

FUNDS AND ETFS  
**ETFs are for trading too**

**Don't just buy and hold, says ETF Capital Management's chief investment officer Larry Berman**



By Larry MacDonald  
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Exchange-traded funds (ETFs) are not just for buy-and-hold investors looking for the cheapest way to tie portfolio returns to financial markets. They can also be put to work trading market cycles and implementing hedge-fund techniques, as chief investment officer Larry Berman shows at Toronto-based ETF Capital Management.

Mr. Berman comes by his active approach naturally. Prior to co-founding ETF Capital Management in 2007, he was the chief technical strategist at CIBC World Markets. And before joining them in 1997, he had been a technical analyst at other investment dealers for eight years.

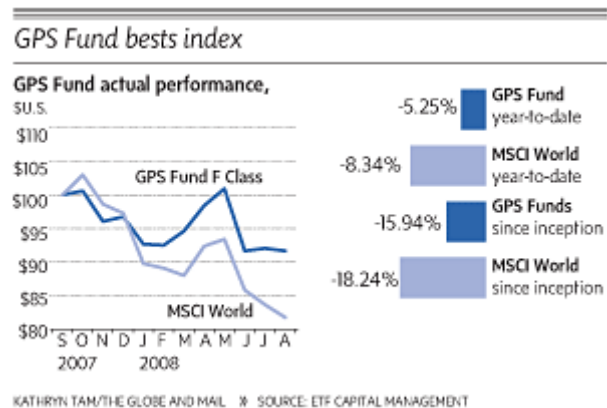
Mr. Berman's Probability Indicator Convergence (PIC) system raises exposure to ETFs that have extensively sold off relative to trend and other ETFs. It also decreases exposure to ETFs that are extensively overbought relative to trend and other ETFs. Investors will earn profits as the ETFs revert back to their trends and historical relationships with other ETFs.

ETF Capital Management's website, <http://www.etfcm.com/>, has more detail on how the trades are done through a top-down, global macro analysis and a bottom-up analysis of support/resistance lines, market breadth, relative-strength indicators, and so on. For portfolios designed for individual clients, the trading will take place within asset allocation models tailored to their risk preferences.

The portfolios managed for clients comprise about 20 ETFs and use a "core plus" approach. Under this, broad-based ETFs track market returns within asset classes (equities, bonds, currencies, and commodities) and important sectors (e.g. U.S., Canada, emerging, and Europe/Asia markets for equities).

Then, an overlay of "alpha" ETFs is added to the core ETFs. These are the sector-based ETFs most likely to add outperformance, according the screens used in the PIC system.

Examples of how Mr. Berman trades ETFs are provided in his popular television show, Berman's Call, appearing every Monday at 11:30 a.m. on BNN (segments are archived on his company's and BNN's website). In his June 9 appearance, for example, he discussed a trade that not only illustrates going short an overbought sector but also a hedge-fund technique (pairs trading) for capturing positive returns regardless of market direction.



The trade sought to make money off the fact that crude-oil prices had soared while price gains for energy stocks had increasingly lagged the rise. A graph of the commodity-tracking United States Oil Fund ETF (USO) against the stock-tracking Energy Sector SPDR (XLE) showed just how wide the divergence had become by early June.

Therefore, one could short crude-oil prices and go long energy stocks on the expectation the relationship between prices for crude oil and energy stocks would converge to the norm. To implement the trade, Mr. Berman advised shorting crude-oil prices with the double-short Horizons BetaPro Nymex Crude Oil Bear Plus ETF (HOD) and going long U.S. energy stocks with the double-long Proshares Ultra Oil & Gas ETF (DIG).

Some idea of how well the PIC system is performing is provided by the GPS Fund offered by ETF Capital Management to accredited investors. A chart on the company's website shows a loss of about 8 per cent for the fund from October of 2007 to August of 2008, compared to a loss of about 18 per cent in the benchmark MSCI World Index.

So what does Mr. Berman think of current events in financial markets and where some investing opportunities might be surfacing? Here is an excerpt from a Q&A session with him.

### **Q&A with Larry Berman**

*Q: What's your top-down, global macro analysis telling you these days?*

A: The markets are in the process of making a cyclical trough. We expect this will take place over the next few months. Once the problems in the U.S. housing sector are cleaned up, we expect to see a global recovery in 2009 and the markets can rally 20 per cent to 25 per cent from their recent lows. I do think we are in for a few years of challenging economic headwinds where equity returns will likely be below their longer-term averages. With ETFs, we can avoid underperforming sectors and enhance investor returns with active asset allocation in these challenging times.

*Q: Can you describe some recent trades in the GPS Fund and customer accounts?*

A: We have been cautious for clients in the past few months. While we are sensing we are closer to a bottom, we still have 15-35 per cent in cash depending on the risk profile of the clients.

We have been adding exposure to financials since the July lows. We have a very low exposure to the consumer and we have been short crude oil since it hit \$147 (U.S.) a barrel to offset our exposure to energy equities. We also like small caps in the early phase of a market recovery.

*Q: What are some ETFs you are currently using to add alpha to core positions?*

A: We like the water infrastructure play and are using PowerShares Water Resources Fund (PHO-N). We also like natural gas, and have just established a small long position using Horizons BetaPro Nymex Natural Gas Bull Plus ETF (HNU-N).

*Q: Which asset classes do you favour now?*

A: We have been net short commodities, but are looking to add some exposure into this weakness. Gold below \$750 (U.S.) per ounce and natural gas around \$7 (U.S.) per million British thermal units are attractive. We focus a lot on equities and global asset allocation, we think the U.S. market will lead the global recovery and want to be overweight relative to European/Asian markets.

*Q: Any thoughts on the financial crisis? Would the financial ETFs be close to tradable rallies according to your bottom-up indicators?*

A: These are ‘five-standard-deviation events’ so most technical/quantitative models do not work that well. Once American International Group, Inc., Wachovia Corp., Washington Mutual Inc. etc. get cleaned up, we should have a good rally in financials.

We now have about 10-per-cent exposure to emerging markets and will build that as a recovery develops. The corrections in emerging markets have been exceptionally deep. We have also increased our exposure to Canada after the massive sell-off.

We are bearish on fixed-income. Bond yields are likely to rise over the next year, but not significantly until there is clear evidence the economy is recovering. We don’t expect much growth until the second quarter of 2009 at the earliest. For our defensive portfolios that are more yield based, we like the REIT sector. Yields are high and prices have declined significantly. We are holding money market instruments for most fixed-income exposure at this point.

*Q: Any thoughts on the financial crisis? Would the financial ETFs be close to tradable rallies according to your bottom-up indicators?*

A: While government intervention is never the preferred solution in free markets, at this point the financial stress has become systemic in the credit markets and the only one with a deep enough balance sheet to fix it is the government. We expect governments to pass legislation that will help mitigate the downside to the economy and Main Street, but we are basically in a recession for the next few quarters. While we do expect tradable rallies in financials to develop off these oversold levels, equity returns in the next few years will likely be lower than longer-term averages. Investors need to have active management to enhance returns and mitigate losses in these difficult times. Most investors today, even with 20-plus years of experience have never witnessed this type of market stress.

*Special to The Globe and Mail*