

Qwest for Returns

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Investors now walk a tightrope between the prospect of inflation and deflation, with little middle ground in between.

The ideal tool for addressing such conditions the use of trend following models used for dynamic asset allocation.

How the Trend can be your Friend

There is a television series called *House*, where on a weekly basis a team of doctors meet a patient with puzzling symptoms. The doctors then try to diagnose the illness and find a treatment.

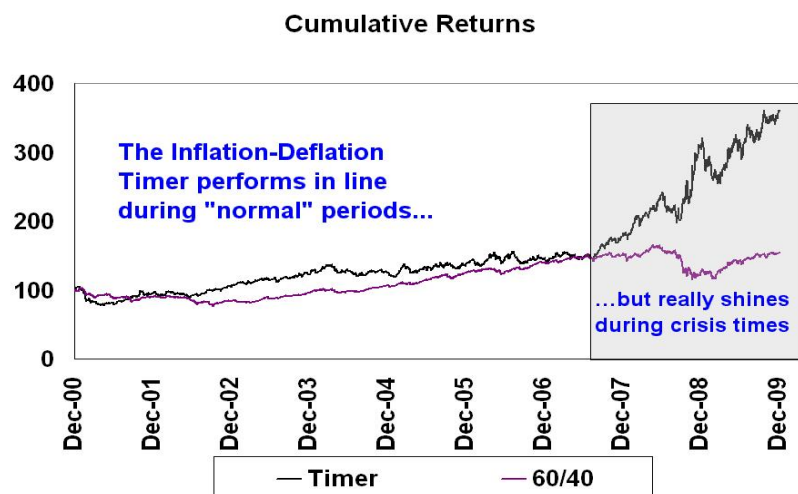
In many ways, the job of the investment strategist is like the fictitious doctors on *House*. He needs to know what kinds of investment conditions he faces and deploy the proper tool to address that condition

In the wake of the Great Recession, investors now walk a tightrope between the prospect of runaway asset inflation on one hand and gut-wrenching deflation on the other, with little middle ground in between. Despite the clouded long-term macro-economic outlook, medium term investor expectations of macro direction are remarkably stable. The ideal tool for such conditions is trend following models used for dynamic asset allocation.

Profiting from trended instability

The high degree of investor doubt about the macro-economic trajectory means that the traditional solution of fixed asset allocation will yield sub-par results.

The chart below shows the relative cumulative returns of our Inflation-Deflation Timer model, which is based on trend following principles, compared to the returns of a 60% stock/40% bond balanced fund benchmark. The Inflation-Deflation Timer model performs in line with the 60/40 benchmark during "normal" non-crisis periods, but returns really stood out during crisis times.



We believe that these periods of long-term macro uncertainty and medium term investor expectations stability will persist, which makes this an ideal environment for trend following models. In the pages to follow, we would like to explore the basis for the success of trend following models, as well as their uses and misuses.

Trend following models identifies macro-economic trends, which tend to be persistent, and tries to profit from them.

The how and why of trend following models

Trend following models are actually very simple technical analysis systems that use two or more moving averages of past price movements. The analyst uses a slow moving average to identify the long-term price trend, a faster moving average to identify the short-term trend and sometimes an even shorter term moving average for risk control. You buy when the model spots an uptrend and shorts when it finds a downtrend.

For many years, we equated such simple technical models with voodoo, but our views changed when we worked at a Commodity Trading Advisor, or CTA, that applied these models to a variety of commodity future contracts. We noticed that the CTA manager often wound up with a single macro-economic bet, e.g. exchange rates, gold, oil, etc., despite claims of diversification across a variety of commodity contracts

The epiphany came to us: Trend following models spot and profits from macro-economic trends, which tend to be persistent. Here is an example of trend persistence: When a central bank begins a tightening cycle of raising interest rates, the next interest rate move will have an upward bias. An investor can use that knowledge of rising interest to position himself to profit from the persistence of a rising interest rate trend.

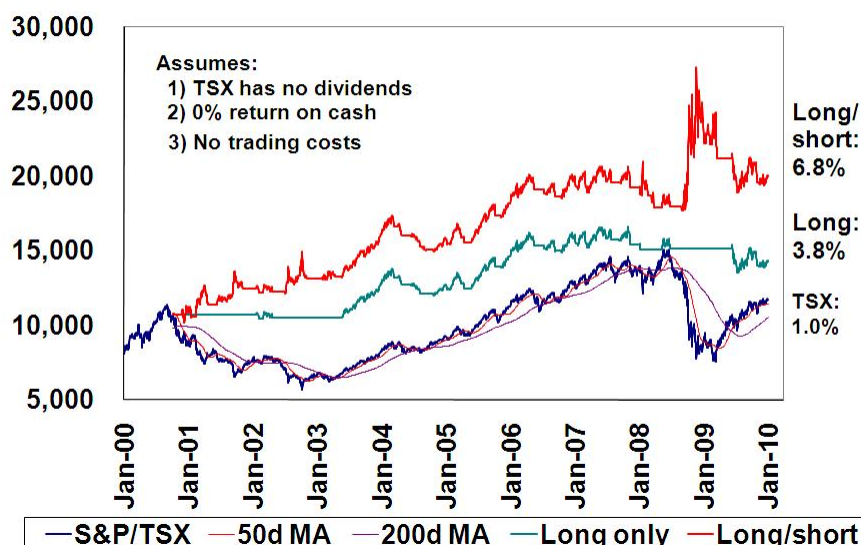
Using trend following for market timing

Consider an example of a trend following model on the S&P/TSX Composite Index. First of all, we use a 200-day moving average of the S&P/TSX Composite to identify the long-term trend and a 50-day moving average to identify the short-term trend. We then define uptrends, downtrends and our investment action as the following:

- An uptrend:** When the TSX > 50 day MA > 200 day MA (buy)
A downtrend: When the TSX < 50 day MA < 200 day MA (short, if possible)
No trend: All other conditions (go to cash)

The chart below shows the cumulative profit and loss of the application of this model to the S&P/TSX Composite Index from December 2000 to December 2009 (see the Appendix for the full details of our assumptions).

Trend Following Model: S&P/TSX Composite



This strategy allowed the investor to spot the periodic bear markets that afflicted the S&P/TSX Composite. Long only investors could then implement risk control to avoid the downturn while more aggressive long-short investors could profit from them.

The simulated results show that a simple long position in the index would have had a return of 1.0% for the test period. A strategy that bought the index when the model identified an uptrend would have had a return of 3.8% and a strategy to allow long and short positions would have had a return of 6.8% over the same period.

Most importantly, this strategy allowed the investor to spot the periodic bear markets that afflicted the S&P/TSX Composite. Long only investors could then implement risk control to avoid the downturn while more aggressive long-short investors could profit from the declines.

Advanced trend following: Style rotation

The previous example of using trend following on the stock market mitigates downside risk when we apply the technique to the S&P/TSX Composite to time entry and exit points. Investors can also apply these models on one index to time entry and exit points on a different index.

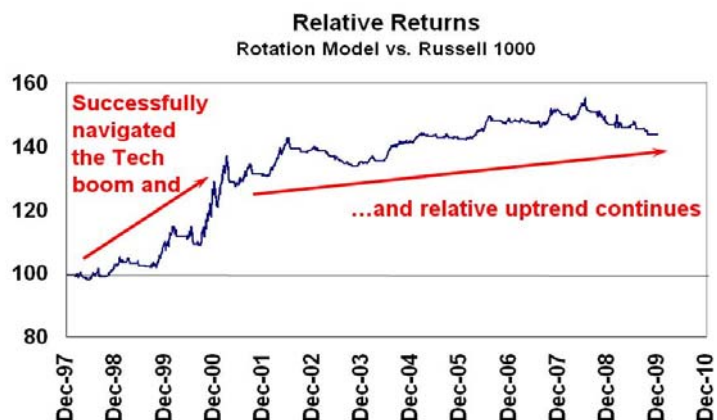
One example is equity style rotation. An important paradigm in the US equity market is the concept of Value (cheap stocks) and Growth (high potential and fast growing companies). At no time in recent history was this gap more evident than during the Technology Bubble of the late 1990's.

To apply trend following techniques for growth and value style rotation, we first calculated the relative growth and value performance index by forming a ratio of the Russell 1000 Growth to Russell 1000 Value Index to gauge the relative performance of Growth against Value. Then we applied the following trading rules:

- Buy Russell 1000 Growth:** When the Ratio > 50 day MA > 200 day MA
- Buy Russell 1000 Value:** When the Ratio < 50 day MA < 200 day MA
- Buy Russell 1000:** All other conditions, which is a neutral signal

A buy and hold strategy of holding the Russell 1000 had a total return of 3.2% from 1997 to 2009, compared to 1.7% for the Russell 1000 Growth Index and 3.9% for the Value Index. The style rotation model's return was 6.4% over the same period, an outperformance of 3.2%, and it had a lower risk (standard deviation of return of 21.5%) compared to the Russell 1000 (21.7%).

The chart below shows the relative performance of the style rotation model. It was able to spot the Technology Bubble forming and correctly bought growth stocks. When the Bubble burst, it correctly switched into the value segment of the market. Since then, it has had a long record of positive relative returns. It should be noted that the magnitude of relative performance was not as large since 2001 because the lower magnitude of relative returns between growth and value US large capitalization stocks.



Trend following models have other uses, such as the identification of shifts in market sentiment and psychology.

This class of model was able to spot the Technology Bubble forming and correctly bought the growth stocks. When the Bubble burst, it correctly switched into the value segment of the market. Since then, it has had a long record of positive relative returns.

The inflation-deflation dilemma

Going forward, we believe that one of the most important issues facing investors and wealth management specialists is the issue of whether we are facing an era of inflation or deflation. Get it right and you'll be a hero. Get it wrong and investment losses will follow.

The issue of inflation or deflation is a macro-economic problem therefore can be addressed by the use of trend following models. Our proprietary Inflation-Deflation Timer model was built using trend following techniques as applied to a variety of commodity prices. The trading rules for the model are as follows:

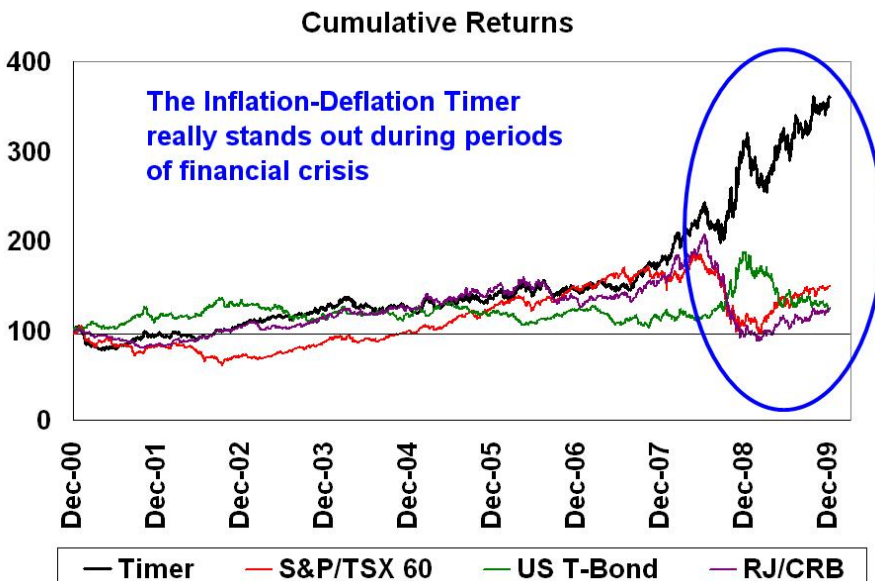
- Inflation:** Buy commodities (R/J CRB Index, hedge Canadian Dollar)
- Deflation:** Buy the U.S. long bond
- Neutral:** Buy equities, (S&P/TSX 60)

The table below shows that the Inflation-Deflation Timer model outperformed a 60% stock/40% bond balanced fund benchmark by over 10% from the inception of the test period. Performance was strong during inflationary periods (2007), deflation periods (2008) and respectable in a recovery year (2009).

	2009	2008	2007	3 years	5 years	Inception (Dec 2000)	Return/ Std Dev	Max Loss
Inflation-Deflation Timer model	18.1%	71.2%	21.7%	35.0%	23.6%	15.3%	0.9	26.0%
60 stocks/40 bonds*	21.4%	-16.5%	8.2%	3.1%	7.6%	4.9%	0.5	30.7%
S&P/TSX 60	31.4%	-31.1%	10.9%	0.1%	8.4%	4.6%	0.3	47.9%
DEX Bond Universe	5.2%	6.2%	3.4%	4.9%	4.6%	3.9%	0.7	8.5%

* 60% S&P/TSX 60/40% DEX Bond Universe

The chart below shows the longer term returns of the Inflation-Deflation Timer model against the 60/40 benchmark and other asset classes. During "normal" periods, the model exhibited returns that were in line with the 60/40 benchmark but performance really stood out during the crisis period in 2008, when it had a return of 71.2% at a time when virtually every other asset class had significantly negative returns.



The issue of whether we face an era of inflation or deflation is a macro-economic problem and therefore it is an ideal problem for trend following models to address.

The Inflation-Deflation Timer model outperformed a 60% stock/40% bond benchmark over the long-term and especially during crisis periods.

Stress testing the Inflation-Deflation Timer model

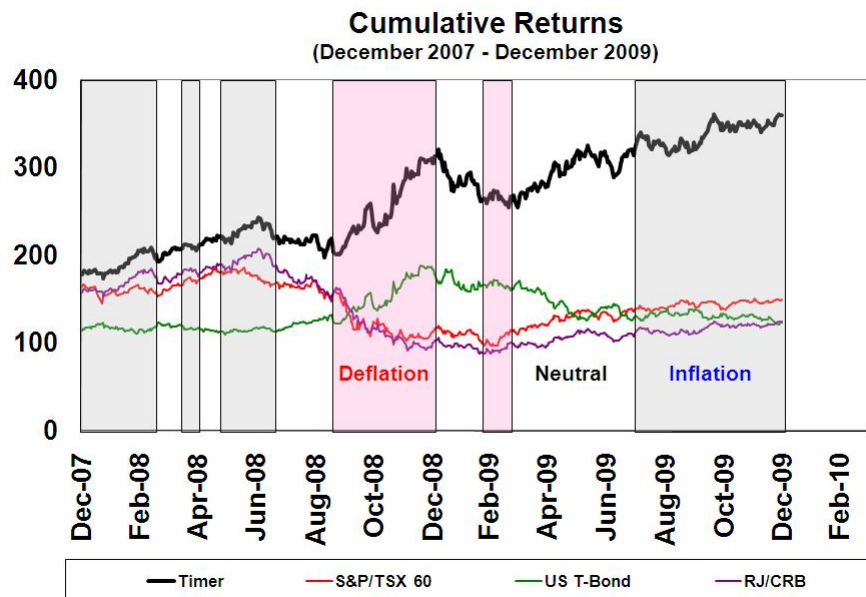
One question that we often get asked is, "How did the Inflation-Deflation Timer model behave during periods of stress?"

The chart below shows the returns and the signals from the Inflation-Deflation Timer "zoomed in" from the longer period of the chart from the previous page to the last two years. The grey areas show periods when the Inflation-Deflation Timer model flashed an "inflation" signal, the pink areas a "deflation" signal and the white areas a "neutral" signal.

Analyzing the performance of the model over this short time period, we can see that it began 2008 with an exposure to inflationary hedges, namely commodities, and successfully rotated out of commodities into deflationary hedges, the US long bond, as the financial crisis hit. As 2009 dawned, the model had a neutral to deflationary bias and later correctly rotated to the riskier asset classes to take advantage of the rally in stocks and commodities.

Turnover for this tumultuous period averaged a manageable five times a year and averaged four times a year for the December 2007 to December 2009 test period.

The Inflation-Deflation Timer mode began 2008 with an exposure to inflationary hedges, namely commodities, and successfully rotated out of commodities into deflationary hedges, the US long bond, as the financial crisis hit. As 2009 dawned, the model had a neutral to defensive posture and later correctly bought riskier asset classes to take advantage of the rally in stocks and commodities.



We continue to believe that we face an environment of great macro-economic uncertainty and instability.

Trend following models are ideal tools for use under these circumstances.

The right tool for today

We began this newsletter with the comment that good investment strategists know what kinds of tools to deploy under different investment and macro-economic conditions. We continue to believe that we face an environment of great long-term macro-economic uncertainty and medium term investor outlook stability. Trend following models are ideal tools for use under these circumstances.

Investors should be aware however, that trend following models must depend on the existence of a trend for them to work. Applying these models to trend-less markets will result in whipsaw losses from price reversals, as well needless trading costs. We believe that we face a trending macro environment and investors should be able to protect capital and profit with the use of trend following models for dynamic asset allocation.

Appendix: Modeling assumptions

In modeling our backtests, we have made a number of simplifying assumptions:

- Signals are generated at the end of the day.
- Trades are done based on closing prices on the day after a signal.
- There are no trading costs.

S&P/TSX market timing model

We have made the following additional assumptions with regards to the S&P/TSX market timing model detailed on pages 2 and 3:

- Returns are capital returns and do not include dividends
- 0% return on cash

Style rotation model

We have made the following additional assumption in the style rotation model described on page 3:

- Returns are total returns, which include dividends

Inflation-Deflation Timer model

We have made the following additional assumptions in the Inflation-Deflation Timer model described on pages 4 and 5:

- Returns are total returns, which include dividends.
- The S&P/TSX 60 return is proxied by the total returns of the iShares CDN LargeCap 60 Index Fund (Ticker XIU), an ETF which has an MER of 0.17%.
- The DEX Bond Universe return is proxied by the total returns of the iShares CDN Bond Index Fund (Ticker XBB), an ETF which has an MER of 0.30%.
- The US long bond return is proxied by the total returns of iShare Barclays 20+ Year Treasury Bond Fund (Ticker TLT), an ETF which has an MER of 0.15%.
- There are no currency hedging costs.

We would like to add the caveat that the returns we have shown for the Inflation-Deflation Timer model represent a proof of concept of the application of trend following models to dynamic asset allocation.

In reality, we would not manage an actual portfolio in this way. The Inflation-Deflation Timer model calls for the purchase of the Reuters/Jeffries CRB Index when the model flashes an "inflation" signal. Holding the CRB Index components in physical form is problematic as the management of physical storage can be a difficult task. If an investor were to try to gain exposure to the CRB Index through the futures market, returns can vary significantly from cash index returns because of rollover costs. Instead, we would suggest holding other inflation hedge vehicles, such as the shares of commodity producers or classic inflation hedge commodities such as precious metals.

The returns we have shown of the Inflation-Deflation Timer model represent a proof of concept of the application of trend following models to dynamic asset allocation

*People are our strength.
Creating value is our
goal.*

About the Author

Cam Hui has been involved in the equity markets since 1980, both on the buy side and the sell side. Most recently, Cam was a Relative Value and Technical Research Analyst with Merrill Lynch in New York. He is currently living in Vancouver, British Columbia with his family. He maintains his interests in the markets through his investment blog:

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Qwest Investment Management Corp.

Qwest Investment Management Corp. ("Qwest") is an investment management firm which specializes in identifying, structuring and managing investment products. Qwest is currently focused on investments in the natural resource sector.

Qwest's executive management team has over 100 years of combined experience in corporate and financial product structuring and investment management which provides the team with the skills required to evaluate and profitably manage the risk and rewards inherent in the capital market industry.

Qwest is the parent company of Qwest Investment Fund Management Ltd., a company which provides investment advisory, portfolio management services and fund management services, and Heritage Bancorp Ltd., a company which provides administrative services.

Interesting Facts About Qwest

- Specialists in investing Canadian capital in the natural resource sector;
- Throughout their careers, members of the Qwest management team have completed hundreds of financings and have raised and/or invested billions of dollars of capital in the natural resource sector;
- Resource company flow-through specialists;
- Recognized for our experience in Canadian oil and gas sector;
- Top quartile oil and gas-weighted flow-through portfolio performance.

Calgary-Based Portfolio Management

From our Calgary, Alberta office, Qwest's portfolio management team is strategically situated to conduct in-depth research and analysis of Canada's oil and gas companies. Our portfolio management team is led by Ms. Jennifer Stevenson who brings over 20 years of oil and gas industry experience and a strong track record in financing and investments in oil and gas companies.

The portfolio management team's additional strengths include:

- first-hand knowledge and insight into the oil and gas sector (i.e. situated in the heart of the Canada's oil patch)
- years of experience working with management teams to finance their oil and gas companies
- specialization in the research and analysis of Canadian mining companies
- considered to be leading experts in the oil and gas sector by Canada's most reputable media outlets

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