CASE STUDY

A Successful Investing Approach:

Tactical Trading Inside a Long-Term Portfolio

The asset management industry is dominated by a buy-hold-hope mentality, which makes sense in most cases because, statistically, the equity markets go higher 80% of the time. We are taught that to achieve great long-term returns, we must be willing to ride through periods of high volatility and that corrections happen along the way. Considering that the long-term average peak-to-trough drawdown in the S&P 500 is 14%, I believe that most financial advisors and clients would agree that a smoother ride would be the preferred way. Strong returns with lower volatility along the way sounds a lot like having your cake and eating it too. What if this might be possible?

TRADING VERSUS INVESTING

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We never know if a pullback will be shallow or deep, and most of the time when markets are selling-off, there are limited places to hide. A logical approach is to step aside, reduce risk exposure, and hold more cash and/or defensive stocks. Historically, that has offered a smoother ride than remaining fully invested and accepting whatever volatility the market offers. However, here is the disconnect; the mutual fund and ETF industry is filled with funds that by mandate have to remain fully invested. These fully invested funds offer returns in good times and heartburn in tough times.

Active trading is one option that can be deployed in volatile times while also delivering during raging bull markets. When can active trading add the most value to a portfolio? There are many answers to this question, but, in my humble opinion, adding a tactical trading focus is most ideal when equity volatility is higher than average. We measure volatility in the equity markets by looking at the VIX (S&P 500) and VXN (Nasdaq) Indexes. My general rule is that when the

VIX is over the 20 level, it means there is sufficient uncertainty in the market to warrant active trading. Investors get sea-sick from higher volatility, but traders get a chance to take advantage of big swings in stocks.

Thus far in 2020, it has been a trader's market. Except for growth stocks, most stocks are flat to down on the year, as of August 2020. The chart to the right shows the VXN (Nasdaq VOL Index). The daily ranges in Nasdaq stocks is wide, indicating that Nasdaq stocks offer a potentially attractive trading opportunity. This volatility allows traders the opportunity to generate attractive returns while being exposed to the stock market for shorter periods of time: get in, set your sell target, monitor the trade closely, capture gains, limit losses and get safely back into cash. Strategies like this help smooth the investment ride along the way.

TRADERS THINK DIFFERENTLY THAN INVESTORS

Once a trader identifies the direction of the dominant trend (e.g., equities up since March 23 as of August 2020), buying dips and selling rallies offers a way to potentially add return while not being constantly exposed to the market. Remember, our goal is to generate attractive returns but with as smooth as ride as possible. Let's look at the mechanics behind trading.

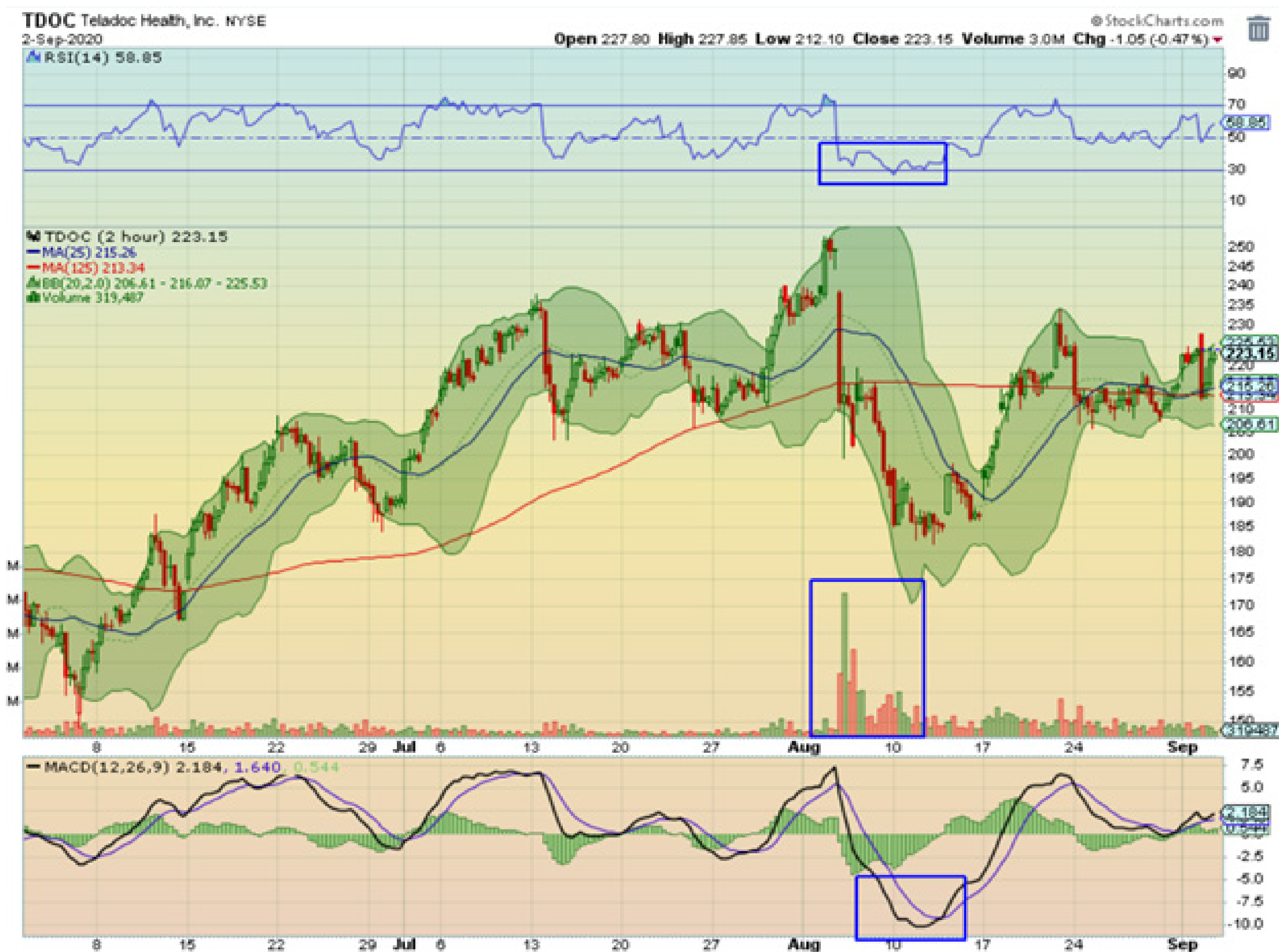
Traders need cash to invest to profit from high volatility. Buying dips is far more difficult for strategies that must be fully invested at all times. Personally, when I see the VIX rise above 20, I tend to raise cash and use that cash strictly for short-term, tactical trading. If successful, the trading gains can keep the overall portfolio moving in the right direction while the core, long-term stocks gyrate up and down. Having this flexibility simply adds an extra, potential money-making component to an otherwise, buy-hold focused portfolio.

Successful trading requires a great sense of timing and an unemotional mental state. Because perfect timing is often difficult, using a tranche system for buying is advised. I rarely buy a trading position in one tranche. Instead, I buy an initial starter position and then build that position bigger in a few further tranches.

> In volatile markets, tactical trading can add value to a portfolio's total return.

EXAMPLE CAPITULATION TRADING OPPORTUNITY

Some traders focus on momentum stocks, akin to jumping on a moving train while buying higher to sell even higher. I tend not to be a momentum trader. I like to buy high quality companies exhib-



iting strong business trends after a short-term dip. I also look for opportunities to buy after a stock has experienced a significant pullback. Some investors would call these stocks "technically damaged," but if you have experience looking for capitulation and understand how the process works, these can be terrific trades.

Above is a recent example of a capitulation trading opportunity. TelaDoc (TDOC) is the leading brand in the telehealth industry. They recently announced a merger with Livongo, a key competitor, and the stock went straight down 26% on heavy volume.

TDOC fell sharply on higher than average daily volume (blue rectangle in top chart). As the non-committed owners of the stock sold their shares over a week, the stock got maximum oversold as measured by the MACD (moving average convergence/divergence indicator) at the bottom and RSI (relative strength index indicator) on top of the chart.

Our team began adding to the stock in tranches as it went lower in combination with the daily volume getting back to normal. When there is nobody left to sell, a buying vacuum gets created, particularly in high quality brands. Over a three-week period, TDOC fell 26% in a week and then rallied 24% over the following week. A buy-and-hold investor just had to take that wild ride while an active trader got a chance to generate a strong return while being exposed for a short period of time.

Trading requires a unique set of skills that long-term investors often lack.

THE BOTTOM LINE

The asset management industry is driven by a buy and hold approach. A normal business cycle though, consists of boom and bust cycles. Therefore, if our goal is to invest for the long term and have as smooth a ride as possible, implementing strategies like active trading inside a long-term fund can significantly aid a funds ability to manage through the periodic and normal corrections that happen through the full economic cycle. When volatility is higher than normal, like today, combining long-term thinking with short-term risk management through active trading simply adds to the number of ways an investor can win. Equity markets often go sideways for periods of time, particularly when an economic healing is happening, like today.

Trading your favorite high quality stocks while markets go sideways can add small increments of value to the portfolio that begin to add up to real excess returns when the compounding effect occurs. Additionally, there's one added potential benefit to trading that few in our industry talk about: with interest rates close to zero and money market funds earning nothing, it generally does not pay to hold cash for very long. Being fully invested, however, forces an investor to be fully exposed to the boom and bust part of the cycle. Utilizing an active trading methodology inside an equity fund offers the potential to manage cash more effectively and attempt to generate incremental return, while generally not being as exposed to the markets as other fully invested strategies require.

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Glossary

Moving Average Convergence Divergence (MACD) is a trend-following momentum indicator that shows the relationship between two moving averages of a security's price.

The **Relative Strength Index (RSI)** is a momentum indicator used in technical analysis that measures the magnitude of recent price changes to evaluate overbought or oversold conditions in the price of a stock or other asset.