SmartTrust®

Screening for "Boomerang Stocks" when a Stock Market Pullback is Expected

Kevin D. Mahn
Chief Investment Officer
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At SmartTrust®, we look to provide for diversified income and total return opportunities through innovative investment strategies. The majority of SmartTrust® Unit Investment Trusts (UITs) offer diversified income opportunities (*as well as the potential for total return*) and have incorporated such underlying investment strategies as individual taxable and tax-free bonds, individual stocks, preferred stocks, business development companies (BDCs), closed-end funds (CEFs) and exchange traded funds (ETFs). This particular report will focus on how we select individual stocks for a certain market environment.

In recent weeks, many advisors have come to us looking for a "defensive" investment strategy fearing that a significant stock market downturn was either long overdue or inevitable. It is important to understand that most analysts believe that we are likely to experience a pullback in the short term as opposed to a more severe market correction or even a stock market crash. The differences between these three down market cycles are critical when defining and implementing an appropriate, complementary investment strategy.

1. A stock market "**pullback**" is defined as a decline in stock valuations between 5% - 10%
2. A stock market "**correction**" is defined as a decline in stock valuations between 10% - 20%.
3. A stock market "**crash**" is defined as a decline in stock market valuations of over 20%.

We, at SmartTrust®, believe that we are currently within the midst of a longer term secular bull market. A secular bull market is generally referred to when the overall trend of the stock market is "bullish" longer term, lasting between 5 and 25 years. During secular bull markets, stocks tend to rise in price more than they fall in price with the declines being less significant and offset by the subsequent increases in prices.

Historical Secular Bull Markets

Time Period	Duration (in years)
1815-1835	20
1843-1853	10
1861-1881	20

1896-1906	10
1921-1929	8
1949-1966	17
1982-2000	18
Average Secular Bull Market Length	*14.71*

Source: *Gold-Eagle.com, "Secular Market Trends" article, April 29, 2014*

To this end, we believe that March 9, 2009 marked the beginning of this most recent secular bull market, meaning that we are at least 9 years away from reaching the average secular bull market cycle. Given the gradually firming foundation of our U.S. economy and the activist nature of the Federal Reserve, we find more rationale to support further upside potential in the stock market than a significant market downturn. Regardless, we do not dismiss the potential for intermittent periods of stock market volatility over shorter term durations. As a result, we feel that an appropriate investment strategy for this outlook would be to create a portfolio of common stocks that could help investors navigate through a short term market pullback while still being positioned for the next leg of this bull market cycle coming out of pullback periods.

The visual image that came to mind when conducting the research for this portfolio construction was that of a boomerang positioned roughly in the shape of the letter "U".

By following the shape of the boomerang, the contemplated portfolio would withstand a short term market pullback without experiencing a sharp downturn and then begin to move gradually higher moving forward. It is important, in our view, to select the stocks of companies that not only had a history of weathering previous historical market pullbacks but also had performed well coming out of those pullbacks by achieving solid, positive longer term total returns.

To achieve our objectives, we started by looking at the performance of companies currently in the S&P 500 index ("S&P 500") for the period December 30, 1990 – August 31, 2014. The S&P 500 was chosen given its broad based nature (it covers approximately 75% of U.S. listed equities) and wide acceptance as a barometer of the U.S. stock market in general. The S&P 500 is a capitalization-weighted index of 500 stocks intended to be a representative sample of leading companies in leading industries within the U.S. economy. Stocks in the S&P 500 are chosen for market size, liquidity and industry group representation. You cannot invest directly in an index.

The nearly 24 year time period of our research study effectively captures several different market cycles while also negating the potential negative bias of less relevant, older time periods that do not encompass the same breadth of products, trading capabilities or access to market data when compared to more recent time periods.

We then looked at the monthly performance of the S&P 500 index as a whole over this time period in an effort to determine which monthly periods that the stock market experienced a market pullback. Monthly periods were reviewed as we find it hard to currently imagine, absent any unforeseen geopolitical/global macro shocks that may take place, any market pullback lasting longer than a month given the large percentage of cash still “sitting on the sidelines”. This idle cash is likely to be positioned back into the market once the much anticipated pullback occurs. This cash infusion, along with the solidifying of the underlying fundamentals of this economic recovery, should help propel the next phase of this secular bull market cycle out of this type of market pullback.

Our research found that there were only 22 different months where the stock market, as measured by the S&P 500, fell between 5% - 10% in a month over the course of this nearly 24 year observation period. Put differently, the market experienced a decline of between 5% - 10% (*i.e. a “pullback”)* over the course of a month just over 7% of the time between the end of December 1990 and the end of August 2014. Granted that this conclusion does not consider declines of greater than 10% a month – *which only occurred four (4) times over the observed timeframe* – or declines between 5% - 10% within a given month, or across months, where each respective final monthly performance may have fallen outside of this range. Regardless, the statistics are quite compelling.

As an aside, the best performing single month for the S&P 500 over this timeframe was December 1991 with a monthly total return of 11.43%. On the flip side, the worst performing single month for the S&P 500 over this timeframe was October 2008 with a monthly total return of -16.79%.

Over the course of the 22 months of stock market pullbacks, we searched for those companies that outperformed the market (*i.e. the S&P 500*) by 5% or more, in many cases even registering a positive monthly performance, in each respective month to identify those stocks that had the highest probability of outperformance over historical monthly periods of stock market pullbacks. These companies thus represent the shallow, downward slope of the boomerang in that they have displayed a history of weathering previous pullbacks relatively well. Our research showed that:

- 443 different companies outperformed the market by 5% or more in at least one of the 22 months when a monthly stock market pullback occurred

- 83 different companies outperformed the market by 5% or more at least 50% of the time (i.e. in at least 11 of the 22 months) when a monthly stock market pullback occurred

- The GICS sector dispersion of the 83 companies that outperformed the market by 5% or more at least 50% of the time when a monthly stock market pullback occurred is as follows (*the majority of which are associated with sectors generally deemed to be defensive in nature such as Utilities, Consumer Staples and Health Care*):

    - Utilities – 40%
    - Consumer Staples – 24%
    - Financials – 18%
    - Health Care – 10%
    - Telecommunication Services – 2%
    - Energy – 2%
    - Materials – 2%
    - Consumer Discretionary – 2%

To capture, the gradual, upward slope of the boomerang we researched how the companies in the index performed on a total return basis, over various time period durations including 1 year, 3 year, 5 year, 10 year and 15 year, with each being measured from the end of our observation timeframe (*i.e. August 31, 2014*). In so doing, we look to exclude any stock that did not have positive annualized total return performance over any of these time periods. Our research showed that:

- Of the 83 different stocks that outperformed the market by 5% or more at least 50% of the time (i.e. in at least 11 of the 22 months) when a monthly stock market pullback occurred, only 10 of these stocks experienced at least one period of negative, annualized total return performance over the 1 year, 3 year, 5 year, 10 year of 15 year time periods as of August 31, 2014 or did not have at least 15 years of performance history.

The successful application of these two portfolio screens created the initial draft of our boomerang portfolio to consider when a stock market pullback in prices is expected.

We then looked to further refine the finished boomerang by including screens on two other measures that we typically use to help identify sound companies that are generally less volatile, or even defensive, in nature. These two measures are dividend payments and Beta.

- **Dividend Payments** – We looked to see which of the companies that met the first two portfolio screens are currently paying a dividend. We tend to prefer stock of companies that pay dividends in our portfolio strategies, including this one, because:

    - Companies that pay dividends tend to have stronger balance sheets to afford their dividend payments and investors may be less likely to sell stocks in these companies during periods of stock market stress due to the cash flows they are receiving from these stocks; and

- S&P 500 dividend paying stocks have historically outperformed non-dividend paying stocks over time with lower volatility than the broader market as the chart below demonstrates

Annualized Returns of the S&P 500 Index by Dividend Policy
January 31, 1972 – June 30, 2014

	Dividend Paying Stocks	Non-Dividend Paying Stocks	Equally Weighted Index
Average Annualized Return	9.35%	2.52%	7.74%
Annualized Standard Deviation	16.83%	25.22%	17.77%

Source: *Allianz Global Investors, Ned Davis Research (NDR). Data as of June 30, 2014. Past performance is no guarantee of future results. Dividend rates are not guaranteed payments, nor can they guarantee a rate of return. Returns based on monthly equal-weighted geometric average of total return of S&P 500 component stocks, with components reconstituted monthly. This chart is for illustrative purposes only. Dividend payers and non-dividend payers included among the S&P 500 Index universe. The Standard & Poor's 500 Geometric Equal-Weighted Total Return Index (S&P 500) is an unmanaged index that is generally representative of the US stock market. It is not possible to invest directly in an index. Standard deviation is an absolute measure of volatility measuring dispersion about an average, which, for an index, depicts how widely the returns varied over a certain period of time. The greater the degree of dispersion, the greater the risk.*

- **Beta** – *We looked to see which of the companies that met the first two portfolio screens have a Beta of less than 1.0. Beta, a measure of volatility or systematic risk, for these purposes was determined by comparing the price movements of each security and the representative market index (i.e. S&P 500) for the past two years of weekly data. A Beta of less than 1.0 indicates that a security has exhibited less volatility than the broader market over the applicable time period.*

Here is one representative example of a current SmartTrust® UIT strategy, developed through our own research, which encompasses the screening criteria described in this whitepaper.

- **Defensive 50 Equities Trust** *(a 15 month Unit Investment Trust)*

While no screening criteria can guarantee a positive total, or protect against a market decline, we believe that the multi-factor screening model employed at SmartTrust® as described throughout this whitepaper can be helpful in creating a portfolio strategy that seeks to provide total return potential in an environment where the stock market may experience a pullback in prices during the life of the Trust.

If you are interested in learning more about this particular Trust strategy, or any of our other innovative UIT portfolio strategies, please contact your Financial Advisor or visit www.smarttrustuit.com.

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