ANALYTICS INVESTMENT ADVISORS, LLC

# *Keep It Simple*[1]

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**What?** Samuel Lee, Editor of Morningstar ETF Investor, wrote in the December 2014 issue that for all of the Exchange Traded Fund (ETF) portfolios he solicited for public scrutiny recently, his universal observation was that: "They were all too complex". He went on to say that for the following reasons, he recommends only a handful of ETFs, while concentrating on a limited number of themes.

**Why?**

- It is not easy to manage and understand a sprawling portfolio because mistakes are inevitable and avoiding mistakes is much more important than making clever moves.
- By understanding a few positions very well, one can better recognize the inherent risks of a given portfolio. Complex portfolios have a tendency to obfuscate risks that are not apparent and undesirable.
- Given that investing in Exchange Traded Funds is an effort to actively manage passive investments, clarity and understanding can be more easily crafted with a limited number of ETF in each strategic allocation.

**How?**

- Start with a good benchmark, one that is universal, has plenty of liquidity and accurately measures the general performance you are trying to achieve;
- Determine which sectors are currently outperforming and are likely to continue to outperform the specific benchmark(s) you have chosen. In this context it is recommend using ETF Screen sorting on Relative Strength[2] (in descending order), filtering possible considerations utilizing the time series and risk/return charting provided;
- Strive to include ETFs with Relative Strength rankings of 90% or better; [3]
- Construct ETF portfolios with no more than 5 to 7 issues depending on the investment objectives;
- Compute Alpha, Beta and the Sharpe Ratio for each strategic allocation;
- Apply stop loss orders (trailing or otherwise) where appropriate, most probably in tax advantaged accounts; and,
- Monitor performance using primarily relative strength and moving averages as benchmarks for buy, sell and hold decisions.

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[1] Lee, Samuel, Editor, "Keep It Simple", *Morningstar ETFInvestor*, December 2014, Vol. 9. No. 4, p.1.

[2] The pioneering work of Jegadeesh and Titman (1993) shows that stocks with high recent performance continue to earn higher average returns over the next three to twelve months than stocks with low recent performance. This finding has been refined and extended in different contexts by many subsequent studies. Laura Xiaolei Liu and Zhang, Lu, "Momentum Profits, Factor Pricing, and Macroeconomic Risk" *The Review of Financial Studies* v.2, n.6, 2008.

[3] The rationale for this decision rule is inherent in the statistically significant statistics for the regression equation between Return and Relative Strength on the following page.

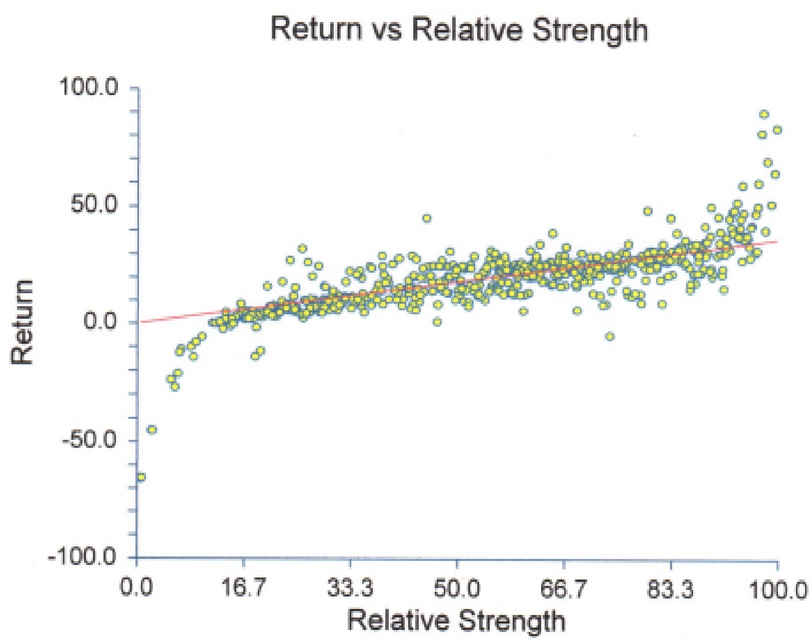
## Exchange Traded Fund Investment Model

The investment strategies below are comprised entirely of Exchange Traded Funds (ETFs): 1) are a way to combine the potentially high returns of individual stock trading with the benefits of diversification of mutual funds; 2) are a basket of stocks that trade on an exchange with the simplicity and liquidity of an individual stock; 3) add flexibility and safety through diversification, access to varied markets; 4) are low cost and tax efficient; 5) trade under the jurisdiction of the Security and Exchange Commission offering protection and liquidity for orderly and continuous trading; and, 6) allow the ability to effectively monitor performance and effectuate sound risk management strategies; for example, stop and limit orders.

### Performance Summary

| | **2012*** | **2013*** | **12/31/2014*** | **Alpha**** | **Beta**** | **Sharpe Ratio**** |
|---|---|---|---|---|---|---|
| **S&P 500** | **13.41%** | **29.60%** | **12.55%** | | | |
| **Barclay US TR** | **4.42%** | **-2.02%** | **5.97%** | | | |
| **Cautious** | 8.53% | 32.73% | 9.01% | 4.04 | .88 | 1.63 |
| **Moderate** | 10.51% | 35.85% | 12.92% | 1.13 | 1.12 | 1.37 |
| **Assertive 1** | 17.10% | 38.40% | 16.90% | 4.19 | 1.10 | 1.55 |
| **Assertive 2** | n/a | 44.93% | 24.83% | 5.09 | 1.34 | 1.53 |
| **Aggressive** | 22.70% | 68.62% | 2.07% | 6.93 | 2.06 | 1.45 |

Alpha Difference between portfolio actual return and expected return
Beta Expected change in portfolio returns per 1% change in the market index return
Sharpe Ratio A measure of risk-adjusted return showing excess return per unit of total risk
* Net Size Weighted Returns, PortfolioCenter, Schwab Portfolio Technologies (Net of Standard Fees)
** Three Year Risk Return Statistics, Morningstar 06/30/2014




N= 596 (1/7/2013 to 6/30/2014); Slope = .0636; $R^2$ =.839; and, T-Value =55.60.