

# AOL MarketTalk Presents

William E. Donoghue

## On Proactive Sector Rotation Investing

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**Brian Stetten:** Hello everyone. Let's give a warm welcome to author and money manager William E. Donoghue. For more information, visit his Web site [www.bestsectors.com](http://www.bestsectors.com) or drop an e-mail to [funds@donoghue.com](mailto:funds@donoghue.com).

**William E. Donoghue:** I think American investors have painted themselves into a real corner, particularly those in 401(k)s. They've accepted some premises that just turned out to be not so good advice:

One is that "Buy and Hold" is a good investment strategy. Buy and hold turned out to be a "deer in the headlights", or "Honey I shrunk the portfolio" strategy, which is sad.

Two, they bought the premise "asset allocation" [don't put your eggs all in one basket, allocate your money around to several different assets and when something goes up something will go down.] is a good strategy and they diluted the returns they got under "buy and hold" by spreading the risk around to too many different types of investments, a lot of which were not appropriate as long-term investments.

Three, they relied upon professional mutual fund managers who didn't manage. In the 1990s, a decade-long bull market, 89.5 percent of professionally managed mutual funds were unable to beat the Standard & Poor's (S&P) 500. To beat the S&P 500, which has 500 stocks in it, all you really needed to do was get rid of a hundred dud [weak investments] stocks and then double up on a hundred winners. If you couldn't do that, you shouldn't be in the business. Nine out of 10 couldn't do that, and finally, traditional mutual funds made a really critical error, and that was putting tax-deferred money in the same portfolio with taxable money. That doesn't work. Those two types of investors do not have the same investment goals.

If you think about it, and you had 20/20 hindsight, two years ago as we turned into the new millennium, if you were a tax-deferred investor, someone with money in their Individual Retirement Account (IRA), you wanted the fund to take the profits they had made in the 1990s, lock them in, sell the securities, go to cash, and protect your money. [You don't pay taxes on your profits until you withdraw your assets after you retire.]

If you were a taxable investor, you didn't want that to happen because in year 2000 you'd have paid taxes on long-term capital gain distributions [in 2000 and 2001] as you watched your portfolio lose value. So the funds did neither. They took neither action. They didn't satisfy anybody, and both types of investors lost out because the funds took little action. That should never have happened.

So what you need to say is, "What have I learned and what was my investment goal?" There are really only two ways of expressing nearly every long-term investor's investment goal. One, you want to retire rich. Two, the way to do that is to invest in investments that go up in value.

So you have to think about it. I have three choices: (1) I can listen to an economist who will tell me what should go up in value; (2) I can listen to a mutual fund portfolio manager who will tell me what's in his portfolio that might go up in value; or (3) I can invest in those stock market sectors that are going up in value. The first two are "market timing" in advance and the third is following the trends that are actually in place.] Momentum in the marketplace is what's real. {Momentum is the way of describing what is going up in value the fastest.]

Now, we know that there's smart money in the stock market, and that smart money is probably making money. The evidence is that a lot of people are losing money, so somebody's got to be making it. Now what does smart money do? Smart money invests in undervalued stocks, and in the process drives up the price of those stocks. That's price momentum, and if you watch the prices of stocks sector by sector, you can see that momentum happening. You can't get at the short-term momentum, but you can pick up the intermediate term.

Now, a prudent investor knows that you need to be diversified, and this is the one thing that mutual funds do extremely well. So when about six years ago I began to realize that the traditional approaches to mutual fund investing, buy and hold, asset allocation, and market timing weren't working, I said, what I need to do is avoid the professionally, traditionally managed mutual funds, because they've got their own problems [economists and portfolio managers who focus on buying and not selling]. So I looked to how I could build a portfolio of the same kind of investments they're investing in and trade it and still be well-diversified.

At the time, Fidelity Investments was the only place I could go. They now have 42 single-industry sector funds, most of which are called Fidelity Select Portfolios. They also have some non-Select Portfolios single-industry funds like Fidelity Export, a number of single-country and single-economic-region international stock funds, and they have a wide selection of fixed-income funds, government, investment-grade, and junk bond funds -- long- and short-term. So I basically had all the tools I wanted within one fund family, and some, the sector funds that, for example, actually priced every hour.

This was exciting, and sector funds were the middle ground between individual securities and broadly diversified mutual funds. These were the sector funds. So, here were about 70 total choices and I said "Okay, let me track the price trends on each of them, compare a short-term period to a long-term period, and ask if this was going up faster in the short term than it did over the long term." This is called relative strength. "Is it stronger now than it used to be? Is performance accelerating?" Then I simply ranked them on accelerating performance, with the fastest-growing funds at the top and the fastest-losing funds at the bottom.

Out of these 70 funds, I invested in four funds at a time and held them as long as they stayed in the top 10. Over the next five years we outperformed, with all the fees, all but two Fidelity funds, and those two Fidelity funds that beat us... you wouldn't have wanted to ride that bumpy ride it took to beat us. As a matter of fact, in the process we've beaten 98 percent of all the mutual funds in existence over the last five years.

Now, about this time, along came a new type of fund, and that was Exchange Traded Funds (ETFs), and most of the money in ETFs are in what's called Barclay's iShares. Barclay's is one of the largest banks in the world; a nice, stable financial institution and their ETFs are the fastest growing stock market fund family in America. There are about 25 broad-index or sector-index funds just domestically, and then there are some internationally.

What was different about these funds was that they were, on average, three-fourths of a percent per year (actually 74 basis points) cheaper than the Fidelity funds. In other words, if Fidelity was charging an expense ratio of 2.74 percent a year, these funds were 2 percent, which was a whole lot cheaper, and there was no 3.0 percent one-time sales charge to get into an ETF. There were commissions, but these you could trade at Internet commission costs -- low cost.

The other thing that these Barclay iShares could do that the Fidelity funds couldn't do was trade like stocks. They didn't price every hour as do the Fidelity Select Portfolios, they priced every 15 seconds as do stocks. You could buy them in the morning and sell them in the afternoon if you wanted to. I wouldn't recommend it, but you could. You could buy them long, or you could sell them short. You can't sell a mutual fund short; you can sell an ETF short. When the stock market goes down in one specific sector, you can bet against it and make money by selling short.

Model returns on Donoghue's Long/Short Diversified Index Portfolio, using the Barclay's iShares over the last three years to 2-28-02 were 27.86 percent per year. Over the same period The Vanguard 500 Index Fund has lost 1.06 percent average annual return. So there are ways to make money in both rising and falling markets. We were managing a portfolio, including eight different ETFs at all times, which probably had more stocks in it than Magellan did.

**Brian Stetten:** What would be your advice to the retail investor with a buy and hold attitude, who is down 60 percent in two years?

**William E. Donoghue:** If the money's in your 401(k), this is the only time in your lifetime you will ever have an opportunity to write off 100 percent of your losses. If you remember, you haven't paid taxes yet on the money in your 401(k). If you've been "fortunate" enough to be laid off or terminated, you can roll that 401(k) into a rollover Individual Retirement Account (IRA) income tax-free. You can then convert the rollover IRA to a Roth IRA and in five years pay zero taxes on the profits. So maybe it's time to take the losses; the losses will not come back to where you lost them. I guarantee it. So I would recommend investing proactively rather than buy and hold.

**Brian Stetten:** How much principal can one lose via the taxation of their pretax money due to a rollover to Roth IRA?

**William E. Donoghue:** This is probably the lowest balance you'll ever have in your IRA and, therefore, if you pay taxes on it now, it's the lowest tax bill on that money you'll ever have. You cannot escape the tax bill, but you can keep it as small as it's ever going to be and never pay taxes on future profits. You owe the money, pay it, be patriotic and fund the war on terrorism, and make sure it's a world you want to live in, and pay the lowest bill you'll ever have. It will cost you more if you wait.

**Brian Stetten:** How can one invest with confidence, given the accounting process revealed and the labile psychology of the herd of investors?

**William E. Donoghue:** By following the trends of the prices of the market, which is the only way you ever make money in the market anyway. You're always working with imperfect information, and as a former Certified Public Accountant (CPA), I can guarantee you as accurate as the information may be about any firm's financial condition or profits, it has little to do with the price of the stock. A rumor on CNBC can move the price of the stock more than any financial statement ever issued.

**Brian Stetten:** Do you have any idea how many mutual funds "hedge" against the stock they buy?

**William E. Donoghue:** Among the actually 99.5 percent of mutual funds that we have outperformed, I'm not sure I care, to be honest with you. Those who have done it have not done it very successfully. Don't confuse hedge funds with funds that hedge; those are two entirely different concepts.

**Brian Stetten:** Which Fidelity Selects do you see as good investments today, and for how long?

**William E. Donoghue:** Actually, ironically, we've been doing quite well investing in Southeast Asia. Basically, Southeast Asia, Japan, Emerging markets, and the Pacific Basin have been some of our more attractive ones, which surprises me. I haven't seen that in a long time, but when our interest rates come down, their interest rates have to come down, because they're tied to our dollar. Chairman Greenspan seems to be having a lot of trouble jump-starting our economy after 11 cuts to jump-start. He really thinks he's in charge. Unfortunately, he's not.

**Brian Stetten:** The Vanguard Morgan Fund (VMRGX) is what I have been investing in for the kids' college education over the past 10 to 15 years. Some are in college now and some will be in college in seven to nine years. The other two funds are T. Rowe Price for my retirement. The funds are the Media & Telecommunications (PRMTX) and the Science and Technology Fund (PRSCX).

**William E. Donoghue:** I wouldn't recommend investing long term in any sector fund because they tend to be volatile, and the problem with T. Rowe Price is they don't have enough sector funds to give you a broad enough range of choice. It's sort of like buying company stock, and you're putting all your eggs in very few baskets. On the other hand, having a portfolio of eight different sector or index funds that is actively traded based on momentum is sort of what you thought any one fund was going to do for you. When you're getting that close to a kid going to college, you don't want to take those kinds of risks. You only want to take risks that pay off.

To give you an indication of risks that payoff, the Sharpe ratio, which is a measure of return per unit of risk, is basically the return divided by the standard deviation on our long/short index fund portfolio, which is .66 over the last three years. Magellan, which is supposed to be managed well has -.33. Only one of the top 10 largest mutual funds, load or no load, in America has a positive Sharpe ratio.

**Brian Stetten:** Would you help me understand, as an average investor, how to reconcile both buy and hold and never buy and hold advice from seemingly well meaning astute professionals; and if one announcement on CNBC can wipe out a lifetime of investments, why would I be in the market?

**William E. Donoghue:** Obviously, it's prudent to start off with any portfolio being widely diversified. That means being in mutual funds that invest in many stocks. I think the fact that you're on the Internet right now gives you some idea of how quickly information flows. That is what has changed in the marketplace. So much information is available to so many people, so quickly, and that is discounted into the price of a security so quickly that it makes long-term buy

and hold kind of foolish. You could make or lose all the gains or losses you're going to have in the next three years in the next three days, and then what do you do? You move on to the next investment, and if somebody thinks that I'm recommending speculating or trading based on some inside knowledge, or trading really actively, I'm not. We average about 15 trades a year on eight positions. So that's only a turnover of about 200 percent. That's not a lot.

We lose money on about 60 percent of our trades, roughly about 7 percent average. We make about 30 percent on the other 30 percent of our trades. That's just our experience over the last three years, but that's enough to beat nearly every mutual fund in America, and we're trying to be completely objective. [We let the market's momentum time us or make the buy and sell decisions for us. Making guesses is not objective.]

Our strategies would work just as well if we took the names off of the funds. We believe growth is a verb, not an adjective. We're trying to get verbs to make money rather than to collect adjectives: growth, value, etc. It's confusing to people because they've been told that buy and hold is prudent, but you have to say, Who told you that? Mutual funds who get paid for assets under management? Perhaps. Who told you to do asset allocation? Mutual funds who knew that if you did that, you'd be spread over so many investments you wouldn't pay attention to any of them? Possibly.

I should point out here that I've been an independent expert on mutual funds for 38 years; I've been an expert witness in court cases on mutual funds; I've audited mutual funds with Price Waterhouse; I have been managing money since 1986, advising investors since 1973, and I've tried to step back and objectively look at what was going on, what was working, and what was not working. I just can't see how investing in things that are going up in value is an investment style that will go out of style. It's the only thing that's real.

**Brian Stetten:** What is your recommendation for asset allocation at the moment, taking into account that the U.S. economy is climbing out of a recession?

**William E. Donoghue:** I would be prudent, but I would be assertive. I would simply look to a more proactive stance, because as we come out of a recession, uncertainty goes up and greed rekindles itself. I'm afraid a lot of people have lost so much money the last two years that they're going to take unnecessary risk. They will likely take too much risk, too soon. Or they're going to do nothing, which simply means they risk their retirement lifestyle by not participating confidently in the rally.

The middle ground is simply to have eight different positions and to have that diversification while letting your winnings run and cutting your losses quickly. Forget about the difference between long-term and short-term capital gains. With the Internet around, there is hardly a long term left for investing. Investing for the long term is different from long-term investing. Investing for the long term is simply to invest in a series of short terms and try to make money on more trades than those on which you lose. Long-term investing is putting all your eggs in one basket and hoping you don't get scrambled eggs. That's risky

**Brian Stetten:** Can I roll a Simplified Employee Pension Plan (SEP) into a Roth IRA?

**William E. Donoghue:** You can roll any kind of IRA into a Roth IRA. You have to qualify to do so; you have to earn less than \$100,000 in the year you do the conversion. For most people, in a year you've been laid off, that's an easy thing to do. Suppose you earn less than \$100,000 this year, but you have \$5 million in your IRA. You can convert it all. If you qualify, you can roll over as much as you want to. If you wait and the market comes back and your investment goes up, you're going to pay taxes on a higher balance. Now there's a tax liability that you haven't paid taxes on -- what's in your IRA, and you owe that. You have to pay it. Now, the problem is how do you pay it?

Well, the money is in your IRA, you can only convert an IRA to a Roth IRA, you can't convert a 401(k) to a Roth IRA. If you use the money in your IRA, you're going to have to use the cash to reinvest in a Roth IRA on an after-tax basis. If you're under 59 1/2, you'll have to pay a 10 percent tax penalty unless you're over 55 and have been terminated. In doing so, you're giving up that reserve space in what could be a potentially 100 percent tax free Roth IRA.

So the best thing to do is to use money outside of your IRA to pay the taxes and leave the money in your IRA that you're converting to a Roth IRA. If you have that money, it's the effect of transferring it from a taxable account to a tax-free account. By paying the taxes, it's effectively of taking money out of your taxable account, paying the taxes, which leaves the money in your tax-free account after five years, of course. If you're more aggressive and liquid, and this isn't all your money, there's another alternative. It seems to me it makes sense for people to refinance their mortgage at historically low mortgage rates on which the interest is 100 percent tax deductible, and do that to pay the taxes, which then go into a 100 percent income tax-free investment at the bottom of a stock market cycle. If that's appropriate for you, then that's a sound investment strategy. A lot of people would rather pay off their mortgages, and if that's what they want to do it's fine. That was really good advice when mortgage rates were high, but not when they're low.

**Brian Stetten:** Do you see a recovery in the utility sector soon?

**William E. Donoghue:** Who knows, and that's only one sector. Right now Fidelity Select Energy Services is our number one pick, so it's already happening at Fidelity. I've got to admit that in our long/short portfolio, where we're using the Barclay's iShares, we did lose about 5 percent of our energy position when Enron went belly-up, so we lost 5 percent of one-eighth of our portfolio. We lose that much when the market hiccups. That's the power of diversification.

**Brian Stetten:** Is it necessary to convert to a Roth, or can you have both a Roth and traditional IRA?

**William E. Donoghue:** If you can afford to pay the taxes to convert to a Roth IRA, why would you want an IRA? When you withdraw your money from an IRA, it will be taxed as if it were ordinary income. When you withdraw money from a Roth IRA, it will not be taxed. Zero taxes are better than high taxes. The name of the game in investing is to have the most money to spend during your retirement years, not to pay the government the most money.

**Brian Stetten:** It seems that you have a sincere strategy. Can it be reduced to a computer program to do it automatically for you, given that you cannot watch everything all the time every nanosecond?

**William E. Donoghue:** We manage portfolios of mutual funds for clients, and in this particular case, the most appropriate place would be at Charles Schwab (SCH). We have the most appropriate transaction pricing there, and I would not recommend people put new money in Fidelity. The Fidelity funds are simply too expensive and too restrictive. At Schwab you can invest in the Barclay iShares, and you have an opportunity to make money in a declining market, which you do not have in Fidelity funds or economically through Fidelity Brokerage.

We've been able to get very advantageous pricing for all the trades at Charles Schwab, so basically we manage portfolios of mutual funds at Charles Schwab; our minimum is \$50,000 and we charge 2.5 percent a year on \$50,000 and 1.95 percent on \$100,000. Given the choice of losing 1.06 percent a year the last three years at Vanguard, which is cheap for paying us, and over the last three years earning 28.86 percent annual gross return (before our fees), I think we deliver value.

**Brian Stetten:** Why do you favor variable universal life insurance?

**William E. Donoghue:** Very simple. Let's look at the problem Americans have saving for retirement. It comes down to the equation  $I=PRT$ , interest equals principal times rate of return times time. There is no other investment equation.

Short of a windfall or refinancing your mortgage, there's no way to increase their principal. You cannot extend the time they have to work productively to save for retirement. Most people aren't being allowed to work to age 65; they're losing their jobs earlier than that with this recession. You can't shorten the time, the longevity, that you will "enjoy" after they retire. If they make it to age 65, the odds are nine out of ten that they will live to see age 90. That's a longer retirement period than they planned on saving for, so all you've got to work on is the rate of return. Rate of return has two components; one is the investment strategy we've been discussing [to earn a potentially higher return], with the potential of earning higher returns by being more objective about their investment choices. The other part of the "R" factor is the taxes they will have to pay on their profits.

Now, there are two ways to literally stop paying income taxes on all your future investment profits. One of them, if you can qualify, and have a substantial amount of money in your IRAs [including what you rolled over 100% income tax-free from your 401(k) plan when you retire, are terminated or change employers], is to convert the IRA to a Roth IRA. If you can qualify, you earn less than \$100,000 in the year you convert (that's on a joint return; you cannot qualify by filing a separate return), The government invites you to join a program where you will never pay income taxes on these retirement savings or profits again.

If you can't qualify or you have a lot of additional money in, say, taxable accounts, and 60 percent of the money that's in mutual funds is in taxable accounts, you can invest in a financial institution that allows you to earn 100 percent income tax deferred profits, investing in mutual-fund-like accounts. That is a variable universal life insurance policy. It's the only financial institution where you can invest in the cash value, have 100 percent of your profits tax-deferred, and if you choose not to *withdraw* your profits in retirement (because then they're taxed as ordinary income), but you choose to *borrow* your profits from the policy at interest rates as low as zero, you pay no taxes. [Withdrawals of profits are taxable as ordinary income and loans, even at rates as low as zero percent, are 100% income tax-free. There are risks associated with the loans if you withdraw too much from the policy and trigger a serious tax problem. At little attention to detail can avoid that risk for most investors.]

There is no tax on a loan, and if you die young, your family's financial independence is protected, because they will receive a 100 percent income tax free death benefit. There may be estate taxes, but not income taxes. One hundred percent income tax free and it will be much greater than what is in your account [your heirs will receive the death benefit which is much greater than your cash balance.] unlike your IRA where the amount could be as little as 30 cents on a dollar (after income and estate taxes).

If you live long, you have the ability to withdraw your principal income tax-free even before age 59 1/2 and borrow your profits out income tax-free after 59 1/2. If you die slowly [in a long-term care facility], which is the really expensive way to die, there are variable life policies where you can add a long-term care rider where your death benefit can be used to pay for your long-term care while your family still has access to your cash value for their daily needs

It takes care of it all. No brokerage account, no mutual fund account, no discount brokerage account, and no bank account can do that. Those institutions don't perform that role; only a life insurance contract does. So that's why I like variable universal life insurance, and it cannot ever cost as much as the taxes you would have made on the profits.

**Brian Stetten:** Thank you Mr. Donoghue. If you would like more information on Mr. Donoghue's program, drop an email to [guru@donoghue.com](mailto:guru@donoghue.com) or visit his Web site at [www.bestsectors.com](http://www.bestsectors.com).

**William E. Donoghue:** I think that people who are looking for how to dig themselves out of this hole, this "Honey, I shrunk the portfolio" hole, have to look at what works and what doesn't work. "Buy and hold" did not work. It exposed investors to a lot of risk and some people lost 20, 30, 40, or 60 percent of their retirement savings at the end of their earnings years. Asset allocation, not putting all your eggs in one basket, simply resulted in owning more partially empty baskets. The management you expected from mutual funds was never anything they promised. A value fund was never going to invest in growth stocks if they were better investments, and they would only invest in value and never go to cash. They will never invest in anything that's a better investment than the stocks what they promised in, that's not what they do. The Securities and Exchange Commission's (SEC's) fantasy that you can read the perspective and understand it is just a bit of wishful fantasy; it's difficult to read and understand them. So really proactive investing is a more prudent way of investing.

By using the more appropriate investment tools, the newer ones like ETFs, you can maintain a diversified portfolio that changes with the times of indexes or no one's judgment is getting involved with this portfolio; those who have shown judgment have shown they couldn't beat the averages. I think that's a prudent way to invest.

We have done this for six years. For the last three- and five-year periods through the end of the year, Nelson's Information Rating Services, part of the Thomson Financial Group, has rated us in the top five of the "World's Best Money Managers," with real money under management and one real arm tied behind my back trying to do business with Fidelity, it is ironically my third-best portfolio. We have found some innovative common-sense investment strategies that make sense, and we've demonstrated that they work with actual money; we've got about \$75 million under management. I'm told we're one of the five largest sector fund rotation managers in America, and I think probably alone among them we have recognized the potential of a Roth IRA conversions and variable universal life insurance -- although we are not life insurance agents, we just manage money within insurance policies. I think we've come up with a way that America can retire with dignity.

I'm just finishing up a book titled 'How to Turn Your Layoff or Early Retirement Into a Financial Windfall.' I honestly think that as many people look for their next job, they can probably add more to their family's wealth in the next year or two, focusing on restructuring their portfolio so they pay no taxes and learning how to proactively invest their money more objectively than they can working. I think that can do wonders for your self-esteem as you look for another job. So life goes on and it changes, and I just want to see people retire with dignity. On the other hand, I'm having so much fun that I'm never going to retire.