MIRACLE MILE ADVISORS

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HOW TO INVEST WHEN EVERYONE IS CALLING FOR A CORRECTION

In the past nine months, the S&P 500 is up nearly 25% and there aren't too many catalysts in the near term to keep the party going - just some headwinds from the Fed and lackluster macro-economic data. So when the markets seem to be at their highs and uncertainty abounds, how does the average investor proceed? Fortunately a new era of ETFs is emerging that can offer investment alternatives suitable in any market environment using ruled based structures, hedging, and selective active management.

The Headline Risks

- The Fed hinted in May that it could begin scaling back QE as early as September. Investors will be awaiting news on tapering as the FOMC meets again on September 17th and 18th.
- The debt ceiling will be reached in either September or October. In past years, there has been much market instability as the debt limit looms.
- Additionally in September the debate on the FY 2014 budget will take place. The fiscal year begins on October 1. If no plan for government funding is passed through congress, a temporary government shutdown may take place.

How to Hedge the Downside

In what many people believe to be an overvalued market due for a correction, a downside hedge is an important tool in every investor's portfolio especially in the doldrums of August. One interesting option is PowerShares S&P Downside Hedge (PHDG) to protect against a market selloff. This ETF, launched in December of 2012, uses a rules based methodology to allocate its holdings between US equities, the VIX and cash. Based on the underlying market conditions the fund can hold up to 40% VIX and if a weekly loss exceeds 2% it switches to all cash. Backtested data on this index shows that in 2008, the fund would've returned an impressive 21.3%.

Another more traditional hedged equity approach is iShares MSCI USA Minimum Volatility ETF (USMV). This fund uses a rules based methodology to select the lowest volatility stocks from the underlying index. In essence, it uses a standard deviation screen to create an equity portfolio with reduced downside volatility (by about 25%) without sacrificing too much of the upside. Low volatility rules based ETFs have gained popularity in recent months as an increasing number of ETF providers have created these types of funds.

A Rules Based Approach that Works

While some ETFs choose to strictly hedge risk and limit downside, others use a variety of screens to attempt to generate alpha above the broader index. Sector based "active indexing" can provide good downside protection based on where we are in an economic cycle (think Basic Materials right now and Healthcare for the year). First Trust has launched a slew of new "AlphaDex" ETFs that replicate an "enhanced index" that screens a variety of economic variables (P/E multiples, technical momentum, sector weightings, etc.). These rules based ETFs (FXG, FXL, FXZ, FXR, FXH, FXD, FXO, FXU, and FXN) apply different criteria in their selection process in order to weed out potential underperforming holdings and generate the greatest potential for capital appreciation within a sector. In 2013, 8 out of 9 of their US sector based ETFs have outperformed their benchmarks (the appropriate S&P 500 sector index). Using backtested data, 6 out of 9 sectors have outperformed by an average of 2.2% annualized over the past five years. Not bad.

Other rules based ETFs weight securities based on characteristics such as dividends, market cap, and geographic location among other things. First Trust's NASDAQ Technology Dividend fund (TDIV) weights its holdings based on dividend contribution, a potentially good alternative to the broader tech market given the yield cushion. In addition there are international focused funds that weight certain geographical regions or sectors heavier than others in hopes of outperforming the general market. For example the iShares Emerging

Market Infrastructure fund (IEMF) seeks exposure to holdings that focus mainly on infrastructure growth to capitalize on expansion in developing countries. These funds have been able to avoid some of the general meltdown in the BRICs which have plagued the broader emerging market indices.

Actively Managed ETFs Are Suitable for Niche Asset Classes

While active managers have largely been unsuccessful in beating their benchmarks net of fees and certainly after taxes, there are a couple of niche asset classes where it still might make sense to pay the higher fees. Active ETFs are gaining popularity given their greater liquidity and tax efficiency compared to traditional mutual funds. Currently they only make up about 1% of assets in the ETF universe, but account for 19% of assets in all newly launched ETFs this year.

At present, the only actively managed ETF we are using is in the more thinly traded MLP space. First Trust North American Energy Infrastructure fund (EMLP) is sub advised by Jim Murchie of Energy Income Partners who has a solid 10 year track record. The fund avoids the double taxation penalty of a C corp by limiting MLPs to 25% of the portfolio and generates alpha almost entirely through security selection.

Asset Allocation is Critical Right Now

It is important to keep in mind that asset allocation is still going to be the primary driver of risk and return in your portfolio so how you weight your exposures right now is critical. We are going into the last quarter with a 25% YTD disparity between Emerging Markets and the US, Gold and commodities have continued their sell-off, and the interest rate spike has surprised almost everyone this summer. If you do nothing else, rebalance now and shift your profits. Timing really does matter in this environment and while these ETFs can help mitigate risk and generate alpha in the long run, they are not a substitute for a dynamic asset allocation strategy.