The Sherman Strategy

An ancient Spanish proverb observes "Lo que hace el loco a la postre, hace sabio al principia", or "That which the foolish do in the end, the wise do at the beginning."

Nowhere is this more true than in the stock market!

In the stock market, every single trend of any significance - both uptrend and downtrend - ends only after the Foolish have piled in. And, at the same time as the Foolish are piling in, the Wise are starting to take the very opposite action, thus beginning the opposite trend by buying from the Foolish who are despondently selling, or selling to the Foolish who are eagerly buying.

It has always been this way, in all markets, and always will be. Simply put, it is human behavior that drives the markets - not cold mathematics or science or even economics. In fact, one of humanity's most brilliant scientists ever, Sir Isaac Newton, said in frustration (after losing a bundle in the stock market of his day), "I can calculate the movement of the stars, but not the madness of men!" Almost four centuries later, the 2002 Nobel Prize for Economics was awarded to two pioneers in this field of investor behavior, now formally called "Behavioral Finance."

The Sherman Strategy is designed to profit from these unchanging, eternal characteristics of human - and thus investor - behavior.

The Sherman Strategy carefully monitors the market for those occasions when the Wise are acting in opposition to the Foolish, and then invests (or un-invests) in alignment with the Wise.

Therefore, at the conclusion of an uptrend, when The Sherman Strategy detects that the Foolish are piling into the buying and that the Wise are beginning to sell, The Sherman Strategy exits the market and patiently waits while the subsequent downtrend unfolds. It doesn't matter how bullish the newspapers are; it doesn't matter how enthused the talking heads on TV are. In fact, just the opposite - as Warren Buffet says, "It's optimism that is the enemy of the rational buyer - you can't buy what is popular and do well." Joseph Kennedy, Sr., asserted that he avoided the crash of 1929 by selling on the very day that his shoe-shine boy gave him a stock tip!

Likewise, at the conclusion of a downtrend, when The Sherman Strategy detects that the Foolish have become the despondent selling majority, and that the Wise are beginning to buy, The Sherman Strategy re-enters the market and participates in the gains as the subsequent uptrend unfolds. This is Warren Buffet's favorite situation! He says "The time to get interested is when no one else is," and "The most common cause of low prices is pessimism...we want to do business in such an environment, not because we like pessimism but because we like the prices it produces."

To quote Mr. Buffet yet again, "We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful."

The goal of The Sherman Strategy is to avoid those market declines and participate in those market uptrends, which are signaled by investor behavior - the actions of the Wise and the Foolish.

The Sherman Strategy (cont.)

A Deeper Look

The Sherman Strategy has two parts: the Risk Management Module, and the Position Selection Module.

The Risk Management Module determines market exposure, while the Position Selection Module determines the composition of the portfolio.

The Risk Management Module

The Sherman Strategy implements highly effective risk management by seeking to avoid most significant declines in the market. It is, after all, declines in the market, which are the risks of the market, so avoiding most significant declines is to avoid most of the market's risks.

When conditions indicating a high probability of a significant decline are detected by the Risk Management Module (i.e., when the Foolish are enthusiastically buying while the Wise have begun to sell), The Sherman Strategy signals a 100% cash position (Money Market or Short-Term Bond funds, typically).

Later, when measurements within the Risk Management Module indicate that the decline has run its course (i.e., when the Foolish are frantically selling and the Wise have begun to buy), The Sherman Strategy signals a return to full 100% market exposure.

The philosophy of the Risk Management Module is very simple: when the market has a high probability of going down, no amount of exposure is appropriate; when the market has a high probability of going up, 100% exposure is appropriate.

The Risk Management Module is designed to detect intermediate-term moves lasting from 1 to 6 months, rather than short-term "wiggles" in the market. A proprietary measurement called the Shermanator, specifically created to perform this task, has signaled just one to three instances per year for the last decade. During that period, about 67% of the time has been spent invested in the market, and 33% of the time has been spent out of the market in the safety of cash (e.g., Money Market or Short-Term Bond Fund).

The Position Selection Module

At the conclusion of a decline, when re-entry into the market is indicated by the Risk Management Module, the Position Selection Module is employed to determine the composition of the investment portfolio.

The Position Selection Module uses measurements of strength and resilience to rank all candidates, and typically chooses several candidates from the selection universe (which might be the Fund list in a 401k plan, or the members of a Mutual Fund family). A selection of four to six from a universe of twelve to twenty candidates is common. The Position Selection Module also works extremely well in less restricted environments, particularly in the ever-expanding world of ETFs.

The Sherman Strategy (cont.)

The measurements used by the Position Selection Module are designed to identify candidates that have intermediate-term strength and staying power, since The Sherman Strategy does not usually change the portfolio composition for the duration of the upmove. Surprisingly, this results in less activity in the portfolio in a typical year than would be experienced by the common "buy and hold with quarterly rebalancing" investing strategy.

The Risk Management Module + the Position Selection Module

Combined, the two Modules within The Sherman Strategy create a complete investing methodology.

In real-time use since January, 2004, The Sherman Strategy has successfully outperformed the market in all up-years, while avoiding the significant downdrafts - including the down-year of 2008 (through 7/31). Analysis of the effectiveness of each module reveals approximately equal contributions from each toward the total outperformance of The Sherman Strategy.

The Sherman Strategy successfully challenges the usual belief that risk reduction must necessarily be associated with performance reduction. On the contrary, by every measure of performance The Sherman Strategy delivers a superior investing methodology.

Contact: Bill Sherman
wesherman@theshermansheet.com
(314) 266-5201