

New index takes quantitative approach to sector plays

Sitting on sidelines unnecessary with neutral, objective plan

By **Janet Morrissey**
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A financial advisory firm is betting that investors who use a quantitative formula — rather than emotion and panic — to move in and out of stocks will get through Wall Street's roller coaster ride with their pocketbooks largely intact.

F-Squared Investments Inc. in Wellesley, Mass., recently launched the AlphaSector Rotation Index, which uses quantitative analysis and other techniques to determine when investors should jump in and out of nine different sectors and, most importantly, when they should keep their cash on the sidelines.

The index, launched last month, uses a quantitative formula to track and analyze the pricing and trading patterns of nine sector-focused exchange traded funds and a Treasury bill ETF.

The AlphaSector strategy differs from most other quantitative approaches because it changes its weightings in the nine equity ETFs each month based on whether each individual sector will generate returns bigger than short-term Treasuries. If the sector won't beat Treasuries, it's removed from the index. Also, no one sector, other than the Treasury ETF, can make up more than 25% of the index at any one time, which means S&P market cap weightings play little role.

"This market collapse has changed individual investors' and advisers' viewpoints on the definition of 'risk' and how they position portfolios and manage money in cataclysmic events," said Howard Present, president and chief executive of F-Squared Investments. It's no longer enough for a fund manager to beat the S&P, he said. "If the market is down year-to-date 38% and you have a manager who's down 33%, it's not like you can go do a happy dance and declare victory," Mr. Present said.

Emotion and anxiety are the culprits feeding the market downturn. "Advisers are getting bloodied. Their clients are terrified — everybody is running for cover," Mr. Present said. A neutral, objective approach based on trading patterns and pricing should take the emotion out of the equation, he believes.

The nine sector ETFs, which track the Select Sector SPDRs, basically divide the Standard & Poor's 500 stock index into nine sector index funds — utilities, technology, industrial, health care, financial, materials, energy, consumer discretionary and consumer staples. The Treasury bill ETF tracks how cash will perform outside the equities market.

Basically, the index model assesses the trading history and -current pricing momentum to determine when it's best to invest in individual sectors and when it's better to move cash into safe Treasuries.

"Even if the S&P goes sideways for the next 12 months, there could be a handful of sectors that show signs of strength, and the product will automatically invest in just those," he said. "Its goal is to, first, outperform cash and, second, beat the market."

The index may be new, but the formula it follows has a track record, Mr. Present said. It's been used by a \$3 billion wealth management firm — which he declined to identify — for private-client accounts since 2001. The strategy directed investors out of financials in July 2007, allowing clients to escape the carnage that subsequently occurred in the banking sector, he said.

This August, the formula moved investors out of energy, saving clients from the hefty price declines that followed, Mr. Present said.

So far in 2008, the index's investment strategy has resulted in a total return, including dividends, of -7.8%, far outpacing the S&P 500's -38.1%.

F-Squared is rolling out products to financial advisers, broker-dealers and others, who can set up accounts that track the index.

"If they want to use a separately managed account on Schwab, we would provide that for them, but if they would rather just get the data feed and implement it themselves, we can do that as well," said Mr. Present.

Over the past six months, the program has been steadily rotating out of sectors and boosting its concentration in Treasuries. The model recommended only two sectors for investment at the end of August, with the remaining 50% being directed into Treasuries. By late September, only one sector remained, and 75% was in Treasuries.

Currently, 100% is in Treasuries, but three sectors — consumer staples, health care and utilities — are on positive watch for possible inclusion in the next few weeks, Mr. Present said.

Don't expect the index to capture every short-term rally. "It's not a trading tool" to move in and out of sectors every time a short-term blip occurs, Mr. Present said. "It's an investment tool" with a longer-term horizon that's "designed to outperform the S&P in good markets with less risk and outperform by a lot in lousy markets," he said.

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