SUNDIAL capital research, inc.

SentimenTrader ANALYSIS OVER EMOTION

In Association with Global Investment Solutions, LLC

Behavioral Advantage Managed Accounts

Investment Philosophy

Over the long-term, auction markets are driven primarily by fundamental forces. Corporate earnings, economic shifts and even demographics determine the ultimate direction of stock, bond and commodity prices.

In time frames of less than one year, however, those same forces have much less impact. More technical factors, such as supply and demand, have a greater influence over whether prices will temporarily rise or fall within the context of the larger fundamentally-driven trends.

As prices make a prolonged move in one direction, there is a strong tendency for participants to expect that move to continue. In the case of the broader stock and bond markets, that tendency rarely persists as prices revert to a moving mean. The Behavioral Advantage Managed Account attempts to capitalize on those times when it becomes apparent that a mean-reversion is most likely to begin.

The tools we use for those determinations are primarily breadth and sentiment based. We use a collection of rigorously tested measures that have a history of successfully identifying periods of behavioral extremes, at which time we look to go the other way.

This is a contrarian mindset, but that can get investors into trouble easily. Because of that, we take the overriding trend into consideration before trying to swim against the tide. Historically, the very best buying opportunities arise when we observe conditions of excessive pessimism in an environment where the longer-term forces are driving prices up.

Principal Background

Jason Goepfert
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Industry Experience: 14 years
2002 – present
President, Sundial Capital Research, Inc.
2001 – 2002
Deephaven Capital Management, LLC
1995 – 2001
Wells Fargo Brokerage
1993 – 1995
Wells Fargo Home Mortgage
Education
University of Minnesota,
Carlson School of Management

At those times, we become aggressive with long positions and may take selective leveraged positions, or for more conservative accounts, at least become fully invested. As the pessimistic conditions ease, likely due to rising prices, we try to let our positions ride until we observe either a change in the overriding trend, or overly optimistic conditions.

Those periods of excessive optimism on the part of investors serve as good opportunities to lighten long exposure, or hedge the portfolio with inverse funds. Except in rare cases, and in aggressive accounts, we do not take net short positions when the overriding trend is positive. Those instances are best reserved for periods of excessive optimism within down-trending markets, and are typically shorter-term in duration.

Behavioral Advantage Managed Account – Exclusive ETF

Program Overview

Exclusive ETF is the most active program, utilizing leveraged and un-leveraged exchange-traded funds, primarily concentrated among the major equity indices. It is a higher-frequency program that attempts to capitalize on the short and intermediate term gyrations that trigger breadth and sentiment based extremes.

This program is only available to accredited investors. An accredited investor is someone that allows a manager to manage a minimum of $750,000 (accounts may be combined to meet total) or has a net worth in excess of $1,500,000.

The management fee for this program is 1% plus 20% of any net profits (performance incentive fee). The performance incentive fee is based on the closing quarterly valuation of the account and must exceed the high water mark for any previous quarter. If the account does not exceed the high water mark for the previous quarters, there is no incentive fee paid for that period. In this manner we have not only a vested interest in the performance of the account, but a concern to control the draw down levels during difficult market conditions.

Trading Process

The primary determinant of directional trades is our proprietary STEM.MR Model (**S**hort-**T**erm **E**xtreme **M**odel - **M**ean **R**eversion).

The model is predicated upon the idea that several of the shorter-term sentiment-related indicators we follow display a mean-reverting tendency. Meaning, when they go "too far" in one direction, they tend to snap back to their average value. Often when they snap back, it correlates with short-term market turning points.

Depending on market conditions, a signal could last anywhere from one to five days. Model signals are most effective when going with the trend - for example, giving oversold signals while the larger trend is positive. Even a simple trend filter like the 200-day average can be effective. When it is rising, we pay most attention to oversold model signals and less attention to overbought ones.

The model is self-adjusting based on recent extremes and the current trend. That means that during an up-trending market, it becomes more difficult for the model to reach an "overbought" status than when the market is down-trending. That helps us to avoid continually selling in a strong market or buying in a weak one.

The model helps us to identify those times when it likely pays to go against short-term emotional extremes. A very basic backtest of model signals over the past four years shows the following risk/return characteristics using S&P 500 prices and a three-day look-forward window:

	Percent Positive	Avg Return	Avg Max Gain	Avg Max Loss
Buy Signals	63%	+0.4%	+1.4%	-0.7%
Sell Signals	44%	-0.3%	+0.7%	-1.2%
Random	**56%**	**+0.2%**	**+1.1%**	**-0.8%**

In reality, we take a discretionary approach that also takes into account divergences between the model and the price indices, as well as divergences between model component themselves, among other factors. But model extremes form the backbone of this active strategy that concentrates on taking high-probability trades that crop up consistently in every market environment.

Behavioral Advantage Managed Account – Standard ETF

Program Overview

Standard ETF takes a slightly longer term view of the analysis used to determine invested positions. This program will utilize leveraged and un-leveraged exchange traded funds, primarily focused among the major equity indices. It is a lower-frequency program that attempts to capitalize on the medium term gyrations that trigger breadth and sentiment based extremes.

Due to the use of Exchange Traded Funds, the minimum size account size is $100,000. The management fee for this program is 2% per year. One fourth of the annual fee is applied to the end of quarter balance each quarter to determine the fee paid.

Investment Process

This program seeks to find opportune longer-term signals than the Exclusive ETF program, so it has a lower turnover and is based on more intermediate-term sentiment trends. Our primary tool for this program is our proprietary **Smart Money Confidence** and **Dumb Money Confidence** Indices.

Generally, we want to follow the "smart money" traders – we want to bet on a market rally when they are confident of rising prices, and we want to be primarily in cash (or short the market in select circumstances) when they are expecting a market decline. We also call this measure the "buy confidence" indicator - it tells us how much confidence we should have in *buying* the market.

We want to do the opposite of what the "dumb money is doing. These traders have proven themselves over history to be terrible at market timing. They get very bullish *after* a market rally, and bearish *after* a market fall. By the time the majority of them catch on to a trend, it's usually too late – the trend is about to reverse. That's why we call this the "sell confidence" indicator too, as it tells us how confident we should be in *selling* the market.

Over the past 20 years, we've been able to see our Smart Money and Dumb Money Confidence Indexes perform through a challenging variety of market conditions.

The table below shows how the S&P 500 index performed during the quarter following days after "buy signals" and "sell signals". For these purposes, we'll consider a buy signal to be any time the Smart Money Confidence was above 60% at the same time the Dumb Money Confidence was below 40%.

A sell signal will be any time the Smart Money Confidence is below 40% at the same time the Dumb Money Confidence is above 60%.

	Percent Positive	Avg Return	Avg Max Gain	Avg Max Loss
Buy Signals	80%	+4.9%	+8.4%	-3.5%
Sell Signals	45%	-1.0%	+4.4%	-7.5%
Random	**68%**	**+2.3%**	**+6.2%**	**-5.3%**

When the Confidence Indices are on a buy signal, we look to be particularly aggressive in taking long-side setups or upping our position sizes on long positions.

When they are on a sell signal, we look to be more aggressive in moving accounts to cash positions, or in select instances taking outright short positions.

Behavioral Advantage Managed Account – Standard Rydex

Program Overview

Standard Rydex will use signals that are similar to those used in the Standard ETF Program listed above. Rydex Funds provides an efficient investment vehicle to move assets that can not be accommodated with Exchange Traded Funds. This program is a lower-frequency program that attempts to capitalize on the medium term gyrations that trigger breadth and sentiment based extremes.

The management fee for this program is 2% per year. One fourth of the annual fee is applied to the end of quarter balance each quarter to determine the fee paid.

Investment Process

This program uses the same basic methodology as the Standard ETF program outlined above.

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