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Cashing Out of Trouble

When Howard Present's quant funds sense danger, they're gone before the market has a chance to turn.



BY DAVE LINDORFF

BACK IN MID-2007, WELL BEFORE the financial debacle that began with the collapse of the investment bank Bear Stearns, Howard Present, co-founder, president and CEO of F-Squared Investments in Boston, had a strategy that determined that financial stocks were becoming too risky. But they didn't just sell down the financial holdings, which at the time represented one-ninth of his strategy's investments. He sold *all* his financial stock holdings.

It's not that Present had some prescient knowledge about the unprecedented collapse that lay only months ahead for the U.S. financial sector. It's just that his strategy is to cash out of an entire sector when his quant model starts to exhibit significant downside risk. "We don't adjust allocations," explains Present. "If we don't like a sector, if we think that we're in an environment when one sector, or several sectors, are heading down, we just clear out. We eliminate those sectors."

The strategy features nine sectors, each of which is reviewed and evaluated either monthly or weekly depending upon the specifications of two mutual funds, the Virtus Premium AlphaSector Fund (adjusted weekly) and the Virtus AlphaSector Rotation Fund (adjusted monthly). Other than frequency or reallocation, the two funds are identical. "We approach each sector the same," says Present. "It's an all-in or all-out philosophy. If a sector has a higher probability of a positive return, it's left in. If it's a lower probability, we're all out. We never do relative under- or overweights. For those sectors that are in the portfolio, they're all equal weighted."

As of Aug. 1, only five sectors were active in each fund, and four had been removed. Each of the five sectors represents 20% of a fund. The five sectors currently in favor are consumer discretionary, consumer staples, utilities, industrials and materials. Out of the running for now are:

healthcare, financials, technology and energy. As it turns out, those four represent 60% of the S&P market cap.

The AlphaSector model is 100% quantitative, with three primary inputs: historical prices, from which they generate rolling moving averages; volatility, including intraday volatility; and changing levels of volatility. "We look at relative momentum [price trends], we adjust our horizon based on changing levels of volatility, and we do some smoothing based on a comparison of near-term and longer-term volatility," Present says. "That gives a structured, objective means of deciding when to get out and when to get back in a sector."

That might sound drastic, especially since AlphaSector only invests in nine sectors—each composed of S&P sector ETFs covering financials, consumer staples, consumer discretionary, utilities, energy, materials, healthcare, industrials and technology. But it's a strategy that has

paid off handsomely for investors over its nine-year history.

BEATING THE BENCHMARK

Present's AlphaSector Premium strategy is up 194% cumulatively from Apr. 1, 2001 through Aug. 31, 2010, compared with the S&P, which rose only 8.2% for the period. Year-to-date through Aug. 31, the Premium strategy was off just -1.2% compared with the S&P, which was off 4.6%. The Premium's one-year performance through Aug. 31, was 8.8% compared with 4.9% for the S&P.

The key to F-Squared's success, says Present, is avoiding the downside. "There's a concept we call capital gap," he explains. "If the market goes down 50%, it has to recover by 100% to get back to where it was. What this means is that if you can avoid that downside, you pick up an exponential benefit. It's not how much you make that matters. It's how much you keep."

F-Squared has managed to hang on to quite a bit for its investors. When the S&P Index plunged 37% in late 2008, F-Squared's AlphaSector Premium strategy dropped just 1.9%. The AlphaSector Rotation strategy, which reacts more slowly because it's adjusted monthly instead of weekly, dropped a mere 8.5% for the year.

Jim Miller, senior trust officer at Merchants Trust Co. in Burlington, Vt., says his bank's reps have been incorporating F-Squared's strategies, which are marketed by Virtus Investment Partners as the Premium AlphaSector Fund (VAPAX) and the AlphaSector Rotation Fund (PWBAX) into virtually all their client portfolios. "We use it as an equity fund, even though it has the ability to be all in cash," he says. "We like it because of the downside protection it provides for our clients. Given what we experienced in 2008, we felt there was a role for a more active fund that could move into and out of the market to avoid losses, and this is the only such fund that uses a technical approach instead of a fundamental one."

Indeed, as the U.S. economy began to turn south in 2008, Present kept dropping

sectors, eliminating all but four in February and then continuing to peel them away, until by September, when the financial crisis hit, he was down to just one sector—consumer staples—and holding 75% cash in the form of an ETF composed of one- to three-month T-bills. In October, he sold his last sector ETF and remained in cash until April 2009.

Present says getting away from fundamentals in volatile times is critical. "The times we're making our key decisions, when the rubber is hitting the road, by definition are periods when there is conflicting market information and a lot

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of emotion—sort of like the current situation," he says. "The only way we know to have a repeatable process is to have an unemotional, objective means of looking at the market, and to us that means a quantitative, technical approach."

The model makes more reliable decisions than Present does. "There were times just lately when I wanted to turn sectors on and off, against the engine—and I would have been wrong if we had." He explains that acting on emotion and intellect, he would have gone more into cash earlier in July. "We only turned several sectors off based on our model, and it turns out this was a fantastic time to be fully invested, and we beat the S&P in August by 3.1%."

Merchants Trust advisors typically make the AlphaSector Rotation Fund

about 6% of a client's portfolio, says Miller. "Initially we considered making it a larger percentage, because it's a conservative approach, but as a general rule our limit for a single fund is 10% of a portfolio, and our highest allocation for any one fund in practice is 8%."

Present explains that while 10% might not seem to be enough to significantly impact a portfolio, it can. "Remember, 10% in a typical portfolio could be 20% or more of that fund's U.S. equities allocation," he says. "To put it in perspective, in 2008, the average equity mutual fund was down 30% to 40%, while we were down 2%. So if we were 10% of a portfolio, and 20% of the equity, that would have translated to a 4% gain in client's overall return."

Present notes several funds and strategies offer downside protection, notably absolute return funds offered by Putnam Investments, Stadion Money Management and Evergreen Investment Management (Present, before founding F-Squared, was a managing director in charge of products and strategy at Evergreen). "While they're great in a bear market," he notes, "these kinds of funds don't do so well when the market rises."

Stadion, for example, which uses more derivatives and shorting, was down only 5% in 2008 when the market crashed, but it rose only 3% in 2009, while the S&P was up 26.5%. In contrast, over 2009, F-Squared's AlphaSector Premium strategy gained 32.3% in 2009, 5.8% better than the S&P, while the AlphaSector Rotation strategy gained 25.3%, nearly matching the S&P's performance. Repeated efforts to obtain comment from Stadion, Putnam and Evergreen were unsuccessful.

Ron Santangelo, president of Santangelo Research & Investment Management in Holmdel, N.J., says he spends most of his time doing due diligence for actively managed products. He argues that F-Squared's strategy has two things going for it. "The ability to control downside risk is obviously critical, as is the ability to go to all cash," he says. "But they've also got an algorithm to determine the direction of each sector, and it's been right on since 2001."

Santangelo claims that a key to F-Squared's upside performance is the firm's rigid adherence to a policy of equal weighting across all sectors it's invested in. "They don't try to allocate sectors," he says. "Each is the same weight: 11.1% when they're fully invested, 20% when there are only five sectors. You might say that's a double-edged sword, because you aren't getting all the gain you could when a sector does well, but what it does is avoid bubbles." For example, during the tech bubble of 2000 to 2001, tech was 42% of the S&P Index at one point, versus a 20-year average of 15%, he says. "That was clearly a bubble. Now, when tech stocks fell 60%, if you were allocated to match the S&P, you got killed, but if tech was just 14% of your portfolio, as with the F-Squared strategy, you weren't hurt that much."

"We eventually dropped the tech sector in 2001," says Present. "The beauty is that when the sector started heading down we were better off because we had a lower allocation, and then at some point we sold the whole sector. So it was a double benefit."

OUT, BUT NOT DOWN

Financials in 2006, he notes, had moved from a historic average of about 15% of the S&P to 28%, or nearly double, which was

another sign of a bubble that F-Squared was able to avoid. The strategy wasn't able to overweight the sector in any case—financials had to share an equal allocation

cash," concedes Present. "While the market rallied hard, we waited 30 days and then went first into the energy sector." Energy, he explains, was the sector that had not declined as much, and was the first to show sustainable recovery or strength. "Now we're out of energy," he adds.

During those initial 30 days of market bounce, the S&P rallied about 25% to be sure, and the AlphaSector strategies missed all that, but Present hastens to add, "Okay, but remember, we missed the 25% decline that preceded that bull run, and that's a trade we'll take happily any day."

Merchants Trust's Miller says he agrees. "We did a lot of due diligence on this strategy and we think it makes a lot of sense for our clients."

Present says his two strategies are both available through Virtus Investment Partners, as Virtus AlphaSector Rotation (PSBAX) and Virtus Premium AlphaSector (VAPAX).

At a time when the equity market seems to be moving sideways, and every other week brings some new scare, the idea of protecting a portfolio against major losses while still being able to ride an upturn has its attractions. F-Squared is arguing that for those who are looking for such an approach, there's no strategy like AlphaSector. ♦

MANY HAPPY RETURNS

Avoiding risk has without sacrificing upside has resulted in positive annual performance.

	AlphaSector Premium Index	AlphaSector Rotation Index - ASRX	S&P 500 TR
YTD Rtn 2Q 2010	-7.90	-7.42	-6.55
1 Yr Rtn 2Q 2010	14.79	14.15	14.43
3 Yr Avg Annl Rtn 2Q 2010	8.02	3.62	-9.81
5 Yr Avg Annl Rtn 2Q 2010	11.27	8.09	-0.79
7 Yr Avg Annl Rtn 2Q 2010	12.80	9.14	2.84
Avg Annl Rtn 4/2001 - 2Q 2010	11.53	5.83	0.62

Source: F-Squared

with all the other sectors then in the fund. And when it started to show signs of decline, F-Squared dropped its entire financials allocation like a hot potato.

Of course avoiding risk means that F-Squared is going to be slow off the mark at spotting an upturn in the market and riding the bull. "On March 9, 2009, we were 100%



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