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Profit Possibilities in a Falling Market

By Ben Warwick
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Now that stocks are trading close to last September's lows, lots of investors have no doubt given up on profiting in the current market.

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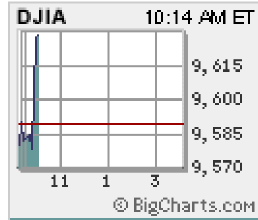
But I don't buy that view for a second. There are plenty of places to make money in this downturn (and no, I'm not just talking about small-cap value funds). And for one methodology in particular -- sector timing -- market conditions are exceptional.

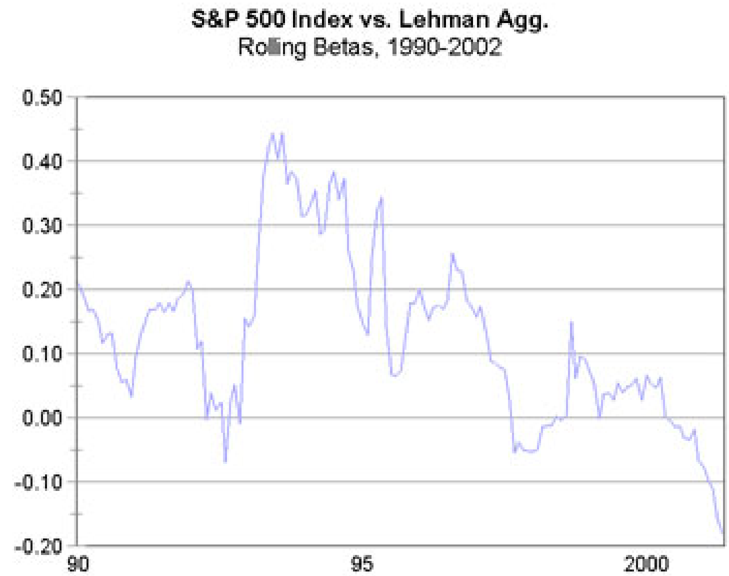
Widening Spreads

Market timers -- those that move between indices and cash on a tactical basis -- are as dependent on widening spreads as long-only managers are on bull markets. If the spread between stocks and bonds is large, timers have the potential for outsized profit as they switch between asset classes.

As the graph below shows, the 12-month rolling beta (which measures how closely two investments move together) has not been this negative for over a decade.



DJIA	9,628.17	
+0.40%	▲ +38.50	Click for chart
S&P	1,032.53	
+0.49%	▲ +5.00	Click for chart
Nasdaq	1,547.00	
+0.75%	▲ +11.52	Click for chart



Source: Sovereign Wealth Management

Why are uncorrelated stock and bond markets good for timers? If stock returns aren't up to snuff, for instance, a tactical shift to bonds can provide some much-needed return. But if yields start to fall, a quick reallocation to equities is in order.

This yin and yang started in March 2000 and is still happening. When the stock market roared ahead late last year, bond prices dropped until rates were so attractive that they stole the limelight from the equity markets. The same can be said for early March, when stocks gained ground mainly due to the low yield on corporate and government bonds. But equities took a digger a few weeks later when interest rates once again proved too tempting to desperate investors.

Sector Temptation

The puny equities markets are also rewarding so-called sector rotation strategies, which move in and out of various industry groups as market leadership changes from one group to the next. According to Roger Schreiner, a registered investment advisor that follows over 500 timers on his Web site (click here for a free test drive), sector rotators have enjoyed handsome returns in the last few months.

Schreiner prefers sector managers to classic timers -- those that move all their assets between stocks and cash -- mainly because of the diversification effect. "If a manager is holding a number of uncorrelated industry groups, there's a good chance that their long-term returns are going to be smoother than someone who is [always] either fully engaged in the market or on the sidelines."

There are two ways to play the sector game. A momentum-oriented timer would purchase the industry groups that show the most relative strength. This is the methodology used in the Rydex Sector Rotation Fund, an offering mentioned in a previous column.

The contrarian approach involves buying the weakest industry group. The difference between the two strategies is trading speed, with the contrarian style having a much shorter (i.e., a few days to a week) holding period than the momentum style, which often holds for two weeks to a month before rebalancing.

Schreiner believes that it's important to use both sector strategies in a portfolio.

"When one style leads, the other lags," he says. "It's difficult to predict which will do best, so we like to cover all the bases."

Ben Warwick is the chief investment officer of Sovereign Wealth Management, an investment firm that specializes in high-net-worth families and institutions. He is the author of five books, including Searching for Alpha: The Quest for Exceptional Investment Performance, and is a hedge fund industry consultant. At the time of publication, Warwick and Sovereign Wealth had no positions in the securities mentioned in this column, although holdings can change at any time. Under no circumstances does the information in this column represent a recommendation to buy or sell stocks. He appreciates your feedback and invites you to send it to Ben Warwick.

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