

Reevaluating Risk Tolerance

Trading 'Style Indexes' Is Great Way To Avoid Risk of Holding Individual Stocks

By David Vomund

Having experienced the worst bear market since the 1930's, many people have reevaluated their risk tolerance. As we approach the end of the third consecutive down year, many people believe that most of the pain is behind us and that things will improve. Yet, risk is still high and there are too many stocks that lose a third of their value based on lower profit guidance from management. Buying individual stocks is scary.

A great way to participate in the market without the risk of holding individual stocks is to buy securities that track "style indexes." By trading securities that track market indexes (i.e., large-cap growth, large-cap value, small-cap growth, small-cap value indexes, etc.) one can outperform the S&P 500 without the risk of holding individual stocks. In

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a sense, it is similar to trading sector funds but is safer because the trading vehicles are more diversified.

I've found two good vehicles that allow for easy trading of style indexes. The ProFunds mutual fund family (www.profunds.com) has six

style funds that have free end-of-day trading. There are also Exchange Traded Funds (ETFs) that track market indexes but trade just like stocks. These choices are listed in

Table 1.

Price history on these securities is limited so it is hard to run a backtest that covers both bull and bear markets. Most of the ETFs began in 2000. Therefore, a backtest of a trading system

can't be run on the actual securities but must instead be run on proxy securities. For example, instead of buying the Nasdaq 100 ETF (QQQ) for our backtesting, we bought the Nasdaq 100 index (NDX). Instead of buying the Large-Cap Growth ETF

(IVW), we bought the S&P/Barra Growth index (SGX). Instead of buying the Large-Cap Value ETF (IVE), we bought the S&P/Barra Value index (SVX). As proxies for the Small-Cap Growth and Small-Cap Value ETFs, we used Vanguard's Small-Cap Growth fund (VISGX) and Vanguard's Small-Cap Value fund (VISVX). In backtests we didn't include mid-cap choices.

Our trading strategy is similar to the one used in the September 2002 *Opening Bell*. We designated all of the proxy securities as mutual funds and the Mutual Fund Relative Strength Short-Term report was run on these securities every other Friday (i.e., there is only one day in a two-week time span when you need to reevaluate).

At the start of the test, the two highest rated ETFs were purchased with equal dollar amounts to establish a fully invested portfolio.

Table 1. Style Index Trading Vehicles

ProFund Choices		ETF Choices	
Ticker	Fund	Ticker	ETF
LVPIX	Large-Cap Value	IVE	Large-Cap Value
LGPIX	Large-Cap Growth	IVW	Large-Cap Growth
BLPIX	S&P 500 Index	SPY	S&P 500 Index
MLPIX	Mid-Cap Value	IJJ	Mid-Cap Value
MGPIX	Mid-Cap Growth	IJK	Mid-Cap Growth
MDPIX	Mid-Cap Index	MDY	Mid-Cap Index
SVPIX	Small-Cap Value	IWN	Small-Cap Value
SGPIX	Small-Cap Growth	IWO	Small-Cap Growth
SLPIX	Small-Cap Index	IWM	Small-Cap Index
OTPIX	Nasdaq 100 Index	QQQ	Nasdaq 100 Index

Two weeks later, the Relative Strength report was run again. If the current holdings were rated in the top half of the report, then there were no trades. If a holding had fallen in the Relative Strength report to where it was no longer in the top half, then it was sold and the highest rated ETF was purchased.

The portfolio was always fully invested in two ETFs. During times when no ETFs appeared on the Relative Strength Short-Term Strong report, then the best performing ETFs were purchased from the Relative Strength Short-Term Weak report.

I assumed that the ETFs were bought and sold on Friday's closing price instead of Monday's opening price. This assumption is reasonable because you can download price data and run the report a few minutes before the close. The backtest doesn't include slippage or commission fees, however.

I began the test on August 31, 1998. This trading strategy can't be automated so I generated the Relative Strength report every other week and manually entered the trades. Although it's time consuming, I found this manual process beneficial because it gave me a "real" feel for how the strategy behaved.

Nasdaq 100 and Large-Cap Growth were the first two securities that were purchased. Amazingly, the Nasdaq 100 was held until May 2000. As a result, it became a very high percentage of the whole portfolio. That was remedied in July 2000 when the strategy sold both holdings and bought two new securities with equal dollar weightings.

From 08/31/98 to 09/30/02 this backtest gained 72% compared to a 10% loss in the S&P 500. The detailed trading statistics from the backtest are found in **Figure 1**. Notice there was an average of only 4.5 trades per year with the largest loss of 11.3%. This is a strategy that

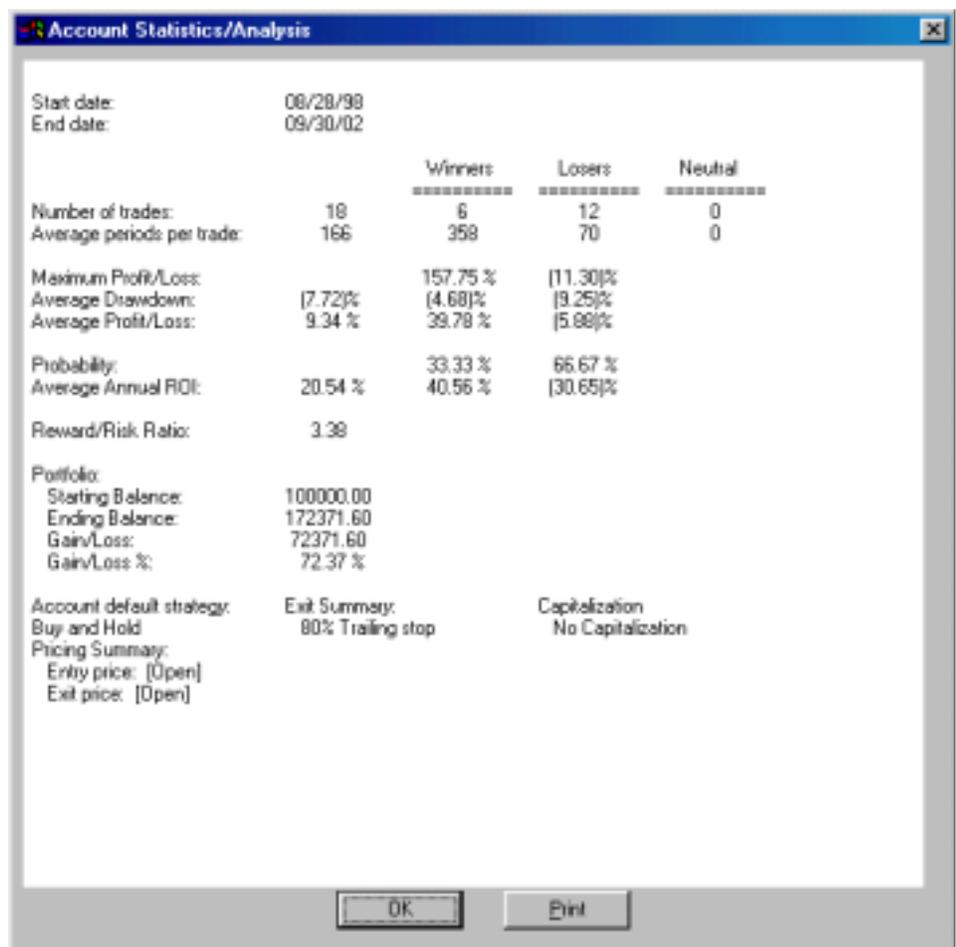


Figure 1. Backtest results of ETF Trading Strategy for period 08/31/98 to 09/30/02. Note the strategy's 72% gain compared to a 10% loss in the S&P 500.

allows you to sleep at night.

The yearly results are found in **Table 2**. This strategy outperformed the S&P 500 index every year and it held its value during the 2000 through 2001 bear market years. It was even unchanged in the first half of this year. It wasn't until the third quarter that all style indexes fell in value, accounting for the 19.93% loss.

Keep in mind that this backtest doesn't represent actual returns — remember, we bought proxy securities rather than what would have

actually been purchased. Instead, the purpose of the backtest is to create and gain confidence in a strategy that successfully trades securities linked to style indexes. To

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emphasize my confidence in this approach, I've started a style index portfolio in my VISalert.com newsletter that trades ETFs using this strategy.

The beauty of the strategy is that

the Nasdaq 100 ETF (QQQ) drives the results higher during very bullish time periods such as in 1999 when the strategy gained 61%, but it rotates to more conservative selections during bearish time periods. It only lost 3% in 2000 because it rotated to Small-Cap Value. In 2001 the strategy actually gained money because Small-Cap Value continued to perform well.

I tried variations of the strategy but they didn't perform as well. The first variation was to shorten the time period on the Relative Strength Short-Term report. The default time period on this report is 6 months. Since there were only 4.5 trades per year, I thought the report could be shortened, thereby increasing the number of trades and hopefully increasing the return. I changed the

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time period used on the report to three months but the return suffered. The strategy was only slightly worse in 1998 and 1999 but in 2000 it lost

22%. Those results put an end to that test.

Another variation was to incorporate some form of market timing. I established a rule that said if no securities appeared on the Relative Strength Short-Term Strong report then nothing would be bought (i.e., you wouldn't buy the best performer on the Short Term Weak report). That rule successfully kept me in cash during the third quarter of this year but it hurt the returns in 2000 and 2001. In 2000 the strategy lost 11.4% and in

2001 it lost 15%.

This form of market timing did not work. I'll continue to test market timing techniques and will report on them in a future article.

The best trading systems are ones that people can employ over long time periods. In the last few years, many investors have bailed on strategies that they once considered appropriate for the long run. Risk tolerance has changed. Trading ETFs is a great way to capitalize on market returns without subjecting yourself to the risk of holding individual stocks. It's a strategy that most people can live with.

Table 2. Percentage Returns

	ETF Strategy	S&P 500	Nasdaq Comp.
1998 *	33.18	28.37	46.26
1999	61.54	21.04	85.59
2000	-3.01	-9.10	-39.29
2001	3.17	-11.89	-21.03
2002**	-19.93	-28.16	-36.48

* 08/31/98 to 12/31/98

** 01/01/02 to 09/30/02