Trend-Following Strategies

MODERATOR

Jeff Sica
Sica Wealth Management

PANELISTS

Alan Lordi
Aequitas Capital Management
Laif Meidell, CMT
AdvisorShares

Jim Welsch
Forward Management
Trend-Following Strategies: A Primer

Presented by Alan Lordi
Vice President, Investor Solutions, Aequitas Capital Partners
Trend Following Strategies: A Primer

- Trend following strategies purchase assets that are rising in value and sell assets that are declining.
- There exist behavioral biases that slow price discovery and perpetuate trends.
- Prices tend to initially under-react to news (good or bad) and trends continue as prices slowly move to fully reflect changes in fundamental value.
- Trends have a tendency to continue even further as investors chase trends (herding).
- Herding causes prices to over-react and move beyond fundamentals after the initial under-reaction.
Anchor and Under-Reaction

Investors tend to anchor their views to historical data and adjust their views insufficiently to new information, causing prices to under-react to news.
Psychological Effects

Investors tend to sell their winners too early and ride losers too long.

- Investors sell winners too early because they like to realize gains. This selling creates downward price pressure which slows down the upward price movement to the new fundamental level.

- People hang onto losers too long since realizeing losses is painful. Investors try to “make back” what they lost. In this case, the absence of willing sellers keeps prices from adjusting downward as fast as they should.
Outside Influencers of Price

**Central Banks operate in the fixed income** and currency markets to manage inflation expectations, stimulate economic activity and reduce exchange rate volatility. This slows down price adjustments to events and/or creates trends in and of itself (Don’t fight the Fed).

**Hedging activity** in commodity markets can also slow down price discovery.
Herding and Feedback Trading

*When prices move up or down* for a while, investors have a tendency to jump on the bandwagon and this herding effect feeds on itself.

*Herding has been documented* among equity analysts in their recommendations and earnings forecasts.

*Mutual Fund investors often move* from funds with recent poor performance and herd into funds that have recently performed well.
Confirmation Bias

People tend to look for information that confirms what they already believe to be true and thus, look at recent price movements as representative of the future.

This leads investors to move money into investments that have recently made money and conversely, out of investments that have recently declined, causing trends to continue.
Risk Management Influences

Many risk management techniques involve selling in down markets and buying in up markets, in line with the trend.

- Stop Losses get triggered causing selling in the same direction as the price movement. In the case of short positions, stop losses create buying in the direction of the up-trend.

- A drop in price is often associated with higher volatility (Value at Risk), leading traders to reduce positions to reduce VaR.
End of the Trend

Ultimately, the markets are efficient and prices correct back toward fundamental value.

As investors realize that prices have gone too far, they revert towards fundamental value and the trend dies out.

The market may then become range-bound until new news cause price movements that set off new trends.

One of the main challenges for trend-following strategies is to minimize losses associated with the ending of trends and to preserve capital in range-bound markets that do not exhibit trends.
The Lifecycle of a Trend

- **Start of Trend:** Anchoring and under-reaction
  - Trend Strategy Buys Here

- **Trend Continuation:** Herding and over-reacting

- **End of the Trend:** Reversal to Fundamentals
  - Trend Strategy Exits

The chart illustrates the stages of a trend, from the start of anchoring and under-reaction, through herding and over-reacting, to the end with a reversal to fundamentals.
Stocks vs Managed Futures: Gain/Loss During Stress Periods

- Surprise Fed Rate Hike 1994: Managed Futures +9.90%, U.S. Stocks -7.75%
- Long Term Capital Fails 1998: Managed Futures +8.72%, U.S. Stocks -15.57%
- Internet Bubble Bursts 2000-2002: Managed Futures +32.65%, U.S. Stocks -45.60%
- 9/11 Tragedy 2001: Managed Futures +3.65%, U.S. Stocks -8.17%
- Credit Crisis 2007-2009: Managed Futures +16.73%, U.S. Stocks -52.56%

Source: Mgd Fut. = CSFB/Tremont Managed Futures Index, US Stocks = S&P 500, Intl Stocks = MCSI World Index
The Skinny on Trend Following Strategies

Trend following strategies can benefit a portfolio by providing a non-correlated source of return. In a down-trend, strategies, like managed futures, can perform well providing significant diversification benefits.

Correlation of managed futures index to stocks = -0.04  
Correlation of managed futures index to Bonds = 0.13  
(Source PerTrac Data 1987 – 2013 Indices = Barclays Systematic Trader’s Index, S&P 500, Barclay’s Agg. Bond Index.)

Trend following strategies perform poorly in range-bound markets. They also suffer when trends reverse abruptly.

Trend following strategies require high turnover, incurring substantial trading costs. These strategies are also not tax-efficient for taxable accounts.
Thank you.

Trend-Following Strategies: A Primer
Presented by Alan Lordi
Vice President, Investor Solutions, Aequitas Capital Partners
Trend-Following Strategies

MODERATOR

Jeff Sica
Sica Wealth Management

PANELISTS

Laif Meidell, CMT
AdvisorShares
Background:

- Chartered Market Technician.
- Began studying technical analysis in 2001 because I didn’t like how the bear market was affecting my clients emotionally and financially.
- Started experimenting with quantitative trend following of equity mutual funds in 2005 to identifying early changes in market trends.
- In Mach of 2008 incorporated fixed income into our quantitative equity models with favorable results.
It Just Might Work!
Trend Following Strategies May Be Right For Your Clients Portfolios If:

- Clients expect you to keep portions of their portfolios up to date with changes in the market place.
- Clients expect you to keep them from experiencing large losses in their portfolio.
- Your client’s investment personality requires a less volatile experience.
What to consider when using a Trend Following Strategy

• Can represent a core or satellite portion of your clients portfolio depending on your clients needs.
• Trend following strategies are typically less tax efficient and may be more appropriate in retirement accounts.
• Don’t wait for the market to peak before incorporating a trend following strategy into your accounts.
Lifting the Veil on Tactical Strategies

• 9 Sector ETFs
  • XLB – Materials
  • XLE – Energy
  • XLF – Financial
  • XLI – Industrial
  • XLK – Technology
  • XLP - Consumer Staples
  • XLU - Utilities
  • XLV – Health Care
  • XLY – Consumer Discretionary

• Calculate the 50 Day Rate of Change of the 200 day exponential moving average for each fund daily
• Rank and own the top 3 ETFs
What is Rate of Change (ROC)?

\[
\text{ROC} = \frac{(B - A)}{A}
\]
The 50 Day ROC of the 200 Day Moving Avg. – Slow Velocity
Performance from 03/08/1999 to 07/17/2014

<table>
<thead>
<tr>
<th>Overall Performance</th>
<th>Overall Performance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Comp. Ann. ROR (%)</td>
<td>5.96</td>
</tr>
<tr>
<td>Ave 12Mo ROR (%)</td>
<td>6.89</td>
</tr>
<tr>
<td>Ave. Monthly ROR (%)</td>
<td>0.58</td>
</tr>
<tr>
<td>Stdv Monthly ROR (%)</td>
<td>4.5</td>
</tr>
<tr>
<td>Max Drawdown (%)</td>
<td>49.68</td>
</tr>
<tr>
<td>Profitable Months (%)</td>
<td>58</td>
</tr>
<tr>
<td>Reward/risk</td>
<td>0.12</td>
</tr>
<tr>
<td>Sharpe Ratio</td>
<td>0.26</td>
</tr>
<tr>
<td>Sortino Ratio</td>
<td>1.25</td>
</tr>
<tr>
<td>Alpha (Ann. %)</td>
<td>2.54</td>
</tr>
<tr>
<td>Beta</td>
<td>0.79</td>
</tr>
<tr>
<td>Information Ratio</td>
<td>0.12</td>
</tr>
<tr>
<td>T-Statistic</td>
<td>0.42</td>
</tr>
</tbody>
</table>
What if You Add Three Bond Mutual Funds to the List?

- **9 Sector ETFs**
  - XLB – Materials
  - XLE – Energy
  - XLF – Financial
  - XLI – Industrial
  - XLK – Technology
  - XLP – Consumer Staples
  - XLU – Utilities
  - XLV – Health Care
  - XLY – Consumer Discretionary

- **3 Bond Mutual Funds**
  - VBISX – Vanguard Short Term Bond Index
  - VBIIX – Vanguard Interm-Term Bond Index
  - VBMFX – Vanguard Total Bond Market Index

- Calculate the 50 Day Rate of Change of the 200 day exponential moving average for each fund daily
- Rank and own the top 3 ETFs
Performance from 03/08/1999 to 07/17/2014

<table>
<thead>
<tr>
<th>Overall Performance</th>
<th>8.22</th>
</tr>
</thead>
<tbody>
<tr>
<td>Comp. Ann. ROR (%)</td>
<td>8.41</td>
</tr>
<tr>
<td>Ave 12Mo ROR (%)</td>
<td>0.71</td>
</tr>
<tr>
<td>Ave. Monthly ROR (%)</td>
<td>0.71</td>
</tr>
<tr>
<td>Stdv Monthly ROR (%)</td>
<td>3.53</td>
</tr>
<tr>
<td>Max Drawdown (%)</td>
<td>24.1</td>
</tr>
<tr>
<td>Profitable Months (%)</td>
<td>60</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Overall Performance</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Reward/risk</td>
<td>0.34</td>
</tr>
<tr>
<td>Sharpe Ratio</td>
<td>0.52</td>
</tr>
<tr>
<td>Sortino Ratio</td>
<td>2.65</td>
</tr>
<tr>
<td>Alpha (Ann. %)</td>
<td>6.22</td>
</tr>
<tr>
<td>Beta</td>
<td>0.44</td>
</tr>
<tr>
<td>Information Ratio</td>
<td>0.27</td>
</tr>
<tr>
<td>T-Statistic</td>
<td>0.94</td>
</tr>
</tbody>
</table>
Thank you!

See me after panel or AdvisorShares booth for additional questions.
Trend-Following Strategies

MODERATOR

Jeff Sica
Sica Wealth Management

PANELISTS

Jim Welsch
Forward Management
Trend-Following Strategies
Innovative Alternative Strategies Conference
Panelist: Jim Welsh, Forward
Obtain Trend Updates on a Monthly Basis

Discover Forward’s Macro Strategy Review at forwardinvesting.com

@JimWelshMacro
Our Philosophy

“One of the best ways to make money is to lose less.”
Trend-Following Tip #1: Listen

The market is a discounting mechanism, so listen to the market’s message

*Market tends to be wrong at every major top and bottom*

Philosophy: One of the best ways to make money is to lose less.
Trend-Following Tip #2: Question Everything

Contrary Opinion – Investor’s Intelligence

62.0% Bulls 19.3% Bears
October 2007

26.4% Bulls 47.2% Bears
March 2009

61.2% Bulls 15.3% Bears
January 2014

Very helpful, but shift in buying and selling pressure must follow

Philosophy: One of the best ways to make money is to lose less.
Fundamental analysis helps to protect your portfolio

- Monetary policy
- Gross domestic product, earnings growth and price/earnings ratio
- Portfolio managers: mostly buy and hold, while invested 95% all the time
- Bottoms-up approach: focusing on sectors and balance sheets may result in being blindsided by macro events

*Driving a car while looking in the rearview mirror – OK until the first curve*

Philosophy: One of the best ways to make money is to lose less.
Trend-Following Tip #4: Technical Analysis

Technical analysis is vital to risk management

• Discipline risk management when the first curve appears
• Importance of knowing when we’re wrong
• Different technical indicators provide the ability to layer time frames
• Chart analysis, advance/decline line and moving averages
• Major Trend Indicator: proprietary tool reviewed in Macro Strategy Review

Potential whipsaws, but a well thought-out technical approach can capture the big moves

Philosophy: One of the best ways to make money is to lose less.
Disclosures

Investing involves risk, including possible loss of principal. The value of any financial instruments or markets mentioned herein can fall as well as rise. Past performance does not guarantee future results.

This material is distributed for informational purposes only and should not be considered as investment advice, a recommendation of any particular security, strategy or investment product, or as an offer or solicitation with respect to the purchase or sale of any investment. Statistics, prices, estimates, forward-looking statements and other information contained herein have been obtained from sources believed to be reliable, but no guarantee is given as to their accuracy or completeness. All expressions of opinion are subject to change without notice.

Forward Funds are distributed by Forward Securities, LLC.
Not FDIC Insured | No Bank Guarantee | May Lose Value
©2014 Forward Management, LLC. All rights reserved.

Jim Welsh is a registered representative of ALPS Distributors, Inc.

FSD000891 083114