ultra-broke or ultra-rich. The climactic scene in the movie involves a showdown hand of five-card stud between Steve McQueen ("the Kid") and Edward G. Robinson ("The Man"). This scene made an indelible impression on me during my school years. With three cards dealt, Robinson bets heavily on a possible flush, a stupid bet if there ever were one, particularly since McQueen has a pair showing. The pot gets bigger and bigger. McQueen ends up with a full house – aces over tens, which loses to Robinson's straight flush. When Robinson turns his hole card, the jack of diamonds; McQueen looks as though he is going to throw up. He has been wiped out. The movie's soundtrack is throbbing. Sweat is dripping down McQueen's face, as he stares at Robinson's hand in disbelief."

Hot July Markets & Autumn Buying Opportunities

July Gains of 3.5% or More			Subsequent 2nd Half Low		
Year	DJIA	% Gain	Date	DJIA	% Lower
1951	257.86	6.3 %	Nov 24	255.95	– 0.7 %
1954	347.92	4.3	Aug 31	335.80	– 3.5
1956	517.81	5.1	Nov 28	466.10	– 10.0
1958	502.99	5.2	Aug 18	502.67	– 0.1
1959	674.88	4.9	Sep 22	616.45	– 8.7
1962	597.93	6.5	Oct 23	558.06	– 6.7
1967	904.24	5.1	Nov 08	849.57	– 6.0
1970	734.12	7.4	Aug 13	707.35	– 3.6
1973	926.40	3.9	Dec 05	788.31	– 14.9
1978	862.27	5.3	Nov 14	785.26	– 8.9
1980	935.32	7.8	Dec 11	908.45	– 2.9
1987	2572.07	6.3	Oct 19	1738.74	– 32.4
1989	2660.66	9.0	Oct 13	2569.26	– 3.4
1991	3024.82	4.1	Dec 10	2863.82	– 5.3
1994	3764.50	3.8	Nov 23	3674.63	– 2.4
1997	8222.61	7.2	Oct 27	7161.15	– 12.9
2005	10640.91	3.6	Oct 21	10215.22	– 4.0
2009	9171.61	8.6	Aug 17	9135.34	– 0.4
2010	10465.94	7.1	Aug 26	9985.81	– 4.6
2013	*15451.85*	*3.6*	***As of 7/16/2013 Close***		
				Total	**– 131.4 %**
				Average	**– 6.9 %**

Source: Stock Trader's Almanac.

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