

Market Update – AlphaSector US Equity

After a tremendous one year market rally from the bottom in March 2009 through March 2010, the second quarter of 2010 has proven to be a disappointing turnabout, with the S&P 500 delivering one of only a handful of calendar quarters over the past decade with a loss of more than -10%.

When viewed through the lens of the sectors of the S&P 500, the picture has become darker and darker. As the saying goes, “bad things come in threes”, and during the second quarter of 2010 we saw three categories of concern: negative performance, accelerating volatility, and exceptionally high correlation convergence.

In the sections below we elaborate on these issues, discuss the implications for AlphaSector’s investment models, and provide a performance update. We also provide some historical context to put the most recent quarter into perspective. However, we will start by providing the key positioning takeaways:

- The consistent and broad-based weakening of all the sectors over the past quarter has shifted all of our indexes from fully invested positions to more defensive ones.
- AlphaSector Rotation Index (monthly) still has the majority of its sectors active, reflecting the market position from late June.
 - However, if conditions stay consistent, we would anticipate that many of the active sectors for the AlphaSector Rotation Index will turn negative as of the month end rebalance date.
- The more dynamic AlphaSector Premium Index (weekly), reflecting market events from late June through mid July, has been transitioning to an even more defensive posture, and is currently positioned with four sectors turned off: Health Care, Technology, Energy, and Financials.
 - These four sectors, defined by the ETFs, represent slightly more than 60% of the market capitalization of the S&P 500, reflecting a very defensive stance.
 - Earlier in July, the Premium Index actually raised a 50% cash position, which while proving to be temporary, is the first cash position seen in the Index since May, 2009.

To better understand our defensive positioning for the AlphaSector Indexes, our portfolio construction and investment engine decision-making does not forecast future results, but interprets current events and seeks to protect the investor from the potential of significant losses. Our definition of significant loss is a 12-month loss of -10% or worse.

Market Status – Backdrop

The S&P 500 lost -11.4% over the past quarter, and was off -6.6% year to date through June 30. This marks one of only six times in the past decade that it has had a calendar quarter with a double digit loss. Looking at the S&P through the sectors underlying the broader index, the picture has few bright spots. As mentioned, the key considerations were negative performance, accelerating volatility, and exceptionally high correlation convergence.

From a performance standpoint, the second quarter stands out in the uniformity of losses seen at the sector level. All nine sectors declined during the quarter, more than one-half of which by at least -10%. When looked at from a year-to-date peak-to-trough perspective, 7 of the 9 sectors suffered a drawdown of more than -10%, and 6 of the 9 sectors lost more than -15%. In other words, there was really no place to hide within the large cap universe over the past quarter.

Normally, the sectors demonstrate a fairly high degree of dispersion, or spread, of returns. This creates a valuable risk management and performance benefit. So far, 2010 has not followed suit, with the second quarter one of the most concentrated over the past decade. Some data to highlight this point:

- Since 2001, the average spread between the best performing sector over a rolling six month period and the worst performing sector is 24.4%, with the maximum at 105.9%.
- For the first six months of 2010, the best-to-worst spread was only 12.9%. And to compound the situation, all nine sectors posted losses on both a year to date and trailing quarter basis.

Another way to measure this lack of dispersion is through correlation. Correlation measures how closely two investments track to one another over time. The higher the correlation, the less the diversification benefits. We measure correlation across multiple factors, and the conclusion is that the second quarter of 2010 ranked among the most highly correlated at the sector level over the past decade.

What makes the past quarter particularly unique, however, is that normally this level of correlation occurs at a market bottom, or a strong rebound after a significant period of loss. Examples would be 2Q 2009, 2Q 2003, or the 4Q 2001. Since 2001, this is first quarter where this level of sector correlation has occurred at a relative top to the market.

The final performance related consideration for the sectors has been volatility, which is universally increasing. Within our models, volatility is not a sell signal, but it is an important risk factor. (To understand our assessment of volatility, please keep in mind that we measure volatility at both the end of day as well as intraday levels. This gives us a more robust understanding of volatility.)

While overall volatility is still well below the peaks of late 2008, the rate of increase that we have seen recently is still striking. For example, based on our definition of volatility:

- Year to date, all nine sectors have seen at least a 100% increase in volatility, and for five of the nine sectors volatility is up more than 200%.
- The largest increase year to date is for Technology, which is up 275%.
- Over the past quarter, seven of the nine sectors have seen a 100% or more increase in volatility, with Consumer Staples leading the pack with a 240% increase.

Implications for AlphaSector – US Equity

AlphaSector makes all of its decisions based purely on quantitative data and tools. Therefore, all decisions are made completely objectively and unemotionally. Further, our analysis is attempting to determine, sector by sector, whether there is a highly probability of a sector gaining, or of losing value. The latter case results in the sector being removed from the portfolio.

Our calculations are designed so that we will always experience at least a modest lag before our models react as a sector transitions from a growth phase to a loss phase, or from a negative trend to a positive one. This lag is designed to prevent over-reacting to a short-term correction in an otherwise longer term trend, and has been a key contributor to the quality of our long term track record of the AlphaSector Indexes.

Traditionally, the diversification at the sector level, and the broad dispersion of sector returns, acts as a critical means of dampening the severity of any short-term negative move. For example, in the second quarter of 2008, when many of the sectors were off more than -10%, Energy gained 17% and therefore provided performance support for the AlphaSector indexes (AlphaSector Premium Index gained 8% that quarter.)

This last quarter was without the benefit of a single positively performing sector. The combination of fairly steep, broad-based market declines in literally all nine sectors, coupled with increasing volatility has resulted in the both the Rotation Index (monthly) and the Premium Index (weekly) tracking the S&P 500 down to more than a -10% loss for the quarter.

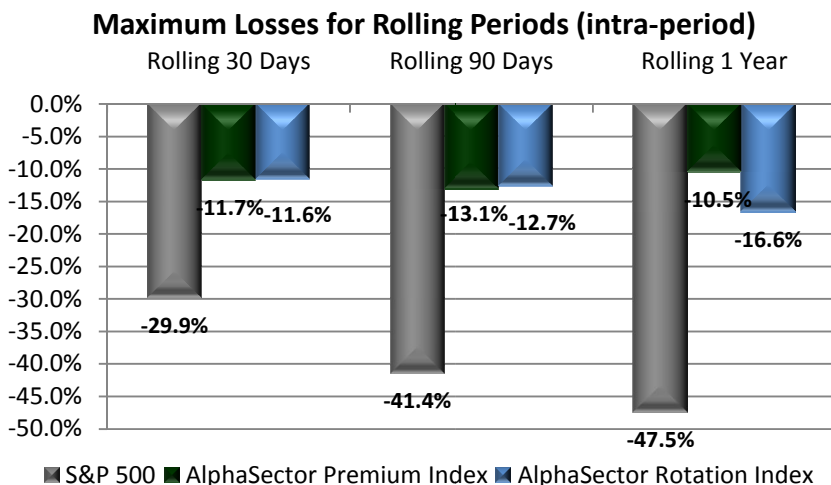
- The calendar quarter loss for the AlphaSector Premium Index was -12.3%, which is just slightly better than the worst intra-quarter rolling 90 day loss of -13.1% (reached during 2010).
- The calendar quarter loss for the AlphaSector Rotation Index was -11.9%, which is near its worst intra-quarter loss of 12.7% reached in January 2008.

It is worth putting the most recent quarter’s performance into historical context:

First, a market where there is extraordinarily high correlation of sector returns – like we have just experienced – is likely to be a period where our investment models and portfolio construction work least well. This means that either we lag due to a defensive positioning as the S&P rallies off of a market bottom (e.g. 2Q 2009), or we track the S&P down through a short-term market pullback like we just saw. *The good news is that in the five prior periods where*

sector correlation reached this level of conformity, the subsequent quarter saw a return to normal pattern of performance and returns.

Second, our investment philosophy is to participate in up markets, and protect against more severe market downturns. A comparison of rolling 30 day, 90 day, and one year performance (intra-period) for the AlphaSector Indexes versus the S&P 500 proves the strength of our approach. The chart to the left shows maximum losses for each of the highlighted rolling time periods:



Current Index Positioning

The more recent market events have translated to an increasingly defensive position for our AlphaSector Indexes.

- AlphaSector Rotation Index (monthly) has eight of the nine sectors active, reflecting the market position from late June.
 - The only sector currently eliminated is Health Care.
 - However, if conditions stay consistent, we would anticipate that many of the active sectors for the AlphaSector Rotation Index will turn negative at the month end rebalance date.
- The more dynamic AlphaSector Premium Index (weekly), reflecting market events from late June through mid July, has been transitioning to an even more defensive posture, and is currently positioned with four sectors turned off: Health Care, Technology, Energy, and Financials.
 - These four sectors, defined by the ETFs, represent slightly more than 60% of the market capitalization of the S&P 500, reflecting a very defensive stance.
 - Earlier in July, the Premium Index actually reached a 50% cash position, which while so far proving to be temporary, is important because the last time the Premium Index reached such a cash position was July, 2008, at a time just prior to a historic market collapse.
 - “Cash” refers to investments in the ETF BIL, which tracks 1 – 3 month T-Bills.

Summary

Based on the increasingly difficult market environment starting in early April, and continuing through July, our analytical models for all nine sectors have moved into either negative territory, or shifted right to the cusp of a negative rating.

For the more dynamic Premium Index, four of the nine sectors are currently removed, and three of the remaining five have been rated “negative” by our models for at least one week in July. The only sector to not have turned negative at all this year is Consumer Discretionary, although even that sector should not be described as healthy. Unless the markets improve rather markedly over the coming few weeks, the AlphaSector Rotation Index (monthly) is likely to lose several more sectors to bring it in alignment with the Premium Index.

Therefore, the AlphaSector Indexes are positioned in such a manner that if the next several months, or even weeks, prove to be the beginning of extended market weakness, the Indexes will rapidly engage in defensive moves, including the ability to begin building a significant cash position. If the market shakes off the current malaise and recovers through the end of the year, the Indexes will be able to participate in most if not all of the recovery.

While the AlphaSector Indexes technically define a bear market as when 6 of the 9 sectors have been turned off, regardless of labels it is very accurate to currently describe the Indexes as very defensive. The objective of the Indexes is not to anticipate a market loss, but to apply a defensive perspective to the decision-making as a means of protecting the client from significant losses.

F-Squared Investment Committee

Howard Present, George McClelland, and Rick Tomney

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