

## The Abandonment Metric: Negative Fund Flows as a Predictor of Excess Returns

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### Abstract

The SweetSpot® Investment Strategy uses negative fund flows to identify investments that are likely to be at or near a market-cycle low and thus ripe for purchase. SweetSpot is a “hybrid” active/passive strategy that captures the best traits of both styles while avoiding the worst. SweetSpot has demonstrated a consistent and significant advantage over the market; yet trades are held for at least three years, and SweetSpot investors enter and exit trades just once each year – no more frequently than passive investors who rebalance their portfolios annually.

Since its inception in 1998, SweetSpot has outperformed the S&P 500 by an average of 12.7 percentage points per year.\* Positions bought each year have *always* collectively outperformed their market benchmark during the period that they were held. The one calendar year that SweetSpot underperformed was 2006, proving only that what happens in any given year has no bearing on our long-term prospects: Despite its sub-par returns, 2006 marked the completion of SweetSpot's best-ever three-year trade.

SweetSpot investing relies on a formula to calculate annual cash flows into and out of the 500 or so mutual funds and exchange-traded funds that make up its investment universe. The funds are sorted into approximately 100 industry sectors and international regions (or “sectors”). Each January, end-of-year fund data are collected, analyzed, and aggregated for each sector, and the sectors are ranked. New positions are entered in several of the highest-ranked sectors (or lowest-ranked, according to the investing public), financed by the sale of positions entered or renewed three years prior (but not freshly renewed). At that point our work for the year is done, and the Super Bowl is still weeks away!

SweetSpot's rules-based method ignores fundamentals – abandoned sectors are presumed to be fundamentally cheap. By default, then, SweetSpot can be deemed technical in nature. Yet most methods of technical analysis – and most value-based metrics, for that matter – focus on price, something SweetSpot considers only tangentially. In contrast, SweetSpot measures human behavior – investors voting with their feet. The annual fund flows that drive SweetSpot's trades are an uncommon – and uncommonly effective – metric, one that is not generally available, or even known, to the investing public.

SweetSpot's method is a variation of an investment approach first suggested by Morningstar and Lipper in 1998. (Inexplicably, neither firm today offers the information that one would need to trade the strategy that they introduced.) More-recent research on the relationship between cash flows and future performance has yielded mixed results, probably because relatively short timeframes were examined. SweetSpot's three-year holding period, as convenient as it is to trade, also has been essential to the strategy's effectiveness. When we look at the average historical year-to-year performance of individual SweetSpot positions, we find that Year Three of a typical trade has outperformed Year Two, which in turn has outperformed Year One. This “trichotomy” shows up consistently, and lately it has gained traction: In 2010, SweetSpot's Year-Three positions gained 32 percent while the rest of the Portfolio struggled to achieve double-digit returns.

The rationale behind SweetSpot is straightforward and easy to grasp. Efforts to refute it have backfired: A virtual mountain of support for the approach can be found in the hard sciences, economics, psychology, anthropology, philosophy, and logic. Some of the principles that SweetSpot relies upon have been expressed and validated over thousands of years.

“Excess generally causes reaction, and produces a change in the opposite direction, whether it be in the seasons, or in individuals, or in governments [or in financial markets].”

Plato (428-348 B.C.)

One such principle: It is wise to invest in opposition to the weight of public opinion. While this idea is widely accepted in theory, most investors find it exceedingly difficult to buck conventional wisdom. Professional money managers face the added hurdle of increased career risk that a contrarian strategy often poses.

“It's simple, but it's not easy.”

Warren Buffett

SweetSpot's mechanistic approach solves this problem by making things simple *and* easy. Removing emotion from the equation (so to speak) essentially *forces* us to take a contrary position. Having faith in our vetted and time-tested method, we hold our noses, put our money down, and buy whatever everyone else has just abandoned, confident that their very abandonment has skewed prices to levels that will be seen as screaming bargains three years hence. This bold stance may qualify SweetSpot as the deepest of the “deep-value” investment strategies.

“Price is what you pay; value is what you get.”

Warren Buffett

As a global strategy, SweetSpot is suitable for a portfolio's entire stock allocation. The 2011 SweetSpot Portfolio holds funds in 17 sectors, widely diversified across industries and geographical regions. While SweetSpot employs a deep-value style, Morningstar classifies current positions as a mix of growth, value, and blend, with just a slight value tilt. Tallied up, the Portfolio's holdings confer an ownership interest in about 2000 companies, foreign and domestic. Even after allowing for some overlap, SweetSpot is three times more diversified than the S&P 500.

SweetSpot can be distinguished from other market-beating strategies of the past that failed to deliver once they had become widely known and whatever market inefficiency they exploited was arbitrated away. In contrast, we can count on behaviorally induced price distortions to continue to recur for as long as human nature remains as it is. This would seem to challenge any active investment approach that demands significant time, energy, or resources to administer. Why bother, when reliable market-beating returns can be achieved with relative ease? Passive investors might wonder why they should settle for mediocre returns when they can aim higher without working any harder. The dynamics of SweetSpot investing call into question the validity of both active and passive investing as they are commonly practiced today.

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\* All completed trades through January 2011 have been verified by an independent third-party auditor.

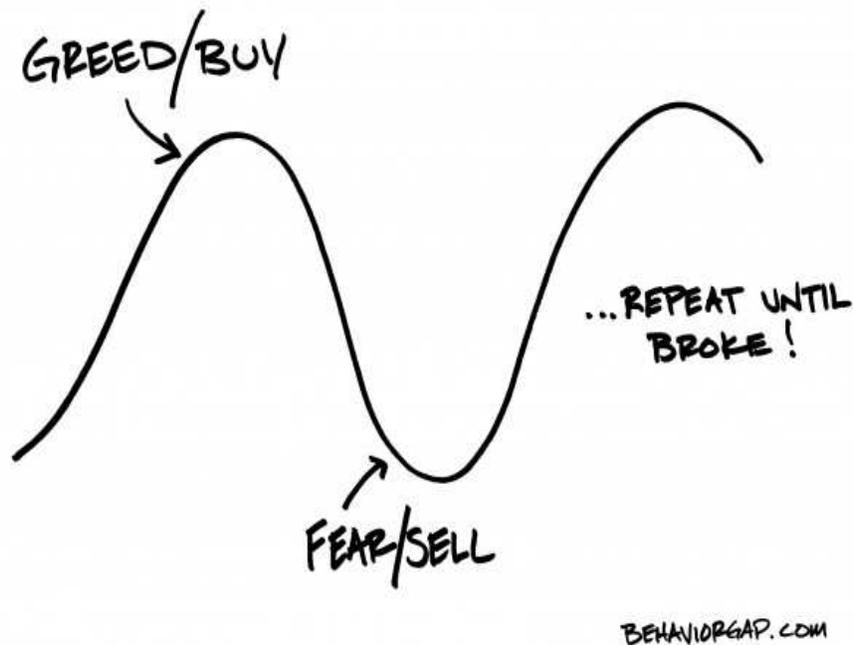
*Past performance is not a guarantee of future returns.*

# The Abandonment Metric: Negative Fund Flows as a Predictor of Excess Returns

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March 7, 2011

## 1. Introduction

It is now well established that people don't make very good investors:



What happens at market peaks and troughs to cause such poor buy-and-sell decisions? What, if anything, can an investor or money manager do about it? This paper suggests answers to these questions that can make it possible not only to sidestep the pitfalls that ensnare so many, but to profit from them.

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## 2. The Situation

Broadly stated, stock-price distortions result from investor behavior induced by factors that have nothing to do with an informed, objective analysis of investment value. The behavior at issue falls into two broad classes:

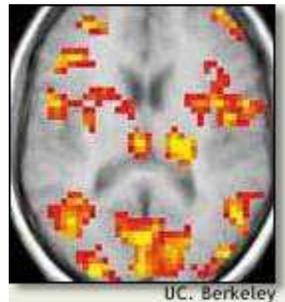
1. Irrational behavior;
2. Rational behavior driven by skewed incentives.

### 2.1 Irrational Behavior

Collectively, investors buy high and sell low. Study after study 1/ has confirmed it. Entire new fields of academic research (Camerer, Loewenstein, and Prelec, 2004, 2005) have sprouted up to find out why. Recent advances (Scherzer, 2007) have shed light on what occurs when the human animal struggles with questions that involve money and risk.

“There is no human activity that I know of to which people have a more irrational approach than the stock market. There seems to be something hypnotic about stocks that makes people behave in a manner which they would never do in any other field of activity.”

Nicolas Darvas (1920-1977)  
Investor and author



[fMRI brain scan](#)

Scientists can now map the human brain and monitor its functioning in real time. They can actually *show* us (Singer, 2008) how tasks involving the prospect of monetary gain or loss cause the “caveman” (or cavewoman) 2/ part of our brain – to fire on all cylinders. One study (Seymour, 2007) showed that during a gambling task, losing money activated an area of the brain involved in responding to fear and pain. Other research (Zweig, 2007) showed that the brain scan of someone who just “scored” financially is almost indistinguishable from that of someone who just ingested cocaine.

It's not surprising that people have difficulty relying on their wits to achieve satisfactory investment results. The list of hard-wired handicaps <sup>3/</sup> that they must overcome is long. Meanwhile, our rational brain is allowed to function just enough to think that it's in charge as it carries out the directives of our caveman within. Yet the stock market as we know it has been around for only a couple of centuries. When it's the caveman's brain that we bring to bear, the human species is maladapted to the stock market.

“The simple fact is most people just do not have brains suitable for investing.”

Douglas French  
President, Mises Institute

This explains investors' sometimes crazy behavior. We think that we're acting rationally but in reality we're at the mercy of subconscious, primal forces.

“All these primary impulses, not easily described in words, are the springs of man's actions.”

Albert Einstein

When the news is bad and everyone around us is selling, those impulses are working overtime. Caveman brains are frantically making bad trades...

## **2.2 Conventional Wisdom Defies Reality**

Many people believe that it's reasonable to hand off the responsibility that we all bear for our own financial well-being. Yet over time, investing with “expert” (Armstrong, 1980) mutual-fund managers has brought mediocre results. Surely, some fund managers beat the market, but as a group they are less likely to continue to do so than poorly performing fund managers are to start doing well. History is replete with wunderkind money managers whose performance suffered after their success became widely known and they found themselves in the spotlight.

Numerous studies document this (Braverman, Kandel, and Tohl, 2005; Sloan, Allen, 2010; Maymin and Fisher, 2011). One study (S&P, 2007) found that for the five years ending on December 31, 2006, only 13.2 percent of large-cap funds, 9.9 percent of mid-cap funds, and 10 percent of small-cap funds maintained a top-half ranking over five consecutive 12-month periods. Just 3 percent of large-cap, 2.5 percent of mid-cap, and no small-cap funds maintained a top-quartile ranking during that period. Said a spokesperson: “Standard & Poor's research shows that a healthy percentage, and in most cases a majority, of top-quartile funds in the future will most likely come from the ranks of prior-period second and third quartiles.”

Another study (S&P, 2008) found that, as a group, actively managed mutual funds have underperformed their index benchmarks over time. These findings don't factor in the up-front sales charges that many managed funds impose, which would make the contrast even more stark.

Perhaps even more startling is the finding of yet another study (Bullard, Friesen, and Sapp, 2008) that most individual investors fare much worse than their already sub-par mutual funds. How can that be? Chalk it up to the all-too-human tendency to buy in at a high price and sell out at a low one.

“The definition of insanity is doing the same thing over and over again and expecting different results.”

Albert Einstein

### **2.3 Rational Behavior + Skewed Incentives = Skewed Behavior**

Professional money managers are not immune to human foibles. Perhaps their training and experience enable them to cope better than others. But any such advantage is reduced by the career risk that they face if they act outside the mainstream.

“Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally.”

John Maynard Keynes (1883-1946)  
British economist

As the market approaches a turning point, the professional is more likely to keep his job if he joins the mass hysteria than if he steps away, or even worse, bets against the crowd. Job retention is a perfectly rational motivator, but it does nothing for efficient stock pricing.

“Career risk drives the institutional world.”

Jeremy Grantham (crediting Keynes: Grantham, Jan. 2011)  
Investor and Chairman of the Board, Grantham Mayo Van Otterloo (GMO)

### **2.4 Big Mo’**

Another big driver of stock-price distortion is “momentum” trading – or investing based on recent price action. Yet if one has a reliable exit strategy, this method makes it possible to achieve significant excess returns over time. Indeed, if it’s time to sell, maybe it’s also time to short, enabling one to profit in both up and down markets. Momentum traders are acting rationally, but their behavior can lead to some crazy results that can be seen most plainly – where else? – near the market’s peak or its trough, where prices have become truly divorced from reality.

### **2.5 The Bit Players**

Playing supporting roles in this human drama are the media, the ratings agencies, and the taxman. The media’s bottom line benefits from a larger audience when the news is sensational,

and somehow, something sensational seems to happen every day. Via faithful reporting, the media effectively reinforce and magnify investors' greed near market tops and their fear near market bottoms.

The ratings agencies tend to lag the news, having a disincentive to make news themselves in a way that might impair their ability to attract new business from the companies that they are paid to rate. As the market approaches a bottom – now that the coast is clear – they announce downgrades essentially confirming what was already known. If the message has any effect at all, it will be to exacerbate already extreme circumstances.

To investors who are in pain from the losses on which they sit, the taxman offers a sweet mail-in rebate if they'll sell before year's end – just the excuse that they need to dump their losers and put themselves out of their own misery. In the process, they artificially drive down the price of already depressed stocks.

## **2.6 The Cumulative Effect**

Notice that virtually all of these skewing effects tend to be most pronounced at or near turning points in the market. What happens as the market approaches a bottom? Mounting losses are motivating investors of all stripes to sell, without caring much about the price they get. Professional money managers are motivated to sell as part of an exercise in “window dressing.” To enhance their career prospects, they need to show that they're not holding investments that might call into question their competence. The momentum players are long gone, or they hold short positions and are actively cheerleading for lower prices. The pervasive urge to sell is reinforced by the media, seizing the opportunity to gain readers with bold-faced apocalyptic headlines. The ratings agencies are finally free to issue downgrades, now that they're the messengers after the message is already out. And the taxman is offering 30 percent off all realized losses.

Put it all together, and an objective look at prices reveals that the market thinks that things are as bad as they can get, and they'll never get any better. Unless Armageddon has arrived, the market is being irrational. But there it is.

## **3. What to Do?**

The evidence to document these dynamics is now extensive, even redundant. What has been lacking, however, is an answer to the question, “So what?” What can be done to thwart the forces that drive so many to take improvident action? Could there be a way to profit from that dynamic? If we ask an investment professional or academic how to respond to these findings, we'll likely be told, “Don't do that!” We might be offered a stratagem or two – such as setting up automatic, fixed monthly investments in a market-index fund, or some other tweaked variation of a passive, buy-and-hold program. While such an approach can be expected to outperform most investors, returns relative to the market are certain to be mediocre. Moreover,

this approach does not insulate us from our own worst instincts. Even one who labels himself a passive investor will sell – at or near the bottom – if his pain threshold has been reached.

The professional's advice is not much help if our problem is both subconscious and primal. It's as if we're being told that we need to evolve, so what are we waiting for?

So, let's evolve. But how? Ironically, we might begin by presuming that most investors won't evolve anytime soon. Investing is a zero-sum game – less than zero when we factor in everyone's "friction" costs. Every trade produces both a winner and a loser. When we know that people are making bad trades, we are right to take the other side. Perhaps our rational brain could overrule our caveman brain, if only it knew why it should. If so, we could lead the way in human evolution!

### **3.1 Abandonment as a Metric**

What is the best evidence that the market is suffering from temporary insanity? We could conduct a poll, but we would rather try to see what people are actually doing and not just hear what they're saying. For our investigation to be useful, we should look at discrete sectors of the market (i.e., industry sectors and international regions). Some sectors are always out of favor with investors, and of those, at least a few are probably close to bottoming.

Near a bottom, we know that investors have been under pressure to sell. If we can measure the investor dollars flowing into and out of each market sector, our candidates for purchase would be the ones that have seen the most dollars leave, as a percentage of assets. As it happens, we can.

### **3.2 The Strategy**

The SweetSpot® Investment Strategy uses negative fund flows to identify investments that are likely to be at or near a market-cycle low and thus ripe for purchase. SweetSpot is a "hybrid" active/passive strategy that captures the best traits of both styles while avoiding the worst. Since its inception in 1998, SweetSpot has demonstrated a consistent and significant advantage over the market; yet trades are held for at least three years, and SweetSpot investors enter and exit trades just once each year – no more frequently than passive investors who rebalance their portfolios annually.

Most investors believe – correctly -- that it's prudent to review their investments at least once a year. But taking action based on that review is usually ill-advised, especially if the action would be to replace poorly performing positions with better recent performers. Even three years might not be long enough to warrant such "corrective" action. According to one study (Goyal and Wahal, 2004): The institutional executives who select investment managers for pension funds, 401(k)s, etc., tend to hire managers who have achieved strong returns over the past one-to-three years. This return-chasing behavior, however, does not deliver strong performance. Instead, post-hiring excess returns are "indistinguishable from zero." Of course, those same executives tend to fire managers after a similar period of poor performance. Yet the post-firing excess

returns of the fired managers are frequently positive. The executives doing the firing and hiring would have done better by doing nothing.

### **3.3 The Method**

SweetSpot investing relies on a formula to calculate annual cash flows into and out of the 500 or so mutual funds and exchange-traded funds (ETFs) that make up its investment universe. The funds are sorted into approximately 100 industry sectors and international regions (or “sectors”). Each January, end-of-year fund data are collected, analyzed, and aggregated for each sector, and the sectors are ranked. New positions are entered in several of the highest-ranked sectors (or lowest-ranked, according to the investing public), financed by the sale of positions entered or renewed three years prior (but not freshly renewed). At that point our work for the year is done, and the Super Bowl is still weeks away!

SweetSpot's rules-based method ignores fundamentals – abandoned sectors are presumed to be fundamentally cheap. (That’s not to say that we blindly accept what our formula would dictate. After our quantitative analysis is complete, but before we act on it, we perform a “reality check” to ensure that our intended target – excessive sector-based selling – was actually present.) By default, then, SweetSpot can be deemed technical in nature. Yet most methods of technical analysis – and most value-based metrics, for that matter – focus on price, something SweetSpot considers only tangentially. In contrast, SweetSpot measures human behavior – investors voting with their feet. The annual fund flows that drive SweetSpot's trades are an uncommon – and uncommonly effective – metric, one that is not generally available, or even known, to the investing public.

### **3.4 Why Do We Invest in Sectors?**

Sectors are uniquely well suited to an approach that relies on market cycles. When we break down the investment universe into its component parts, we find that each sector is moving within its own market cycle – going strong, going bust, or going nowhere. We work with a sizable universe; there are always sectors that are out of favor with investors and, of those, some are likely to be at or near a bottom. SweetSpot’s analysis of fund flows identifies the most likely candidates.

It’s kismet that sectors are well suited to the analysis and the analysis is well suited to sectors. SweetSpot’s formula would not work if we tried to apply it to individual stocks. Every stock trade has a buyer and a seller, and it’s not always evident which party was under more pressure to act. When funds are bought and sold, however, the sponsor creates the shares that are bought and redeems the shares that are sold. This activity causes the total shares outstanding – information that is readily available – to fluctuate in a way that can be measured with relative ease and accuracy. That’s just as well: A sector-based strategy lets us avoid the company-specific risks associated with individual stocks. It’s odd that so many investors who would not consider investing in supposedly risky sectors won’t hesitate to buy a stock if they like its “story.” Stocks are much riskier than sectors.

It's true that individual sectors are often more volatile than the broad market, and volatility is a commonly accepted measure of risk. But what if we hold a diversified basket of sectors? Depending on how closely the price movements of our sectors correlate to each other, the resulting volatility may be lower than that of the market itself. Indeed, by most measures the SweetSpot Portfolio historically has been less risky than the market (see 7.6 Risk Measures, below).

## 4. The Dynamics

SweetSpot directs investors to the other side of bad trades, relying on cold numbers to identify the mispriced assets left behind after the frenetic selling has played out. We escape the “buy high, sell low” cycle that plagues most investors, while capitalizing on others' failure to do so. Buy-and-sell decisions are virtually automatic, leaving us to apply our judgment to something that it's qualified to decide — that this is a course of action worth pursuing.

“We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful.”

Warren Buffett

If we reduce Mr. Buffett's approach to a simple qualitative formula, we can appreciate the anomalous behavior that he has been able to exploit so effectively for more than 40 years:

*Greed - Fear = Risk Tolerance*

When greed exceeds fear, risk tolerance is high (but should be low, according to Mr. Buffett). When fear exceeds greed, risk tolerance is low or nonexistent (but should be high). If you're asked to describe your risk tolerance, an honest answer might be, “How's the market doing?”

Investors sell in droves when fear predominates. SweetSpot investors buy the sectors that have seen the most pronounced selling. In effect, we assume an attitude of greed in the face of fear. Mr. Buffett would approve.

## 5. Performance

In its 12 years of real-time trading, SweetSpot has outperformed the S&P 500 by an average of 12.7 percentage points per year. Positions bought each year have *always* collectively outperformed their market benchmark during the period they were held. The one calendar year SweetSpot underperformed was 2006, proving only that what happens in any given year has no bearing on our long-term prospects: Despite its sub-par returns, 2006 marked the completion of SweetSpot's best-ever three-year trade.

A comprehensive list of all completed SweetSpot trades through January 2011 – along with detailed disclosures – can be found at <http://sweetspotinvestments.com/>. For years, the absolute and relative returns of SweetSpot's multi-year trades told us all we needed to know as long-term investors. We didn't even bother to calculate annual returns until 2005 when we became curious about how they compared to others' track records. They compared quite favorably.

One way to present the annual returns of a model portfolio is to assume an equal investment in all positions held each year, rebalanced to equal weightings annually. Taking that approach, the gross, unhedged annual returns of SweetSpot's model portfolio since 1999 are presented below alongside the corresponding returns of its market benchmark. Performance figures assume the reinvestment of all dividends and other distributions.

<i>periods:</i>	<b><i>Cumulative SweetSpot Returns, 1999-2010</i></b>				
	<b><i>average annual return</i></b>		<b><i>relative</i></b>	<b><i>cumulative returns</i></b>	
	<i>SweetSpot</i>	<i>benchmark*</i>	<i>excess pts.</i>	<i>SweetSpot</i>	<i>benchmark</i>
<b>since inception</b>	17.1%	4.4%	12.7	362.7%	26.2%
<b>ten years</b>	11.1%	4.1%	6.9	118.9%	15.0%
<b>five years</b>	10.2%	6.3%	3.9	33.5%	12.8%
<b>three years</b>	8.3%	1.2%	7.1	4.4%	-13.3%
<b>one year</b>	18.1%	13.1%	5.0	18.1%	13.1%

\*Benchmark is the S&P 500 (SPY) from 1999-2006, and global stocks from 2007 onward (see 8. SweetSpot Goes Global, below). Both measures since 2007:

2007: Global +12.4%; S&P +5.5%  
 2008: Global -42.2%; S&P -37.0%  
 2009: Global +32.7%; S&P +24.5%  
 2010: Global +13.1%; S&P +14.6%

(All completed trades through January 2011 have been verified by an independent, third-party auditor.)

## **6. SweetSpot's Genesis and Evolution**

SweetSpot's method is a variation of an investment approach first suggested by Morningstar and Lipper in 1998. According to the Wall Street Journal's Monthly Mutual Funds Review published on December 7, 1998 (Damato, 1998):

Buying selected lagging categories and lightening up on the leading categories is essentially a form of buying low and selling high. While it sounds smart, though, it is tough psychologically. Indeed, investors feel far more comfortable jumping into categories that have done well and bailing out of the laggards. [Ed. note: When it comes to investing, comfort is overrated.]

The result: “People tend to buy particular segments of the market as they are topping out, and they tend to pull out of sectors of the market as they are bottoming,” says Susan Dziubinski, editor of Morningstar’s monthly Morningstar Fund Investor publication. “Investors tend not to have great timing.”

Intrepid bargain hunters might want to look not at funds with big losses, but rather at those categories that have seen the biggest outflows of investor dollars, Ms. Dziubinski suggests. That has been a winning strategy over the years, Morningstar has found...

The article disclosed Lipper’s picks for the current year: Latin America; Pacific Basin; and Canada.

## **6.1 SweetSpot is Born**

SweetSpot’s first trade using a fund-outflow strategy was comprised of positions in Fidelity Latin America (FLATX); Fidelity Pacific Basin (FPBFX); and Fidelity Canada (FICDX). The trade was entered just before the final “blow-off” year of the 1990s bull market. In 1999, the S&P 500 returned +20.4 percent. In comparison, Fidelity Latin America (FLATX) returned +54.9 percent; Fidelity Pacific Basin (FPBFX) returned +119.5%; and Fidelity Canada (FICDX) returned +40.6 percent.

Attempts were made to learn the least popular sectors in 1999. But Morningstar failed to respond to repeated inquiries and Lipper, having noticed how well its picks had performed the year before, offered to charge a prohibitive amount for the information. (Inexplicably, as of 2010, the fund-flow information SweetSpot relies upon wasn’t available at any price from either Morningstar or Lipper.)

A leap of faith was made that Fidelity’s broad array of non-diversified mutual funds could serve as an effective proxy for the market. Measuring the fund flows associated with that universe, and treating each fund as its own “sector,” might yield some interesting investment candidates. It was an exciting concept. Most appealing was the likelihood that no one else on the planet was trading this particular strategy. If it turned out to be a winner, this was an opportunity to get in on the ground floor.

A rough formula for calculating fund flows was devised and, after some prodding, Fidelity agreed to provide the necessary fund data. The ensuing analysis showed that 1999 was such a boom year in the markets that only two Fidelity funds saw any appreciable outflows: Select Food & Agriculture (FDFAX, since renamed Select Consumer Staples) and Select Medical

Delivery (FSHCX). With just a few months remaining in the bull market's run, fund flows were saying that there wasn't much worth buying.

Of course, lots of funds showed substantial inflows in 1999, but at the top of the list was Pacific Basin. The outflows that had made it a pick the year before executed a U-turn in 1999. The fresh inflows explained Pacific Basin's triple-digit gain in one year. Because the thesis for buying the fund (as an outflow leader) no longer applied, this was treated as a sell signal. Pacific Basin was sold and the proceeds were used to buy equal shares of food & agriculture and medical delivery.

Medical delivery issued a sell signal of its own one year later. It had returned +77.3 percent in a year when the overall market was down, outperforming the S&P 500 by the same margin as Pacific Basin the year before.

The strategy continued to perform very well in the ensuing years, suffering no losing trades throughout the three-year bear market that commenced with the new millennium. When the time came to sell food & agriculture in 2003, it had appreciated 23.4 percent since purchase. The S&P 500 had declined 35.6 percent during the same period. Indeed, the strategy now dubbed "SweetSpot" exited no trade at a loss until January 2009, fully 10 years after it had begun trading.

## **6.2 Morningstar's Folly**

In 2004 it was learned that Morningstar had been publishing information about its "Buy the Unloved" strategy since 2000. The firm issued press releases announcing its picks every January from 2000-2005 (Morningstar, 2000-2005). The press releases enabled us to confirm that Morningstar's strategy had performed very well, even rivaling SweetSpot. We began to selectively trade Buy the Unloved alongside SweetSpot.

SweetSpot's small advantage over Morningstar was probably due to differences between the two investment universes. Morningstar traded many broadly diversified fund categories such as "large value," "small growth," "convertible securities," etc., whereas SweetSpot traded more-volatile sector funds. Although volatility is a common measure of risk, volatility bought at the right time can be a wonderful thing.

"Look at market fluctuations as your friend rather than your enemy; profit from folly rather than participate in it."

Warren Buffett

Then, in January 2006, something happened to rival any of the bizarre behavior discussed elsewhere in this paper. Morningstar's 2003-2005 trade – consisting of positions in Latin America, utilities, and financials – was due to be closed out. Together those positions returned +129.6 percent versus +46.0 percent for the S&P 500. While the returns of SweetSpot's 2003-2005 trade were half again the market's, Morningstar's numbers were strong enough to bring

Buy the Unloved to within a point of SweetSpot's long-term returns. Yet just when we expected Morningstar to declare victory for Buy the Unloved, they conceded defeat instead! After six consecutive years of press releases touting the strategy, none was issued in 2006. In the January 2006 edition of Morningstar's FundInvestor newsletter, its editor did not refer at all to the just-closed-out trade, but instead reported:

...[R]eturns of our buy-the-unloved strategy have lagged... [They] could improve, but I think we can do better. The long-term returns of the strategy have been middling since we began tracking it in 1996, so I think it's had time to prove itself, and it hasn't done that.

At the time of publication, Morningstar still had pending trades due to be sold in 2007 and 2008, both of which were showing (and ultimately realized) market-beating gains. In the context of Morningstar's past statements and the strategy's actual performance, the editor's statement (and his silence on certain newsworthy matters) was baffling.

The report continued:

I'm adopting a more fundamentally driven strategy that should unearth winners that you can buy and put away for the long haul. To get there, I looked for categories that have lagged over the past three years and that are trading at a discount to fair value as judged by Morningstar stock analysts...

Calling this new approach "Buy the Unloved v2.0," the editor wrote that Morningstar still would perform flow analysis. But whereas flows used to be ranked by their percentage of assets, now they would be ranked by absolute dollars. This "change" redefined the strategy out of existence. It promised to skew things in favor of Morningstar's largest categories, such as the ones comprising its "style boxes." Those were exactly what SweetSpot investors had been glad to avoid. The style boxes are simply diversified subsets of the market, lacking the potential for outsized gains of the magnitude offered by Morningstar's smaller categories and the non-diversified sectors in SweetSpot's universe.

Subscribers who had been paying attention were left to wonder what could have caused this bizarre outcome. Morningstar had abandoned "the abandonment metric," joining the multitudes that create "distortions... induced by factors that have nothing to do with an informed, objective analysis of value" (see 2. The Situation, above). Corporations are run by people, so perhaps we should not be surprised when even objective data providers exhibit irrationality. We reluctantly bade a fond farewell to Buy the Unloved v1.0, which did not deserve its fate.

"The irrationality of a thing is not an argument against its existence; rather a condition of it."

Friedrich Nietzsche

*Post-script:* In the ensuing years, FundInvestor has mentioned fund flows only sporadically. There have been no press releases since 2005. Most recently, in its February 2011 issue, the newsletter included an unadorned announcement of the 2011 v2.0 picks: “large-growth, large-blend, and large-value.” [Read: “The market”]

For the record: From 2000-2007, Morningstar’s three-year trades under Buy the Unloved v1.0 averaged +49.3 percent, versus +7.8 percent for the S&P 500. All eight trades were profitable, whereas the S&P 500 showed a corresponding loss in two of the eight trade periods.

## **7. The Backtest**

SweetSpot’s beginnings relied upon the backtesting that Morningstar and Lipper had performed, as reported in the Wall St. Journal in 1998. Then, in 2006, seven years after real-time trading had commenced, SweetSpot’s specific strategy was subjected to a backtest going back to 1989 (the earliest that it would have been possible to trade sectors using mutual funds as the vehicle). The results gave a small edge to SweetSpot versus the S&P 500, but returns were “lumpy.” Unlike our actual experience trading SweetSpot, we would have been put to the test during the backtest period. The first three trades in 1989-1991, for example, would have dramatically under-performed the market. If some adventurous soul had devised SweetSpot and started trading it in 1989, he would have given up after a year or two, wondering where he went wrong.

Why the poor start? Who knows? Note that in 1989 there were only 34 funds in SweetSpot’s universe. Perhaps the “right” funds to trade did not yet exist.

Then, in 1996-1998, investors would have had to endure a brutal stretch. SweetSpot didn’t suffer any losses, but showed flat returns during a period when the stock market was booming. This time, however, the reasons for the poor performance were apparent:

- The stock market was in the final years of a bubble that was 20 years in the making.
- "The madness of crowds" drove the market.
- Momentum trading became prevalent; investors bought what was going up and sold what was not – for three straight years.
- The large growth stocks that dominated the NASDAQ and S&P 500 were bid up to unprecedented valuations.
- Investing in S&P 500 index funds (SweetSpot's benchmark) emerged as a “superior” investment strategy.

Under these conditions, a deep-value strategy such as SweetSpot had no chance. At least we would have been in good company: Several seasoned money managers with outstanding long-term track records exited the market during this period, saying that it had morphed into something that they didn’t understand. Even Warren Buffet – who shunned technology stocks because he couldn’t value them using his tried-and-true methods – was said to be "out of touch."

Just because we can explain SweetSpot's poor performance during discrete periods, however, doesn't mean that we could have avoided it. Nor should we even have tried. Our takeaway here was that an advantageous long-term strategy can produce sub-par returns for long stretches. For this reason, SweetSpot investors were advised only to invest assets that they wouldn't need for at least five years, and longer was better.

“The things we are doing will not go away. We may have bad years; we may have a terrible year sometimes. But the principles we've discovered are valid.”

James Simons, PhD, Mathematician and hedge-fund manager

## 7.1 Good and Lucky

The backtest instilled in us a heightened awareness of the role that luck plays in any human endeavor. As it happened, SweetSpot's timing could not have been better, getting underway in real time just as the world entered the Internet Age (Barber and Odean, 2001; Choi, Laibson, and Metrick, 2000). The ever-increasing velocity with which information was being generated and disseminated fed directly into the kind of behavioral anomalies that SweetSpot exploits. Human evolution, it seems, does not move relentlessly forward – it's more like three steps forward, two steps back (if we're lucky).

All of the forces that encourage “group think” have been progressively magnified over the past decade. It used to be that access to a stock ticker was needed to check the price of a stock more than once a day. Today one can check prices countless times throughout the trading day, and go crazy in the process. Everyone who's interested in the same stock can go to a chat room and reinforce one another's views. Then, when things go south, all run for the exits simultaneously, resembling schools of fish or flocks of geese that change course simultaneously in an instant.

The backtest looked at past events, but SweetSpot will be traded in the future. The differences that we can see between the recent past and the more distant past combine to explain SweetSpot's extraordinary real-time performance, and to make the strategy's prospects appear even brighter than its returns to date would suggest.

Considering SweetSpot's actual performance since 1998, a backtest showing *any* hypothetical advantage before 1998 is significant. Indeed, a backtest usually precedes actual trading, and most strategies fall short when investors attempt to duplicate backtested results in real time. Here, the backtest occurred only after seven years of trading had been logged. (Before 2006, we relied on the research that Morningstar and Lipper had conducted.) Yes, the backtest gave SweetSpot an edge over the market, but SweetSpot's real-time results far exceeded what the backtest would have predicted. The backtest merely confirmed that the strategy would have worked over a longer time horizon than the period in which it was actively traded.

Any report on backtested results must be accompanied by certain caveats: Backtest results do not represent actual trading. They may not reflect the impact that material economic and market

factors might have had on decision-making if one had actually managed money during the backtest period.

The backtest yielded other findings that informed future trades. We discovered:

- It would have paid to trade “also-rans,” or funds that were ranked closely behind each year’s picks.
- On average, the third year of a SweetSpot trade outperformed the second, which in turn outperformed the first. The differences were significant.
- Perhaps most surprisingly, the sell signal that we had been using lacked merit.

## 7.2 Sell Signals

From 1999 until 2005, SweetSpot sold a position early if it became a fund-inflow leader one or two years after it was bought. The 2006 backtest, combined with real-time data, showed that despite a strong beginning, sell signals did not improve returns over time. Not that they hurt – they just didn’t help. Funds that we would have held but for a sell signal outperformed the S&P 500 by virtually the same margin as the funds we held. The lesson: As a group, positions that generate sell signals are no different from those that don’t. If sell signals had no value, they weren’t worth the increased turnover that they entailed.

This analysis was performed on a small sample size, however; among all back-tested and real-time trades, there were only 13 sell signals. Such a small universe prompted us to look at the performance of all fund-inflow leaders from 1989 through 2005, regardless of whether they were SweetSpot positions. Theoretically, if our sell signal really were meaningless, fund-inflow leaders as a group should perform roughly the same as the overall market. The results, based on 45 completed three-year “trades” over a 16-year period:

### *Fund-Inflow Leaders:*

Average return per three-year trade: +46.0%

Average S&P 500 return during corresponding periods: +46.2%

Average relative return per three-year trade: -0.2%

Annualized, the difference was less than one-tenth of one percent. This finding validated the decision to forego sell signals, but it also had two other significant implications:

## 7.3 Three Years is the Charm

SweetSpot had adopted the same three-year holding period that Morningstar and Lipper advocated in 1998 based on their research. We were not party to that research, but we had no reason to question it. Our study on sell signals not only gave us none, but it highlighted the futility of trying to distinguish – before the fact -- a sector that should be sold from any other sector. It also made intuitive sense that sectors in severe distress – of the sort that SweetSpot

trades – need time to recover their value. Three years seemed about right. Our experience trading SweetSpot to date told us, “If it ain’t broke, don’t fix it.”

A topic for future research may be to assess whether advances in the effectiveness of short-term exit strategies make it worthwhile to try to fine-tune our sells. In the absence of any such analysis, we will contentedly adhere to our discipline, exiting SweetSpot positions 36 months after we enter them.

#### **7.4 Positive Fund Flows Predict Nothing**

The backtest refuted the intuitive presumption that if negative fund flows lead to positive excess returns, positive fund flows should lead to negative excess returns. (Morningstar’s unconventional practice of using its “most popular” fund categories as a benchmark for its “Buy the Unloved” strategy seemed to have been based on this presumption.) On the contrary, positive fund flows have no apparent predictive value.

This may be explained by a key difference between market tops and bottoms: Tops are formed when most investors who would buy have already bought, depleting the pool of prospective buyers who could push prices higher. Conversely, bottoms are formed when most investors who would sell have already sold, depleting the supply of sellers who could push prices lower. But now the laws of physics come into play: The number of investors who have not bought a particular sector is orders-of-magnitude greater than the number of holders who have not sold it. That is, many more people do *not* hold a sector (and therefore could buy it) than *do* hold it (and therefore could sell it). Moreover, prospective buyers include those who have already bought but wish to buy more. They are limited only by their means. In contrast, holders who wish to sell cannot sell more than the shares they own (shorting aside).

We can gauge the status of prospective sellers by calculating fund flows as a percentage of sector assets. This exercise is not productive when applied to prospective buyers, however, as fund flows would have to be compared to all available assets that could reasonably be invested in a sector. It probably isn’t even feasible to try to calculate “all available assets” for this purpose.

Helping us along in our search for a bottom are the “strong holders” – not unlike SweetSpot investors – who buy late in a downtrend and are unlikely to sell. This further reduces the already depleted pool of prospective sellers, and increases the likelihood that a bottom is near at the time SweetSpot’s method judges it. It is thus worthwhile to rely on fund flows to gauge whether a bottom may be at hand, but not to do likewise in search of a top. We don’t mind: Successfully navigating market bottoms tells us both what to buy and when. We already know when to sell.

Also impairing the predictive value of fund inflows are macro-economic forces that can create inflows that have nothing to do with froth. In recent years, for example, the materials, commodities, energy, and precious-metals sectors all have been promoted to the status of “asset class” alongside stocks and bonds. As a result, funds in those sectors (many more than existed a few years ago) have seen copious inflows. At some point things may become excessive, but it’s anyone’s guess when that will be.

That's not to say that macro-economic forces are irrelevant to fund outflows. In the early-to-mid-2000s, for example, utilities were demoted from their status as an asset class. A few years earlier, during the mid-to-late '90s, the managers of utilities funds had missed out on gains being achieved all around them. Many of them finally capitulated, reclassifying high-flying stocks like Lucent and Nortel as "utilities" stocks and adding them to their holdings. The "widows and orphans" – and their fiduciaries – who owned utilities funds were not pleased with the outcome. The result: The utilities sector was a Morningstar Buy the Unloved pick in three consecutive years from 2003-2005. Those were outstanding trades for Morningstar (and SweetSpot investors who traded in tandem), producing market-beating gains while lowering overall portfolio risk due to the lack of correlation between utilities and the stock market (once the chastened – or newly hired – fund managers ejected Nortel and Lucent).

There is no known instance when a sector was promoted to asset-class status immediately following a period of poor performance and fund outflows; nor has any known sector's demotion from that status been preceded by a period of strong performance and fund inflows. To the extent macro-economic forces affect fund flows, SweetSpot's method accounts for them. But we can't rule out the possibility that such forces will have a confounding effect on the significance we attach to fund flows in any given instance.

## **7.5 Year Three is the Charm**

If more-recent research on the relationship between fund flows and future performance has yielded mixed results, it's probably because studies finding no predictive value in negative flows have tended to examine relatively short timeframes. SweetSpot's three-year holding period, as convenient as it is to trade, also has been essential to the strategy's effectiveness. When we looked at the average historical year-to-year performance of individual SweetSpot positions, we found that Year Three of a typical trade outperformed Year Two, which in turn outperformed Year One. This "trichotomy" has shown up consistently in both backtested and real-time trading, and lately it has gained traction: In 2010, SweetSpot's Year-Three positions gained 32 percent while the rest of the Portfolio struggled to achieve double-digit returns.

Seeing better returns later in a trade seemed counterintuitive at first, but it makes sense. SweetSpot trades abandoned sectors. In Year One whatever sad tale caused investors to flee is still fresh in everyone's mind, reinforced by the fear-mongering financial press and the late-to-the-party ratings agencies. But new and different fears eventually emerge; memories fade over time; nightmare scenarios tend not to materialize; and mean reversion kicks in and then plays out. By Year Three, the pool of buyers has expanded to include momentum players. Those are the same folks – minus the ones who went broke along the way – who drove prices down before we bought in. Now they're driving prices up before we sell! Bless 'em...

Independently of SweetSpot, the Year-Three phenomenon was seen elsewhere in 2010. A study (Faber, 2010) that looked only at annual returns found that the worst-performing asset class three years prior outperformed a buy-and-hold strategy in the following year by an average of six points.

### 7.5.1 Hot Tip

Prospective investors sometimes ask about the latest SweetSpot picks, as if they're looking for a hot tip. Now they're told, "Okay, what you want to do is wait two years and then buy funds in these sectors." Maybe they'll frown at the long wait. "Okay, then buy these other sectors we bought two years ago." At that point they walk away muttering, "Why is he wasting my time? He could've just said no..."

### 7.6 Risk Measures

In 2007, the backtest data were combined with real-time data to enable a long-term risk analysis of SweetSpot. The test period ran from 1991 (the first year the SweetSpot Portfolio would have held trades entered over a three-year period) through 2006. The analysis concluded that SweetSpot posed lower-than-market risks while achieving better-than-market returns. Specific findings:

*Sample size: 16 years*

Mean (average) return: 18.55%  
S&P 500 mean (average) return: 12.94%

Variance (standard deviation): 281.56  
S&P 500 variance (standard deviation): 297.32

Standard deviation: 16.78 (lower is better)  
S&P 500 standard deviation: 17.24

Population standard deviation: 16.25  
S&P 500 population standard deviation: 16.70

Variance (population standard deviation): 263.97  
S&P 500 variance (population standard deviation): 278.73

Sharpe ratio:\*  $18.55 - 3.88 / 16.78 = .87$  (higher is better)  
S&P 500 Sharpe ratio:  $12.94 - 3.88 / 17.24 = .53$

Losing months: 58 of 192  
S&P 500 losing months: 66 of 192

Percentage losing months: 30.2%  
S&P 500 losing months: 34.4%

Maximum drawdown: -24.4%  
S&P 500 maximum drawdown: -24.2%

Average maximum yearly drawdown: -6.7%  
S&P 500 average maximum yearly drawdown: -7.5%

Number of years with a double-digit drawdown: 2  
S&P 500 number of years with a double-digit drawdown: 4

Maximum yearly upswing: 35.15% (1/3/95-10/2/95)  
S&P 500 maximum yearly upswing: 38.17% (1/3/95-1/2/96)

Average maximum yearly upswing: 18.85%  
S&P 500 average maximum yearly upswing: 14.63%

Number of years with a double-digit upswing: 13 of 16  
S&P 500 number of years with a double-digit upswing: 8 of 16

Future research should be performed to update this analysis, and also to address a major flaw in the Sharpe ratio (2011), which penalizes an investment for both upswings and downswings. The analysis would be more meaningful (and, coincidentally, SweetSpot would fare even better) with the application of the Sortino ratio (2010) that measures risk after filtering out the upswings that investors find desirable.

Pending future research, one can refer to the list of completed SweetSpot trades through January 2011 at <http://sweetspotinvestments.com/>. It addresses relative risks in basic terms by showing that 26 of 29 completed SweetSpot trades through January 2011 were profitable, while SweetSpot's market benchmark was profitable during only 14 of the 29 corresponding periods.

\* Sharpe ratio = average return minus risk-free return (3-month T-Bill) divided by standard deviation. Average 3-month T-Bill rate from 1991-2006 was 3.88%.

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## **8. SweetSpot Goes Global**

From 1998-2006, SweetSpot trades were selected from a universe of Fidelity sector funds, with each fund representing its own sector. This approach made sense because Fidelity offered the only way to invest in sectors using mutual funds as the vehicle. That gradually changed with the proliferation of sector ETFs that competed with Fidelity, making Fidelity's funds a less-reliable proxy for market behavior when viewed at the sector level. For all we knew, investor dollars leaving a Fidelity fund might be headed to an ETF in the same sector. The sector as a whole would be in fine shape, but we couldn't know that by looking only at Fidelity data. (Subsequent analysis showed that this scenario in fact did play out, i.e., a Fidelity fund saw severe outflows that were more than made up by inflows to an ETF in the same sector.)

Compounding this problem was the ongoing movement toward globalization of the financial markets, increasingly blurring the line between domestic and international sectors. Clearly, something had to be done. Reluctantly, the decision was made to expand SweetSpot's universe to include all known sector ETFs and mutual funds. Effective with trades entered in 2007, SweetSpot's formula was applied to data for this much-larger universe, thus increasing the likelihood that market behavior would be accurately gauged.

This decision was a reluctant one because it increased the size of SweetSpot's universe by an order of magnitude. Required data processing would henceforth take a *week* or more each year instead of just the one afternoon to which we had become accustomed. Yet even with a workload many times heavier than before, we were still required to put in just two percent of the time the professionals spent each year trying to beat the market. Their Herculean efforts notwithstanding, history told us that the professionals – as a group -- would fail, while we were likely to succeed.

## 9. Science in Support

In addition to Morningstar and Lipper in 1998 and beyond (and Faber, 2010), other researchers have lent support to SweetSpot's specific method. One detailed study (Evergreen, 2005) showed that broad sectors (a la Morningstar's "style boxes") experiencing capital outflows tend to produce market-beating returns in the future. In 2010, research firm TrimTabs published a study that concluded, "Regression analysis suggests the probability that equity ETF flows are not a contrary leading indicator is less than 1 percent."

The rationale behind SweetSpot is straightforward and easy to grasp. Efforts to refute it have utterly backfired: A virtual mountain of support for the approach can be found in the hard sciences, economics, psychology, anthropology, philosophy, and logic. At its base, SweetSpot relies upon bedrock principles of contrarianism that have been expressed and validated over thousands of years:

"Excess generally causes reaction, and produces a change in the opposite direction, whether it be in the seasons, or in individuals, or in governments [or in financial markets]."

Plato (428-348 B.C.)  
Philosopher and mathematician

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"What is food to one is to others bitter poison."

Titus Lucretius Carus (99-55 B.C.)  
Roman poet and philosopher

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“Fortune turns round like a millwheel, and he who was yesterday at the top, lies today at the bottom [and vice versa].”

Miguel De Cervantes (1547-1616)  
Spanish novelist, poet, and playwright

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“Follow the course opposite to custom and you will almost always do well.”

Jean Jacque Rousseau (1712-1778)  
French writer and philosopher

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“Buy when everyone else is selling, and hold until everyone else is buying. This is not merely a catchy slogan. It is the very essence of successful investing.”

J. Paul Getty (1892-1976)  
American industrialist

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“When people are desperately trying to sell, help them and buy.”

Sir John Templeton (1912-2008)  
Investor and philanthropist

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The validity of contrarian investing is widely accepted in theory, but in practice people find it exceedingly difficult to buck conventional wisdom. Professional money managers face the added hurdle of increased career risk that a contrarian strategy often poses.

“It's simple, but it's not easy.”

Warren Buffett

SweetSpot's mechanistic approach solves this problem by making things simple *and* easy. Removing emotion from the equation (so to speak) essentially *forces* us to take a contrary position. Having faith in our vetted and time-tested method, we hold our noses, put our money down, and buy whatever everyone else has just abandoned, confident that their very abandonment has skewed prices to levels that will be seen as screaming bargains three years hence. This bold stance may qualify SweetSpot as the deepest of the "deep-value" investment strategies.

“Price is what you pay; value is what you get.”

Warren Buffett

## 9.1 Full Disclosure

Research uncovered numerous memorable quotes lending support to SweetSpot, only some of which are presented in this paper. But two quotes in particular – one from Warren Buffett and one from Albert Einstein – might be considered less than supportive:

“So far as laws of mathematics refer to reality, they are not certain. And so far as they are certain, they do not refer to reality.”

Albert Einstein

SweetSpot employs a precise mathematical formula, but the formula only serves to provide a rough measure of the recent past. We do not pretend that it predicts the future with any certainty. Rather, it informs our estimate of the probabilities, and in that capacity it has performed very well. In order to be worthwhile, an investment strategy does not need to offer certainty. It needs only to achieve excess returns over time.

Not unrelated to the first quote:

“Beware of geeks bearing formulas.”

Warren Buffett

SweetSpot's use of a formula can be viewed as a necessary evil. It's the only way that we have found to determine when fleeing investors qualify as a stampede. Our formula is not a black box, but a way of measuring human behavior. We know exactly what it tells us. We feel confident that if Mr. Buffett and Dr. Einstein were presented with all available information about SweetSpot, they would approve. They are, after all, the two most-quoted luminaries in support of SweetSpot elsewhere in this paper.

## 10. Diversification

As a global strategy, SweetSpot is suitable for a portfolio's entire stock allocation. The 2011 SweetSpot Portfolio holds funds in 17 sectors, widely diversified across industries and geographical regions. Although SweetSpot employs a deep-value style, Morningstar classifies current positions as a mix of growth, value, and blend, with just a slight value tilt. Some sectors offer a variety of funds that enable an investor to fine-tune target allocations by emphasizing value or growth, small-cap, mid-cap, or large-cap stocks, dividend payers, etc. Talled up, the Portfolio's holdings confer an ownership interest in approximately 2000 companies, foreign and domestic. Even after allowing for some overlap, SweetSpot is three times more diversified than the S&P 500.

## 11. Will SweetSpot Lose its Edge?

SweetSpot's persistence to date has come from the fact that every year the Portfolio sheds what has had ample time to recover its value, and is "refreshed" with new sectors that have years of value recovery ahead of them. This is not a transient dynamic. There is no reason to expect it to change or disappear.

Perhaps just as significantly, as a true contrarian strategy, SweetSpot by its very nature is unlikely to catch on (just ask Morningstar). Many of the investors who sell the sectors that SweetSpot investors buy were told to do so by their investment advisers, the financial press, or the ratings agencies. Professional advisers tend not to contradict their own advice. They are not likely to reverse themselves just because SweetSpot says "buy."

Even if SweetSpot were to catch on, the strategy can be distinguished from other market-beating strategies of the past that failed to shine once they became widely known and whatever market inefficiency they exploited was arbitrated away. In contrast, we can count on behaviorally induced price distortions – the kind SweetSpot exploits -- to continue to recur for as long as human nature remains as it is.

The laws of physics are even less likely than the laws of human nature to change anytime soon. SweetSpot investors enjoy an immutable margin of safety: Investors who have sold the sectors that we're about to buy cannot then sell them *after* we buy. And if everyone has sold, the next buyer will have to pay a higher price.

The trends that feed into the kind of behavioral anomalies that SweetSpot exploits are not going away – on the contrary, they are accelerating. Adjustments to the strategy based on our experience and research – such as overweighting Year-Three positions – likewise make the strategy's prospects appear even brighter than its performance to date would suggest.

## 12. Conclusion

This paper has described an alternative method of investing that offers both the superior returns sought by active investors and the freedom cherished by passive ones. SweetSpot's unique combination of features would seem to challenge any active investment approach that demands significant time, energy, or resources to administer. Why bother, when reliable market-beating returns can be achieved with relative ease? Anyone wishing to make the opposing case must first adjust his or her argument for the world as it is today. Active investors who can point to past excess returns now must account for the added costs imposed on them by high-frequency traders and other denizens of the financial nether world lying in wait to exact their toll on every trade. Those elements have "evolved" more effectively than most humans.

Passive investors might wonder why they should settle for mediocre returns when they can aim higher without working any harder. They might also wonder if they have felt truly "free" to ignore their investments in recent years. Indeed, just how passive were they when put to the test?

It's natural to be skeptical about the effectiveness of a simple, hands-off program in a world that seems to be growing more complex every day. But consider the views of two people whose capacity for coping with complexity is unparalleled:

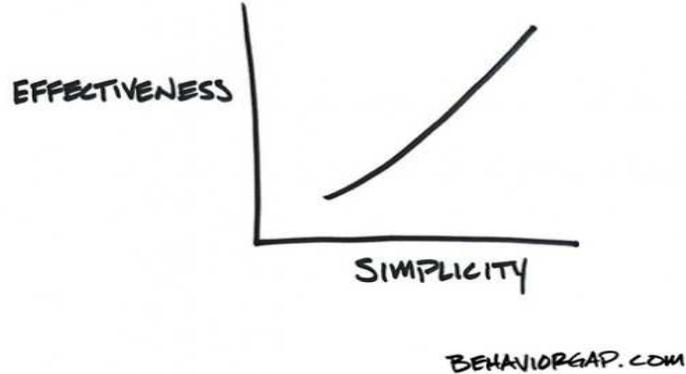
"The business schools reward difficult, complex behavior more than simple behavior, but simple behavior is more effective."

Warren Buffett

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"Everything should be made as simple as possible, but not one bit simpler."

Albert Einstein



SweetSpot meets Dr. Einstein's test: Trading just once a year is as simple as possible. The only thing simpler would be a completely passive buy-and-hold approach to investing. In today's world, that is simply too simple.

SweetSpot's unique program calls into question the validity of both active and passive investing as they are commonly practiced today. It offers enlightened investors their best chance to end the cycle of self-defeating behavior that they otherwise have been unable to overcome.

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*Past performance is not a guarantee of future returns.*

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