GREEN ZONE STOCKS

October 25, 2019

We've Got the Whole World in Our Hands

By Adam O'Dell, Editor

Let's say you have no clue where we are in "the business cycle." How would you invest?

It's a tough question. Most people assume you *must* – or at least *should* – know where we are in the business cycle before answering the question or choosing investments.

With knowledge of where we are – even if only "closer to a top than a bottom," or vice versa – a wise investor should be able to home in on the specific sectors of the economy that tend to do best during that particular stage of the business cycle.

For instance, in business school they taught me...

- In strong bull markets, the industrials, materials, and energy sectors typically outperform.
- After the stock market peaks, consumer staples, utilities, and the healthcare sectors tend to hold up the best.
- Once the market has bottomed, it's typically the technology, financials, and consumer discretionary sectors that lead the recovery.

This is textbook "sector rotation" along the business cycle.

It makes a lot of sense intuitively. But studies (like the *Sector Rotation Across the Business Cycle*, published in 2009) have shown that even if you had a crystal ball, affording you perfect foreknowledge of when the business cycle will peak or bottom ahead, this old-school "textbook" sector rotation strategy will *not* make you rich. I've known this since 2011, when I developed a

IN THIS ISSUE

sector-rotation alternative to the business cycle approach, *Cycle 9 Alert*.

Good in Theory, But…

As I see it, there are two problems with the business-cycle approach to sector rotation. For one, it takes far too long for one complete business cycle to play out. That means that if you happen to make even a small miscalculation about where you are in the business cycle, or which sector is best-positioned for outperformance, you'll find yourself committing way too much capital, for way too long… before you'll find out if you're "right" (and rich) or "wrong" (and penniless).

The other problem with trying to play sector rotation on the business cycle level has to do with the amount of intervention and what some would call "manipulation" – from the Federal Reserve… the big banks… the President.

The point is… if you're at least a little suspicious that the global economy's natural business cycle is partially affected by *artificial* forces… well, then you're in the exact same camp as me! These are the reasons I don't even try to time to exact tops and bottoms of full business cycles.

But that doesn't mean the principle of sector rotation is worthless. It just needs to be adapted to today's fast-paced economy… and to the realities of today's global, 24/7 financial markets.

That's where my shorter-term, adaptive approach comes into play. I developed my sector-rotation approach to put you in the right place, at the right time – just as the business cycle strategy aims to do. The biggest difference is… instead of trying to play a full business cycle, my strategy is geared toward identifying outperforming sectors over the next several *months*, not years.

My focus on shorter time-frames is one of the keys to my readers' success, since it allows us to be nimble and to reduce the amount of time and risk we expose our hard-earned capital to.

I call these short-term windows of opportunity "Green Zones."

My *Cycle 9 Alert* service is a "go-anywhere" options swing trading program. And since time is of the essence with our short-term, two- to three-month plays, I've done extensive research on just how much outperformance we can expect when we find a tradeable asset in its Green Zone.

For instance… individual stocks. While they're in my strategy's proprietary Green Zone – individual stocks have generated annualized returns averaging 70% a year! That's far better than the 11.7% they've returned when outside the Green Zone. The same goes for diversified stock market ETFs, which have generated annualized returns of 15.5% while in my algorithm's Green Zone versus only 3.2% per year the rest of the time.

And it gets even better when we look at my strategy's Green Zone performance among ETFs that track investments outside the stock market, including bonds and commodities. These outside-market ETFs have returned annualized gains of 18% in the Green Zone, but only a measly 0.7% per year when not.

Taken together, my trend-and-momentum algorithm does a fantastic job of homing in on any asset's hottest returns. On average, you can position yourself for annualized returns of 46% if you only invest in assets that are currently in the Green Zone. Otherwise, you'll have to make do with just 6.7% a year… investing in them the rest of the time. I don't know about you, but I think that's a huge advantage, particularly in a market environment that's as uncertain and volatile as today's.

Why Does Sector Rotation Work?

It all comes down to momentum. Remember Newton's first law of physics: An object in motion will remain in motion, unless acted upon by an external opposing force. And that's how you can think about momentum in the markets, too. A stock that's moving higher – particularly one that's moving higher at a *faster rate* than its peers – is likely to remain moving in that direction, unless acted upon by an external opposing force (i.e. selling pressure).

This isn't just me saying that and trying to fit market dynamics into a physics law. The momentum factor has been well-proven by both academic research and real-world, practitioner performance.

If you want to read the seminal academic paper on momentum in the stock market, find *Returns to Buying Winners and Selling Losers: Implications for Stock Market Efficiency.* Pretty much everything you need to know about the momentum strategy is tidily contained in the title: **you're buying winners and selling losers.** In fact, I recently joked with folks at our Irrational Economic Summit that if you want to sound smart (and a tad smug) when you talk about your investment strategy, simply tell them your strategy is to do just that: buy winners and sell losers.

Anyway, there have been doubters and haters of the momentum strategy for as long as it's been debated. Originally, Eugene Fama and Kenneth French claimed the market was efficient and that momentum didn't work. They stood by this argument through the early 1990s, even despite evidence of actual money-managers who were beating the market with this strategy.

Eventually though, evidence in favor of momentum mounted and Fama and French caved. In 1996, Fama admitted, that not accepting the power of momentum was the "biggest embarrassment" of his model. And he further endorsed the momentum anomaly, calling it "persistent, pervasive, and above suspicion," even, "the *premier* anomaly."

Indeed, while Jegadeesh and Titman's 1993 paper proved that the momentum factor worked in the U.S. stock market, a number of other researchers have since investigated the strategy – which, again, merely involves "buying winners" – and have found it to produce market-beating returns in every asset class, including foreign stocks, commodities, currencies, and bonds.

Of course, the momentum effect doesn't last forever. In fact, that's what most momentum haters get wrong about the strategy: They point to major turning points in the market and say, "See… the market is *reversing*. Momentum doesn't work! Mean-reversion does… or 'value' does…"

Here's the thing… the momentum factor has shown to produce market-beating returns over a three- to twelve-month period. Nothing more.

That means if you rank a basket of stocks based on their recent performance – say, over the past 12 months – the top-ranked stocks are likely to outperform for the next three- to 12-month period… and then their odds of outperformance go back to a mere "50/50" coin toss.

But that's perfectly fine, as I see it. Remember, my brand of sector rotation isn't trying to put us in the right sector for the next several years! Instead, we're merely trying to ride momentum waves that lasts for a few months… perhaps up to one year, but no longer. This allows us to harvest the momentum premium, and also stay flexible and adaptable to the market's ever-changing trends.

Introducing Our Model

Here's how it'll work. Each month, you'll receive an issue of this letter, *Green Zone Stocks*. And each month, I'll offer crystal-clear "buy" and "sell" signals on our momentum-based, global-rotation model.

We will always hold seven positions. Positions can be carried over from one month to the next, if the position continues to command a top-rank among the universe of markets we'll consider.

Some months, we may carry over all seven positions. Other months, we may swap out a few positions – for example, selling three of the seven open positions, and replacing them with three "new buys." Occasionally, we may find ourselves turning over the whole portfolio from one month to the next. Regardless, I'll be running my model's algorithm once a month… and then we'll position ourselves long in the model's seven top-ranked markets.

Which markets will we consider? Let's take a look at the "All-Weather" mix of global assets I've curated as our universe…

The GZS-70

US Sectors (11)			
XLB	Materials	XLP	Consumer Staples
XLC	Communication Services	XLU	Utilities
XLE	Energy	XLV	Health Care
XLF	Financials	XLY	Consumer Discretionary
XLI	Industrials	VNQ	Real Estate
XLK	Technology		

U.S. Industry Groups (20)			
IYK	Consumer Goods	XHE	Health Care Equipent
KBE	Banks	XHS	Health Care Services
KCE	Capital Markets	XME	Metals & Mining
KIE	Insurance	XOP	Oil & Gas Exploration
KRE	Regional Banks	XPH	Pharmaceuticals
PSP	Private Equity	XRT	Retail
XAR	Aerospace & Defense	XSD	Semiconductors
XBI	Biotech	XSW	Software & Services
XES	Oil & Gas Equipment	XTL	Telecom
XHB	Homebuilders	XTN	Transportation
Disruptive/Thematic (8)			
BFIT	Health & Wellness	SNSR	Internet of Things
BOTZ	Robotics & Artificial Intelligence	LIT	Lithium & Batteries
CLOU	Cloud Computing	MILN	Millennials
FINX	FinTech	MJ	Cannabis
Foreign Stock Markets (15)			
EWA	Australia	EWU	United Kingdom
EWC	Canada	EWW	Mexico
EWG	Germany	EWY	South Korea
EWI	Italy	EWZ	Brazil
EWJ	Japan	FXI	China
EWN	Netherlands	INDA	India
EWP	Spain	RSX	Russia
EWQ	France		
Bonds (2)			
IEF	U.S. Treasury Bonds 7-10 Year	TLT	U.S. Treasury Bonds 20+ Year
Commodities (5)			
DBA	Agriculturals	GLD	Gold
DBB	Base Metals	SLV	Silver
DBC	Commodity Index		
Leveraged (9)			
DDM	2x Dow Jones Industrial Average	UGL	2x Gold
EET	2x Emerging Markets	UPW	2x Utilities
EFO	2x EAFE	UST	2x U.S. Treasury Bonds 7-10 yr
QLD	2x Nasdaq 100	UWM	2x Russell 2000
RXL	2x Health Care		

Why Foreign Stocks?

You'll no doubt notice a number of foreign stock market ETFs in this mix. And if you're like most U.S. investors, those may feel, well, somewhat foreign to you.

But did you know that U.S. gross domestic product (GDP) makes up just 22% of global GDP… the U.S. equity and bond markets make up just 36% of the global markets… yet, U.S. investors allocate 74% of their capital to U.S. investments?!

Simply put, most U.S. investors are over-allocated to U.S. investments, for no good reason other than it makes us feel comfortable.

Humans are comfort-seeking creatures. We tend to do what feels easy, often at the expense of doing what is right. Not everyone, not all the time. Plenty of good people make good, disciplined decisions. But the urge is still there… comfort is a powerful temptress.

The same goes for investors. We tend to invest in things that make us feel comfortable, often at the expense of investing in things that could offer us better returns.

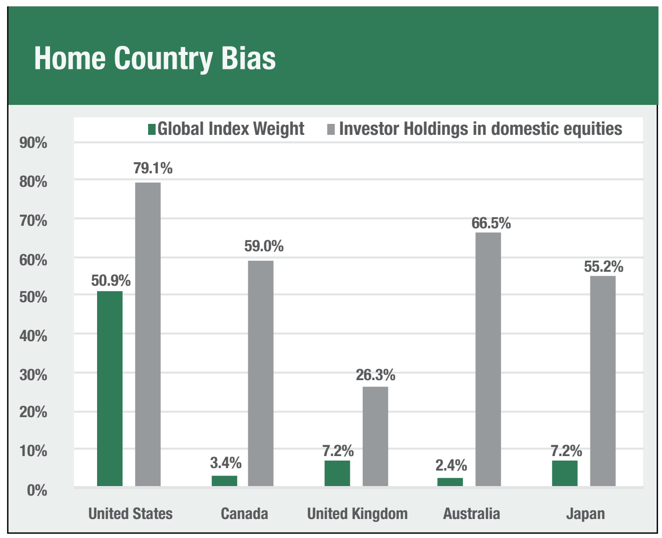
Peter Lynch popularized the idea of investing in what you know, which to some meant buying shares of Campbell's Soup (if you're a soup fanatic)… and to others may mean investing in U.S. stocks if you're an American. But investing-for-comfort goes well beyond Peter Lynch's colloquialized approach. Home-country bias is actually a powerful phenomenon that stretches the world over.

For the purposes of investing, home-country bias can be defined as follows:

Investors' natural tendency to be most attracted to investments in ***domestic*** *markets. Investors tend to focus more on their home markets and the companies that do business within these markets,* ***because they are familiar with them.***

These investors ***do not strongly diversify their portfolios with international*** *market securities,* ***which could become a weakness for their portfolios if their home-country suffers serious economic decline.***

This isn't just a phenomenon that U.S. investors fall victim to. It happens all across the world…

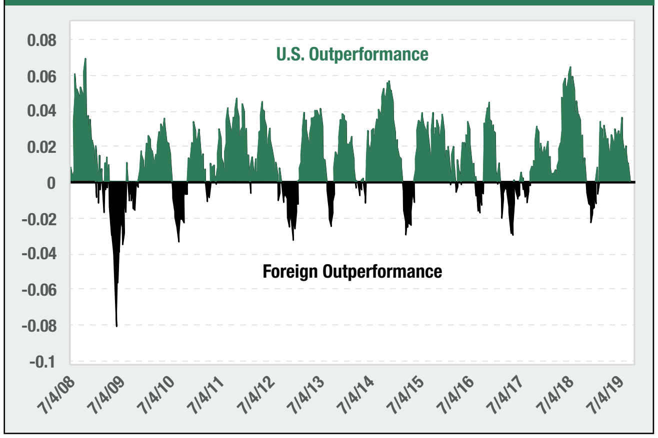


But again, there's no good economic reason for over-allocating to domestic investments. In fact, doing so nearly guarantees your underperformance!

If you're the type of investor who will only consider U.S. stocks… or, likewise, if you'll only invest in foreign stocks… **you're missing out on half of the global markets' best opportunities.** While U.S. stocks have been on a tear in recent years, they've historically outperformed foreign stocks only around half the time.

As you can see on the next page… sometimes U.S. stocks outperform (green plots), while at other times foreign stocks do better (black plots).

Outperformance is Cyclical



This means **you have to keep an open mind** and be willing to **make plays on both U.S. and foreign stocks**… to be a truly successful investor.

This isn't always easy.

As you could probably tell from the chart above, sometimes the advantage between U.S. and foreign markets can quickly change. Other times, one market can outperform the other for an extended period of time.

There are two solutions to this issue.

First, it's never a bad idea to hold a *diversified* mix of both foreign and U.S. stocks. This is a simple way of hedging your bets and gaining the benefits of diversification.

Second, you should remain flexible and willing to adapt to the market as conditions change – increasing your exposure to foreign stocks, when warranted, or to U.S. stocks, as better opportunities arise there.

And that's precisely what my momentum-based, global-rotation model will help us do. Each month, we'll re-evaluate the global market landscape and, if needed, adapt to changes in the relative performance of U.S. and foreign markets. Or, if we find ourselves well-positioned in an extended outperformance trend… we'll stick with it!

Simply put, my adaptive model will guide you into newly evolving opportunities – whether they're based in the U.S. or abroad.

Why Bonds and Commodities?

Famed hedge fund manager Ray Dalio popularized the "All-Weather" moniker, though there's some evidence that the term was in use before he started the fund. Nonetheless, it resonates with people because its aim is intuitive: perform, regardless of the conditions.

During economic "storms," to extend the analogy, the best stock market investors can do is hunker down and ride it out. An "All-Weather" approach, on the other hand, is flexible enough to switch into different asset classes, depending on the prevailing winds at any given time.

During deflationary environments, bonds do well. When inflation strikes, gold gets a bid. And depending on where we are in the global business cycle, each of the major sectors and industry groups are constantly rotating in and out of favor, relatively speaking.

Wall Street's traditional "60/40" portfolio simply can't adapt to changes in the economic and financial market "weather." An adaptive, momentum-based "All-Weather" strategy can. And that's the type of strategy I'm excited to bring to you now!

Founder's Portfolio: Buy These 7 Funds Now

I've completed the once-a-month update to my model's ranking system. Here are the seven top-ranked ETFs among our universe of 70 potential markets.

Ticker	Name
GLD	SPDR Gold Trust
VNQ	Vanguard Real Estate ETF
TLT	iShares 20 Plus Year Treasury Bond
UGL	ProShares Ultra Gold
XLP	Consumer Staples Select Sector SPDR
XLK	Technology Select Sector SPDR Fund
XSD	SPDR Series Trust S&P Semiconductor

As this is our "Founder's Portfolio," all seven of these funds are "new buys" this month. Go ahead and make your purchases as soon as you're able.

As for position-sizing – since I know that's a question I'll get – I'm recommending you follow an "equal-weight" position-sizing method. That involves investing roughly the same amount of capital in each of the seven positions.

It's perhaps a bit annoying that dividing your capital by seven doesn't give you a nice round number. Specifically, a 1/7 allocation works out to 14.3% of your total allocation to this strategy.

If you desire to be fully allocated to the strategy, and you don't mind calculating your 14.3% each month… then by all means simply do that.

Otherwise, I'll offer another suggestion on how you might conservatively size your portfolio. That is… divide you capital by 10… then invest that amount in each of the seven positions, while reserving the remaining 30% as a "cash buffer."

For example, let's say you've decided to put $10,000 to work in this strategy. Here, the math is easy… $10,000 divided by 10 is $1,000 per position… so you could invest $1,000 in each of the seven positions, while reserving $3,000 as your buffer.

No matter how you choose to size your positions (the choice is always yours), I recommended committing to a specific action plan and sticking to it, month in and month out. Consistency is the key.

One Final Note

You'll notice there are two allocations to gold: the non-leveraged GLD fund and the 2x-leveraged UGL fund.

We'll get into the mechanics of my proprietary ranking model another time, but for now you should know that it ranks each market's recent historical performance based largely on volatility-adjusted returns. That means, in essence, that a more volatile fund, such as a 2x-leveraged gold fund, must provide market-beating returns sufficient to account for the increased volatility of the fund.

So in layman's terms, that means when we get a buy signal on a leveraged fund, it generally means it's worth the risk. And when we see buy signals on both the non-leveraged and leveraged-version of the same market (i.e. gold), it tends to be a confirming signal that the market is indeed poised to outperform.

It's your choice whether you decide to invest in both GLD (non-leveraged gold) and UGL (2x-leveraged gold), or just one of them. But for the sake of keeping true to a fully rules-based, systematic strategy, we'll officially track the performance of both positions as they're both included in this month's model portfolio.