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PRECISION PROFITS

Sector Rotation Strategy:

Guide to Finding the Best Performing ETFs

By Michael Carr

When I was managing more than $200 million as a registered investment adviser in 2010, one key rule was to trade exchange-traded funds (ETFs) exclusively. This allowed us to focus on sectors instead of individual stocks and to search the world for the best investments.

Assets in ETFs were then only about a half-trillion dollars. It's now about $6 trillion, so we were ahead of the curve there. Then I programmed rules to follow Will Rogers' investment advice.

Rogers was a popular columnist in the 1930s and often offered advice on life. When it came to investing, his advice was sound. He said: "Don't gamble; take all your savings and buy some good stock and hold it till it goes up, then sell it. If it don't go up, don't buy it."

Rogers was reaching for a laugh with that line. But he was actually describing an investment strategy known as relative strength that was first explained in a 1933 *Barron's* article. It's a mathematical way of defining how to buy stocks that go up. After that article, relative strength went out of favor.

There was an academic journal published on it in 1946 and another one in 1966. Finally, in 1993, the academic community realized that buying stocks that go up is a good idea. It sounds obvious, but this simple idea has been the crux of investment research for decades. Since then, there have been hundreds of journal articles documenting that this idea works.

Our Sector Rotation strategy keeps the same rules I established in 2010 that allowed our firm to maintain a relatively conservative trading account while still following the fastest-moving market at any given time. It allowed us to grab higher returns at a lower risk.

Now, I'm excited to share the details behind this powerful strategy with you…

Buy Uptrends for Higher Returns and Lower Risk

The overall idea of this strategy is to buy strength.

This isn't always easy for individuals who often prefer to buy weakness. They might believe a stock that's already fallen 50% can't really decline much more.

The truth is, that stock can still fall 100%. In fact, it's *likely* to fall further after dropping 50% because the stock is in a downtrend.

Traders should know to avoid stocks in downtrends. They say things like "the trend is your friend," because trends are important. Yet, many buy downtrends anyway. They ignore that trend because value investing requires buying at a discount.

Think again about the word "discount." A discount on a sweater at Macy's means the price is marked down from its base value. We love a discount when we're shopping, but we also know the reason they're marked down is the store wants to be rid of them.

The problem is that markdowns in stocks are often a sign of problems. However, investors tend to think these stocks automatically offer value, because they're "cheaper."

But Macy's doesn't discount its top sellers. The sweaters on sale are the ones that no one wants. The same applies to stocks. The ones on sale are often the ones no one wants to buy. And we know this because sellers wanted to get out of their positions so badly that they didn't wait for better prices. They sold into the decline so they could take their loss and move on. This tells us they believe the worst is yet to come.

Despite these facts, many traders buy downtrends and then wonder what went wrong.

Years ago, my research showed me what went wrong. Trends are simply more likely to continue than to end. Think about that and you can see it makes sense. Trends last for weeks, or months, or sometimes even years. Being on the right side of the trend is the key to long-term profits.

This was the insight I used to manage more than $200 million. We simply picked the ETFs with the strongest uptrends.

To me, that means the ones that have gone up the most in the past six months. This might sound simple, but following this strategy beats the market. This has been known since 1967.

That's when Robert Levy published a paper called *Relative Strength as a Criterion for Investment Selection*. It's a short paper, just 16 pages and nine footnotes. The paper was a summary of Levy's PhD dissertation.

He found that a portfolio of stocks with the highest relative strength over the past six months tended to beat the stock market. He calculated relative strength by comparing a stock's current price to its 6-month moving average (MA). His paper showed stocks that were trading well above their 6-month MA were most likely to continue moving higher.

Levy's calculation is just one way to calculate relative strength. As I explained in *Smarter Investing in Any Economy*, there are at least 10 ways to calculate relative strength. The simplest calculation, the 6-month rate of change, was often the best-performing method of stock selection. That's how I managed money, and that is what I still follow.

The reason for using ETFs is simple. ETFs are less volatile than individual stocks, and they are less subject to outlier influences, like an earnings report. Once an ETF enters a trend, it takes more for it to break that trend one way or the other.

This quality makes them dependable trades. That's why I focused on them when I was managing money.

Now, the other piece of the puzzle is knowing how to pick the best ones…

Picking the Top-Performing ETFs

When I managed money, we started by identifying a list of ETFs we could invest in. Because we could be making trades of $40 million or more in one day, we needed to ensure the funds were liquid. By liquid, I mean that we could place our trades without moving the markets.

As individuals, our liquidity demands are lower. Among the smallest ETFs is the iPath Series B Carbon ETN (GRN) with about $60 million in assets. This is liquid enough for most individuals to trade, so liquidity won't be a constraint. But for multimillion-dollar positions, it's not suitable.

Now that we have an investment universe to analyze — liquid ETFs — we need a procedure to determine what to buy.

Here, the rule is simple. We buy the ETFs that score highest on 6-1 momentum. That's pronounced "6 minus 1". To find 6-1 momentum, you calculate the ETF's return over the past six months and subtract the return from the past month.

The six-month return identifies the strongest ETFs. By subtracting the one-month return, we avoid ETFs that spiked higher on news and are likely to experience a decline in the coming weeks.

I calculate 6-1 momentum and sort highest to lowest. Here's an example of what that looks like in the chart below:

Symbol	Momentum 6minus1	RSI(2)
XLE	11.64	17.32
XLB	6.24	91.81
XLF	5.45	70.49
XLI	3.32	52.24
XLV	0.35	3.70
XLC	-2.84	41.05
XLP	-4.12	2.02
XLK	-6.99	37.68
XLRE	-8.52	29.39
XLU	-9.97	1.27
XLY	-10.76	52.05

The top three in the chart are our call option candidates for the month. The bottom three are our put option candidates. But we don't buy right away. We wait for a timing signal. That signal will be given by the RSI(2) indicator.

RSI(2) is a variation of the popular Relative Strength Index (RSI) indicator. I explain the details behind RSI in a separate report.

For the sector rotation strategy, we buy a call when the RSI(2) for one of the top three ETFs is less than 10. We are buying long-term strength on short-term weakness. Long-term strength is defined by the 6-1 indicator. Short-term weakness is defined by RSI(2).

For puts, we buy when RSI(2) rises above 90. That indicates the ETF is overbought and is likely to fall.

Specific exits are explained in our Trade Room session when the trade is identified.

Regards,

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