August 2019

A Unique Methodology Using the Principles of the Austrian School of Economics Applied Toward Investing and Trading

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Abstract: We provide a unique methodology to using the Principles of the Austrian School of Economics toward investing and trading in the financial markets. This methodology can be applied to the equity markets in any geography, sector, market capitalization or country. The methodology is based upon 7 quantitative smart-beta factors, each with studies indicating positive outperformance to industry benchmarks, and 7 qualitative smart-beta factors. These 14 factors together combine for a powerful approach to outperformance. We believe this methodology is applicable to address the key challenges to investing and trading in today's challenging environment. The results generally confirm our views.

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We begin by observing that followers of the Austrian School of Economics (ASE) have been generally successful at anticipating major economic events like the Great Depression, the stagflationary environment of the 1970s, the Dotcom Bubble and the Housing Bubble. Leveraging from this success, we explore the potential of using the ASE towards investing and trading in the financial markets.

We view the ASE as maintaining that policy changes, which allow markets to operate freely, result in economic growth and wealth creation, whereas interventionist policies are not friendly to the markets and result in economic stagnation and wealth destruction. Austrian economists look towards understanding the true causes of

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inflation and recessions, with an emphasis on the artificial expansion of the money supply by central banks. It is critical for investors and traders to understand inflation and recessions and their causes.

Further, we view that the ASE emphasizes savings and investment, with minimal debt and leverage. This can apply to economies as well as to companies. Profit opportunities exist in anticipating and interpreting the changes to free market or interventionist policies, and in identifying cash-flowing businesses characterized by scarcity, innovation, longevity and growth in value.

Before translating these ASE basic principles toward investing and trading, it is necessary to understand the key challenges to investing and trading in the current environment:

1. How do you get real yield in an environment of essentially 0% interest rates or negative real interest rates (nominal interest rates minus inflation)?
2. How do you preserve purchasing power when central banks around the world are intentionally weakening their currencies? How do you preserve purchasing power in a rising inflation environment?
3. How do you invest in an environment characterized by ongoing central bank and government interventions and ring-fencing regulations?
4. How do you mitigate potential adverse risks such as defaults, capital controls, protectionism, trade wars, bank account bail-ins, nationalizations, climate change and regulatory capture?

Keeping these challenges in mind, we observe that there have been several books exploring the value proposition of using the principles of the ASE towards investing and trading, helping to address these key challenges in the current environment:

- One such book is called ***Austrian School for Investors*** by Incrementum Fund Managers Ronald-Peter Stoeferle and Mark Valek and Incrementum Advisory Board Members Heinz Blasnik and Rahim Taghizadegan. – *"The Austrian analytical framework is not a prescription for short-term investment success or even a pathway to building a fortune. The Austrian investment approach eschews leverage, promotions, and fads. It is likely to steer one away from disastrous investment outcomes through a balanced approach to wealth preservation. In short, the Austrian methodology is based on reality, not fancy, and its application in daily practice will provide an investor with favorable odds to achieve financial well-being."*

- Another excellent book is called ***The Dao of Capital*** by Mark Spitznagel, Founder and Chief Investment Officer of Universa Investments. – *"What I have dubbed Austrian Investing contrasts starkly to the far more typical investing approach that only weighs current contemporaneous opportunities, one against the other, hungry for yield, blind to the changing opportunities likely to materialize around the next bend."*

These books highlight and provide an overview of the great potential for using the ASE towards investing and trading.

Based on all the considerations discussed above, we have developed a methodology approach to investing and trading given the current challenges in the environment listed above.

For trading, we opportunities by identifying distortions and imbalances in the financial markets and the economy, the trends in monetary and fiscal policies, and through fundamental and technical analysis.

First, we translate the ASE principles into value-based factors. In the industry, these are called smart-beta factors as they capture the market inefficiencies in a rules-based and transparent way.

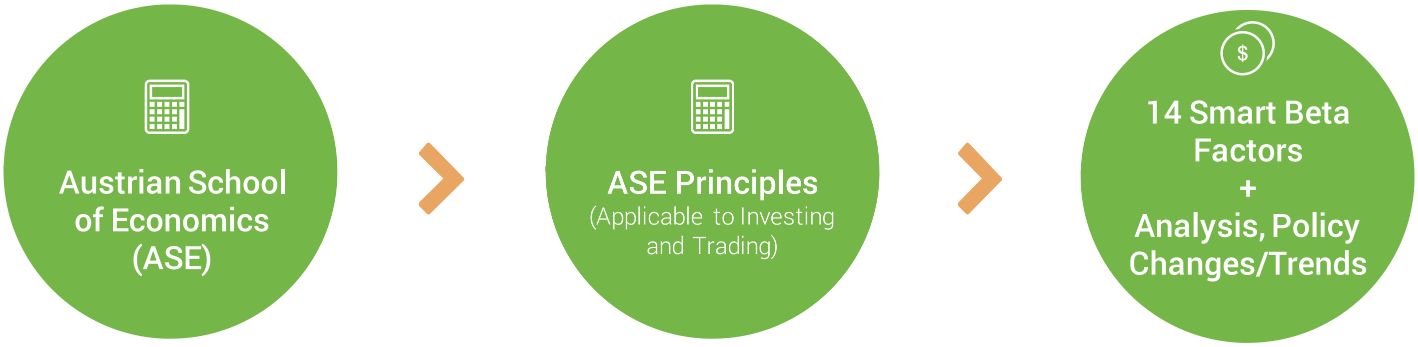
We identify 7 quantitative smart-beta factors:

1. ***ASE Principle - Value is placed upon cash-flowing businesses*** – with high free cash flows representing high profitability of the business overall
2. ***ASE Principle - Value is placed upon limited or manageable debt and leverage –*** not using debt to foster share-buy backs and not overleveraging the business a pre-requisite for attainting profitability
3. ***ASE Principle - Value is placed upon high earnings per share*** – emphasizing an indication of profitability with minimal dilution through excessive shares outstanding
4. ***ASE Principle - Value is placed upon payout distribution like dividends*** – emphasizing profitability with ability to pay back investors with yield
5. ***ASE Principle - Value is placed upon enduring operations*** – businesses that have been around for a relatively long period of time, proving to be an indispensable part of the economy
6. ***ASE Principle - Value is placed upon owner-operators*** – where the operators and management team of the business have a vested stake as owners in the business
7. ***ASE Principle - Value is placed upon stable or decreasing float*** – high value on businesses that are not diluting the share structure ownership with increasingly levels of issued shares outstanding, and not performing share-buy backs using debt instead of cash.

Then we identify 7 qualitative smart-beta factors:

1. ***ASE Principle - Value is placed upon corporate social responsibility (CSR)*** – characterizing strong CSR programs with supporting Environment Social and Governance (ESG) factors
2. ***ASE Principle - Value is placed upon alignment to economic trends*** – businesses that support or are involved directly with the trends in the global economy including ability to trade war risks and challenges
3. ***ASE Principle - Value is placed upon alignment to millennial trends*** – businesses that are aligned with interests and trends covering the millennial generation
4. ***ASE Principle - Value is placed upon uniqueness and scarcity*** – businesses that are characterized by elements of scarcity in supply, and are unique in their approach or product or geography on industry
5. ***ASE Principle - Value is placed upon innovation*** – businesses that are based or rely to some significant extent upon innovation or innovative methodologies or services
6. ***ASE Principle - Value is placed upon risk mitigation***- businesses that are able to minimize market, credit and operational risks in the economy and industry segment
7. ***ASE Principle - Value is placed upon holding value/purchasing power*** – businesses that represent a value proposition or ability to hold share value in the event of consumer price inflation or changes in the level of shares outstanding

We then map these principles into specific measurable metrics that can be used as the basis to assess companies to serve as as a qualification process for investing in the equities of these companies. These metrics are aligned towards studies that correlate with positive equity market outperformance.



The power in this methodology approach is in the statistics – given positive correlation to equity outperformance in each of the factors indicated through various studies – see Appendix. The probability of overall investment portfolio success is compounded positively by requiring as many of the 14 total factors to comply with our researched metric limits. However, even if not all of the 14 beta factors are met, the results still generally lead to overall success in portfolio performance.

As the basis of the methodology approach to trading, we identify distortions and imbalances in the economy and the financial markets, particularly stemming from government fiscal and central bank monetary policies. We recognize these policies and their trends between the major governments and central banks of the world. For example, distortions and imbalances resulting from negative nominal or real interest rates or in yields on bonds, or resulting from currency devaluations or changes in trade policies.

Finally, we provide suggestions on ways to holding "cash" between investments and trades. In other words, what are methods or forms of holding "cash" before using that "cash" for entering into investments or trades? Instead of holding government-based fiat currency, we emphasize holding stores of value as leveraging the ASE principles of scarcity and value. For these stores of value, we suggest holding cash in the form of physical precious metals such as gold or silver backed cryptocurrencies that are scarce and fully regulated within the financial and banking system. We view that governments will likely enforce regulations upon cryptocurrencies as a way of enforcing the historical role of the control by governments and central banks on money.

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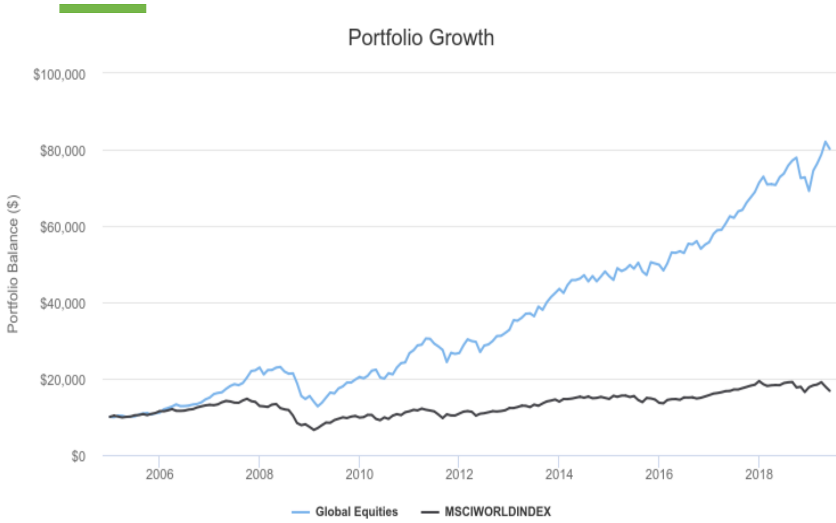
Note how this unique methodology addresses the key challenges to investing and trading in the currently environment:

- Powerful overall portfolio performance correlation to equity market outperformance for targeting 10%-12% annual returns in USD terms, addressing negative real and negative nominal yields, and the preservation of purchasing power challenges
- Risk management on the potential for defaults, capital controls, protectionism, trade wars, bank account bail-ins, nationalizations, climate change and regulatory capture – addressing the risk challenges

What do the results show for taking this approach? Here are some back-testing results on an exemplary model portfolio where we have applied our methodology approach. The results are very optimistic and promising. We have applied the approach to other model portfolios – for example in Japan, Brazil and Switzerland, and the results are very similar - outperformance at lower risk relative to the industry benchmarks.

Backtesting Results from 2005 on an exemplary equities portfolio - Outperformance relative to MSCI World Index- at lower risk



METRIC	PORTFOLIO 1	MSCI WORLD INDEX
Start Balance	$10,000	$10,000
End Balance	$80,191	$16,822
End Balance (inflation adjusted)	$59,716	$12,527
CAGR	15.54%	3.67%
CAGR (inflation adjusted)	13.20%	1.57%
Annualized Volatility	14.89%	14.90%
Beta	0.11	1.00
Max. Drawdown	-44.78%	-55.38%
Sharpe Ratio	0.97	0.23
Sortino Ratio	1.49	0.32

$ = USD

lower risk

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It is noteworthy to point out the maximum drawdowns are generally much less in the model portfolio versus the industry benchmark index – this would be helpful in the event of a severe financial crisis environment on investing and trading.

For results on trading, we point out that our Research Strategist is Yra Harris. Yra frequently appears on CNBC and other media outlets, and he has been a successful Floor Trader with a track record of over 40 years. His approach is characterized by identifying the distortions and imbalances as we mention above. His track-record speaks for itself as a successful approach in trading.

It is noteworthy to emphasize the ASE values of savings, investment, scarcity, endurance, innovation and entrepreneurialism as promoting a strong corporate social responsibility (CSR) methodology approach, with strong supporting Environment Social and Governance (ESG) factors for overall Responsible Investment (RI). We incorporate RI into the investment decision-making process because it is a key part of our investment strategy, it enhances the returns on our portfolios and it enhances all stakeholders – investors, communities, employees, customers, suppliers and governments.

The guiding principles for our methodology approach for investing are as follows:

1. We have a dual focus on businesses with both great financial and socially responsible performance;
2. We see this dual focus as providing mutual synergy:
    a. Increasing profitability grows the stakeholder pie, enhancing socially responsible performance to all stakeholders
    b. Implementing responsible corporate actions and activities with respect to a strong CSR program has a positive influence on financial performance;
3. We incorporate ESG issues into our investment analysis and decision-making processes;
4. We seek appropriate disclosure on ESG issues by the businesses in which we have in our model portfolios.

We feel the responsibility of providing services that promote growth in sustainability in all areas of life while providing an excellent service that will satisfy our most concerned clients.

In summary, we have formulated a methodology approach using the principles of the ASE. We believe this methodology approach is very applicable to address the key challenges to investing and trading in today's challenging environment. The results confirm our views. Summary has to be extended for sure, however we can work on it once we come up with more context.

Appendix – Some Studies Indicating Outperformance

TrimTabs Ted Theodore February 2017 – Free Cash Flow – An Update to Management Reporting

"Optimal Debt-to-Equity Ratios and Stock Returns" - D. Winn, Utah State University, May 2014

Opler and Titman (1994)

Hossain, A. T., & Nguyen, D. X. (2017). Capital Structure and Firm Profitability: NYSE and NASDAQ Firms. Capital Structure and Firm Performance, 93-104

Pushner, G. M. (1995). Equity ownership structure, leverage, and productivity: Empirical evidence from Japan. Pacific-Basin Finance Journal, 3(2-3), 241-255

Lee, H., & Moon, G. (2011). The long-run equity performance of zero-leverage firms. Managerial Finance, 37(10), 872-889

Yuliza, A. (2018). The Effects of Earnings Per Share and Firm Size to Stock Price, International Journal of Engineering & Technology, 7(4.9), 247

Majanga, B. B. (2015). The Dividend Effect on Stock Price- An Empirical Analysis of Malawi Listed Companies. Accounting and Finance Research, 4(3)

The Power of Investing in Long Term Dividend & Cash Flow Growth. (2018). Retrieved from https://harvestportfolios.com/the-power-of-investing-in-long-term-dividend-cash-flow-growth/

Mauboussin, M. J., Callahan, D., & Majd, D. (n.d.). Why Corporate Longevity Matters - Credit Suisse. Retrieved from https://plus.credit-suisse.com/rpc4/ravDocView?docid=V6y0SB2AF-WEr1ce

Pattanayak, M. (2008). Insider Ownership and Firm Value: Evidence from Indian Corporate Sector. SSRN Electronic Journal.

"In the ten years ending November 2013, the S&P Buyback Index was up 158 percent, outperforming the S&P 500 by 90 percentage points." https://www.investopedia.com/terms/f/floatshrink.asp