Rydex Sectors Newsletter

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There are two contrasting approaches I use for accounts trading the Rydex sector funds: STAR, standing for Sector Trading Adverse to Risk and ART, which stands for Aggressive Rydex Trading.

STAR (Sector Trading Adverse to Risk)

Due to data considerations, I changed the way STAR is traded in early November. However, the basic philosophy of avoiding meaningful losses of capital, which is the essence of risk reduction, was not changed. Prior to the change, the trading method I used called for decisions based on an estimate of that day's closing prices of the funds for which I may have to place an order. I call this "same-day execution." For this method to be effective, it is necessary to have a sufficiently accurate estimate of the value of the fund about 20 minutes before the market closes, just before the order placement deadline. Although it is possible that an actual closing price would have resulted in a different trading decision had it been known, that happened rarely and had only small effects, some beneficial and some negative, on the performance of the trading system.

I had been getting the estimates of the Rydex sector funds' current prices from a web site that was reliable and very accurate. However, in October, that web site ceased operation. I was left with the choice of finding another method of obtaining the information I needed to continue the same-day execution system or seeing if I could develop an alternative method of "next-day execution" based on the prior day's closing prices. The latter is how my other mutual fund trading methods work. I determined that it would be possible to generate my own real-time estimated prices and continue the same-day trading method. However, doing so would be somewhat cumbersome and costly—the site I had been using was free, and would require frequent maintenance and updates to assure the degree of accuracy I wanted. Before doing that, I decided to research trading methods I had read about in the past few months to see if I could develop a viable next-day system.

One feature of the old STAR method was that it is "fussy" about when to buy a Rydex sector fund. Any of the sixteen, which does not include the Precious Metals fund, could be bought, but only when it had dropped to some extent and then started to move ahead. The new method incorporates that concept, but implements it in a different way. It requires a fund to be trending up over a past period, pull back somewhat, and then resume its move up. The old method did not require as clear of an uptrend. The old method could hold up to three of the sector funds at a time, and if fewer than three had buy signals, all or part of the accounts would be in cash. With the new method, up to five funds may be held at a time as I mentally divide the accounts into five "pots of money" that can be invested. My research had shown that the old method was expected to have about 50% exposure, but in practice it was somewhat lower depending on market conditions. The new method is also expected to have about 50% exposure over longer periods.

There is a major practical difference between the two methods. The trades in the old one were all of very short duration. A week was typical. The new method has much longer trades due to its trend following nature. This can be seen in our holdings for the past two months. By November 3, we were fully invested in five Rydex sector funds. Four of those five are still held at the end of the quarter. The one that was sold was exchanged into another sector fund, so we have been fully invested since early November. With the broad market generally moving up, that is advantageous and an improvement over the old method, which often would not stay fully invested after the market moved up by a large enough amount. My research shows that the trend following aspect of the new approach combined with splitting the investments over five funds is expected to make it adverse to risk, the AR in STAR.

The frequent trading of the old method made it suitable only in retirement accounts in order to avoid tax considerations. The new way, with an expectation of about 20 transactions per year, is also practical in taxable accounts.

The one completed trade under the new method gained just about two percent and the fund it switched into was up one and a half percent at the end of the year. The other four trades were all well ahead. The weakest of them was up almost five percent in less than two months and the other three were up nearly or over ten percent. For the fourth quarter, accounts were up 8.1%, and for 2009 the two methods worked extremely well and produced a 37.3% gain.

<u>ART (Aggressive Rydex Trading)</u>

As its name implies, this method, unlike STAR, is not risk adverse. The basic method calls for owning just one—it can be any one—Rydex sector fund at a time. The fund is the one that has been the weakest recently using a standard technical indicator with the idea of catching either a turnaround or a brief recovery. The basic method calls for always being fully invested in a Rydex sector fund. However, when the system starts performing poorly, which almost always is during very weak market periods, I will suspend ART trading as a risk control measure. Testing on historical data and real-time experience tracking the trading system have shown me that owning a technically weak fund during falling markets can quickly lead to substantial drawdowns. We were fully invested for the entire fourth quarter.

The system did not do well in the quarter, which was not what I would have expected given the strong stock markets and the performance of STAR. There were fifteen completed trades in the quarter, but only seven were profitable. For the market conditions we had, I would expect nine or ten winners. No trading system works well all the time, and ART was not "in tune" with the market.

Unlike STAR, ART accounts may own a gold or precious metals fund according to the model for trading those funds I developed in 2005. There is more than one way to apply that model, and in May 2007 one of the methods indicated it was time to buy, so we took a position in Rydex Precious Metals (RYPMX) with 20% of account assets, which is still held. The other way of trading the fund according to the model gave a buy signal in January 2008, and I added to our holdings bringing them to about a third of account assets at that point. Since that fund can be quite volatile, limiting our exposure to it usually results in the overall effect on the accounts during the down periods being bearable. Gold and to a greater extent gold stock funds fell a lot in 2008, but they showed very strong performance in 2009. Rydex Precious Metals gained 9.6% in the fourth quarter and 51.6% in for the year. At the end of the year, ART accounts were 30% in the gold fund and 70% in a sector fund.

Overall, the sector fund trading hurt ART accounts in the fourth quarter and they lost 2.2%. For the whole year, they gained not quite eight percent.

As always, you should not assume that any system or trading method will produce any particular rate of return presented in this newsletter. Past performance is not predictive of the future returns. The systems and managed account clients may lose money in the future.