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## **The Secret to Winning the ETF Game: Market Timing**

by: By Matt Blackman

Since bursting onto the investment scene more than 12 years ago, the growth of exchange-traded funds (ETFs) has been nothing short of phenomenal. The reasons are simple. While they offer the benefit of buying baskets of stocks like mutual funds, ETFs generally have lower fees and offer a number of other benefits.

First of all, they can quickly and easily be purchased and sold. There are no penalties or restrictions for trading them or moving between different issues like mutual funds. Second, they offer the ability to trade like a stock with the added advantage of diversification because one ETF is generally made up of a basket of stocks. This means that large and small traders and investors alike now have the ability to create their own fund of funds, a practice that was available only to professional money managers a few years ago. Last but certainly not least, ETFs offer unparalleled liquidity compared to just about any other asset class.

### **The ETF Growth Story**

According to an industry report released by Morgan Stanley earlier this year, as 2004 wound to a close, there were 336 ETFs with assets of nearly \$310 billion, managed by 40 managers on 29 exchanges around the world. (See Figure 1.) The U.S. sat atop the pack of countries with 152 ETFs totaling \$228 billion assets under management. Europe tallied the second highest number of ETFs with 114 and assets of \$34 billion, and Japan was a distant third with 15 ETFs and assets totaling \$30 billion.

In the last year, assets under management worldwide increased 46 percent – 51 percent in the U.S., 66.5 percent in Europe and nearly 10 percent in Japan. Since 1993, ETF assets in the U.S. have grown from \$460 million to more than \$227 billion, an average growth rate of nearly 50 percent per year. Of course, the use of ETFs could not have grown at such a breakneck speed if they did not offer an advantage over many existing financial instruments – one of the main advantages being liquidity.

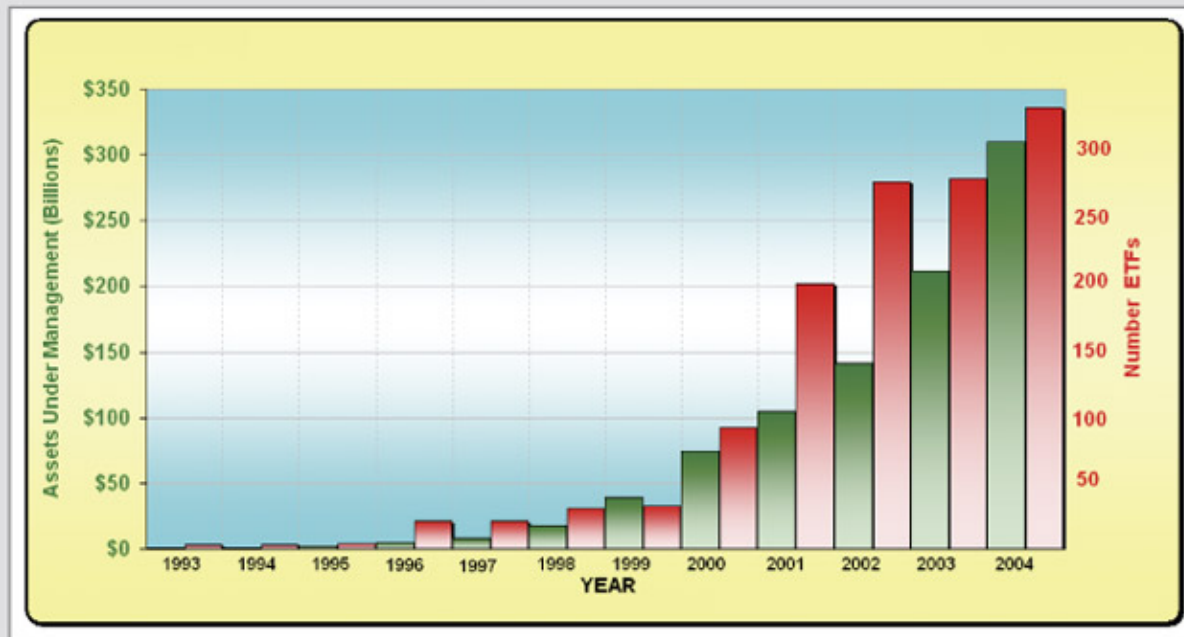
### **The Liquidity Challenge: ETFs v. Stocks**

Lack of liquidity is the trader's enemy, so from a money management standpoint, liquidity is the major advantage of trading ETFs versus mutual funds or individual stocks. Of course, liquidity benefits large players who trade often and in large quantities, but it also helps retail traders and investors because they too will be able to get out of a position rather than get stuck in one. Individual stocks offer less liquidity because they have a set number of issued and outstanding shares. More cannot be issued without going through an exhaustive filing process with the Securities and Exchange Commission and notifying the public, all of which can take months.

Increasing or decreasing the number of outstanding shares on ETFs, in contrast, does not require government intervention. In fact, it changes daily depending on the demand by market

participants, giving ETFs a second form of liquidity (besides traditional volume) and making it easier for traders to move in and out of the markets. How is this possible?

**FIGURE 1: Global Growth in Exchange Traded Funds (ETFs)**



Source: Data provided by Morgan Stanley Investment Strategies, Bloomberg

Worldwide growth in ETFs from three ETFs with \$811 million in assets under management in 1993 to 336 ETFs worth \$310 billion in 2005.

“Valuation in an ETF is more a function of the underlying securities in the index that they represent, not the number of shares issued and outstanding like a common stock,” explains Grahame Lyons of Barclays Global Investors. In common shares, the number of shares issued and outstanding have a direct bearing on share value. The higher the number of shares, the greater the demand must be to maintain share price. “ETFs, on the other hand, are valued based on the underlying index or basket of securities they represent,” says Lyons.

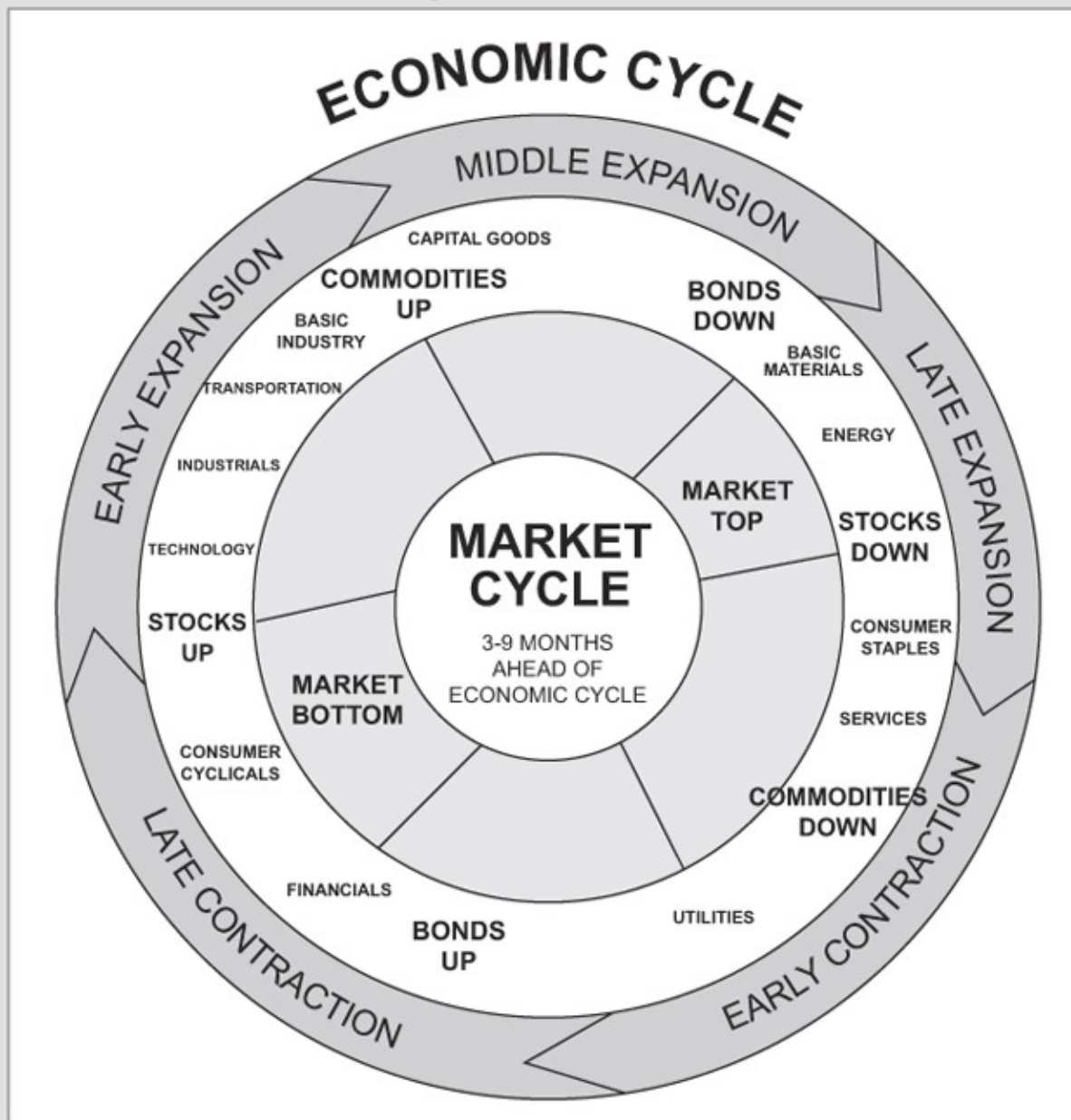
So how does it work? Known as the creation/redemption process, this procedure “translates the liquidity of the individual positions that comprise the index into the ETF,” Lyons explains. “[This process] allows for large blocks of ETFs, typically in blocks of 50,000 shares (called creation units), to be issued (or retired) by the in-kind delivery of securities from an institutional investor to the ETF (or vice versa).” He further explains that if a client wishes to purchase a large block of an ETF, “the creation/redemption process usually allows the trade to be facilitated at or very close to fair value due to the fungibility (or exchangeability) of the ETF with the underlying securities.” As a result, no matter how big the block of ETF shares the market participant wishes to transact, he or she almost never has to worry about liquidity; this is a tremendous advantage to the trader and money manager alike.

### ETF Strategy: Sector Rotation

With liquidity on their side, individual traders can employ a number of different strategies with ETFs. One of the most common is sector rotation. Sector rotation and relative strength both are well documented in John Murphy’s *Intermarket Analysis* book and have been summarized in Figure 2. Sectors shown between the tan and gray circles are leaders, having high relative

strength compared to the overall market at that point in the cycle. Essentially, technologies, industrials, transportation and basic industry lead in recovery, and as that expansion matures, capital goods, basic materials, and energy and consumer staples follow. As the market and economy begin to wind out of the late expansion period into early contraction, services and utilities become the leaders. Finally, financials and consumer staples tend to be the leading sectors at the end of the economic contraction. The goal is to find the best performing sectors in an uptrend and either be in cash or short the worst performers in a downtrend.

**FIGURE 2: Sector Rotation Showing Both Economic and Market Cycles**



Source: Data from *Intermarket Analysis* by John Murphy

### The Trick to Trading with ETFs

As with many basic principles, there are caveats, and there is a caveat to sector rotation, too. Most sector rotation systems are momentum based and rely on playing trends, so they do best in

trending markets when breakouts occur; however, such systems can lag the market. In a recovery or upside reversal, the sectors that do best are those that have been hit hardest, so they are not part of a standard ETF sector portfolio when this occurs.

“This means that most systems will miss much of the move out of the hole, and these moves can be significant,” points out John McClure, president and CEO of Equitrend and winner of a top market timer award by [TimerTrac](#) for 2004 (in the long and short S&P 500 category). As a market gets going, good examples of groups generally making the biggest moves are technologies, Internet and telecom. In a bear market, though, managers prefer to stick with those groups that have held up best – such as consumer cyclicals, energy and materials groups – and to avoid those, like technologies, that have not.

The approach works well in a trending market but effectively misses the best part of a move in a market reversal. In a market breakout, this strategy does not include those groups that have been performing poorly (but often experience the biggest breakouts), like the Internet and semiconductors.

McClure prefers a two-pronged approach that uses a market-timing strategy based on thorough quantitative analysis combined with a fast-acting sector rotation technique.

## SIDEBAR

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### **What Is Market Timing?**

As a point of clarification, market timing is completely legal and should not be confused with the practice targeted by New York Attorney General Eliot Spitzer, which was employed by some mutual funds. It was incorrectly labeled “market timing” by the media, which in reality was nothing more than illegal front running or after-hours trading at the client’s expense. True market timing simply is a strategy that relies on the use of proprietary quantitative statistical analysis or technical indicators such as the advance/decline line to provide the trader with an indication of when market direction may be changing. This practice is completely legal and is used best by a few star performers who consistently outperform the indexes.

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“When we include an indicator that utilizes technology and small caps combined with a timing strategy, the lag experienced by a traditional sector rotation model can be drastically reduced,” he says. “Market timing allows us to quickly change our portfolio to add the first groups to respond to changing market conditions when the time is right.”

Using McClure’s method, a trader who gets a market-timing sell signal in an uptrending market would have to sell all sectors that have a correlation of 0.65 (65 percent) or higher with a major index, such as the Russell 2000, Nasdaq or the S&P 500. “For example, when I get a sell signal in an uptrend, assuming the technology stocks are the leaders, I will sell technology groups such as semiconductors and computer stocks if they correlate to the existing trend, since I expect that market leadership to change,” he says. “The signal is telling me that my leading horses are getting tired, and it’s time to give them a rest.”

That being said, sometimes leaders will continue to lead the pack – so if a trend continues, follow the leaders that have a high correlation with the trend. Don't market-time yourself out of a good position. Market timing is most effective during a reversal.

## **Final Word**

Money managers and good traders are made, not born. "Anyone can make money in a bull market like we had from 1982 to 2000, but those only come along once in a lifetime," says McClure. "A good market timing system will add about 20 percent per year when there are a number of swings and drops like occurred in 2001, 2003 and 2004. These types of markets are far more common, so it's important for you to know the best ways to play them."

Of course, understanding the best ways to play market reversals may seem daunting to the neophyte, but like any task, it is achievable with commitment, perseverance and homework. But it also is true that there are no guarantees in life, and when it comes to markets, only the best and most committed ultimately prevail. Is the effort worth it? Just ask those who continually outperform the market. They are laughing all the way to the bank.

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