

## Perspective: Election Woes, Security, HoF Boot, Nose for VIX

Oct 05, 2014

Dear Scott,

### Are EWZ and EWH Reacting to Election Woes?

Brazilian funds, such as EWZ, were all looking quite strong at the end of August, as were Latin America funds FLATX, ILF and LBJ - also heavily weighted in Brazilian stocks. Then the sharp drop. (see chart)

"Why?" is the question. It's more than just a rhetorical question for me because I personally have Strategies that owned EWZ, LBJ, and FLATX during September. Furthermore, most SectorSurfer's know quite well how I preach calmly staying the course through short term market glitches, such as the one in July. (see [Sept. Newsletter](#))

My SectorSamurai Investment Club discussed this at length a few days ago. There were three main questions: (1) is there ever a sufficiently good reason to second guess the algorithm, (2) what was the root cause of the glitch and might it persist, and finally (3) should we lock in our loss and run for the hills, or should we grit our teeth and sell on a better day? (see also [Panic Selling on Bad News](#).)

I must confess that over the long and many years of SectorSurfer's development it took me roughly 10 years to stop second guessing the algorithm. I liked to believe that I knew something that the partially developed algorithm did not yet account for ... those improvements I had been contemplating. It turns out that even then the algorithm was more often right than my challenges were. These days, I just do it and go on with life - **except for this time?**

There are generally many contributing causes to market moves, but sometimes you get that perfect storm of events and bad things happen. When I started researching what was going on with Brazil, there seemed to be three main components: (a) economy sliding for three years after a long boom, (b) sensitivity to the rising dollar that hurts their commodity prices, and (c) their presidential election is on Sunday (today). Regarding component (b), the third chart shows the US Dollar index plotted alongside EWZ.

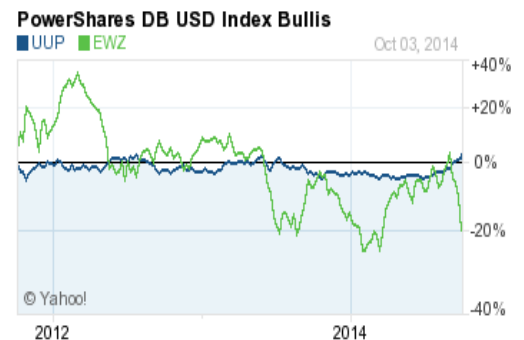
While (a) and (b) may be contributory, the sharp selloff seems best correlated to the current president moving ahead in the polls suddenly. Presumably the markets believe that reform won't happen if the current president is re-elected. But, since the markets were happy in August, Perhaps this is just a market hissy fit that will be over as soon as the voting is done? This is significant information that the SectorSurfer algorithm does not have. Thus the SectorSamurai Investment club decided not to lock in the loss of selling EWZ and LBJ in favor of waiting until Monday October 6th to review the matter.



6-Months S&P500 vs EWZ Brazil



6-Years S&P 500



3-Years EWZ vs US Dollar

## What about EWH - Hong Kong?

Last week democracy protests were triggered by China's decision that all candidates for Hong Kong's 2017 election of a new chief executive will be vetted by a government committee. Most of the city has now been shut down for days. This is not likely to be a short lived event. Unfortunately one of the country fund strategies selected EWH just as the protests started - something the algorithm obviously knew nothing about. Your knowledge of world events can at times be a sufficient reason to override the algorithm and select an alternative - perhaps the second runner up.



## Announcing Secure Surfing — Like Totally Dude!

As of late September, fully secured SectorSurfing is now an option. Although we neither ask for, nor store any credit card or brokerage account information on our site, security experts say that clever hackers can find ways to combine and infer information from multiple sources to hack into other accounts. That can't happen here anymore! Use the LogIn button at the top of the page to automatically use https security when you surf. To convert any shortcut links you may have substitute "https:" for "http:". Give it a try here: <https://www.SumGrowth.com>

## Tougher Rules for Hall of Fame BornOn Date — Many Strategies Booted!

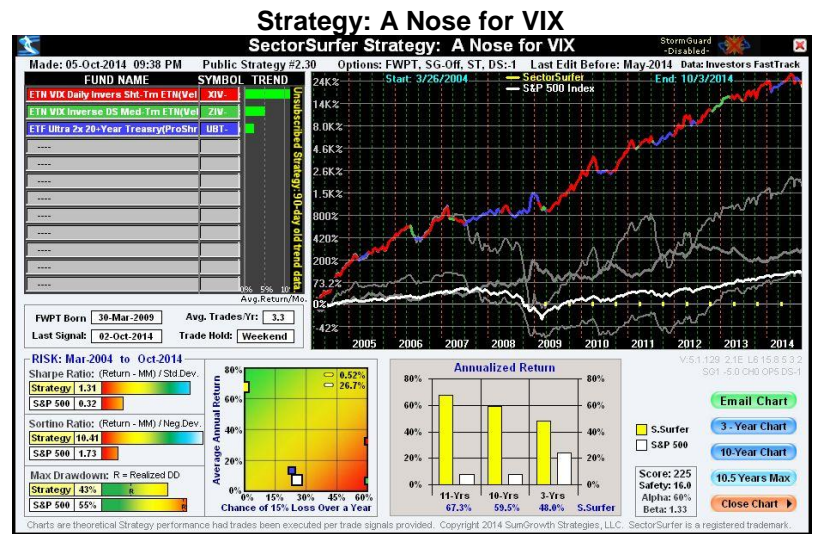
To improve the quality of Strategies listed on the Hall of Fame page, new listing rules have been enacted to prevent gaming the system to get a Strategy listed. A Strategy without FWPT enabled is now banned from listing unless its BornOn Date (same as Last Edit Date) is at least one year ago. A Strategy with FWPT enabled will not be listed unless its BornOn Date is at least four years ago.

We sincerely believe that forward-walk testing is of paramount importance to providing confidence that backtesting did not just find a lucky path between land mines, but that it instead found a stable characteristic of the candidate stocks/funds that more likely will continue to perform similarly into the future.

## A Nose For VIX?

This article is a continuation of last month's article about using ETFs based on the VIX volatility index. (see [Sept. Newsletter](#)) The "Managed Volatility" Strategy described in the the article last month has been improved and replaced by the "Nose for VIX" Strategy, shown to the right, which incorporates the leveraged long term treasury ETF UBT as a backstop.

Although the Nose for VIX Strategy may be commended for its simplicity, it is generally beneficial to provide additional diversity in fund selection options to SectorSurfer's algorithm should a future set of market circumstances not be so well matched to the simpler Strategy. The "Stuffed Nose for VIX" Strategy directly addresses this concern by further stuffing it with four leveraged sector ETFs and three leveraged market index ETFs. Okay, so I like clever names. But, you'll likely remember them. They are both available to be imported to your My Strategy page from the Select-a-Strategy popup window.



[Click To Enlarge Chart](#)

## It's a Drag Being Short.

You may have noticed that when both the long and short versions of an ETF are plotted on the same logarithmic chart that they aren't symmetrical. The short version always drags down over time. (see chart at right) The effect is particularly noticeable in the more highly leveraged and volatile ETs.

Without getting into the details of the derivation (a fun spare time exercise), one can show that the process of adjusting the daily gain/loss for the shorted version in the opposite direction as the long version results in a second order drag effect that is approximately the square of daily price standard deviation. For example, a 3X ultra fund with a 3.5% daily price standard deviation would have about a 27%/year drag. That's pretty close to the drag effect shown in the chart to the right.

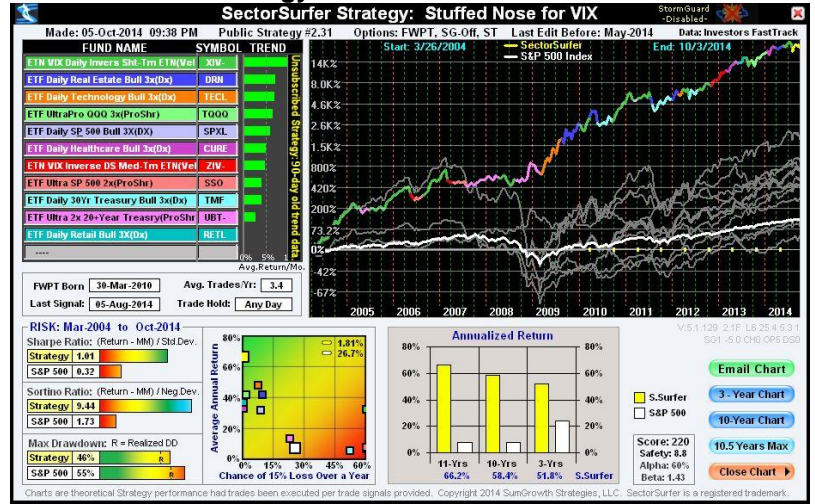
So, let's turn that frown upside down and harvest that drag. All we have to do is to short the ETFs, right? Unfortunately, none of the volatility ETFs are available for shorting. But the door isn't shut yet! There is a technique called the [synthetic short](#) that solves the problem.

## The Synthetic VIX Strategy

The synthetic short is a put/call spread that replicates the risk/reward dynamic of taking a short position in a stock or an ETF by combining a long put and a short call at the same strike price. This technique provides a method to synthetically sell a stock or an ETF short even if there are no shares available, so long as put and call options are available. That's no problem for ETF VIXY.

The "Synthetic VIX" Strategy (right) is built around the synthetically shorted ETF VIXY. To provide SectorSurfer's algorithm with plenty of other fund selection options, the Strategy also incorporates, two additional VIX ETFs, four ultra 3X sector ETFs, three ultra 3X market index ETFs, and a long-term treasury ETF. Click the chart and check out its performance statistics. The numbers do impress!

## Strategy: A Stuffed Nose for VIX

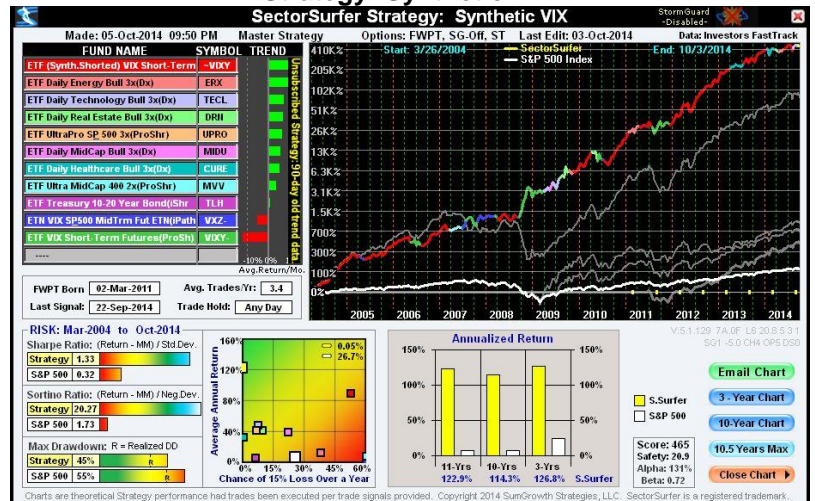


[Click To Enlarge Chart](#)

## Shorted Fund Daily Adjustment Drag



## Strategy: Synthetic VIX



[Click To Enlarge Chart](#)

The Synthetic VIX Strategy is configured as a Master Strategy, and can be imported from the Select-a-Strategy popup window. You may recall that unlike normal Strategies, a Master Strategy may not be edited as its configuration and maintenance is controlled by SumGrowth Strategies. This Strategy does have 3x Premium pricing — and I'm sure you'll agree it is more than worth it for almost any account size. We also hope its pricing makes everyone think three times about the implications of executing this Strategy before importing it.

Finally, please note that the special synthetically shorted ETF ticker symbol, ~VIXY, may only be used within a Master Strategy. I think some mean control freak made up that rule.

### **Volatility Web Page Coming Soon ...**

We are working on a Web page for the volatility material presented in these newsletters and plan to include background material about the VIX index, the VIX ETFs, extending data back to 2004, the Hurst exponent trend measure, how to do synthetic shorts, and what's behind the "drag". Hopefully we will get all of this done in the next few weeks. Until then, these newsletters will serve as the source of background information and documentation for these Strategies.

### **Speaking Engagement Calendar**

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

**Seminar Title: True Sector Rotation, and How to Own the Bubble: New Tools Simplify Everything.**

- **Denver, CO AAI Chapter - Monday Oct 20th 7:00 PM** - (local and web streamed)
- **Boulder, CO AAI Subgroup - Monday Oct 20th 1:00 PM**
- **Colorado Springs AAI Subgroup - Tuesday Oct 21st 7:00 PM**

Surf Well and Prosper,



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