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ETF Strategist Works With 200-day Line

By Trang Ho

As the adage in trading goes: The trend is your friend. Sticking to the trend "allows investors to participate in the lion's share of the upside and avoid the majority of the downside," Tom Lydon, editor of ETFtrends.com, asserts in his second ETF book, "The ETF Trend Following Playbook."

It's the same investment strategy that he uses to manage private client assets as president of Global Trends Investments, based in Newport Beach, Calif.

Tom Lydon

- Global Trends Investments
- President
- 49 years old
- B.S., management, Babson College
- Author of "The ETF Trend Following Playbook"
- Editor of ETFtrends.com

The strategy has returned 8.9% for the year through Sept. 30 vs. 17% for the S&P 500. Last year saw a loss of 10.5%, while the S&P fell 38.5%. Annualized return over the past five years is 5.9% vs. -1.1% for the benchmark.

Lydon spoke with IBD.

IBD: How do you identify a trend?

Lydon: Simply put, I identify a potential long-term uptrend when it crosses the 200-day moving average. While there's the chance that the trend could end the day after you take a position, there's also the chance that the uptrend could go on for weeks or months. Getting in at the point when the 200-day is crossed gives a clear, logic-based signal to buy, and vice versa.

IBD: Don't most major moves to the downside occur below the 200-day moving average?

Lydon: Yes. It's never a guarantee that when a position breaks its 200-day that it's the start of a major correction. But the fact is that every major correction has occurred with a crossing of the 200-day.

Investors would be better served recognizing that the potential for a correction is there once the position drops below the 200-day moving average. Remember, buying is easy. It's selling that requires the lion's share of a successful investment strategy.

IBD: How do you know when it's too late to jump on board and that the trend has run out of steam?

Lydon: The truth is that you don't. This is why it's important to buy something when it first crosses its trend line. The longer you wait, the greater the risk is that you're just buying at the top.

I often advise people on the importance of being prepared to act when the time comes. For example, earlier this year you could begin to see small shifts in the tide. After the March lows and into April, it became clear that soon we could see the S&P 500 cross its 200-day.

For that reason, it was important for investors to keep a close eye on the trend line and be prepared to hit the "buy" button when the time came. Valuations have never been better, and if you've participated in this current rally by acting at the appropriate time, you've done nicely, even if it was a difficult and emotional decision to buy.

If you have missed the majority of an uptrend but would still like to participate with available cash, put in 50% and wait for a 5% appreciation before adding the other half. This prevents you from adding money at the absolute high. Most importantly, have a stop-loss in place. For my clients, I sell when a position drops below its 200-day or 8% off the recent high — whichever happens first.

IBD: If everything is going up, how can you find the particular countries or sectors that will outperform the broad market?

Lydon: Right now there are an overwhelming number of opportunities for investors. Most of the ETFs we track are currently above their 200-day moving averages.

When most asset classes and sectors are above their trend lines, look to those that are showing the best relative strength in the past two to four weeks of performance. For example, emerging markets are hot right now and are forecast to show even greater growth as a firm recovery takes shape.

Some of our current positions include funds that have rebounded handsomely off their March 9 low: **iShares** MSCI Emerging Markets (EEM), iShares Dow Jones U.S. Basic Materials (IYM) and SPDR S&P Latin America (ILF) are all up more than 100% off the low.

IBD: Do you think people should invest in alternative asset classes like currencies and commodities?

Lydon: Absolutely. Currencies and commodities have been thrust into the spotlight thanks to a weaker dollar and a growing global population. These alternative asset classes can be effective hedges against a changing global climate in which the dollar is falling out of favor and more people are demanding resources.

IBD: What advice can you offer to improve one's results?

Lydon: The primary challenges in executing this strategy are overcoming emotion and having "stick-to-it-iveness." This strategy won't work if an investor doesn't have the discipline to put it into action. Nobody knows what the market is going to do next.