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Perspective: StormGuard-Armor's Behavior Explained

Sept 18, 2019

Seeking A Deeper Understanding

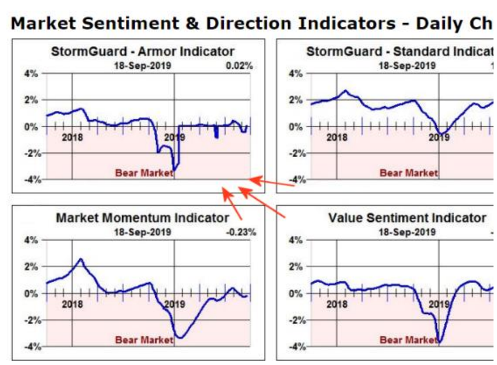
The recent behavior of StormGuard-Armor has left some wondering if it has somehow become broken. Without taking a close look, one might superficially jump to that conclusion ... how else could one explain its recent performance? In the paragraphs below, we will examine (1) the recent sequence of events, (2) performance over longer intervals, and (3) how prudent investment principles are easy to turn upside down.

S&P500 Index - 6 Months

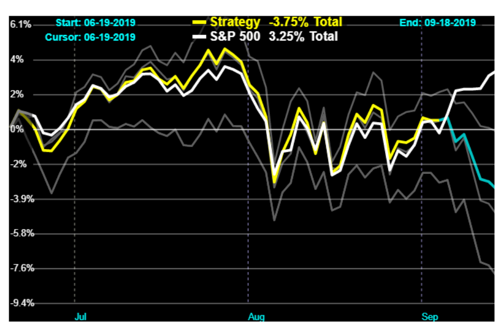
The Recent Sequence of Events

In the S&P500 chart (right), the sharp sell-off in May triggered SG-Armor. Unfortunately (for us), two days later the FED Chairman, Jerome Powell, effectively stated: "never mind about the China tariffs, I've got your back." The market instantly shot up. That is an example of a random "punctuated event." Sometimes they are beneficial (like this one), and sometimes they are not (like the tariff announcement in early May). We must endure punctuated events but can profit from trends that flow from them ... if they last long enough. Similarly, at the end of August, SG-Armor triggered as the Momentum (institutional volume) and Value Sentiment (new-high/low) signaled that traders were starting to seriously sit on the sidelines. However, just days later in September, investors got excited about a future trade negotiation meeting with China and about lower rates in Europe (suggesting the FED would be more likely to cut rates, as they did last Tuesday). Finally, the drone attacks on the Saudi oil fields last weekend did not have any significant impact on the market likely because of our own strong domestic supply and the belief that any retaliation by the Saudi

StormGuard-Armor



Merlyn vs. S&P500 - 3 Mos.



government would purposely not create further damage to the world's oil supply. As a result, during the past week, both the Momentum and Value Sentiment components of SG-Armor continued to rise strongly enough to trigger the SG-Armor reversal we saw Wednesday. While positive punctuated events are well appreciated, the timing of them was unfortunate.

Short-Term vs. Long-Term Perspective

In the series of four Merlyn vs. S&P500 charts (right), which span periods from 3 months to 15 years, one can draw a variety of conclusions depending on focus. Below is a set of rhetorical questions intended to help put things in proper perspective:

- Considering the first two charts, should different investment strategies be expected to track one another all the time?

- Considering the second chart, if the Strategy is toast because of Sept. 2019, was the S&P500 toast because of Q4-2018?

- Is it a prudent investment policy to switch back and forth between strategies based on quarterly reports received a brokerage?

- In the fourth chart, do the bumps at the end of the chart look any worse than other bumps throughout the 15-year time span?

- In view of all four charts, which of them helps us understand the character of the two investments methods, and which of them is most important when making a prudent investment decision between them.

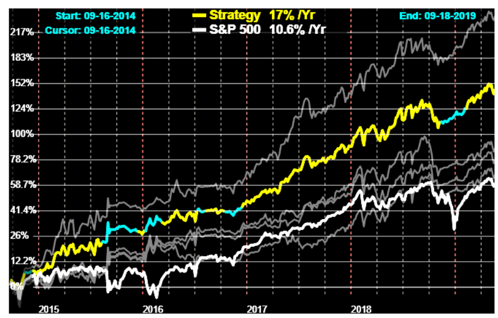
- The fourth chart suggests a significant difference in the risk associated with a large down-side market event. SG-Armor is designed to function much like a smoke alarm. When a smoke alarm has a false trigger (the house is not actually on fire), should the smoke alarm be removed?

Merlyn vs. S&P500 - 1 Year

(click to enlarge)

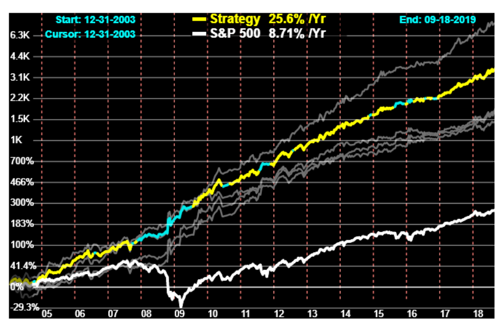
Merlyn vs. S&P500 - 5 Years

(click to enlarge)

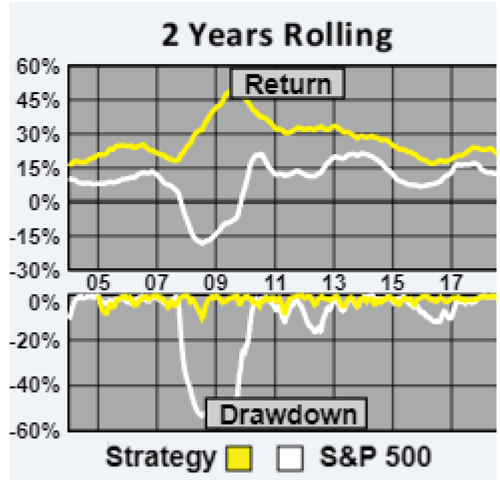


Merlyn vs. S&P500 - 15 Years

(click to enlarge)



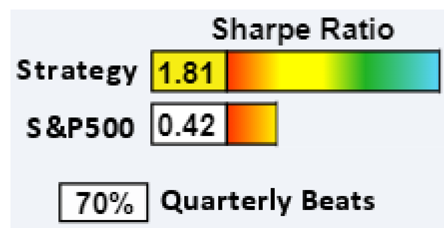
Rolling Return and Rolling Drawdown



When performance has dropped and it feels like something is broken, the 2-Year Rolling Return chart (below-right) helps put things into perspective. A review of the chart shows that there is nothing special about the recent period of time because Merlyn's return was equal or lower during three other prior periods. Similarly, the 2-Year Rolling Drawdown chart puts into perspective the character of the risk. While there are occasional -10% spikes, they are always relatively short-lived compared to the serious drawdowns of the S&P500.

Sharpe Ratio and Quarterly Beats

Other Relevant Statistics



The Sharpe Ratio (below-right) speaks for itself. It is the industry standard for measuring the risk-adjusted return. However, perhaps of higher current relevance is the Quarterly Beats measure shown on every basic AlphaDroid and SectorSurfer chart. It measures the percentage of time that the strategy performed better than the S&P500 on a quarterly basis. What is instructive is to note that a 70% beat ratio means that 30% of the time the S&P500 will beat Merlyn on a quarterly basis. Furthermore, the probability that Merlyn will get beat twice in a row is 9%. That means that the S&P 500 typically will beat Merlyn for two quarters in a row about once every three years. When that happens, it is normal – not the end of Merlyn. That said, it is also normal not to like this particular kind of normal occurrence.

I hope this was helpful.
SG-Armor will remain ever vigilant!

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