

## Perspective: The Academic Six-Factor Flop Fix

Nov 23, 2017

Dear Scott,

### Long Trends Are Your Friends

First, I'd like to say, "The monthly Perspective is back." For a short period of time its priority took back seat to publishing "Conquering the Seven Faces of Risk," doing two trade shows, making six presentations, and keeping the website running. But now it's back, and just in time to be digested with some yummy turkey and pie.

By now most have noticed that longer trends are back, producing fewer trades per month. This is a direct result of having policy certainty associated with a new administration, as opposed to policy ambiguity common during a looming election. Trend algorithms typically take more than a month to detect and confirm new trend leaders. When trends flounder and change every two or three months, the algorithm locks-on to the new leader just in time for its trend to end. It is in periods of longer trends that SectorSurfer's algorithms do their best, and we're in that zone now.

### Biotech - Be Thou Not Afraid

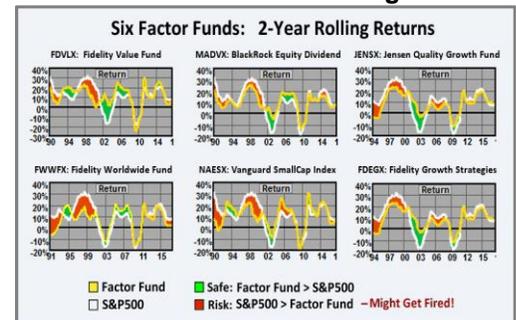
The IBB biotech sector chart (right) has a logarithmic vertical scale of 12% per vertical grid, showing that IBB recently dropped about 11%, resulting in some subscribers expressing concern that a sell signal has been long overdue. However, a common refrain in the book and on the website is that "*sharp drops often snap back*." (See [The Faster Response False Dilemma](#).) While not a certainty, the odds clearly favor a longer-averaging time constant so that the trend following algorithm can tolerate the undulations observed in IBB over the last year and allow its longer term trends to be successfully harvested. The undulating pattern during this period is not related to underlying value changes, but rather to the actions of traders. Although IBB has returned 18% YTD — about the same as the S&P500 market index — it lost 22% from its July 2015 high during which time the S&P500 gained 28%, leaving plenty of headroom for a strong rebound. Furthermore, considering that human genome science is still in its infancy, the pressure is certainly toward the upside for biotech. Be thou not afraid.

### Six Academic Strategy Factors

Academic researchers of investment strategies have identified six primary "factors" to experimentally examine: value, dividends, growth, size, quality and countries. The Six-Factor Rolling Return set of charts (right) illustrates the 2-Year Rolling Returns of each factor in comparison to that of the S&P500 market index. Mutual fund companies typically market funds



### Academic Six-Factor Rolling Return



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focused on these factors. It is notable that mutual funds from different companies focused on the same factor perform quite similarly to one another. Thus, for the purpose of the 2-Year Rolling Returns charts, a single mutual fund was selected to represent the performance typically achieved by mutual funds that focus on each of the six factors. The green areas show outperformance while the red areas show underperformance of the factor strategy relative to the S&P500. While there are some differences between them, none of these factor strategies appear particularly outstanding.

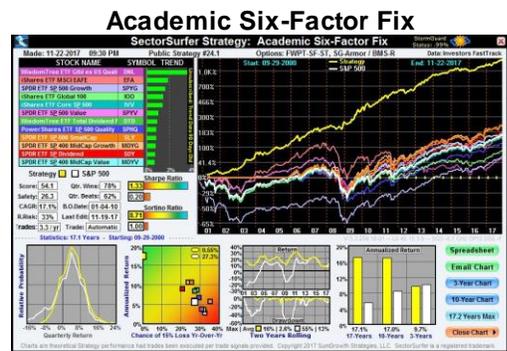
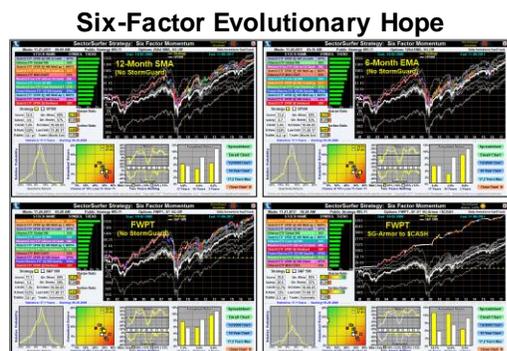
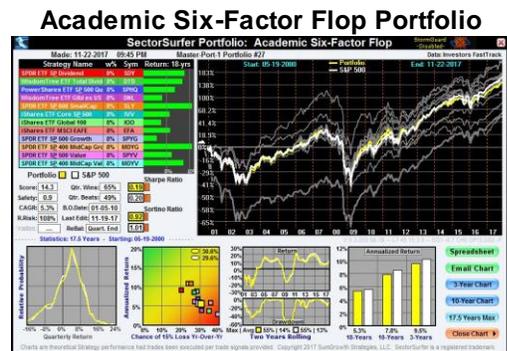
### The Academic Six-Factor Flop Portfolio

The equally weighted portfolio (above-right), consisting of a pair of ETFs representing each of the six factors, surprisingly reveals that professional fund managers executing scholarly factor analysis strategies have not been able to produce any meaningful performance advantage over the S&P500 market index. The portfolio equity curve (yellow) effectively lies under the S&P500 performance curve (white). Any advantage a particular factor strategy had for one period was apparently reversed during another period. What hope could an individual have of beating these professionals at their own game? Won't professionals squeeze out all of the value/dividend/growth opportunity before individuals can even detect its presence? Fifty years ago there was more lag in the system, making these opportunities not so quickly arbitrated away and thus more easily harvested. But today, computer-aided fund managers leave few scraps for anyone. These factors all have negative feedback characteristics and thus dissipate quickly as more participants attempt to harvest any mispriced market value.

### Six-Factor Evolutionary Fix

The set of charts (above-right) illustrate the evolutionary steps to the "Academic Six-Factor Fix" Strategy (right). The 12-Month SMA (Simple Moving Average) strategy with month-end trading and no market crash protection provides very little improvement, as is also the case for the 6-Month EMA (Exponential Moving Average) strategy with month-end trading and no market crash protection. However, the FWPT (SectorSurfer Forward-Walk Progressive Tuning) strategy with no market crash protection provides nearly 2%/year better returns — improving to 7%/year better returns when StormGuard-Armor with a money market exit during bear markets is provided. But by far the best solution is achieved by incorporating an integrated Bear Market Strategy, with an impressive 11.5%/year improvement over the S&P500.

The takeaway here is that strategies involving the six academic factors provide very little, if any, investment advantage today because their "negative feedback" character inherently makes them less valuable as more and more investors fight for the smallest of scraps. Conversely, momentum strategies have a "positive feedback" character that is self-reinforcing as more investors participate: A self-fulfilling prophesy. The "Academic Six-Factor Fix" strategy incorporates momentum on two levels: (a) momentum temporarily favoring one factor over another, and (b) momentum of the market overall (exiting during a bear market). This strategy can be found and imported by clicking the blue S icon on the My Strategies page.



Surf Well and Prosper,



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## Additional Resources

**Sector Surfer  
Live Forum**  
*By the Seattle SectorSurfers Meetup Group*



The SectorSurfer Live Forum provides Internet-streamed access to the Seattle SectorSurfers Momentum Investing Meetup Group so everyone can attend the presentations and discussions hosted by Chief SectorSurfer. [Click HERE](#)

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Users Group**  
*Join the Conversation*



The SectorSurfer Users Group is an online Google Groups Forum created by Joe Gruender of San Jose, CA to provide a platform for exchanging strategies, ideas and learning from the experience of other SectorSurfers. [Click HERE](#)

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*Professional Help - Change the Game*



Bryan Sullivan founded AlphaDroid Strategies to provide True Sector Rotation and StormGuard technology to financial advisors in a framework that helps them manage high performance portfolios for their clients. [Click HERE](#)