Perspective: Santa Claus Rally, Low-DD Portfolios, FWPT Std.

Dec 02, 2014

Dear Scott,

Full Santa Claus Rally Mode?
Some pundits have already proclaimed the early arrival of the "Santa Claus Rally" in view of the S&P500's recent stellar performance (see chart at right) — even though December has only just begun.

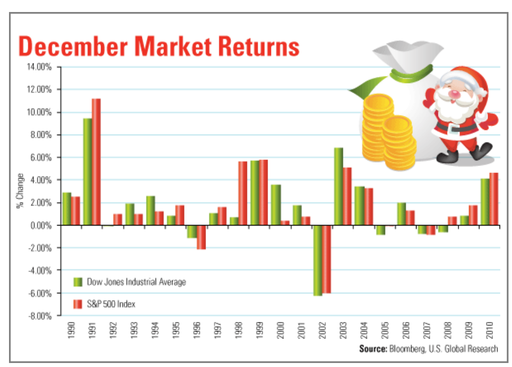
6-Months

The Santa Claus rally traditionally occurred during the week between Christmas and the New Year and was first noted and defined by Yale Hirsch in his Stock Trader's Almanac of 1972. The rally is believed to occur for two reasons: (a) investors often sell stocks for tax purposes late in the year, then use the proceeds to buy other stocks before the new year, and (b) in late December fund managers load up on popular stocks that did well during the year (called window dressing) so their annual reports can say their funds held them.

6-Years

After many years of personal observation, I believe the Santa Claus rally has behaved much like the introduction date for new model year cars — creeping toward ever earlier debuts. Since no auto maker wanted to be last to launch its new models, introduction dates kept sliding further into the prior year. But there are limits; it would be ridiculous to introduce model year 2016 cars in January 2015.

Likewise, who wants to be last to get in on the Santa Claus rally? If odds are good for a market pop in the last week of December, you'll want to be "all in" at least a day early. Since many other investors think similarly, the pop occurs a bit earlier. To stay competitive, investors have to act even more in advance next year — and so on. Eventually the Santa Claus rally creeps into November and gets lost among other market events, such as [Black Friday](). Perhaps it is then free to restart again on its traditional schedule.



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Many investors have come to measure the Santa Claus rally as the performance premium achieved in the full month of December compared with the market's average annual performance. The 20 year "December Market Returns" chart (at right) shows the S&P500 averaged 1.8% in December compared with only 0.5% in other months. Notably, the S&P500 posted negative returns during December only four times during this period.

The "True Santa Claus Rally Return" chart (at right) uses the more traditional definition in that it includes only the last week of December and the first two market days of January. During these few days, Santa delivers about 0.61%, whereas for the same number of days during the rest of the year the market returns only about 0.15%. So while Santa apparently does deliver premium performance over the long term by either measure, sometimes his sled is short a few reindeer.

What's Powering Santa's Sled Now?
While the secular trend in biotech and healthcare sectors continues, it is notable that many strategies are selecting transportation and retail funds this month — likely beneficiaries of lower oil prices. The national average for gasoline is now about $2.50 per gallon, which leaves consumers a few more bucks for holiday shopping. Lower fuel prices will also measurably boost earnings posted by airline and trucking companies and/or reduce the transportation and manufacturing cost of goods. These are probably the best reasons to believe the market still has upside potential.

How to Build Low Drawdown Portfolios — Examples Posted
After retirement, without the support of a regular paycheck, the fear of retirement account drawdown due to market volatility or poor investment choices increasingly becomes much more important than the drive to achieve higher returns. Thus, the example portfolios listed below and charted to the right were designed with a primary focus on minimizing drawdown and a secondary focus on maximizing return.

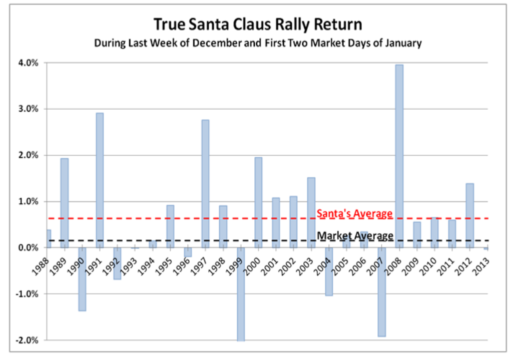
- 1. ETF Low Drawdown Portfolio with **2.9%** QR MaxDD
- 2. Fidelity Low Drawdown Portfolio with **1.4%** QR MaxDD
- 3. SOS Low Drawdown Portfolio with **2.7%** QR MaxDD

Max Drawdown is a measure of risk. While there are many sources of risk, there are only two basic ways to reduce it: 1) dilution, or 2) avoidance. **Tactical Diversification** strategically applies the right type of risk reduction to each risk source in a portfolio. Let's examine the four primary sources of risk, and methods for their reduction:

1. Company Selection Risk: Risk associated with individual companies includes a) poor quarterly reports, b) key employee loss, c) lawsuits, d) product disappointment, and e) acts of nature. These are unpredictable punctuated events that cannot be avoided. They can only be diluted through diversification. Mutual funds and ETFs provide such diversification through owning multiple companies.

2. Fund Selection Risk: The risk associated with fund selection is that sometime in the future it may perform poorly because the fund manager's magic runs out, or the fund's investment focus is out of vogue. Asset classes, sectors, and manager performance all have trends that can last from months to years. SectorSurfer Strategies inherently avoid trend laggards in favor of owning only the trend leader. This is called Serial Diversification — owning multiple funds over the long run, but only the best trending fund at any given time.

3. Strategy Selection Risk: The risk associated with selecting a single Strategy includes the short term market bumps associated with the individual fund selected by the algorithm. A Portfolio



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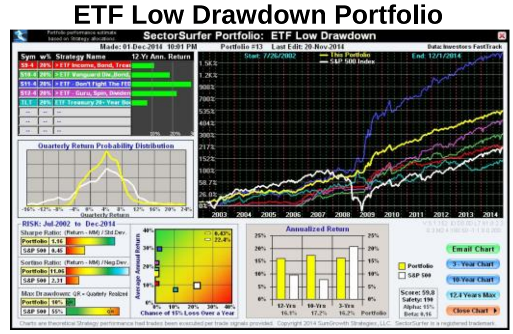
ETF Low Drawdown Portfolio


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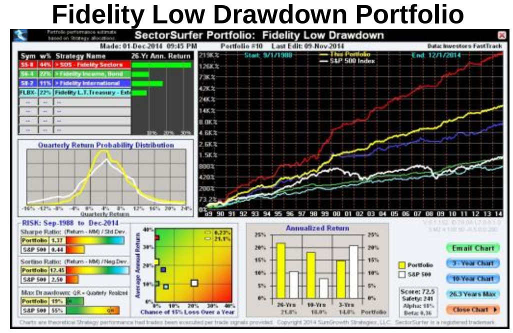
Fidelity Low Drawdown Portfolio


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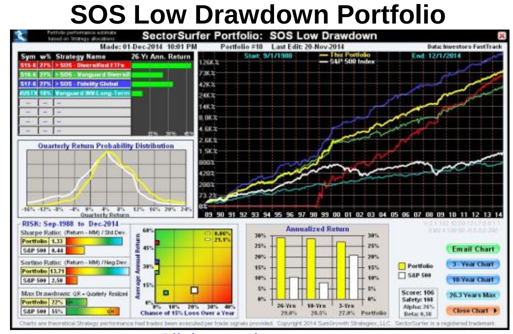
SOS Low Drawdown Portfolio


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holding multiple Strategies, each selecting a single fund to own, will further reduce risk if each of the Strategies have a divergent focus — such as sectors, countries, and asset classes. We call this Post-Surfing Diversification. It further reduces medium-term variability.

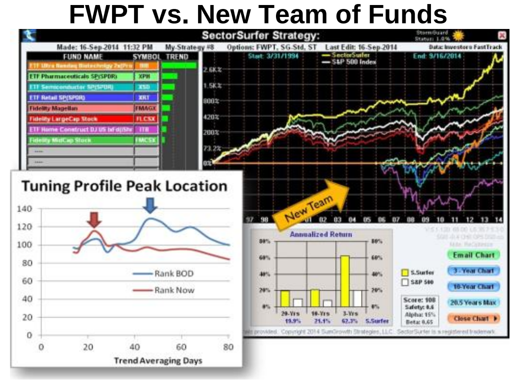
Learn More

4. Market Volatility Risk: Even after taking the aforementioned risk reduction steps, some market volatility remains in the assembled Portfolio. Fortunately, long-term treasury funds are fairly anti-cyclical to the overall market and can be added directly to the Portfolio to further reduce the remnant volatility. Each of these example Portfolios include a long-term treasury fund for this purpose.

FWPT is Now Standard in All New Strategies

Forward-Walk Progressive-Tuning (FWPT), the industry gold standard for credible backtesting, is an important Strategy option that was added 18 months ago to perform two functions: 1) forward-walk testing to identify weakness in a Strategy's construction that makes it susceptible to poor trend leadership transfer, and 2) progressive-tuning to automatically adapt to changes in the character of the Strategy's set of funds.

FWPT vs. New Team of Funds



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As of November 20th, all newly created Strategies have FWPT enabled by default. Strategies created without FWPT in the past will not be affected, but we strongly recommend enabling FWPT in all Strategies. If you enable FWPT and your Strategy takes a significant performance hit, it means there is a problem to fix — it's not a reason to turn FWPT off. To the contrary, the problem is almost always related to one or more of the funds having a common mode noise problem.

The default BornOn Date (where backtested tuning ends and FWPT begins) will be set to 1/4/2010. You may alter the BornOn Date as you please — with caution. While it might seem like a good idea to set the BornOn Date to have as much FWPT as possible, doing so may unreasonably shoot your Strategy in the foot by providing it with a deficient data set for initial tuning that is not sufficiently representative of the Strategy. There are two primary considerations, described below.

First, the backtested data set (prior to the BornOn Date) should contain at least one market crash cycle, and at least a few years of bull market data. Failure to include both could impact the initial operating parameters of your Strategy, which then may take a few years to optimally adjust with progressive tuning following a market crash. Operating with sub-optimum parameters during this adjustment period will likely produce sub-optimum performance.

Second, your Strategy may contain funds with both a fairly short data history (having one character), and other funds with a much longer data history (having a very different character) — such as the Strategy (above right) entitled "FWPT vs. New Team of Funds." Starting in 2006, five new aggressive sector funds are added to a set of comparatively stodgy asset class funds. The white chart shows that when the BornOn Date (BOD) is set to early 2006 (just before the new funds start), optimal tuning of the trend filter is about 46 days. But by 2014 the tuning profile has changed, peaking at about 22 days. Since the Progressive-Tuning algorithm is purposely designed to slowly adjust the trend filter to ensure operational stability, the algorithm would be expected to produce sub-optimal results during the few years it takes to progressively re-tune this radically transformed Strategy.

Setting the BornOn Date requires good judgment. More FWPT might be a wise choice, or it might be poor judgment. It depends on the nature of the funds in your Strategy.

Speaking Engagement Calendar
Please come and see one of these seminar presentations if you are in the neighborhood. Alternatively, ask your AAII Chapter or Investment Group leader to schedule a presentation. Webex presentations for smaller investment clubs and groups are also possible.

Seminar Title: True Sector Rotation: Why Better Returns Don't Require Higher Risk.

- **San Francisco, CA AAII Chapter - Saturday January 21st 9:00 AM**
- **Charlotte, NC AAII Chapter - Sunday March 15th 10:00 AM**
- **Myrtle Beach, SC AAII Chapter - Tuesday March 17th 5:00 PM**
- **Los Angeles & Orange County, CA AAII Chapters - Saturday March 21st 9:00 AM**

Surf Well and Prosper,

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