

## **How was ETF PM Positive in 2008?**

Following a 12-year decline in the S&P 500, investors are looking for strategies capable of positive returns in down markets as well as long-term outperformance. One strategy that clearly stands out is called "trend following": this rules-based investment approach has been successful in the financial markets for over 30 years, and a number of trend-following money managers were able to deliver positive returns in both of the equity market crashes this decade. Trend-following systems have well over \$100 billion under management worldwide yet many investors are still unaware of this dynamic investment discipline; therein we find opportunity.

As an institutional research analyst and hedge fund manager from 1996-2002, I learned firsthand that fundamental analysis could not manage the extreme technology market volatility that characterized the Internet bubble and subsequent crash. However, as with the credit crisis in 2008, a number of portfolio managers that employed trend-following strategies were successful in protecting and growing client capital under the most adverse circumstances.

Having studied the great long-term success of both intensely active trend following and completely passive multi-asset class indexing, our firm has created an investment platform that combines both of these approaches. In addition, we employ cost-efficient exchange-traded funds (ETFs) in order to maximize our value proposition to investors.

### **What is Trend Following?**

Trend-following strategies shift portfolio exposure according to rules-based processes that react to existing trends in the price and volatility of securities, as opposed to fundamental strategies, which attempt to predict future security valuations. By reacting to the market efficiently, trend-following encompasses three critical characteristics of successful portfolio management: discipline, diversification, and risk control.

#### **1) Discipline**

*"The market can stay irrational longer than you can stay solvent." - John Maynard Keynes*

#### **2) Diversification**

*"Diversification is a free lunch." - Harry Markowitz*

#### **3) Risk Control**

*"Rare events are always unexpected, otherwise they would not occur." - Nassim Taleb*

In my investment experience, I have learned that only a reactive rules-based investment process can consistently capitalize on both rational and irrational market environments, enhance diversification by employing a broad range of asset classes, and protect investors from adverse rare events that cannot be anticipated. When executed successfully, trend-following portfolios shift quickly, as needed, to produce a growth-oriented return that is somewhat non-correlated to equities.

### **Index Investing and Trend Following**

The success of passive indexing stems from diversification, low cost, and a process that focuses on asset allocation while minimizing expenses related to position turnover. Index investing does not try to predict which industries will thrive and which will die; it avoids emotion when the markets bubble or crash; and it gradually shifts to reflect the composition of the broader representative market. In many respects, we consider index investing to be the most passive form of trend following.

Ironically, the main strength of index investing is also its greatest weakness at times. Passive, low cost, multi-asset class diversification offers a competitive return long-term, but it does not respond quickly to sharp market volatility to protect capital and deliver positive returns in a crash. Trend following is intensely active in terms of portfolio turnover but similar to indexing in that they both react to pre-existing trends in a rules-based approach.

Trend following attempts to solve the "crash risk" that is inherent with indexing by shifting portfolio exposure quickly across various asset classes as needed. Given the success of passive indexing, it makes sense that a variety of disciplined, rules-based approaches (with different levels of activity, position concentration, and risk control) might offer investors significant diversification benefits long-term.

Many investors still focus on fundamental investment strategies because they are looking for the "edge" employed by Warren Buffett. While fundamental analysis has been extremely successful, it has attracted tremendous competition that has made it somewhat commoditized. For years now, Warren Buffett and David Swensen, chief investment officer for Yale University's endowment, have both strongly recommended that investors employ passive indexing, rather than predictive fundamental strategies, for core investment portfolios. In time, I believe they may both acknowledge the value in disciplined trend following as well.

### **Trend-Following Delivered In 2008!**

A number of portfolio management firms, including ETF PM, used trend-following investment programs to deliver gains for their clients in one of the toughest market environments since the Great Depression. According to Michael Covell, author of "*Trend Following*," at least five of the top 25 hedge fund managers in 2008, ranked by Alpha Magazine, employed trend following to engineer positive returns in the crash.

While trend-following strategies often trade futures ("managed futures") with significant leverage, the growth in ETFs as an investment vehicle has finally made trend-following available to traditional investors without leverage (visit [www.etfpm.com](http://www.etfpm.com)). For example, ETFs such as SPY, EFA, QQQQ, MDY, IWM, EEM, SMH, ICF, XLF, OIH, EWZ, FXI, and GLD give portfolio managers efficient, liquid, and unlevered tools for managing extreme volatility, both long and short, in broad developed market indices, emerging markets, semiconductors, real estate, financials, oil services, Brazil, China, and gold.

## **Beware of the Commodity Cycle**

Experienced investors know that the "buy and hold" strategy does not work in secular equity bear markets, which can last well over a decade. Famed investor Jim Rogers helps explain why there are regular down decades in equities through his book, "Hot Commodities." Rogers notes research by Barry Bannister, a top Wall Street analyst with Stifel Nicolaus, that shows the secular commodity cycle and stock cycle run inversely to one another roughly every 18 years. Rogers believes the length of the cycle reflects the fact that commodities are core inputs to stocks, and it takes a long time to increase the supply of commodities when demand gets extended.

According to this research, and following the equity bull market of 1982-2000, we may currently be near the middle of a secular bull market in commodities. Emerging markets (EEM) as a group are heavy in commodities, and their total return has beaten the S&P 500 by over 100% this past decade making it critical for investors to beware of the commodity cycle.

## **The Bottom Line**

It is not surprising to see efficient reactive portfolio management outperform predictive fundamental investing. Human emotion, market imbalances, and rare events will always impact investors in a manner that enables disciplined rules-based strategies to deliver valuable diversification. The \$13.5 billion planned acquisition of indexing giant Barclays Global Investor's asset management unit, by fundamental oriented BlackRock, highlights the growing demand for diversification in investment process.

When David Swensen was asked to comment on the future of portfolio management, he responded that, "[T]he investment management world is a strange place in that the right solution is not in the middle. The right solution is at one extreme or the other . . . intensely active or completely passive." At ETF PM, we employ intensely active trend following and completely passive core portfolios in order to maximize client value.

While disciplined trend-following strategies will still decline at times, they are somewhat less likely to be in sync with major declines in the equity market. At ETF PM, we employ a number of overriding risk controls in order to limit our downside exposure and defend against rare unexpected adverse events. In my opinion, our strategies are a vital component in diversified portfolios because they offer potential for a growth oriented return long-term with low correlation to stocks, protection from extreme losses, and the possibility of positive returns in a crash.

Like David Swensen, our research also concludes that investors should start their growth portfolios with passive multi-asset-class ETFs in order to capture a diversified market return. While strategically passive core portfolios will decline in a stock market crash, these portfolios still offer investors a great value proposition long-term.

The financial markets evolve quickly. In order to stay ahead, investors must actively seek to employ client-centric portfolio managers that are both disciplined and innovative.

Please contact us at ETF PM for additional information.

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