

## **MAKING MONEY WITH EXCHANGE TRADED FUNDS**



**MAKING MONEY WITH EXCHANGE TRADED FUNDS**

**How a New Trading Strategy**

**Turns an Investor into a Hedge Fund Superstar**

**Richard A. Feit**

*Making Money with Exchange Traded Funds*

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## INTRODUCTION

Modern technology has changed not only the way we do business but also the way in which we look at the world. Forty years ago when I started trading, the major function of computers was to facilitate the clearing and settlements of trade execution.

We had neither laptops nor desktop PCs. The mainframes were housed in huge air-conditioned rooms. Instead, all we had were slide rules and a few bulky mechanical calculators.

Today, a simple basic desktop PC has more computational power and skills than all the mainframes of the 1960's combined. In 2008, a single fiber-optic cable has the potential to carry much more data per second than most of the older copper wire of the 1980's.

Financial instruments have kept pace with the phenomenal advances in technology. It is precisely this new technology that which is at the center of the 21<sup>st</sup> century investment world.

It's time to get on board. It's time to get savvy. How? This eBook will show you how to utilize the new technology available to attain an amazing profitability quotient. In an easy, innovative and time-saving manner, you will learn how to focus on stretching your existing wealth to heightened proportions.

Furthermore, you will learn how to explode your assets. Remember it's not about surviving in a bear market or triumphing in a bull market—it's about repeatedly and

consistently earning more on your existing wealth regardless of the economy and or market trends. And it's about adding \$\$\$\$\$\$\$\$ in your net worth column.

There are no 'secrets' or 'insiders' guides to profit. Only 'smart' work and experience can get you through to the 'other side.' However, this eBook is designed to give you some very important tools to not only help you achieve your personal financial goals, but go beyond your expectations.

## CHAPTER 1

### THE BEGINNING: First Steps

It was 1966. Young, adventuresome, ambitious, motivated and with life-size dreams of earning big bucks, I began my Wall Street career at Weeden & Company. Exclusively a family launched trading firm, Weeden 'made markets' in Corporate Bonds and listed equity securities.

Not a member of the New York Stock Exchange (NYSE), the company made what was called a 'Third Market' in NYSE listed securities, creating an over-the-counter market in over 500 NYSE listed shares. Their goal was to 'democratize' the securities market.

Lucky to be in the right place at the right time, I landed a job, as a rookie trader-in-training, in an era of non-negotiated commissions. The process was innovative and promising.

In possession of a commission book, every member firm salesperson was equipped to calculate the commission rate for buying and selling listed shares through a NYSE member. An additional quarter-point was charged for an odd lot-- less than 100 shares. However, the commission rate was not linked to the number of shares purchased. In fact, IBM, trading at over \$200, had the highest commission rate at the time, approximately seventy-five cents per share.

The Weeden strategy was devised to 'make a market' in listed shares, net of commissions. This meant that an Institutional buyer of IBM would have options. They could go either to a NYSE member and pay the price offered on the NYSE plus the

seventy-five cents commission, or do business through Weeden, get a market for IBM and deal at the offered price without payment of a commission. Weeden made a profit by buying at the bid side of the market and selling at the offered side of the market as often as possible.

For instance, if the last sale on the NYSE was \$212, the price would be \$212 plus 75 cents commission or \$212.75. On the other hand, if a buyer called Weeden and asked for a market and the trader made a market \$211.75-\$212.25, the customer would fare better because the net price would be \$212.25, a savings of 50 cents per share.

Weeden conducted business with most of the large financial institutions and mutual fund managers in the world. These clients included large money center banks and smaller fund advisors from Boston to Los Angeles with stops in between, like Omaha, to speak with high end investors.

Now in the 21<sup>st</sup> century, it is amazing to note how technology has revolutionized the world. Computers, cell phones, Ipods and a vast array of other high tech toys and gadgets have moved into the business world.

Times have certainly changed. In my initial days, we answered calls on telephones with sliding switches, similar to the antiquated switchboards featured in the movies of the 1930's and 40's. The holes were numbered, and when a client called, a trader identified him/her by yelling a number in lieu of a name. I still remember callers '42' and '50' as First National City and Morgan Banks, respectively.

In the day of 10:00 to 3:30 trading and seven day settlements, I started as a trainee in the so-called back office, learning how securities were handled. It was still the era of

paper. Securities were delivered to the broker/dealer at a selected time in the morning, and payments were procured at a designated hour in the afternoon.

When I moved on to the trading floor, I discovered it was rather helpful to know not only how the system worked, but whose assistance I could solicit if a client conveyed a problem through their trader.

The trainee position was multi-faceted. First, the rookies were responsible for maintaining the 'position pad' of the trader to whom they were assigned. How did this work? Every few minutes during the trading day, to make sure the trader knew his/her net position, the trainee/assistant would put all the trader's tickets in order, sum up the number of shares in each security purchased by the trader, and subtract the number of shares the trader had sold.

Next, the trainee would scrutinize the trader's presumed position, and adjust it to reflect the actual number. But it did not end here. Second, the trainee would go for coffee, change the ticker tape, and more importantly, make sure that the 'trading turrets' were protected from coffee spills. Every 30 minutes, one of the trainees would rush over to the Dow Jones News Ticker and copy the Dow averages onto the blackboard in the front of the room.

A trainee's job was to listen and learn: listen to how the markets worked, and learn the symbols and the clients' numbers. We were expected to pick up phones and yell out to the traders the orders we received from clients.

Furthermore, we were required to learn that 'in' was a client sell and 'out' was a client purchase—it was in to us, and out to them. Once again this was not the end of it.

We still had to master the names and symbols of every stock we traded. Since most stocks had nicknames, this was quite a challenging task.

IBM was 'I-Beem,' Coca Cola with its KO symbol was 'knock-out,' and Anaconda Copper was 'snake.' Included in the training process was learning how to define and differentiate between a proper and improper market.

Nonetheless, despite it all, it was the best of times. I had the opportunity to study and work together with the most generous, knowledgeable and empowering people in the profession. Eventually I did get a trading pad; an event that was exciting even if the pad was not exclusively my own.

During the administration of President John F. Kennedy, the U.S. balance of payments was moving in the wrong direction. An interest equalization tax, which basically halted U.S. companies from financing their overseas expansion with U.S. domestic debt, was levied. Simultaneously the Eurodollar market was born. A U.S. company could now expand outside the U.S. if they were willing and able to raise the money from U.S. Dollars already held overseas.

In addition to its many offices in the United States, Weeden had a branch office in London from which they reached the large overseas market in U.S. shares. To gain additional entry to that market, the London office started to make markets in Eurodollar debt. There was a supplementary Eurodollar client market in Canada, as well as the offshore Bermuda and Nassau banks. Many large U.S. institutions active in the Eurodollar market also managed large investment portfolios for foreign international clients.

Eventually, Weeden made the decision to engage a trader in New York to handle the North American market and to take over the Euro pad from London at their closing bell. During the overlap, both desks would share position responsibilities. At the time, most of the trading was in convertibles, a hybrid of debt and equity.

Weeden took the lead and became not only the most important market maker in Europe during that period, but the major market maker in the United States. It was an exciting moment!

The Euro Convert market was exploding, three to five new issues every week. To communicate with London, I used a quarter-speed teletype and learned how to type using a trader's shorthand. In the days before direct dialing, transatlantic calls were costly, almost prohibitive, and to phone abroad, it was necessary to set an appointment for a telephone line.

Always on our feet, we were constantly apprehensive about getting 'picked-off' by a large order hitting both our desks simultaneously. But the experience at Weeden was phenomenal. Almost by default, so to speak, I gained expertise in convertible securities and used the knowledge profitably during a career spanning three and a half decades.

While at Weeden, I started to entertain the idea of formulating a system to predict convertible bond change from the actual variation in the price of the underlying shares. Although it was far from easy, I knew that a challenge conquered is a vital and valuable lesson learned. The challenge was intricate—instead of PCs, with almost effortless access to information, we had large IBM mainframe computers.

I asked the Service Bureau Corporation (SBC), a subsidiary of IBM, to help me develop a model of convertible security behavior. Concurrently, Charles Lard, doing

business on the trading desk of Bear Stearns had a similar goal. Mr. Lard also had engaged SBC to assist him with the development of a similar program.

SBC took the initiative to introduce us, and we agreed to combine our efforts. This would be a strategic alliance to find a model. Convertible Arbitrage Security Holdings was born, a pioneer partnership, trading in convertibles. Charlie formulated the abbreviation “CASH,” perhaps believing it would live up to its name. Unfortunately the initiative did not enjoy longevity. No one believed in the concept.

However, not easily discouraged, Charlie and I stayed together and became General Partners in the NYSE member firm Hamerslag, Borg & Co, trading convertibles and brainstorming to get a proprietary convertible hedge account off the ground. It was another challenging experience.

The margin requirements were not what they are today. Consequently, we had to put up margin on both sides of the trade. In return we received no interest rebate on the short side. Nevertheless, prior to quitting and calling it a day, we had the opportunity to talk to and ‘help out’ J. Paul Getty, at the time winner of the prestigious title “richest man in the world!”

Hamerslag employed an oil analyst who had compiled a comprehensive and detailed research report on Getty Oil. In fact, Carl Kempner, one of the firm’s Senior Partners, phoned Mr. Getty in London and asked if he would be willing to comment. Responding affirmatively and following some additional dialogues, he opened an account with Hamerslag, Borg & Co.

Carl’s secretary filled out the New Account form, and in the box “Net Worth” wrote ‘*are you kidding!*’ I wish we would have made copies of that document.

Mr. Getty, an active trader of oil shares, would receive a call from our trading desk just before the opening of trading on the NYSE and would give us some orders from time to time.

One day, I picked up his call and introduced myself. “Mr. Feit, he said, “what do you do at the firm?” I cleared my throat and described my dealings in Convertible Arbitrage, perhaps hoping I could stir up enough interest to get him to fund my operation. He listened attentively. “Mr. Feit,” he replied, “could you prepare a spreadsheet on the oil stocks and get it to me on a regular basis?” Beyond excited I responded: “Sure Mr. Getty, I’ll get on it right away”—and I kept my word.

A few weeks later, I had another conversation with him. “Mr. Getty, was the spreadsheet I sent you helpful?” I inquired. He made it known he had reviewed the information and requested some modifications. I took the opportunity to ask some more questions in my quest to discern exactly what investment path he was interested in pursuing.

Although Mr. Getty was somewhat reticent in revealing what he was really after, I had some pretty precise ideas. We discussed price changes and dividend dates and the homogeneous nature of the oil from the Arabian Peninsula. Having calculated the relative value of most of the large oil companies, he was swapping in and out of them for his investment account. A clever investor, our spreadsheet was just an additional arrow in his quiver,

I continued to trade convertibles, and in the early 70’s, was hired by Sandy Weill to start a convertible department at CBWL-Hayden Stone. It was a position with a dual

job description-- educating the retail arm and speaking with institutional investors from the institutional desk.

Eventually an article in the August 1974 edition of *Business Week* detailing what I was doing netted me a call from Dick Tierney, the head institutional trader and a senior partner of Blyth Eastman Dillon.

Mr. Tierney lured me over, offering me the opportunity to make markets in stocks on the block desk against the offsetting positions of convertible bonds and the newly- created listed options market in Chicago. Thrilled, I seized the moment. It was an empowering experience.

In addition to being on the block desk, I was also part of the investment banking department. My position entailed not only making rounds talking to various investment bankers about the markets after the close but went further. I also had the task to convince the investment bankers to offer an equity linked product to their banking clients.

Although somewhat challenging, my effort was very successful. In fact, that year Blyth Eastman Dillon was number one in the category. Pleased with my performance, Mr. Tierney promoted me to Vice President. I liked where my career path was heading. I loved my work. I had nothing but respect from my peers. What could possibly go wrong?

In October of 1979, Insurance Company of North America (INA), with a majority interest in Blyth Eastman Dillon, sold the company to Paine Webber. We were instructed 'to stay in place' because in due time we would be presented with an interesting proposition, and if, after a six month paid hold, we were not offered a comparable position at Paine Webber, we would get a severance package of an additional six months pay in addition to an extra bonus.

For the next six months I sat in an office at Paine Webber and played hearts while waiting for their decision regarding my professional future. Paine Webber, the purchaser, was plagued with a dilemma. Blyth Eastman Dillon had a capital structure totaling one-third of Paine Webber, but did twice the business in equity related businesses and reaped more than twice the profits.

However, they discovered it too late. Six months thereafter, all the solid figures of Blyth Eastman Dillon opted to go with Jay Perry, a former partner of Salomon Brothers. Perry had been hired to run investment banking and institutional sales and trading at Blyth. He was going to take most of the business professionals to Dean Witter.

Perry had made a deal for me to start a proprietary convertible trading department. Promised a percentage of the profits, I was deliriously happy.

Jay assigned Jesse Gerstel to help me with the programming of my strategy. Jesse had worked with Jay Perry and Michael Bloomberg at Salomon Brothers. He was the computer whiz who helped Bloomberg develop and advanced trading information system for Salomon. Jay's plan was for me to have Jesse sit in for a few days and see what he could do to help me manage my strategy.

I had purchased a Casio programmable calculator that I took home each night to calculate my returns and profits. During the trading day, I used the Casio to help me judge new and old positions. It took a few minutes to calculate each position.

Jesse had discovered a mini-computer on our floor. It was in its own air conditioned room along with its tape drives and large disk assemblies. The printer was in another room.

After a week or so of looking over my shoulder, he had completely programmed all my various calculations into the mini. We could generate a new report at any time. Instead of looking at only 20 or so issues, we could look at hundreds of opportunities and make more informed decisions.

Jesse became my partner in the department and we were off to the races.

Our returns on capital were over 100 percent. After five years, we had only four losing months and the average losing month was only one-fifth of our typical profitable month. We were riding the big waves. Thoroughly disciplined and exceptionally focused, we had no obstacles on our path to slow our course.

Dean Witter was acquired by Sears, setting in motion two major changes. One, Sears started to demand budget projections. Our budget projection for that particular year was \$5 million or \$1,250,000 per quarter. It was a budget for PROFITS, not expenses.

In fact, one quarter we made \$1,750,000, which was half a million over budget. This created panic in the Sears Tower. An accountant was sent to investigate why we had exceeded the budget by such a large figure.

We couldn't control our laughter when the accountant finally came to the conclusion that it was acceptable to make more money than budgeted.

The second change factor occurred when Sears selected as President and Chairman apparent, Phil Purcell—a man with absolutely no Wall Street experience. When we asked Mr. Purcell for additional capital, instead of inquiring: “How much capital can you run at a return in excess of 100%,” he agreed to give us the extra capital if we in turn would concur to take only half the profit percentage on the additional capital.

After thanking him for his consideration, I went directly to my boss. Even though I was a Senior Vice President, I reported to Perry, who was one of the three Executive Vice Presidents. I told Perry I thought it was a worthless response. Perry saw an opportunity and immediately phoned Jeff Cohen, who ran the incredibly profitable Risk Arbitrage department at Dean Witter. Cohen and I, friends since our Blyth Eastman Dillon days, had arranged for our departments to be situated in adjoining spaces at Dean Witter because many merger transactions at that time involved the issuance of convertible preferred securities and I was able to judge the value quite quickly and position and hedge the paper in house.

Perry proposed that we seriously consider leaving Dean Witter and start a hedge fund built around the synergy of risk and convertible arbitrage. Perry would raise the money and assume the role of managing partner. Cohen and I were in full agreement.

Certain Perry was a superstar, we felt he could pull it off. Our intuitions were unfaltering--in just a few days, he had raised a substantial sum of money from solid investors, including Dean Witter. Immediately, we made the decision to resign from Dean Witter and start Perry, Cohen and Feit & Co. Our goal was to be NYSE members and do risk and convertible arbitrage.

Unfortunately several weeks later, Perry was diagnosed with medically unresponsive terminal Leukemia and passed away shortly thereafter. Cohen and I continued with the formation and development of the firm, changing the name to Cohen Feit and Co. Most of the gang from Blyth and Dean Witter came with us. Gerstel, however, opted to remain at Dean Witter and brilliantly continued to run the convertible effort there.

Not long after, Cohen Feit & Co., gained a reputation as the absolute best place to work on Wall Street. Whenever the firm had a job opening or an expansion plan, the number of applicants soared. The working environment was fun and easy-going, and morale was high.

Convertible arbitrage was a new concept for investors to grasp. With the exception of our former employer, Dean Witter, none of our potential investors had ever invested in the strategy. The offering memorandum for Cohen Feit & Co., outlined in some detail the actual transaction set-up. Within 20 years, a strategy that had only about \$100 million invested in 1980 had over \$20 billion invested in 2000.

The returns suffered in conjunction with the increase in those employing the strategy. What happened? A strategy that threw off returns well in excess of 30% net per year started to have periods of negative returns. There was too much money chasing after the few lucrative opportunities. New issues were designed exclusively for the ‘arbs.’ Investment bankers started to persuade client companies to issue equity-linked securities with increasingly new complex terms and too-attractive-to-resist tax-avoidance schemes. The day of the ‘plain vanilla’ convertible was over.

After my retirement from Cohen Feit & Co., the developers of STAR, one of the first statistical arbitrage quant strategies, inquired if I would be agreeable to starting a joint venture. In the past, while at Cohen Feit & Co., I had used their services to develop an index trading strategy.

We traded the physical shares of the S&P 500 against the S&P futures with a great deal less than the 500 different component parts which lowered our trading costs. The quant strategy traded was like a sub-manager for large French Bank. Additionally, I

traded the Japanese Warrant market against the underlying shares using their ‘factor’ models.

The idea was to balance out the risk in the uncontrollable, huge and volatile Forex market to insure that our returns were ‘plain vanilla,’ and not because the currency moved in our favor.

It was a long day. The Japanese Warrant market started at approximately 8PM EST and peaked in the early morning in London. We were spared the time disconnect when the French Bank was merged and the new owners decided not to pursue the business.

Of course, we missed out on some major profits since the Japanese equity market was taking a nosedive. Undoubtedly, our strategy would have been a ‘home run.’ Fortunately for me, the convertible arbitrage strategy was still very strong, and I started another hedge fund as a general partner. Although I was not certain how long the convertible market could continue offering the kinds of returns that I was generating, I tried very hard to develop another strategy that would.

One day I had what I called my “Lost Chord” event. I still remember the first chorus from a song we learned in Elementary School:

*Seated one day at the organ,*

*I was weary and ill at ease.*

*And my fingers wandered idly*

*Over the noisy keys;*

*I know not what I was playing*

*Or what I was dreaming then,  
But I struck one chord of music,  
Like the sound of a great Amen,  
Like the sound of a great Amen.*

I had discovered what I now call *SwingTraderMidas*, an incomparable method of determining the strength and direction of trends, so different from any system I had previously explored or worked with. Like most traders, I had investigated, analyzed and studied everything publicly available.

Eventually I concluded that they were all lacking in various aspects. *SwingTraderMidas*, on the other hand, did not disappoint! It offered an innovative approach to anticipating opportunity in a fast-paced volatile market. With its cutting-edge minimum effort methodology it gave investors maximized results enabling them to far surpass their performance goals.

A lesson was learned--I vowed I would never again disclose a winning strategy. Realizing that the only profitable trading strategies were those being done outside the glare of public disclosure, like Mr. Getty, I started to be reticent about my strategies when talking to old friends about my trading deals. It was my observation that once people started to broadcast successful strategies, they would lose their winning streak and start to fail.

How does the *SwingTraderMidas* method work? Actually, it's rather simple to learn and adapt. The *SwingTrader.com* website will offer the investor a method of analyzing the market in a unique way; unique because of its broad perspective design that shuns a quick 'one size fits all' approach. Instead, it focuses on a proven and robust

trading strategy incorporating the Relative Strength and *Swing Trade Midas* tools utilized by many of the world's most successful trading funds.

In the following chapters I will outline and explain the different variables of the *SwingTraderMidas* method, demonstrating how you can easily apply this strategy to increase your investment performance—and maybe even outperform the market!

A system and strategy for the day trader is available at:

[www.perfectstormtradingstrategy.com](http://www.perfectstormtradingstrategy.com)

## **CHAPTER 2**

### **BLACK MONDAY: Launch of the ETF**

Forty-something years ago, when I embarked on my career as a trader, the average daily volume on the NYSE was a little over 7,500,000 shares per day. Since NASDAQ, the electronic computer link between NASD members for trading over-the-counter stocks had not yet been established; therefore it was not possible to accurately calculate non-listed share volume.

On January 2, 2008, the year's first day of trading, the most active stock traded was SPDR 500 (SPY) with a volume of 174,245,000 shares. The second was PowerShares QQQ (QQQQ) with almost 148,000,000 shares traded, and the third was iShares Russell 2000 (IWM) with 89,056,000 shares traded. All three-- the day's most actively traded issues, were Exchange Traded Funds (ETFs).

What are ETFs? They are investment vehicles designed to replicate the movement of a market index or other portfolios. They are listed on the major stock exchanges and trade throughout the day, closely following the vehicle they have been created to replicate.

For example: Some of these ETFs have been created to track the Standard and Poors 500 Index, the Dow Jones Industrial Average, and the Hang Seng Index, as well as various sub sectors of these indexes, particularly those based upon market capitalization such as large-cap, mid-cap and small-cap.

Currently there are over 600 ETFs replicating almost everything trading. Examples include:

- Country indexes on the stock markets of Austria, Spain, Singapore, China, Japan and others.
- Foreign currency ETFs available to replicate the FOREX market.
- The 20 Year US Treasury Bond ETFs replicate various fixed income products
- Many other ETFs have been established to follow various commodities i.e., crude oil among the most active.

ETFs developed as a result of the stock market research initiated during the onset of the computer age. As previously mentioned, Wall Street's utilization of computers is a relatively recent phenomenon. Today's PC's, however, are power houses, thousands of times more potent and precise in their calculation, storage and retrieval ability, than the most powerful main frame computers of the 1960's.

Prior to the mid-60's, there were neither criteria to compare returns of different managers and mutual funds nor a suitable method to calculate a total return in an agreed-upon format. However, thanks to the availability of computers and the establishment of databases containing histories of stock and bond prices, as well as mutual fund performance, this has all changed.

The new-found ability to calculate the performance of money managers and their stock selection over time resulted in a large academic investigation into the relative return and performance of actively-managed accounts.

In 1965, Eugene F. Fama, currently Finance Professor at the University of Chicago's Graduate School of Business, published an article in *The Financial Analysts Journal* titled, "Random Walks in Stock Market Prices" in which he discussed the hypothesis of an efficient market theory. The article proposed the argument that an active market which includes well-informed intelligent investors will be priced accurately because it reflects all available information.

If the stock market is efficient, then no additional analysis can be expected to result in the out-performance of an appropriate benchmark such as the Standard and Poors 500 Index. Current prices will fully reflect all available information.

Fama, in his article "Random Walks in Stock Market Prices," *Financial Analysts Journal*, September/October 1965 writes;

"An 'efficient market is defined as a market where there are large numbers of rational, profit-maximizers actively competing with each other trying to predict future market values of individual securities, and where important current information is almost freely available to all participants. In an efficient market, competition among the many intelligent participants leads to a situation where, at any point in time, actual prices of individual securities already reflect the effects of information based both on events that have already occurred and on events which, as of now, the market expects to take place in the future. In other words, in an efficient market at any point in time the actual price of a security will be a good estimate of its intrinsic value."

In 1973, Burton Malkiel published his book: "*A Random Walk Down Wall Street*," in which he presented most of the current academic findings of the efficient

market hypothesis (EMH) to the non academic public. At that time, it was common knowledge that most mutual funds were not beating the market indices.

“Of course you can’t buy an index,” was the standard response to this information, made accessible by the increasing availability and use of computers. However, refusing to accept this reply, Malkiel retorted, “It’s time the public can.”

Based on the arguments discussed in academic literature, Wells Fargo Bank in the early 1970s created the first index type fund for the Samsonite Corporation. It was an equally-weighted index comprising all the shares listed on the NYSE. Six years later, that money was transferred together with some of the company’s own pension fund to another account using a market-weighted Standard and Poors Stock Price Index.

Paul Samuelson, Noble Laureate in economics and Finance Professor at the Massachusetts Institute of Technology, wrote an article in the Fall of 1974 in *The Journal of Portfolio Management* suggesting “that, at least, some large foundation set up an in house portfolio that tracks the S&P 500 Index- if only for the purpose of a model against which their in-house gunslingers can measure their prowess.”

Batterymarch Financial Management of Boston, which had been trying since 1971 to find a client for its index fund product, attracted its first client in late 1974, perhaps as a result of this article. The index fund movement was gaining strength.

In the July/August 1975 edition of *The Financial Analysts Journal*, Charles Ellis of Greenwich Associates wrote an article titled, “The Losers Game.” His main point was that “The investment management business is built upon a simple and basic belief: professional managers can beat the market. The premise appears false.”

Before the end of 1975, John Bogle of Vanguard Funds created the first index mutual fund based upon the Standard & Poors 500 Composite Stock Price Index. Originally called the First Index Investment Trust, it was mercilessly criticized by its competitors. Fidelity Chairman Edward Jones was quoted as saying that he could not believe the great mass of investors was going to be satisfied with receiving average returns.

Mr. Bogle projected the operating fees for the index fund to include 0.3% per year in operating and 0.2% in transaction costs. Since at that time the average cost of operating an actively managed fund was about 2%, he expected to have an edge of approximately 1.5% above a managed fund.

Over time, that spread proved to be even wider, as the performance shortfall between actively managed funds and the S&P 500 exceeded 3% and the expenses of passively managed index funds shrunk. The fund was later renamed the Vanguard 500 Index Fund and by 2000, the funds assets were larger than Fidelity's flagship Magellan Fund.

The Journal Report on Investing in Funds published in the January 3, 2008, edition of *The Wall Street Journal* page R8 carried an interesting observation. "Fourteen- - that is how many U.S. stock and bond mutual funds can claim the longest streaks, nine year triumph over the Standard & Poors 500 stock index, according to Morningstar Inc."

All the index mutual funds created to offer the public a way to emulate an index could only be purchased at the end of a trading day. If markets moved one way or another during the day, the holder could only buy and sell at the closing price.

This inability to buy or sell an index fund during the trading day was clarified from October 14 1987 through Monday, October 19, 2007, collectively referred to as “Black Monday.” On that fateful Monday in 1987, the Dow Jones Industrial Index lost 22.6% of its value or approximately \$500 billion. Meanwhile, the Standard & Poors 500 Index fell 20%. It was the largest decline ever recorded, overshadowing the 12% decline on Monday, October 29, 1929, which triggered the Great Depression.

When market prices fluctuate dramatically over a relatively short period of time, investment professionals like to claim that such price movements prove the inefficiency of the markets.

How does Fama, father of the Efficient Market Theory, respond to that? “I don’t think you can ever say much about a particular price change,” he says, “but the 1987 crash is the one that lots of people point to. My response to it, some people think it’s facetious, but I don’t think it really is. We’ve had two big crashes in this century. One was an under-reaction to subsequent economic events in 1929. The last one turned out to be a mistake. So one out of two, it’s about exactly what you’d expect from an efficient market. But, I don’t know how deeply you want me to go into this.”

Prior to the all-determining Monday, October 19, 1987 ‘crash day,’ there was a 10% decline in the market for the previous three days, Wednesday, Thursday and Friday (October 14<sup>th</sup>, 15<sup>th</sup>, and 16<sup>th</sup>). It was the largest three day decline since 1940. My partner, Cohen, was on vacation and during our conversation on Thursday, we discussed the latest happening, expressing our mutual concern for our own positions. On Friday, Cohen cut short his vacation and flew back to New York.

Since Cohen Feit & Co., was involved in both risk and convertible arbitrage, we had on balance what we thought to be a market neutral position. What happened on Monday was more than we had expected.

Mark Rubenstein, Professor of Applied Investment Analysis at Berkeley's University of California, in a comment on the 1987 market crash, wrote in *Risks in Accumulation Products*, Society of Actuaries 2000;

“Adherents of geometric Brownian motion or lognormal distributed stock returns (one of the foundation blocks of modern finance) must ever after face a disturbing fact: assuming the hypothesis that stock index returns are lognormal distributed with about a 20% annualized volatility (the historical average since 1928), the probability that the stock market could fall 29% in a single day is  $10^{-160}$ . So improbable is such an event that it would not be anticipated to occur even if the stock market was to last for 20 billion years, the upper end of the currently estimated duration of the universe. Indeed, such an event should not occur even if the stock market were to enjoy a rebirth for 20 billion years in each of 20 billion big bangs.”

Appointed by the President to investigate the causes of the crash, The Brady Commission concluded that the failure of stock markets and derivatives to operate in sync was a major factor contributing to the severity of the collapse. Futures and stock options were so far above and below their fair market value that their use to hedge the broad market decline only accelerated the process. At times the Standard & Poors 500 future was trading at a 6% discount to its fair value.

As a consequence of the crash, the markets set in motion ‘circuit breakers,’ mechanisms that would require a trading ‘slow down’ under certain statistical events.

Unfortunately, the tools in place at the time of the crash were clearly not robust enough to keep the decline from accelerating.

The American Stock Exchange formed a new products team, headed by Nathan Most to answer the question; “How do we get an index based product trading on an exchange that would not fail during severe market volatility?”

Following six years of study, research and actual design work, in 1993 they found an answer. The first ETF was launched in collaboration with State Street Bank and Trust who understood the trust side of the instrument. Identified as the Standard & Poors Depository Receipt, *aka* SPDR, it is now the largest ETF traded, with \$80 billion dollars in assets.

The ETF was initially designed for the institutional side of the market as a companion to futures and index funds. In fact at its inauguration in 1993, the original group of ‘inventors’ thought perhaps there would be five or six more funds added to the ETF family. Surprise! Surprise! Today there are over 600 ETFs in the United States market and perhaps as many as 500 in the foreign markets.

Why was the ETF concept so exceptional to investors? The events of September 11, 2001 would bear out the premise and promise of the ETF concept.

The attacks on The World Trade Center had a significant personal effect on me. When I worked at Dean Witter, now Morgan Stanley, our offices were situated in 2 World Trade Center, identified by the media as the ‘South Tower.’ Furthermore most of our operations were conducted in 5 World Trade Center. Morgan Stanley was one of the largest tenants in the WTC complex, and I, among millions of Americans was concerned about the survivability and welfare of my former co-workers. Thankfully almost all

survived the attack. However, the economic impact on the United States was yet to be tested and long to be discussed.

The NYSE, the American Stock Exchange and NASDAQ did not open on September 11 and remained closed until September 17. When the markets reopened, after the longest closure since the Great Depression in 1929, The Dow Jones Industrial Average index (DJIA) fell 684 points, the most momentous points decline in history. By the end of the week, the DJIA had dropped almost 1,370 points, the largest one week point plummet in history.

When the markets reopened, many stocks, especially the airlines AMR, American Airlines and UAL, United Airlines endured long opening delays. This was instrumental to investors because airlines were an important component of The Standard & Poors 500 index.

Standard & Poors calculated the index, but since many of the stocks had not reopened, the index would be out of sync with reality until they opened. Traders in the SPDRs were smarter. Participants in the SPDR market predicted what the stock would reopen at and priced the SPDR market accordingly. When the stocks reopened, the SPDR prices were within a few pennies of the recalculated index. The market mechanism worked. ETFs had withstood the test.

In the next chapter I will discuss how the ETF is created, why its particular make-up is responsible for the in sync trading of the ETF market and what happens when the buyers-sellers ratio is unbalanced.

## CHAPTER 3

### TELEPHONE ARBITRAGE: The ETF Process

As a result of a seven year antitrust suit initiated by the Justice Department in 1974, American Telephone and Telegraph Company (AT&T) and the Justice Department negotiated a settlement.

Signed on August 24, 1982 by Judge Harold H. Greene who had overseen the case, the proposed settlement allowed AT&T to spin its exclusively owned 22 companies into seven regional bells operating companies, (RBOCs). Under the terms of the settlement, AT&T had six months (until February 24, 1983) within which to file a plan detailing the conditions and stipulations of the settlement followed by a period of one year within which to carry it out on February 24, 1984.

AT&T stockholders were to receive one share of the 'new' AT&T and one share of each RBOC for every 10 shares of AT&T. Therefore, for each 100 shares of AT&T the holder would receive 100 shares of the 'new' AT&T, and 10 shares each of the seven regional bells-- Ameritech, Bell Atlantic, BellSouth, NYNEX, Pacific Telesis, Southwestern Bell and U S WEST.

The United States Supreme Court affirmed the issuance of the consent decree on February 28, 1983. Later that year, shares of the new companies began trading on the NYSE on a 'when issued' basis.

How exactly did this work? It was easy to figure out. If you take 10% of the RBOCs value and add it to the price of the 'new' AT&T, the total should equal the price of the 'old' AT&T.

Did it? Yes or no, and if not why? It did not, because of a money time value and other factors. The point is it was a rather complex and intricate transaction to set up with the technology available in the early 80s.

Cohen and I set up an AT&T arbitrage trading unit at Dean Witter. All we had at our disposition was a simple computer program, unlike today's versions, a program that calculated the bid prices of trade pieces: AT&T 'new' and the soon to be issued but already trading RBOCs. Since Michael Bloomberg was still a trader at Salomon Brothers, the 'Bloomberg' terminal was not available.

So how did we do it? We used comparisons. We contrasted the value of the new pieces with the 'old' AT&T and when the values promised a profit, we bought the 'old' and sold the 'new' pieces. Our orders were executed physically on the floor of the NYSE.

Although the 'old' AT&T and the 'new' AT&T were traded at the same specialist post, the new RBOCs were traded all over the floor. Floor brokers were contacted by phone and were told to execute the different orders at the various trading posts on the NYSE floor, in the eventuality it became profitable to do so.

However, many times because of a lag between our spread calculation and the actual spread being in line, the entire order could not be completed. It was not always a lay-up. Very few member firms attempted the trade. In fact at the close of the transaction, we were told that we held the largest arbitrage position.

With today's sophisticated electronic trading tools, the trade would be almost impossible to do with the large spreads that occurred then. During that period, stocks traded in eighths (0.125 cents) compared to today's pennies. Today, the trade could be done with the click of a finger or even automatically through a 'trade bot' in an algorithmic trading platform.

How are ETFs created?

Unlike an initial public offering for a common stock, ETFs are not created all at once. Instead, they are continually being created and redeemed to the ETF custodian according to the (ETF's) supply and demand ratios. Unlike the AT&T arbitrage where the old AT&T was exchangeable for the new AT&T and the RBOCs package and not vice-versa, ETFs are recurrently put together and pulled apart.

The creation and redemption are handled by 'authorized participants,' very large financial institutions prepared to successfully deal with the minimum size of the 'creation units.' In the case of the SPDR-- its 50,000 SPY shares are currently valued at almost \$7 million.

With knowledge of the index components and the weighting, a trader is able to keep the ETF and the index in sync. Furthermore there is always the opportunity for profit should the underlying components and the ETF get out of sync. With today's sophisticated IT highway, at the fingertips of traders, a few clicks and the appropriate orders are generated.

*The Wall Street Journal* publishes a brief weekly report on 'program trading.' A segment of that activity serves a means to arbitrage out the differences between the ETF's indicated net asset value (NAV) and its component parts. Generally most indexes'

indicated NAVs are computed every 15 seconds throughout the trading day.

Consequently, an ETF can be redeemed for its component parts at will by an institutional investor, with a minimum size.

Investors ask--What keeps the market close to the NAV? The arbitrage pricing mechanism keeps the market extraordinarily close to NAV. If there is excess demand for an ETF, institutional market-makers create them by purchasing the component parts and having the custodian issue new shares of the ETF.

At times, however, when the underlying shares are trading on a foreign exchange, like Hong Kong or Singapore, the ETF price may be either a premium or discounted from its indicated NAV, since that NAV is old and the ETF will trade at a rate at which the market participants think the shares will reopen.

## CHAPTER 4

### ETFs versus MUTUAL FUNDS

How do Exchange Traded Funds differ from Mutual Funds?

ETFs differ in:

- Price Scale
- Purchase Technique
- Management Strategy
- Transaction Fees

To the investor, ETFs are different from mutual funds with respect to the cost advantages they offer. Investors can buy a diversified basket of securities paying a competitive price. Unlike open ended mutual funds, ETFs are bought and sold through a broker-dealer and not a fund company.

Investors buy mutual fund shares at a cost equal to the funds net asset value (NAV), plus the sales load. The NAV of both ETFs and mutual funds is calculated on a daily basis immediately following the market's closing bell. Although a mutual fund's net asset value can change during the trading day, all orders to purchase or sell the fund are processed at the end of the day at the net asset value as of the close of that day.

However, in comparison, the ETF share price constantly adjusts, reflecting the change in NAV. The indicated NAV is calculated and displayed. An investor, acquiring or liquidating an ETF during the trading day may not always realize the indicated NAV as buying and selling pressures during that trading day may temporarily favor a small discount or premium to the NAV. Arbitrage among the authorized participants tends to

keep these events to a minimum. It is possible for an ETF investor to purchase or sell shares at any time the exchange is open, and not only at the closing price.

Since the ETF has a passive management structure, it is not necessary to assemble and bring in a costly research team to make recommendations to the portfolio manager. In addition, the sole task of the manager of the ETF is to monitor the adjustments required by the third party controlling the index components i.e., the Standard and Poors Company would control the Standard and Poors 500.

In the case of a country tracking index, the portfolio manager makes adjustments only if the individual initially selected security no longer meets the requirements as published by the third party index creator.

A mutual fund may incur higher internal trading costs since the portfolio turnover within a particular non index fund is significantly higher than an ETF. A precise accounting of this increased trading cost is not always easy to compute because a related party may be the recipient of the fund's trading fees.

Besides trading expenses, mutual funds charge a 'management expense ratio,' which is fully disclosed in the fund's prospectus and in the various financial publications sometimes abbreviated MER.

Mutual funds are frequently sold to the investor with a 'load' which is often left undisclosed when the fund is sold. Many times the 'load' is disclosed only when the investor receives confirmation of the transaction. Often times when there is no 'front end load,' the sales load is charged on the 'back end' the moment the investor sells the fund. The longer an investor holds the fund, the lower the 'load.'

Sometimes the seller of the fund receives part of the annual total fees. Whether the investor makes money or not, the salesperson gets a check.

What are the transaction Fees for ETFs?

ETFs have low scale managerial expenses, i.e., expense ratio. Due to the fact that ETFs have no research overhead, the expense ratio is usually a small fraction of a mutual fund's ratio. The managers of an ETF are not responsible for the investment choice which is determined by the publisher of the index and eventually followed by the ETF manager.

Since ETFs are traded on an exchange, the broker will charge a commission for executing an order to purchase and/or sell the ETF. Most discount brokers charge less than \$10 per trade. Consequently, an investor set on spending \$10,000 to acquire an ETF would pay \$10 for the transaction. In comparison, a \$10,000 mutual fund purchase would cost as much as \$525, a 5.25% load.

Proponents of mutual funds like to point out that the hidden purchasing and selling cost associated with an ETF is the spread between the bid and offered side of an ETF market. However, in the case of the SPY (SPDR S&P 500) the spread is sometimes as low as one cent. This rate would equate to less than \$1 in added expense.

In many other instances the spread between the bid and ask of an ETF is larger, i.e., a country fund like EWG (iShares MSCI Germany). This tracks the Morgan Stanley Capital International Germany Index and has a spread which widens and narrows during the trading hours of the German stock market (FWB). When both the U.S. market and the country market are open, the spread can be as low as just one cent. Moreover, it can be less than \$3 on a \$10,000 investment, such as in the case of EWG.

Besides sharing redemptions, mutual fund expenses are also increased by large new purchases. However, the trading expenses resulting from the acquisition of additional holdings are sustained by all the holders, not just the new ones.

In the event of large redemptions, the mutual fund may have to sell holdings, a decision that would trigger capital gains and/or losses. These capital gains are passed on to the shareholders, even if the value of the fund is lower. Mutual funds also restrict the trading of shares in their companies because they incur an additional overhead cost.

With ETFs, investors do not face this problem, because share redemption is merely a transfer of stock from one account to another on the books of the authorized participants in a tax-free exchange. Only when adjustments are made to the index itself and a particular stock is removed from the index is a share sold in the market.

Recently, many financial planners and big Wall Street full service commission brokers assembled baskets of ETFs to meet their customers various financial goals. There is a fee for this service in addition to the fees charged by the ETFs.

It is essential to use knowledge in structuring an investment. Smart investors focus on selecting winning ETFs instead of utilizing a losing strategy in their stock picks. Same people, same game—different score, different outcome!

In the following chapters investors will learn how to select winning ETFs and employ an investment pitfall proof strategy to expand wealth.

## CHAPTER 5

### ETF VOLATILITY: The Players

Fifteen years ago, the first ETF was traded. Born a clone of the Standard & Poors 500 Index, it was nicknamed “spiders” because of the SPDR symbol. Traded today under the symbol SPY it is one of the most active stocks traded in the U.S. market.

Two years later, in 1995 another ETF which tracked the S&P MidCap 400 Index joined the list. By 1996 more than 15 ETFs linked to international stock exchanges were trading.

Today, after almost 14 years of ETF expansion, there are more than 600 ETFs trading in the U.S. market. ETFs track a wide variety of sector-specific, country specific and broad market indexes. Furthermore, the non-U.S. markets boast as many as 500 additional ETFs trading.

What makes the ETF market so exciting and financially advantageous—what makes it a money-spinning experience?

The existence of a currently-trading ETF with the potential to replicate almost any wealth expanding strategy the mind can conjure in the investment world contributes to the high profitability factor.

Let’s investigate just how this works. If you are interested in jumping into the Foreign Exchange market (FOREX) you can select and trade ETFs which track the currencies of the most industrialized nations.

How does this function? “CurrencyShares British Pound Sterling Trust” (NYSE: FXB, the ETF created by Rydex Investments of Rockville Maryland), tracks the British

Pound/ US Dollar currency pair. Of course, the market is diversified. In fact, to build FOREX exposure, an investor has about a dozen different ETFs. Although trading exclusively during market hours, the FOREX ETFs still afford the investor a broad range of global exposure unavailable elsewhere. FOREX opportunities in the Forex direct and/or the FX futures market are enticing options to large intuitional investors.

After State Street Bank and Trust developed the Standard& Poors 500 ETF (SPY), Barclays Global Investors, a division of Barclays Bank, developed the iShares suite of products. Their website offers investors an in-depth categorization of available products among which:

**Market Cap**

Small Cap

Mid Cap

Large Cap

Broad U.S. Market

**Style**

Value

Growth

**Sector/Industry**

Basic Materials

Consumer Services

Consumer Goods

Energy

Financial

Healthcare

Industrial

Natural Resources

Technology

Telecommunications

Transportation

Utilities

**International**

Europe

Asia

Africa

Americas

Global

Regional

Emerging Markets

**Specialty/Real Estate**

Specialty

Real Estate

**Fixed Income**

Broad Markets

Government/Credit Bond

Credit/Corporate Bond

Treasury Bond

Mortgages

Municipal Bond

International

**Commodities**

Broad Based

Precious Metals

The iShares suite of products is indicative of the monumental universe of Exchange Traded Funds. There are numerous sponsors of ETFs, namely; State Street Global Advisors, Rydex, Vanguard and PowerShares. Additionally many other sponsors offer niche products such as Claymore, ProShares and Wisdom Tree.

The [www.SwingTrader.com](http://www.SwingTrader.com) website categorizes the list as follows:

Broad Market

Commodity

Currency

Income Related

Industry

International

Large Cap

Leveraged Long

Leveraged Short

Mid Cap

Short

Small Cap

Specialty

Among the most successfully launched ETFs are the leveraged funds offering investors the opportunity to multiply their returns. ProShares is a major sponsor of leveraged funds.

What is the difference between traditional and leveraged ETFs?

Traditional ETFs aspire to replicate a given index or sub-strata of the market. On the other hand, leveraged ETFs like many of the ProShares ETFs depend on a series of derivatives and index swaps to double the target returns whether the target is escalating or diving down.

The concept mimics the investor who uses margin to purchase twice as many shares as in a cash account, borrowing on the original stock to purchase the rest. The most active leveraged ETFs are those geared to the Nasdaq100, the Russell 2000, the Standard & Poors 500, the Dow Jones Industrial Average, and the Financial sector.

The latest niche market ETFs follow specific investment strategies. Sponsored by Claymore Securities, these new ETFs include Claymore/BNY BRIC ETF which follows the equity index called the BNY BRIC select ADR index—all of which tap into exciting technologies. BRIC stands for Brazil, Russia, India, and China. The American depository receipts (ADRs) all trade in the U.S.

The ETF world offers something of value for every investor geared towards wealth growth and the outpacing of expectations.

The next chapter will discuss how to choose the ETFs that best suit your investment prospective and goals.



## CHAPTER 6

### ETF DYNAMICS: The Relative Strength Connection

In April 1984, William J. O'Neil founded *Investors Business Daily* (IBD), to discuss topics and impart information not contained in *The Wall Street Journal* and other newspapers and periodicals targeted to investors and business people with little time to browse through larger publications with more complex formats.

Published Monday through Friday IBD contained global business and financial news, stock trade tracking and market trend reports. In addition it carried numerous and various statistical tables. Prominent among these tables is Mr. O'Neil's Relative Strength Ranking (RSR). This RSR involves the daily ranking of almost 8,000 stocks.

How does this work?

The rank corresponds to the performance of the particular issue's price, relative to all the others in the IBD universe over a 12 month period. Since Mr. O'Neil defines this ranking as an extremely successful tool in his 'CAN SLIM' approach to security selection, he offers it to IBD to readers.

What exactly is the 'CAN SLIM' approach?

CAN SLIM is a comprehensive compilation of the seven elements high performing stocks have before they hit their largest gains. This important tool assures a lesser risk

factor while promising greater returns due to its information-oriented performance tracking which offers investors an edge in rating the stock before a purchase.

- C = Current earnings
- A=Annual earnings
- N=New product or service
- S=Supply and demand referring to trading volume
- L=Leader or laggard? If the leading stock in an industry is purchased, a stock's Relative Price Strength Rating should be 80 or higher.
- I= Institutional sponsorship
- M= The Market indexes.

Besides Mr. O'Neil's adherence to the power of Relative Strength in the selection of profitable investment stocks, The Motley Fool— [www.fool.com](http://www.fool.com) one of the leaders in publishing unbiased and evenhanded financial insights, also sanctions this reputable tool. "Foolish requirement number five introduces one of our favorites: Relative Strength."

According to both IBD and The Motley Fool, Relative Strength measures the performance of one stock with respect to the entire cosmos of stocks in their universe. IBD considers all stocks trading in the U.S. market. Most practitioners of technical analysis use Relative Strength to track and compare individual stock performance either to a benchmark such as the Standard & Poors 500 index, or to some other overall market universe.

How does this play out?

A stock's relative strength measures the stock's performance on a relative basis and compares it to other stocks. It does not measure performance on an absolute basis.

This is where [www.swingtrader.com](http://www.swingtrader.com) comes into focus. Why?—Because the Swingtrader tool allows investors to easily and accurately calculate the relative strength of an individual ETF with respect to the ETF universe.

Currently [www.swingtrader.com](http://www.swingtrader.com) follows over 400 ETF issues, comprising most of the active ETF universe trading in the U.S. market. A ranking of 90 indicates that a particular ETF has outperformed 90% of the ETFs tracked.

Both The Motley Fool and IBD have minimum requirements for purchase in their screens. It is no secret that Mr. O’Neil favors stocks with high relative strengths. In his book, “How to Make Money in Stocks,” Mr. O’Neil writes; “If ...you buy equities that haven’t yet moved or are down the most in price, because you feel safer with them and think you are getting a real bargain, you are probably buying...sleepy losers.... Why buy equity whose relative performance is inferior and straggling behind a larger number of other, better acting securities in the market? Yet most investors do, and many do it without ever looking at relative strength line or number.”

There are, in my opinion, two conflicting strategies at play in today’s stock selecting process.

- One, the Pendulum approach which stipulates that what goes one way will in time revert and go in the opposite direction. In other words buy stocks when they are in the dumps, because they have the potential to change course and soar again, once they hit rock bottom.
- Two, treat stocks as if they were part of the Kentucky Derby. Focus on the horse in front when racing down the stretch. Why? Because the odds favor the horse

leading the race at that specific point. That's how the successful handicapper selects the winner every time.

Research and studies indicate that buying when a stock is high and selling when it climbs higher is a more profitable strategy than trying to pinpoint the turnaround of a falling stock. The old adage, "don't try to catch a falling piano" has merit.

Gomes and Islam, using data from 1967-1997, and Levy, utilizing even earlier datasets, emphasize the persistence and value of Relative Strength in clear-cut terminology.

What exactly does this mean? It means that once a stock outperforms its peers, it will continue to do so. Levy, in his article published in *The Journal of Finance*, December 1967 concludes that: "There appears to be good correlation between past performance groupings and future (26-week) performance groupings." Levy also concludes that a four week Relative Strength tracking is too short a time period to be a good predictor.

Current studies also conclude the same result. Volkman and Wohar from the University of Nebraska in an article published in *The Review of Financial Economics*, Volume 5, and Issue 2 state: "Counter to an earlier study on relative strength of fund performance, this study's results do not support the decay of performance persistence after one year. Rather we find persistent abnormal fund returns over a one to three year investment period based on a three to four year evaluation period."

The results are irrefutable. Over the long term, covering many different investment climates and cycles, the Relative Strength strategy for stock selection is excellent. Buying the stronger stocks and culling out the weaker ones is a very profitable tactic.

What's the value behind the [www.swingtrader.com](http://www.swingtrader.com) service?

The value is that [www.swingtrader.com](http://www.swingtrader.com) tracks Relative Strength on a 65 day (13 week) period along with another measure of Relative Strength which adds an additional dimension of market timing—an important factor for high net profit.

The SwingTrader daily service computes Relative Strength after the closing bell-- then sorts the results into the following categories:

Broad Market

Commodity

Currency

Income Related

Industry

International

Large Caps

Leveraged Long

Leveraged Short

Mid Caps

Short

Small Caps

Specialty

[www.swingtrader.com](http://www.swingtrader.com) ranks the Relative Strength on the entire ETF universe and then the rankings are ‘frozen.’ Afterwards, The ETF universe is apportioned into categories and then sorted within the grouping according to overall rank. With this strategy, it is easy to decipher at a glance which categories are performing better and which individual ETF in the category is the top achiever and vice versa.

The main reason why Relative Strength is so successful in identifying and locating strong ETFs is the broad diversity of the ETF product. The expression “there is a bull market somewhere” has found a spot in the ETF marketplace. While the broad market may be on a downward turn, commodities may be soaring or vice versa. And although some foreign markets may be spiraling south, many are heading north. Also, small caps may be in and large caps may be out. Some sectors may be hot while others cold. There is a constant rotation among the many different types of investments and the ETF market has almost all of them.

Serious investors aiming for high productivity products are logging on to [www.swingtrader.com](http://www.swingtrader.com) to learn what is happening in the ETF world. Buying ETFs with high Relative Strength and not filling portfolios with weak Relative Strength stocks not only enhances investment returns, but continues the wealth accumulation cycle indefinitely, all while protecting capital.

Specific strategies are discussed at the [www.swingtrader.com](http://www.swingtrader.com) website. The next chapter will introduce Trend and Momentum, another valuable ETF tracking tool.

## CHAPTER 7

### TREND and MOMENTUM SPIN

How to identify and distinguish between high profit earning ETFs.

Applying the Relative Strength tool is the first step in the acquisition process of high yielding ETFs. Why? Because it provides a handy guide enabling investors to identify and select the most profit promising ETFs.

Some investors believe Relative Strength tracks stocks on a relative basis instead of on absolute terms. Let's assume all the stocks in the relative value universe were heading south. We all agree that choosing the better stocks in that universe would not be a wise option. Why? Because in a scenario in which all the stocks were diving, the investor would undoubtedly choose those with the lowest decline rate. It is important to note that this strategy would function better if the position is hedged with an offsetting short position in even weaker stocks.

To gain the assurance that the high Relative Strength stocks are in fact moving higher in price and not just traveling downhill at a slower pace than the others, the selection process should be taken a step further. How? By adding another element to the selection course: trend and momentum.

Almost all items trading in open liquid markets exhibit the ability to trend either up or down in price, at one time or another. The trend may be short-term i.e., within the trading day a stock may demonstrate a short-term price trend lasting a few minutes or more. Yet, over more extended time frames it may display a price trend holding steady for a few days or longer.

Observing price histories, it is possible to identify, in retrospect, trends enduring for weeks or even months. It all depends on trend identification and measurement. The example illustrated in Graphs 1-6 of the weekly price history of the Dow Jones Industrial Average starting in 1950 clearly exemplifies this point.

A 150 period weighted moving average (WMA) is utilized and the price is represented in a modified candle-stick called “*Heikin-Ashi*” which in Japanese translates to “average bar.” Since the *Heikin-Ashi* candle uses a look-back approach, it is thought to be an excellent way to observe price bars. Although not part of the SwingTrader trend recognition system, it is a more user friendly illustration of price.

Adding another WMA, 25 periods, will assist the momentum of the larger period WMA. When the price listed in the illustrations is above the 150 period weighted moving averages (150WMA) and the shorter period 25WMA, the trend and momentum points up.

Conversely when the price is below the 150WMA and the shorter period 25WMA, the trend and momentum dives down. Not subject to diverse interpretations, it is rather simple.

When the price is above both weighted moving averages, the investor is long. And when the price is above the 150WMA but below the 25WMA, the investor is in cash. Using this one easy guide, an investor would enjoy profitability over the time illustrated.

How does the [www.swingtrader.com](http://www.swingtrader.com) service differs from the one herein illustrated? [www.swingtrader.com](http://www.swingtrader.com) focuses on employing a more sophisticated measure of trend and momentum, instead of depicting what can be accomplished through a trend-based type system.

In summarizing—a profitable investment approach equates to combining the Relative Strength method with a simple trend following guide.

- Isolate and select high Relative Strength issues with positive trends.
- Eliminate lower Relative Strength and/or weak trends.
- In other words-keep it simple (KIS).

What are the benefits of [www.swingtrader.com](http://www.swingtrader.com)? Why use it as an investment tool?

Every evening after the closing bell, [www.swingtrader.com](http://www.swingtrader.com) engages its trend and momentum system to rank the ETFs in the SwingTrader universe based on a positive to negative trend and momentum. Taking it a step further, [www.swingtrader.com](http://www.swingtrader.com) assigns numbers from plus 10 to minus 10 to rank the issues with +10 for the strongest and -10 the weakest.

The SwingTrader Midas system draws on four measures of trend and two measures of momentum in allocating the numbers. To assist the investor in selecting issues meeting their specific criteria, SwingTrader Midas sorts the results from +10 to -10. The numbers are color-coded with green representing positive and red negative. On a black and white printer +10 is represented as '10' and -10 as '(10).'

## CHAPTER 8

### ORACLE of OMAHA: The Sultan Speaks

In March of 2008, Warren Buffett was interviewed on the CNBC series titled “Oracle of Omaha Unplugged.” Renowned as a phenomenal investor with a value on investing theory that made him billions using uncomplicated but powerful strategies, he was asked to discuss the large payments made to the current field of hedge fund managers and questioned whether he considered it justifiable.

Earlier in his career, Mr. Buffett, managing partner of his own fund, developed a unique perspective. An audience participant on the CNBC program came forward, “Mr. Buffett,” he said, “in your annual letters you make it very clear you are not a fan of hedge funds and believe they destroy wealth. Do you think hedge funds have an edge which justifies their huge fees?”

“In the aggregate, no,” Mr. Buffett replied. “When there were very few of them and a lot of talent but not a lot of competition with each other it’s very likely they did. On Wall Street you have the progression from the innovators to the imitators to the swarming incompetents and what happens is that the results achieved by the innovators enable the product to be sold by a lot of people simply because the record of the few people was good.”

After years in the investment business, I thought his response to the compensation question was, exceptional.

Mr. Buffett continued: “The idea that trillions of dollars can be managed to get above average results while charging fees that are way higher than normal just defies the

logic, so in aggregate people are going to be disappointed with the results they get from hedge funds, but there will be ones that do terrifically, but I would not want to buy them across the board.”

This is precisely what Cohen Feit & Co., was all about. Innovators, we were among a handful of hedge funds, doing either convertible arbitrage or risk arbitrage. It is said that imitation is the best form of flattery. Soon after, recognizing our investment/trade strategies as valuable, imitators sprung up trying to emulate our successful methods.

In the same CNBC interview another question was posed. Mr. Buffett was asked about his strategy today, considering his past experience as a hedge fund manager. Without pausing to ponder, he replied that he would advise the individual investor to buy broad market index funds because of their low cost. However, due to the market’s cyclical nature, he would not purchase all at once—an answer and a strategy shared with [www.swingtrader.com](http://www.swingtrader.com).

This is swingtraders.com’s forte-- to provide a method of identifying and focusing on those index products that are moving during an above average part of the market cycle while avoiding those traveling in the opposite direction. By utilizing the techniques advised on the [www.swingtraders.com](http://www.swingtraders.com) web site, a serious investor centered on high earning can outperform most of the high fee managers without paying exorbitant fees.

Although the SwingTrader trend and momentum system was originally designed as an interday trading system, easily plugged into the modern algorithmic trading platforms, the modern investor, with limited time to scrutinize the markets, will find it a

unique and successful stand alone method for reaching and surpassing their investment earning goals while moving beyond mainstream investing.

## CHAPTER 9

### THE ART OF ETF STRATEGY: Putting it Together

The most lucrative advantage of utilizing ETFs as the centerpiece of an investment portfolio is the astonishingly hefty universe of investment options open to investors.

The history of stock prices has continually demonstrated that, at any given time, one sector of the marketplace will perform better than others, and that various sectors of the trading universe favor earning whereas others do not.

Imagine turning massive losses into phenomenal growth. It can happen without having to venture far. Herein lays the value of [www.swingtrader.com](http://www.swingtrader.com) with its precision investment reportage and no-nonsense straight talk. It's not just a strategy—it's a surefire way of down-turn proofing investments.

Howard Marks is one of the founders of Oaktree Capital Management, LP, an international investment firm based in California involved with the management of over \$50 billion in alternative investments. I first noticed Marks when he was managing a large convertible securities portfolio for Trust Company of the West in the 1970's.

Mr. Marks letters to his investors are avidly read, enjoying popularity almost as infamously as Warren Buffett's communications to his shareholders. In fact, according to *The Wall Street Journal*, he actually developed a cult-like following after he rang the alarm to give warning prior to the technology stock implosion in January of 2000.

In his memo dated March 2008, “The Tide Goes Out” he not only expounded upon the knowledge he acquired about market cycles but explained and portrayed the three stages of a bull market:

“The first,” he said, “when a few forward-looking people begin to believe things will get better; the second when most investors realize improvement is actually underway, and the third, when everyone’s sure things will get better forever. Buying during the first stage can be highly profitable, while buying during the last will carry you over the cliff with the rest of the herd; when just a few prudent investors recognize that despite the prevailing bullishness, things won’t always be rosy” he continued; “when most investors recognize things are deteriorating, and when everyone’s convinced things can only get worse.”

Interesting concept. Well, the Relative Strength report, diligently researched, prepared and sent each trading day by [www.swingtrader.com](http://www.swingtrader.com) pinpoints those same market segments portrayed by Mr. Marks, in various stages of the investment cycle.

Plus, in addition to identifying the ETF position, i.e., in which stage of a bull or bear market it sits, the [www.swingtrader.com](http://www.swingtrader.com) report also assists and encourages investors to trade while honoring their own personal investing style.

What exactly does this mean?

I have discovered that there are various trading styles. Each style is designed and maneuvered by an investor’s psychological make-up and the specific risk factor—in other words how much an investor is willing to “gamble” in order to attain his/her personal earning objectives. Of course, there may be style variations, but I have grouped them as follows according to time in the trade:

1. Scalping-- a trading tactic that investors employ to increase profits on small price fluctuations by completing from 10 to over 200 trades in one day. This approach is favored because traders are convinced that it is less complicated to catch small fluctuations than large. The trader attempts to make a few cents per trade, trading either in the direction of a trend or using a counter trading strategy that involves betting on a small reversal of the present trend.

2. Interday Trading-- a tactic whereby the day trader attempts to make more than a few cents per share while holding a position for more than a few seconds and often as long as the entire day. In the case of the Scalper and the Interday Trader, positions are closed out at the end of the day and not carried overnight. Both the Scalper and Interday Trader are excellent candidates for the SwingTraderMidas trading system, available as a valuable add-in to various trading platforms. Both the scalper and the interday trader can also use the strategy and systems developed at [www.perfectstormtradingstrategy.com](http://www.perfectstormtradingstrategy.com)

3. Swing Trading-- a trading technique used by an investor to take custody of gains in a stock within one to four days. Positions are held for a few days and in many cases for a few weeks. Investor/Traders hold positions in the direction of the primary trend and adjust their portfolio holdings according to trend momentum. With the

swing trading strategy, the daily reports prepared by [www.swingtrader.com](http://www.swingtrader.com) are a lucrative asset.

4. Intermediate Trading or Trend Trading-- a strategy triggered towards embracing gains via the scrutiny of an asset's moment in a specific direction. What happens is that a trader jumps into a long position when the stock is in an upward trend with more elevated highs in sight. On the other hand, a short position is sought when the stock slips into a down trend with lower highs predicted. In other words, an investor owns portfolio securities based in part on the long term trend. Once again the [www.swingtrader.com](http://www.swingtrader.com) reports are a profit-promising resource for identifying, selecting and monitoring positions.

5. Long Term Investing-- a method that favors even down trends. Long term investors using the tools available in [www.swingtrader.com](http://www.swingtrader.com) involved in diversified investments, are in a position to wait out bear markets without suffering devastating losses. Trying to predict the market has more often than not resulted in serious financial penalties for investors. However, the investor should own portfolio positions giving more weight to fundamentals. The long term stock trend will be driven in large part by the long term trend of earnings. But in the short term, stock prices are driven by the investment sentiment reflected by trend and momentum—all of which is reported daily with clock-like precision and accuracy in the [www.swingtrader.com](http://www.swingtrader.com) reports.