

A **Spectrum Financial** White Paper



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## **An Unemotional Technicality**

*Using innovative technical analysis to navigate market trends and achieve Active Portfolio Management*

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## **About Spectrum Financial, Inc.**

Spectrum Financial is a SEC Registered Investment Advisor with a 24 year track record of building client assets using active management strategies consistently through volatile markets. Founded in 1986 by money manager Ralph Doudera, Spectrum has long been considered one of the more successful active investment management firms serving individual investors. Spectrum is also recognized for its unique philanthropic stance. The majority of corporate profits are contributed to charitable organizations dedicated to helping people throughout the world live better lives.

## **Introduction**

We must all first come to the realization that no one knows with certainty what will happen to the market next. Whether it will go up, down, or sideways is dependent upon circumstances that happen outside of any one investor, or financial advisor's control, and therefore, will leave us with only guesses, projections, and intuitions. Furthermore, the investor can never completely separate himself/herself from the emotional pull of investing. When putting money at risk, fear and greed become the ultimate navigators for investors. To counteract the confusing effects of emotion, investors must embrace and practice disciplined investing or partner with professionals using this concept within Active Portfolio Management.

In the financial market there are navigators and tools that provide emotional grounding. Active Portfolio Management allows investors to step confidently into the future with their decisions concerning market trends. Technical analysis, the study of charts, and knowing the changing landscape of the financial markets become emotional stabilizers. Using quantitative methods to understand qualitative patterns will give some understanding to this market phenomenon.

Not all active portfolio managers implement the techniques discussed in this paper. Technical Analysis and its methods of understanding the changing market environments is the driver of investment decisions practiced by Spectrum Financial when actively managing portfolios.

## **Part One: The Case for Active Portfolio Management**

### **What are we talking about?**

Active Portfolio Management is essentially assessing the evidence and concluding the odds of future events and investing accordingly. This differs from Passive Portfolio Management in which portfolios are designed to closely mimic popular indexes, changing the investments only when the index adjusts its parameters. Every investor wants to avoid big losses, the major set-backs that can take precious time to recover. For example, a portfolio that loses 20% takes a 35% gain to recover that loss. If a portfolio has a 50% loss, it will take 100% gain to recover. Active Portfolio Management can help curb portfolio losses through assessing risks and the probability of events by way of charts that convey history through patterns. When a weather man tells us that there is an 80% chance of rain he does not know for certain that rain will come. He has

relied on models, education, and background to point him to a probable conclusion. Comparatively, that is what Active Management embodies.

### **Why use Active Portfolio Management?**

Professionals use the tools of Active Management to be invested during favorable market conditions and less exposed during periods of high risk- opting to be less invested in the market or fully moved to cash. Through Active Portfolio Management, clients have greater odds of minimizing extreme losses which should put them in better position for wealth accumulation. Active Portfolio Management, by way of Technical Analysis, can allow professionals to invest in disciplined ways that cater to specific client objectives. Investment techniques can be combined to form systems that alert the portfolio manager when market conditions are unfavorable or favorable for the conservative to aggressive client.

Most investors are paralyzed by the emotional extremes of fear and greed when investing in the financial market. Active Portfolio Management can allow disciplined, quantitative methods to take the place of emotional investing.

### **Part Two: Technical Analysis**

Technical Analysis is the study of charts practiced by some professional active money managers. It looks at the relationship between Price, Time, and Volume and also may incorporate Sentiment Analysis.

The following are noteworthy characteristics of Technical Analysis:

- *Price, Volume, and Time*  
These components of Technical Analysis measure people's thinking by looking at their actions. Garfield Drew, a trader at the beginning of the last century said, "Stocks do not sell for what they are worth, but for what people think they are worth." That is what creates the chart of Price, Volume, and Time. When we look at a chart of Price, Volume, and Time what we are really looking at is the distance an investment has traveled, how fast and with how much power.
- *The Three Cornerstones*
  - Market actions include all buy and sell decisions based on all forms of analysis. The main deciding factor being price, the ultimate reality.
  - Prices move in trends of various time frames. Defining those specific time frames is important. Everybody has a time frame they feel comfortable with, but stock prices do move in trends. The market is pushed up and down by market psychology and there is often an ebb and flow.
  - History repeats itself. As market psychology is repeated, patterns play out in similar forms throughout history and probably throughout the future.
- *Diversification*  
Many people feel comfortable with what they know. They often go back to the stocks, industry groups, or indexes that they bought in the past for the sole reason that they find familiarity and high levels of comfort in those choices.

Technical Analysis allows diversification as a technique to bring to light investments that have not been a focus in the past.

- *Relative Strength Analysis*

Technical Analysis allows for the use of Relative Strength Analysis for sector rotation that enables us to see which groups may be coming into or out of favor at different times. Many complacent investors tend to choose investments that attempt to mimic the broad market (passive management) which may include strong *AND* weak performing issues. Relative Strength Analysis, however, is the concept of investing only in the strongest or strengthening areas.

- *Different types of charts allow you to see the big picture*

The importance of using charts is having the ability to more dynamically see the periods in which the market is controlled by bullish or bearish trends. Different chart styles allow a user to gain multiple perspectives of market conditions. Several examples are: bar charts, Japanese Candlesticks, and Point and Figure charts. Charts can also be viewed that display intra-day prices, as well as daily, weekly and monthly prices.

- *Sentiment Analysis*

This is the attempt to detect overall market mood and the psychology of investors. One method is that survey companies call individual investors to assess whether they believe market conditions seem bearish or bullish. Sentiment Analysis is a contrary indicator at extremes: a high percentage of bearish investors are usually seen at market bottoms and high levels of bullish investors are usually seen at market tops.

- *Additional Technical Analysis Basics*

This is a list of a few basics of Technical Analysis that should be considered:

- The Trend is your friend
- There must be flexibility for event risk: news that can quickly alter market conditions.
- Pattern Analysis: support and resistance is the backbone behind understanding price patterns
- There are indicators based on the movement and relationships between Price, Volume, and Time
- Indicators can be used by themselves or combined with other that may outperform and beat the standard “buy and hold” strategies

- *At times, Cash is King.* The goal of Active Management is not to buy at the exact low or to sell at the exact high. The goal is to move into cash and to side step the volatile or negative periods. The buy low and sell high mentality can be put into place to go into cash when the odds are high enough that a more difficult period may be ahead. An active manager is searching for those clues often delivered through Technical Analysis. We never know the depths of the negatives to come or if they will come at all. But, if we are using disciplined methods, clients can often side-step these negative periods so when positive market clues return, clients can step back in and become invested. This concept is the core of Active Portfolio Management.

Of course any system has shortcomings and when implementing technical analysis the shortcoming is often that it does not explain “Why?” With human emotion as it is, investors often want that question answered. Technical analysis does not satisfy that desire. When you see a stock move up, you want

to know why. If you do not know the reason behind a move, it can be difficult to take action. With Technical Analysis we are not trying to predict the future; we are just looking at the odds of a particular path. As Stan Weinstein, author of *Secrets for Profiting in Bear and Bull Markets* said, "The chart is the ultimate reality."

### **Part Three: The Changing Market Conditions**

Over the last decade, the financial industry has undergone major changes, altering both its functions and characteristics. These changes include regulation, investment choices, technology, and how we access markets. Many investors have underestimated the ripple effect of changes in each of these areas. A better understanding of the changing market environment should prove beneficial in how representatives assist clients in reaching their goals. Flexibility to adapt to structural market changes finds itself in Active Portfolio Management. Technical Analysis and recognizing the current market conditions work together in order to find the most efficient and profitable methods for your portfolios.

There have been numerous changes in the market environment, mostly in the last decade, that have brought us to our financial market today.

- *Decimalization*  
Stocks were quoted in fractions ever since the stock market began in 1792. However, from August 2000 to April 2001 various US equity markets transitioned from using fractions to decimals. The decimalization made US markets complimentary with other global counterparts. The use of decimals tightened market spreads and made stock quotes easier to understand by the general public. NASDAQ representatives hoped that it would make investing less intimidating and attract a much wider appeal. Decimalization marked an indelible point in which the public was now beginning to break down the barriers previously upheld by Wall Street.
- *Technology- the exponential growth of the internet.*  
Technology has played an immense role in changing and reinventing many areas of this world, and has touched the financial one. Because of falling prices for home computer systems, their use has greatly increased. Before the internet, important information was once more quickly attainable by institutional investors and analysts. It would then make its way to the general public slowly but surely. The explosive growth of the internet allowed the public to receive the same information as Wall Street at the same time.
- *NASDAQ*  
The NASDAQ stands for National Association of Securities Dealers Automated Quotation. The NASDAQ is not the same as the New York Stock Exchange (NYSE). The NYSE is a physical building located in New York, housing specialists utilizing mostly an open outcry system. The NASDAQ is a network of securities dealers around the country that display quotes and inventories. The NASDAQ served as the model for ECNs, electronic

communication networks connecting buyers and sellers electronically 24 hours a day.

- The modernization of China, the Middle East, many countries in Africa and other emerging markets**

These new markets are powering the world's economy forward. There is now an overall interdependence between global economies which affects the balance of payments- how much one country owes another. This also affects currency markets. For example, going into the fourth quarter of 2010, China was holding a little under one trillion dollars of U.S. treasuries. Globalization is a two-edged sword in that economic prosperity and failures in one area of the globe now have greater positive and negative effects to the economies of other countries.
- The Elimination of the Uptick Rule**

The Uptick Rule was established in 1938 and states that in order to short a stock, the last trade must have been after a lifting of the price on the preceding trade or prices must have been stable since the last uptick (zero uptick). The reason being that stocks in the process of falling could not be repeatedly shorted which could end up accelerating the sell-off. In July 2007 this rule was eliminated and could quite possibly be a major reason for increased market volatility.
- Proliferation of Hedge Funds**

Hedge funds have given investors access to methods and markets that historically were the domain of institutions. They often are responsible for very fast movement of very large sums of money. Hedge funds also incorporate the use of algorithmic trading and high frequency trading allowing for trade speeds to be measured in micro-seconds.
- ETFs: Exchange Traded Funds**

ETFs are financial instruments that package together investments with a similar theme while providing diversification. They remain different from mutual funds because of the availability to be bought and sold intra-day instead of just receiving an end-of-day price.

**What are the Impacts?**

- Investors now have access to more markets than any other time in history.**

This has led to *herd mentality*, where investors rush into stocks exhausting their buying efforts more quickly. This can create a spectacular rise but at the same time trends are becoming shorter and more compact.

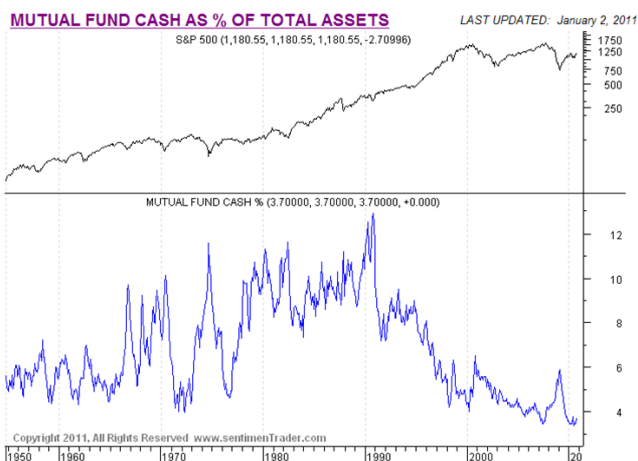
**Asset Class Correlations** with S&P 500

	1970-2006	Sept. 2007	2007-2010
Mid-Cap	.76	.97	.98
Small Cap	.62	.96	.96
EAFE	.60	.93	.92
Emerging Markets	.59	.87	.91
Corp. Bonds	.32	-.421	-.37
High Yield	.50	.54	.58
Cash	.02	.02	.04

\*\*\*Data Sources: JP Morgan Asset Management, Asset correlation.com, Jeck Wilson and Charles Jones, N.C. State University, Morgan Stanley Smith Barney

- Correlation Drift** is defined as the growing tendency for an asset to move in the same direction as another. A correlation of 0.50 means that the asset has historically moved in the same direction as the second asset only half of the time. A correlation of -1.0 means that the asset has historically moved in the opposite direction 100% of the time. The most common correlation measure is an investment versus the S&P 500 Index representing the stock market as a whole. Correlation analysis has played a vital role in

diversification of portfolios for many years. Modern Portfolio Theory, practiced by the majority of mutual funds, has historically leaned heavily on correlation analysis. In general, a portfolio with assets having correlations less than .50 is considered moderately diversified. If the stock market drops, a low correlation portfolio theoretically should be able to out-perform the overall market. The assumption is that as the market declines, assets with lower correlations will likely decline less, allowing the portfolio as a whole to perform better than the market. As seen in the accompanying chart, from 1970 to 2006, commonly held assets had correlations low enough to imply diversification. The investment landscape had already begun to change as described earlier. In September 2007, the Lehman Brothers bankruptcy acted as a catalyst that spiked volatility. Simply put, it made people scared and increased the tendency toward herd mentality. Since 2007, correlations have not been as diverse across a large number of assets. The herd mentality, by definition, has investors buying and selling in greater unison. Investments such as ETFs, that have numerous components, are being liquidated in a manner that does not discriminate. Healthy companies that are components within ETFs are being sold. Historically, companies in stronger fiscal shape were assumed to weather storms better than companies with weaker fundamentals but that tendency can no longer be relied upon. Scared U.S. investors selling down their portfolios out of fear now have the ability to liquidate ETFs that have far reaching effects. For example, foreign ETFs that if sold, may lead to the selling of illiquid component stocks. This could even accelerate the prevailing weakness and creating a powerful “Domino Effect”. Fear initially brought on by a weak stock market may have scared investors into selling their ETFs, impacting a wider range of asset classes. It should be noted that a few asset classes such as investment grade bonds, high yield bonds, cash and several others have maintained low historical correlations. The increase in speed of information flow and access to numerous investment choices has been applauded by many investors but the negative effects brought on by its role in changing the market’s landscape must be taken into account.



#### Part Four: Mutual Fund Cash Levels

Most of us are familiar with mutual funds being our access to markets. However, investors have been continually surprised, just as in 2008, when their investments sank quickly. Most mutual funds did not avoid losses to the degree in which investors expected and depended on. This is where cash becomes the asset of choice. There are times where cash must be the asset of choice in order to maintain safety. Mutual funds tend to keep cash levels low as most mutual funds are mandated to have high levels of market exposure. This graphic shows that during the market’s brutal decline in 2008, mutual fund



cash levels rose to their highest point in years but were still only approximately 6%. What does this mean? On average, mutual funds were still 94% invested. In order for mutual funds to achieve a defensive stance they must use methods such as buying low correlation assets, buying undervalued securities and other methods of Modern Portfolio Theory. But it must be noted that the market landscape has been changing and will continue to change from what we know it as today. Investors need to consider Active Portfolio Management techniques that may achieve return objectives while better controlling risks. These include traditional risks such as bear markets and risks unique to the new market landscape.

### **Part Five: Macro Tools Used by Active Portfolio Managers & Non-Traditional Diversification**

Having an understanding of these five macro tools will help you compare the similarities and difference between active portfolio managers.

- *Buy low and sell high*  
A goal of most methods, and really the driving force of any investment decision pertaining to the financial markets.
- *Shorting*- sell high and buy back low  
Shorting is a less familiar term but should be readily understood. Shorting refers to when a stock is theoretically borrowed, and then sold with the idea of buying it back at a later time and returned to the owner. The goal is to sell the stock at a higher price and buy it back at a lower price while pocketing the difference. The risk of shorting is traditionally considered high. Theoretically, risk is unlimited as a shorted asset could rise indefinitely. In reality, disciplined rules can be implemented through technical analysis methods, including stops, in order to minimize risks as much as possible.
- *Hedging*  
Just as the term implies, hedging refers to when an asset is put in the portfolio to off-set potentially negative effects to other positions. This assumes the positions could be harmed in the short-term but the portfolio manager chooses to hold the position. This could be for a variety of reasons; some of which may be holding out for longer-term capital gains, mutual fund required holding periods, and others. One hedging method is through shorting. This is often done through shorting broad market products such as index futures, but can also be through shorting similar or highly correlated assets. Hedging through the use of options is also a common method. You must recognize that some option techniques are designed to potentially offset portfolio losses. A newer area of hedging is through the use of inverse ETFs and other types of negatively correlated ETFs. Generally speaking, these are designed to rise as the market falls and therefore, limit losses of the overall portfolio.
- *Leverage*  
Leverage describes the use of borrowed money to increase the amount of exposure. Leveraging it has the possibility of providing extremely successful returns or the possibility of realizing devastating losses. Leveraging can have high risk. There are techniques that can soften the extremity of leveraging. For example, sometimes the use of leverage can be used to purchase assets

on the lower end of the risk scale. An example of lowering risk by using leverage is when the borrowed funds are used to pay for hedging instruments.

- *Relative Strength*

Relative strength is best defined as leadership by way of out-performance versus its peers or more commonly, a broad based index such as the S&P 500 Index. Do not confuse relative strength with the Relative Strength Index (RSI indicator). Relative strength is a comparison of the price action of one asset to another. Mathematically, it is the result of dividing the price of one by the other to create a spread or ratio. Relative Strength tends to trend, and an active portfolio manager would seek to ride a trend higher on the out-performing asset and then later shift to another asset that is showing early signs of leadership.

### **Non-Traditional Means of Diversification**

Many investors consider diversification to be a portfolio of numerous investments such as a wide variety of stocks. However, the changing market environment has increased the periods where true diversification is more difficult to achieve. That is why the following should be considered in order to potentially achieve diversification in various market environments.

- *Assets of low correlation*

One asset of low correlation is cash, among many others. Having the flexibility to go into cash plays an important role in active portfolio management. Other asset classes often take their own path, not tied to the direction of the stock market.

- *Investment techniques*

Using various techniques is a form of diversification as some methods perform better in certain times than in others. Skillful managers can shift among techniques as the investment markets change environments.

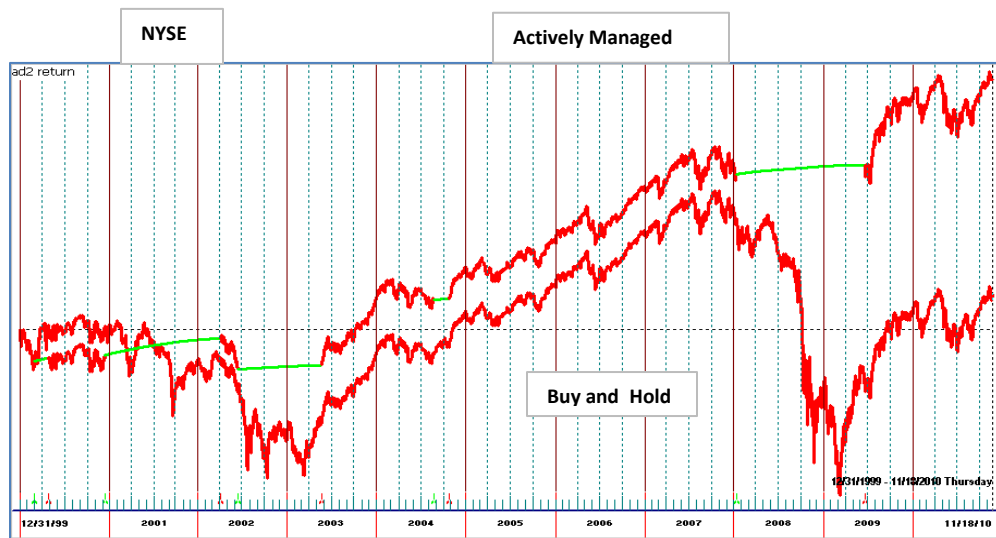
- *Themed objectives*

Active portfolio managers also have at their disposal a class of investments known as “alternatives”. These are best described as themed objectives. Categories in this area would include market neutral funds, long/short funds, merger and acquisition funds, commodity funds, arbitrage funds and others.

### **The Final Statement**

Active Portfolio Management often incorporates the Technical Analysis tools covered in this paper. They also monitor and take into account changing market conditions. The chart below is an example of just one method among many that incorporates some of the techniques discussed. As the chart displays, there can be a significant difference between the performance of funds with “buy and hold” strategies when compared to funds using Active Portfolio Management methods. The avoidance of loss, the capability of strategies catered to client objectives, and the opportunity for emotional grounding all build the case for Active Portfolio Management. To counteract the confusing effects of emotion, investors must embrace

more disciplined methods by practicing disciplined investing themselves or partnering with professionals who use Active Portfolio Management.



## Conclusion

2500 years ago cosmologists in ancient Greece sat around debating the essence of the universe. The debate was whether the universe operated at the essence of change or the essence of permanence. Two traditions began and out of that grew *philosophia* and *rhetoric*. The philosophers believed in the absolutes and full objectivity- true Love, true Knowledge. The rhetoricians believed that you cannot know, that there are no absolutes and everything we have come to know is based on subjectivity. For generations the two stood at a standpoint unabridged. Until Aristotle, the father of logic and empiricism, pulled the two together. He said it is neither the one nor the other but both in full harmony, operating as a well-oiled machine to make sense of the reality we find ourselves living in. Aristotle's theories of understanding the environment around us has not been disproved and has remained intact for over two thousand years. He believed in asking questions, looking at history, observing patterns to obtain as much subjectively as we can in order to understand the objective truth of what may occur.

An investor must do the same in the financial arena. Use all resources, ask questions, look at patterns, and study history in order to understand and make choices in the market to best achieve goals. Active Portfolio Management goes beyond "buy and hold" often through the use of Technical Analysis and knowing the changing landscape of the market environment. Aristotle concluded that both means of knowing the subjective and the objective must be used. Active Portfolio Management remains an innovative way to grow a portfolio and manage client investments.

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