

New Strategy Offers an Alternative to Fear and Loathing of Volatile Equity Markets

A departure from conventional wisdom, “active exposure management” acts on market signals in a bid to limit downturn risks

by Jeffrey P. Cusack, President, Forward Management

Many investors today find themselves in the grip of a classic approach—avoidance conflict. They can see any number of days when they don't want to miss out on equity market gains...but then there are those other days that make them want to run for the hills. Recent events such as the Greek debt crisis and the startling May “flash crash” have only dramatized the steady rise in market volatility over recent years.

Of course, it's an investment truism that no one can consistently time the market. So what's a prudent investor to do?

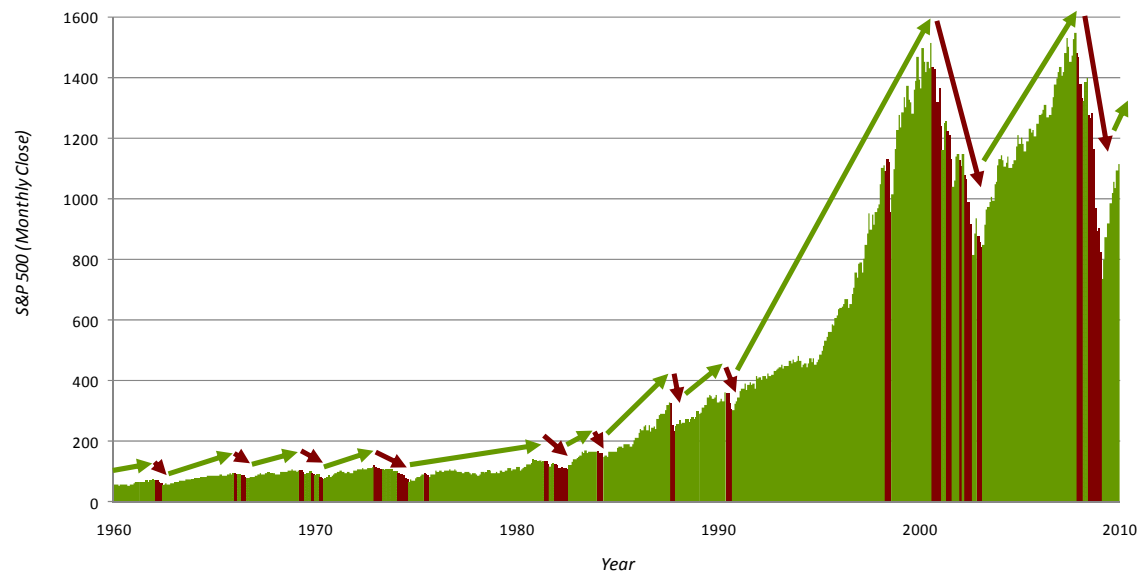
Traditional, supposedly “conservative” thinking holds that you should stay fully invested, diversify and ride the market rollercoaster, figuring that long-term market gains will put your portfolio ahead in the long run. But if we've learned anything from the last two years, it should be to question conventional wisdom.

While the traditional approach may have worked well in the upward-trending markets of the 1980s and '90s, one is hard-pressed to say that it's working now. The first ten years of the millennium proved to be a “lost decade” for equity investors, as the S&P 500 slumped more than 23% between January 2000 and December 2009. That gives investors one more reason not to flee equity markets now; no one can hope to make up lost ground by sitting on the sidelines.

Instead, investors who want to avoid absolute losses might be well advised to step back, take a deep breath, and rethink some of the fundamentals of portfolio construction. For some time now, academic researchers have been telling us that a greater share of investment return derives from asset allocation than from security selection. From these findings grew the formulaic, “set-it-and-forget-it” approach to asset allocation that is now so engrained in the industry, it is rarely even questioned.

Sure, advisors and investors typically do rebalance asset allocation periodically. Some may even label that “active asset allocation” if they do it frequently or in response to market shifts. But with today's dizzying volatility levels and relatively high asset class correlations, occasional adjustments to a fully-invested, long-only portfolio may not be enough to protect investors from sudden market downdrafts. While it's true that historically, positive movements have slightly outnumbered negative ones, major downturns such as those in 1987, 2000 and 2008, generally have been more sudden and violent than the upturns.

Frequency and Severity of Market Downturns



Source: Standard & Poor's, Forward Management, LLC

In uncertain times like these, investors may want to consider a fresh approach—one we call *active exposure management*. By this we mean continuous tuning of equity market exposure based on market conditions. The idea is not only to sidestep market downturns, but also to capitalize on both negative and positive market movements.

A strategy of this kind requires portfolio managers to be nimble and highly flexible, ideally operating with no constraints on cash. They must always be poised to turn on a dime, increasing equity exposure when risks appear low and going to cash or shorting when risks of a significant downturn are deemed relatively high.

To pull off this approach, investment teams also need the tools for early detection and proper reading of market signals. A crucial point is that active exposure management entails following market trends—not attempting to predict them. That's what distinguishes it from market timing.

At Forward Management, our investment team for this strategy (which we call Forward Tactical Growth) conducts both qualitative and quantitative analysis to assess the market's direction. The process starts with fundamental analysis of macroeconomic factors, including market valuation, monetary policy, market liquidity and investor sentiment (from a contrarian perspective). From this, the team derives indicators of shifting and emerging market trends.

To validate and assess the strength of perceived trends, the team then employs a proprietary Volume/Breadth Momentum Model designed to capture real-time market momentum. Based on whether the outlook is bullish, bearish or neutral, the team incrementally adjusts market exposure, seeking to eliminate stock-specific risks by investing through highly liquid sector ETFs and inverse ETFs.

In this way the team aims to capture 85%-90% of the market's upside while sidestepping all but 10%-15% of the downturns. In terms of what this strategy brings to portfolios, investors can think of it in several ways: as a new kind of core investment, or as a risk cushion, or as an alpha-seeking approach residing alongside more exotic alternative strategies.

No matter how you categorize it, a strategy of active exposure management provides some new thinking on how to invest with greater confidence through times of market volatility and upheaval.

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