Designing a Tactical System

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We have often argued that buy and hold is not only dead, it was never alive. It worked from 1982-1999 but so did anything else, that doesn't make it valid. We have also argued for an active, tactical approach to markets. Such an approach would attempt to be in the market or a certain sector when the risk/return was favorable, and out when it wasn't. This is of course easier said than done. How does one decide when the risk/reward is in your favor? Most people do this by using their emotions, but your emotions cause you to get greedy and scared at just the right times. This paper will take you through the process of creating a simple tactical system. While Tuttle Wealth Management, LLC manages money using a tactical approach, we do not use the system that we are going to describe in this paper. In our backtests, this simple system works extraordinarily well but for us to use it we would need to make many more modifications. The purpose of this paper is to demonstrate a basic system that just about anybody could replicate.

Start With a Premise

The first step in creating a tactical system is to start with a premise that should work and then test it. We have always been proponents of intermarket analysis. In intermarket analysis you use one market that has historically been predictive of another market to generate buy and sell signals. For our purposes we will use stocks and bonds. Typically when bond yields are low (and the interest you earn by owning them is low) then stocks are more attractive. When bond yields are high (and you can earn higher rates of interest) then stocks are less attractive vs. bonds. This system is based on the classic intermarket divergence model between S&P500 futures and Bonds developed by Murray Ruggiero in the mid 1990's. The concept of intermarket divergence is simple and our rules are explained below. We will trade the S&P 500 Depository Receipts ETF (SPY) and the 30 year Treasury Bond Futures to predict the movements of the SPY.

Rules

The rules of our system will be simple, when Treasury Bond futures are going up in price (meaning yields are going down) and the SPY is going down we will buy the S&P. This is predicting that as bond yields go lower, stocks will become more attractive and go up. We will exit when Treasury Bond futures are going down (yields going up) and the SPY is going up. This is predicting that as yields rise, bonds will become more attractive vs. stocks. Instead of using daily prices, which can be noisy, we will use a 10 day moving average. So here are our rules:

If the SPY closes below its 10 day moving average and the 30 yr Treasury Bond future closes above its 10 day moving average, then we buy the SPY.

If the SPY closes above its 10 day moving average and the Treasury Bond future closes below its 10 day moving average, then we exit our position.

Assumptions

All calculations were done in TradersStudio™ software

In our system we made the following assumptions:

Start Date:	12/30/1994
Starting Equity:	$1,000,000
Commissions:	1 ½ cents per share
Slippage:	1 cent per share\

We make no assumption for taxes

Results

Average Annual Return:	8.05%
Total Profit Over Period:	$2,051,820.48
Maximum Drawdown:	32.60%

Period	Trades	Winning Trades	Win%	Open Trade	Net Profit	Return %	Running %
1995	10	9	90.00%	1	$176,655.21	17.67%	17.67%
1996	5	4	80.00%	0	$90,657.16	7.70%	25.37%
1997	8	8	100.00%	0	$392,176.47	30.95%	56.32%
1998	9	8	88.89%	0	$19,737.28	1.19%	57.51%
1999	6	3	50.00%	0	$54,232.59	3.23%	60.73%
2000	11	7	63.64%	0	$252,214.69	14.55%	75.28%
2001	10	7	70.00%	0	($58,267.99)	-2.93%	72.35%
2002	16	9	56.25%	1	$1,274.08	0.07%	72.42%
2003	11	10	90.91%	0	$409,405.33	21.23%	93.64%
2004	9	6	66.67%	0	$200,355.28	8.57%	102.21%
2005	9	8	88.89%	1	$132,042.14	5.20%	107.41%
2006	11	9	81.82%	0	$374,443.90	14.02%	121.44%
2007	13	9	69.23%	0	$323,664.51	10.63%	132.07%
2008	16	11	68.75%	1	($287,241.65)	-8.53%	123.54%
5/31/09	5	4	80.00%	0	($29,528.50)	-0.96%	122.58%
Total	149	112			$2,051,820.48		

What is interesting about these results is the fact that we are not expecting to be right every time. Over this time period the system was correct about 75% of the time, more than enough to be profitable.

Next, we compare our system to the results you would have had if you just bought and held the S&P 500:

Period	**Return System**	**Return S&P 500***	**Net Profit System**	**Net Profit S&P 500**
1995	17.67%	37.58%	$176,655.21	$375,800.00
1996	7.70%	22.96%	$90,657.16	$315,883.68
1997	30.95%	33.36%	$392,176.47	$564,345.68
1998	1.19%	28.58%	$19,737.28	$644,773.19
1999	3.23%	21.04%	$54,232.59	$420,968.86
2000	14.55%	-9.10%	$252,214.69	($302,281.20)
2001	-2.93%	-11.89%	($58,267.99)	($359,017.39)
2002	0.07%	-22.10%	$1,274.08	($587,964.49)
2003	21.23%	28.69%	$409,405.33	$594,602.64
2004	8.57%	10.88%	$200,355.28	$290,181.67
2005	5.20%	4.91%	$132,042.14	$145,203.07
2006	14.02%	15.79%	$374,443.90	$489,884.07
2007	10.63%	5.49%	$323,664.51	$197,221.65
2008	-8.53%	-38.49%	($287,241.65)	($1,458,617.59)
5/31/09	-0.96%	2.96%	($29,528.50)	$68,997.12
Total			**$2,051,820.48**	**$1,399,980.96**

The system significantly underperforms during the go-go years of the late 1990's but protects principal much better during the 2000-2002 decline and the decline in 2008. Over this time period, the system also results in over $600,000 more in profit than just buying and holding the S&P 500!

Conclusion

Our goal in this paper was to show the process of developing a simple tactical system based on intermarket analysis. Our simple example shows one possible way that tactical asset allocation can beat buy and hold by generating more return and taking less risk.

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