

 WILEY Trading

"Included among the 'Year's Top Investment Books' in the 2011 *Stock Trader's Almanac*, *Super Sectors* identifies five 'super sectors' that will likely advance far faster and higher than the general indexes due to several economic and social 'megatrends' on the horizon."

—JEFFREY A. HIRSCH, Editor in Chief, President, *Stock Trader's Almanac*

SUPER SECTORS

HOW TO OUTSMART
THE MARKET USING
SECTOR ROTATION
AND ETFs

JOHN NYARADI

Super Sectors

*How to Outsmart the Market Using
Sector Rotation and ETFs*

JOHN NYARADI



WILEY

John Wiley & Sons, Inc.

Copyright © 2010 by John Nyaradi. All rights reserved.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.

Published simultaneously in Canada.

No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, scanning, or otherwise, except as permitted under Section 107 or 108 of the 1976 United States Copyright Act, without either the prior written permission of the Publisher, or authorization through payment of the appropriate per-copy fee to the Copyright Clearance Center, Inc., 222 Rosewood Drive, Danvers, MA 01923, (978) 750-8400, fax (978) 646-8600, or on the Web at www.copyright.com. Requests to the Publisher for permission should be addressed to the Permissions Department, John Wiley & Sons, Inc., 111 River Street, Hoboken, NJ 07030, (201) 748-6011, fax (201) 748-6008, or online at <http://www.wiley.com/go/permissions>.

Limit of Liability/Disclaimer of Warranty: While the publisher and author have used their best efforts in preparing this book, they make no representations or warranties with respect to the accuracy or completeness of the contents of this book and specifically disclaim any implied warranties of merchantability or fitness for a particular purpose. No warranty may be created or extended by sales representatives or written sales materials. The advice and strategies contained herein may not be suitable for your situation. You should consult with a professional where appropriate. Neither the publisher nor author shall be liable for any loss of profit or any other commercial damages, including but not limited to special, incidental, consequential, or other damages.

For general information on our other products and services or for technical support, please contact our Customer Care Department within the United States at (800) 762-2974, outside the United States at (317) 572-3993 or fax (317) 572-4002.

Wiley also publishes its books in a variety of electronic formats. Some content that appears in print may not be available in electronic books. For more information about Wiley products, visit our web site at www.wiley.com.

Library of Congress Cataloging-in-Publication Data:

Nyaradi, John.

Super sectors : how to outsmart the market using sector rotation and ETFs / John Nyaradi.
p. cm. – (Wiley trading ; 468)

Includes index.

ISBN 978-0-470-59250-2 (cloth); ISBN 978-0-470-88030-2 (ebk);

ISBN 978-0-470-88031-9 (ebk); ISBN 978-0-470-88032-6 (ebk)

1. Exchange traded funds. 2. Stock funds. 3. Portfolio management. I. Title.

HG6043.N93 2010

332.63'27–dc22

2010030440

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

Additional Praise for *Super Sectors*

“John Nyaradi’s *Super Sectors* is that rare book that can give anyone—from a relative newcomer right up to the most expert reader—insights into actionable ways to profit from the information presented. From the psychology of investing, to ‘point and figure charting’ and ‘moving average crossovers,’ John shows how trading ETFs with sector rotation can beat the pants off ‘buy and hold’. He clearly illustrates why his theories have worked in the past and makes a good case for why they’ll continue to work in the ‘new normal’ environment since the 2008 market melt-down. His concluding segment on the Super Sectors he sees dominating future returns should contribute mightily to your future financial well being while letting you feel confident that you’re well positioned for what’s over today’s investment horizon.”

—**Dr. Paul Price**, Founder/Editor, www.BeatingBuffett.com

“If the first decade of the twenty-first century has proved anything, it is that investors cannot afford to let precious time slip through their investment fingers with a buy and hold strategy. Change is occurring too rapidly and trends shift with ever-greater frequency, rendering buy and hold as a high risk strategy unfit for the times. *Super Sectors* goes right to the heart of this issue and provides investors with the vital tools (and reasoning) that will enable them to take advantage of the opportunities such change presents and to help avoid its pitfalls. Investors who read this book will not let that most precious of resources—time—slip by.”

—**Vinny Catalano**, CFA, President and Global Investment Strategist, Blue Marble Research; Nonresident Senior Fellow, Information Technology and Innovation Foundation; Former President, New York Society of Security Analysts; Author, *Sectors and Styles*

“For investors concerned about market volatility and global trends, *Super Sectors* demystifies the technical approaches used by professional traders and offers simple techniques to reduce risk, manage a collection of sector ETFs, and keep a portfolio tuned into the strongest trends. John Nyaradi’s bonus interviews on the subject of Super Sectors, with more than fifteen investment experts, are also more than worth the price of the book.”

—**Mark Kramer**, Editor, *Confident Investment Strategies*

“This book clearly answered why buy and hold is the most dangerous and damaging piece of advice in Wall Street. It reviews what ETFs are and how they work. If you want to manage your own retirement or trading accounts through ETFs, this book is a must for you. It summarized major and basic sectors, and how to rotate with scientific methods and trading systems. With more and more people involved in their own financial management, I highly recommend the book to all investors.”

—**John Wang**, CEO, AbleSys; Author, *AbleTrend*

Founded in 1807, John Wiley & Sons is the oldest independent publishing company in the United States. With offices in North America, Europe, Australia and Asia, Wiley is globally committed to developing and marketing print and electronic products and services for our customers' professional and personal knowledge and understanding.

The Wiley Trading series features books by traders who have survived the market's ever-changing temperament and have prospered—some by reinventing systems, others by getting back to basics. Whether a novice trader, professional or somewhere in between, these books will provide the advice and strategies needed to prosper today and well into the future.

For a list of available titles, visit our Web site at www.WileyFinance.com.

Preface

Thanks so much for sharing your valuable time with me and my book, *Super Sectors: How to Outsmart the Market Using Sector Rotation and ETFs*.

This book has been designed to help you avoid bear markets and prosper during bull markets by deploying sector rotation techniques using Exchange Traded Funds.

Some of the techniques outlined in this book are so simple that a sixth grader could do them while others are geared towards the professional trader.

Whether you're a novice trader just looking for ways to get started or a seasoned pro, in these pages you're going to be introduced to valuable trading concepts and get detailed insight into trading systems, opportunities and obstacles so that by the time you reach the end, you will be armed with a powerful arsenal to help you successfully trade Exchange Traded Funds using sector rotation techniques.

If you've suffered through the Bear Market of 2008 and feel less financially secure than you did on October 9th, 2007, when the S&P 500 reached its record closing peak of 1565, you're not alone. Since that fateful autumn Tuesday afternoon, trillions of dollars of assets have been lost in global stock markets and much of that money will likely never be recouped by individual investors. If you lost money over the course of the Bear Market of 2008, I'm looking forward to discussing ways that you can potentially avoid losing money during future bear markets.

However, bear markets aren't the only reason, in my opinion, to actively trade your assets and I say this because as bad as this bear market has been, the losses suffered since late 2007 are not the worst part of the news.

Stock market activity over the last ten years has proven that "buy and hold" is a dead concept and it's very likely that going forward over the next ten years, "buy and hold" will continue to be an invalid and ineffective concept. Because over the last ten years, the S&P 500 has generated a negative rate of return and that doesn't even factor in the ravaging effects that inflation has on your portfolio.

So, in this book we'll discuss why Wall Street's "conventional wisdom" may not be effective going forward and we'll take a close look at the tactical portfolio management alternatives that are available to average retail investors and professionals alike.

Through the pages of this book, you'll learn how you can take control of your destiny and your financial future and not rely on market forces to determine the outcome of your investing activity.

You'll get valuable insights into the features and benefits of Exchange Traded Funds and why they're a great choice for today's active markets.

You'll learn about sector trading and how this style of portfolio management can be one of the most successful you can find and we'll discuss various methods of identifying potential "super sectors," the sectors of the market that are outperforming the general indexes.

As the old saying goes, "there's always a bull market somewhere" and through these pages you'll learn techniques for identifying and profiting from these "super sectors."

Trading systems will be discussed in detail, ranging from the most simple for people who don't want to make trading a "job" all the way to the most detailed and complex systems for professionals who monitor the markets on a daily or even minute by minute basis.

Beyond trading systems we'll look at concepts, challenges and conundrums that all active traders face and how to meet those challenges head on and conquer them.

We'll identify five "super sectors" that quite likely will advance far faster and far higher than the general indexes due to several economic and social "mega trends" that lie just ahead. We'll dive into these macro trends and then identify the sectors that will allow you to gain exposure to these "super sectors" over the coming years.

Finally, we'll have the opportunity to listen to "Interviews with the Experts" in which we'll hear from well-known experts in the fields of investing, technical trading, economics and various market sectors, and we'll gain insight into their views about what opportunities and dangers lie ahead for us as investors.

By the time you finish reading this book, you'll have a wide arsenal of weapons to adapt to your own temperament, trading style and lifestyle so you'll be able to design a complete trading program uniquely suited to you.

And this is important because the bottom line in today's post-crash world is that you're on your own.

You are on your own and you need to arm yourself with the knowledge necessary to survive during what could be very difficult days ahead. No longer can you afford to believe that "the market will come back" or that it will keep going up forever. No longer can you believe that "everything will work out" and no longer can you believe in the "conventional wisdom" spouted by Wall Street and in most of the financial media.

The Great Recession of 2008–2009 has changed everything in the investing landscape, and the “mega trends” I’m going to describe could change it even more drastically. It’s quite likely that Darwinian principles of natural selection will be in play and only those who will be able to adapt to this new world will survive and prosper.

A successfully-managed tactical trading program can be the most difficult job in the world or the easiest. It can be one of the most lucrative things you could ever do or it could lead you to financial ruin. Many, many people have tried and failed at active trading and the goal of this book is to arm you with the tools that you need to be successful.

It’s not an easy path and it’s lined with the school of hard knocks. Along the way you will experience setbacks and failures and feel like giving up, probably more than once. But if you can stick with it, if you can become one of the few who can succeed, you will have the ability to protect and grow your net worth if that’s your goal or you will possess the tools necessary to make trading a full time career or second career to supplement your retirement or regular income.

If you can be one of the few who can succeed, you can literally become like the ancient alchemists, able to create money literally out of thin air. When you sit down at your computer and enter some numbers on an order screen, only two things can happen. The numbers can get bigger and be painted green or they can get smaller and be painted red.

The goal of *Super Sectors* is to help you find and stay on the difficult and challenging route to green and growing numbers so that you can grow your wealth, achieve your financial goals and meet the challenges of the demanding days ahead.

Finally, I invite you to visit www.SuperSectors.net for more valuable information about sector rotation using Exchange Traded Funds.

There you’ll be able to subscribe to a special membership offer from *Wall Street Sector Selector*, my online newsletter covering sector rotation and Exchange Traded Funds, as well as get more in depth research, reports and links to other leading financial web sites and portals.

I wish you all the best in your endeavors and look forward to working with you towards your trading success.

JOHN NYARADI
Publisher
Wall Street Sector Selector
Bend, Oregon
August 2010

Acknowledgments

Writing a book like this is a mammoth task that couldn't possibly be accomplished by one person alone, no matter how talented or energetic the author might be.

Many people helped *Super Sectors* come to fruition and I would particularly like to thank the following individuals for their help, support and invaluable assistance:

Gabriel Wisdom, fellow pilot, Managing Director and Founder of American Money Management, LLC., who made this entire endeavor possible.

My editors at John Wiley and Sons, Laura Walsh and Judy Howarth, for their expert guidance, encouragement and insight.

The financial and investment experts who were so kind to offer their expertise, insights and unique knowledge to make "Ask the Experts" such a valuable portion of this work. These contributors include Larry Conners, Dr. Marc Faber, Keith Fitz-Gerald, Todd Harrison, Gene Inger, Carl Larry, Timothy Lutts, Tom Lydon, John Mauldin, Lawrence McMillan, Paul Merriman, Michael Moore, Robert Prechter, Jim Rogers, Matthew Simmons, Sam Stovall, Cliff Wachtel, Gabriel Wisdom.

And finally, a special thanks to my family; my wife, Ann, and sons Dan and Chris for your understanding and encouragement during all of the hours and days that disappeared so that *Super Sectors* could become a reality.

Contents

Preface	xiii
Acknowledgments	xvii
PART I Five Wall Street Fairy Tales and Why the Conventional Wisdom is Flawed	1
CHAPTER 1 The Bear Facts about Bear Markets	3
The Bear Facts: Another Bear is Out There Waiting to Maul Your Portfolio	3
Conclusion	7
CHAPTER 2 The Fairy Tale of Buy and Hold	9
Ten Years of Negative Returns	9
Impact on Retirement	11
The World is Changing	18
Conclusion	18
CHAPTER 3 Four More Wall Street Fairy Tales: Conventional Wisdom That Could Cost You Money	21
Is Asset Allocation the Answer?	21
The Fairy Tales Revealed	23
Conclusion	24

PART II	Why Exchange Traded Funds?	27
<hr/>		
CHAPTER 4	History and Growth of Exchange Traded Funds	29
	From Zero to 836 in 19 Short Years	29
	Conclusion	32
CHAPTER 5	Types of Exchange Traded Funds	33
	Standard Exchange Traded Funds	34
	Index Funds	34
	Market Cap and Style Funds	35
	Bond Funds	35
	Sector Exchange Traded Funds	35
	Global Regions and Country Specific Exchange Traded Funds	36
	Inverse Exchange Traded Funds	37
	Leveraged Exchange Traded Funds	38
	Actively Managed Exchange Traded Funds	41
	Currency Exchange Traded Funds and Exchange Traded Notes	42
	Conclusion	43
PART III	Sector Rotation: What It Is and Why It Works	45
<hr/>		
CHAPTER 6	Sector Rotation—The Traditional View	47
	There's Always a Bull Market Somewhere	47
	Nine Basic Sectors	49
	Will This Time be Different?	50
	The Business Cycle Has Not Been Repealed	51
	Why Use Sector Rotation?	52
	Conclusion	52
CHAPTER 7	The New Science of Sector Rotation	55
	It's a Brave New World	55
	Are There Only Nine Sectors?	56

The Velocity of Money and the Incredible Disappearing Investor	56
Conclusion	65
 PART IV Trading Systems Designed to Outperform the Indexes	 67
<hr/>	
Your Personality	67
Your Lifestyle	68
Your Goals	68
 CHAPTER 8 Almost Like Buy and Hold	 69
But It's Not That Easy	71
Cut Your Losses and Let Your Winners Run	72
"Almost Like Buy and Hold" Trading Rules	73
Conclusion	74
 CHAPTER 9 The Simple Trading System	 75
Conclusion	82
 CHAPTER 10 The Golden Crossover Trading System	 85
Conclusion	90
 PART V The Sector Scoring System: Trading Concepts, Challenges and Conundrums	 91
<hr/>	
CHAPTER 11 The Five Signals for Entering a Trade	93
Signal No. 1: Point and Figure Charts Buy Signals	93
Signal No. 2: Point and Figure Charts: Trend and Bullish Price Objective	98
Signal No. 3: Moving Average Convergence Divergence (MACD)	101
Signal No. 4: Relative Strength Index (RSI)	107
Signal No. 5: Relative Strength	108
Conclusion	110

CHAPTER 12 Scoring Your Trades	113
Selecting What You Want to Trade	113
Scoring Your Trades: The Heart of the System	114
Scoring the Indicators	123
Conclusion	130
CHAPTER 13 Getting Out is Harder Than Getting In	131
Selecting What You Want to Trade: The Other Side of the Coin	131
Getting Out of a Trade: How, When, Where	132
Risk Management and Position Size	144
Exiting a Trade or “What Now?”	146
Signs of Weakness	147
Conclusion	150
CHAPTER 14 The Psychology of Trading	153
The Biggest Single Risk to Your Trading and Investing Success is You	153
Begin at the Beginning	154
Greed, Fear, and the Herd	154
Three Secrets to Trading Success	156
Trading and the Art of War	160
The Five Essentials for Victory	161
Trading With the Buddha	162
What Happens When Your System Stops Working	163
How to Manage Drawdowns	164
Conclusion	165
PART VI Super Sectors: Five “Super Sectors” That Could Change Your Life	167
<hr/>	
CHAPTER 15 Super Sector No. 1: The Rise of Asia	169
A Closer Look at China	169
The Story Doesn’t End with China	171

How Can You Participate?	172
Conclusion	173
CHAPTER 16 Super Sector No. 2: Energy	175
The Bad News about Supply	175
The Bad News about Demand	176
Economic, Political, and Social Impacts	177
Possible Solutions	177
Possible Outcomes	178
How Can You Participate?	179
Conclusion	180
CHAPTER 17 Super Sector No. 3: Health Care	181
The Aging Baby Boomers	181
Baby Boomers and the Cost of Health Care	182
Growth in National Health Care Expenditures	182
Possible Solutions and Outcomes	183
The Ever-Growing Medical Monster	183
How Can You Participate?	184
Conclusion	184
CHAPTER 18 Super Sector No. 4: Technology	187
A Connected World	187
Highways in the Sky	189
Emerging Technologies	190
How Can You Participate?	190
Conclusion	191
CHAPTER 19 Super Sector No. 5: Financials	193
The Financial Sector	193
Warren Buffettology	195
The Dollar and Global Currency Markets	196
Interest Rates	197
Precious Metals	197

How Can You Participate?	198
Conclusion	198
 CHAPTER 20 Ask the Experts: Insights and Advice from Today's Top Investors, Traders and Managers	 201
Larry Connors	201
Dr. Marc Faber	205
Keith Fitz-Gerald	207
Todd Harrison	211
Gene Inger	214
Carl Larry	216
Timothy Lutts	217
Tom Lydon	220
John Mauldin	223
Lawrence G. McMillan	224
Paul Merriman	228
Robert Prechter	230
Jim Rogers	233
Matthew Simmons	234
Sam Stovall	236
Cliff Wachtel	238
Gabriel Wisdom and Michael Moore	241
Conclusion	245
 APPENDIX ETF Resources	 247
Web Sites	247
Exchange Traded Funds Providers	247
Books	248
 Notes	 251
About the Author	253
Index	255

PART I

Five Wall Street Fairy Tales and Why the Conventional Wisdom is Flawed

There are many good reasons to actively manage your portfolio but one of the most compelling is to try to avoid the devastating consequences of bear markets.

Bear markets happen more frequently than you might imagine and do devastating and long-lasting damage to investors' portfolios. But it is possible to avoid these downdrafts and later we'll get into trading systems ranging from simple to complex that are designed to do just that.

For decades, Wall Street and the financial media have fed investors a steady diet of investment advice and concepts that have been proven to be devastatingly flawed during the Tech Wreck of 2000–2002 and again during The Great Recession of 2008.

The financial carnage has been well documented in the press with trillions in assets disappearing, maybe forever, as investors followed advice like “buy and hold,” “invest for the long term,” and “hang on, it will come back.”

And the result was no different during The Great Recession of 2008 than it was during the Tech Wreck or the Bear Market of 1982 or any bear market dating back to the Great Depression.

In every case, the average retail investor typically bought at the top and sold at the bottom and watched the stock market devour his or her hard-earned savings. As the old saying goes, “the stock market will make as big a fool out of as many people as possible,” or put another way, “the market will do everything it can to separate you from your money.”

In this section we’re going to take a look at the 5 Wall Street Fairy Tales that I feel are at the root of these problems and how they’re a real and present danger to your net worth. You’ve heard of all of these before but we’re going to delve into each one and see why it’s a hazard to your net worth.

And the danger isn’t past once The Great Recession ends because there will be other bear markets and other dangers and challenges along our paths.

So let’s start with a look at bear markets and how they’re an ever-present danger to your portfolio and financial future.