



## ANALYTICS INVESTMENT ADVISORS, LLC

### Buy – Don't Hold (Part 2)

Richard C. Hoyt

January 15, 2011

Having made a convincing case for active management in the last month's commentary, Buy – Don't Hold (Part 1) (based on Leslie N. Masonson's recently published book, *Buy – Don't Hold: Investing in ETFs Using Relative Strength to Increase Returns with Less Risk*) the subject of the current presentation tests Mr. Masonson's main thesis (using relative strength to increase returns) and outline definitive steps that can be followed to implement such a strategy.

The efficient market hypothesis states that past performance of share prices is not a guide to the future. The high priests of efficient markets argue that: market anomalies are statistical quirks, any gains from a particular strategy will be arbitrated away, any gains will be dissipated in higher trading costs, and higher returns simply reflect the higher risks of the strategy. However, the momentum effect drives a stake through the heart of this tenet.

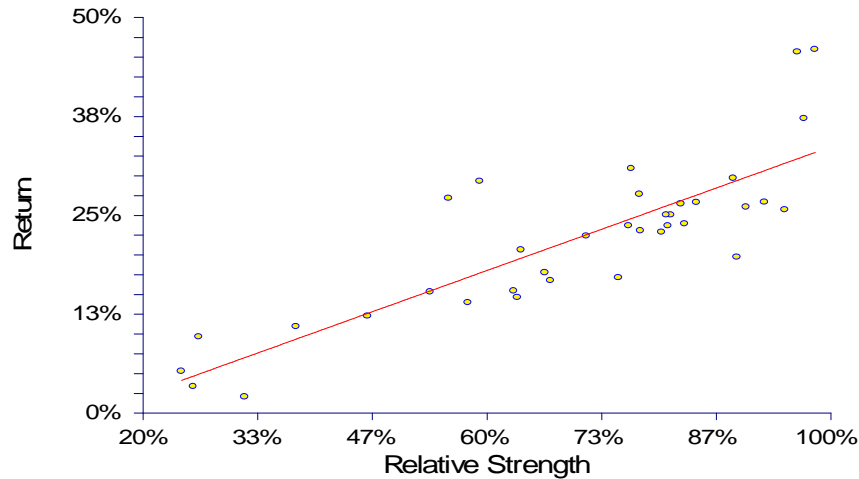
The concept of momentum advanced by Isaac Newton over four hundred years ago stated: "An object in motion tends to stay in motion unless an external force acts on it". This is analogous to the Wall Street adage: "the trend is your friend". Stocks or funds spend time in a trading range, before external forces move the issue in one direction or the other. The external force may be an economic fundamental or totally unrelated to underlying economic considerations. In theory, investors can profit without knowing why a stock is moving.

Since the 1980's, academic studies have repeatedly shown that, on average, shares that have performed well in the recent past continue to do so for some time in the future. One recent long term study (the longest ever undertaken) confirmed that the momentum effect has been observable for most of the last century (see Dimson, Elroy, Paul Marsh, and Mike Staunton. *Global Investment Returns Yearbook*, "Triumph of the Optimist, 101 Years of Global Investment Returns". 2008). Another recent study by AQR Capital Management, a hedge fund, found that stocks with the best momentum out performed those with the worst momentum by more than ten percentage points a year between 1927 and 2010.

Relative strength, which allows investors to incorporate momentum investing into a complete investment theory, makes it possible to develop clearly defined buy rules, establish sell criteria in advance in case the buy decision was wrong, know how to implement winning trades and lock in gains. Relative strength strategies take advantage of the business cycle. Economies around the world for centuries have shown repetitive patterns of growth and decline or expansion and recession. These cycles are typically measured by changes in Gross Domestic Product (GDP). Other economic indicators such as unemployment rates and inflation also demonstrate cyclical patterns. The reason for these cycles is the subject of debate among economist, but there is almost universal agreement that they exist, which is all that matters for the relative strength investor. (See Commentary by Richard Hoyt: *ETFs, Moving Averages and Risk Management* November 9, 2009, for an outline of different phases of the business cycle).

The notion of return being influenced by relative strength can best be exemplified by the following regression chart and analysis, which is based on average annual returns for 37 randomly selected ETFs as a function of relative strength for the calendar year 2010.

Return vs Relative Strength



$$\text{Return} = -5.4196 + .3909 * \text{Relative Strength}$$

(-1.6721)      8.8030) T-Values      R-Squared: .6950  
Correlation: .8337

The above statistically significant regression equation indicates that 70% of the variability in average annual return is explained by relative strength, and that there is an 83% correlation between the independent and dependant variables. These results, in conjunction with numerous other studies demonstrate that relative strength is pervasive and persistent. The following steps outline how an investor can exploit relative strength, which has the potential to be an important determinant in investment performance.

1. Determine Risk Tolerance  
Understand the stock market and establish one's maximum drawdown.
2. Examine Existing Portfolios for Possible Reallocation  
Conduct a detailed analysis of one's portfolios taking into consideration: risk/return, stock intersections, number of issues, past performance relative to appropriate bench marks, risk management, and ease of management.
3. Evaluate Current Stock Market  
Assess current market conditions using both fundamental and technical analysis. Moving averages and point and figure charting are useful tools for the latter.
4. Develop a Suitable Subset of ETFs  
The universe of approximately 1,000 ETFs allows systematic categorization and detailed analysis.
5. Select Top-Rated ETFs Based on Relative Strength  
Go to [www.etscreen.com](http://www.etscreen.com) or [www.etftable.com](http://www.etftable.com) to find top rated ETFs based on relative strength.
6. Protect the Resulting Portfolio Using Stop Loss Orders  
Since profits are not guaranteed, one should consider placing stop loss orders immediately (See Commentary by Richard Hoyt: *ETFs and Stop Orders*, June 5, 2010 for one methodology that can be applied to determine an appropriate range of stop orders.