

# Follow the Trend

*Instead of focusing on the data and noise flooding the equity markets, Gregory L. Morris, the manager of the PMFM Managed Portfolio Fund, prefers to measure and ride the market trends. After all, it is not important what caused the buying enthusiasm or the speculation. The important part is having a system to detect the upward trend early enough to gain, as well as the downward trend to avoid losing.*

## **How would you describe your investment philosophy?**

Our philosophy is based on the fact that the stock market trends. There are up trends, there are down trends, and there are periods when the market doesn't trend. Fortunately, the markets trend considerably more than they don't, and you can always get into short, medium, or long-term trends.

We believe that investors have a 15 to 20 year period in their life when they can accumulate their retirement wealth. Those are the years after the bulk of the house bills have been paid and after college education for the children has been secured, or the period after one reaches 40 years. And while many proponents like to analyze 80-year averages, there are many 15 to 20 year periods where you wouldn't have made a cent. If you started in 1929, it would take 25 years to break even, and breaking even is not exactly a good strategy.

You don't control when you're born, when you reach your early forties, and when you start to accumulate your retirement wealth. If you reached the age of 40 in 1980-1981, you were in a very good position to make money. The people who started their retirement wealth accumulation in the late 90s would be very

unhappy today, especially if they are buy-and-hold investors or index investors.

We believe that by trend following, we can participate in most of the up moves and avoid most of the down moves. Occasionally, we do get a whipsaw, but that's the cost of doing business that way. The important part is that preservation of capital, while striving to get returns, is a very worthy goal. That's what we aim to do.

## **What do you consider a trend? How would you define it?**

I believe in supply-and-demand. I believe that buyers, on the demand side, want to buy a stock at a certain price, while sellers want to sell it at a certain price. For a transaction to happen, they do have to agree on a price. That agreement determines whether the seller made a profit or a loss. It isn't the earnings; it is the price. It is the ebb and flow of buyers and sellers, or the supply and demand that causes the markets to move.

Therefore, I believe that it is the human nature that causes the markets to trend. We try to measure the buying enthusiasm, the speculation, and the excitement. This is what causes both the up and the down trends. Of course, there are periods when there are no trends, and those periods are



**GREGORY L. MORRIS** is the Chief Investment Officer for PMFM, Inc. From 1996 to 2002, Morris was CEO of MurphyMorris, Inc., the leading provider of web-based market analysis tools and commentary, with his partner, John Murphy, a former CNBC analyst. MurphyMorris, Inc. was acquired by StockCharts.com, Inc. in October, 2002. In 1999, Morris and three associates started MurphyMorris Money Management Co. to manage assets for individuals. This focus was later changed to address the firm becoming the Advisor to the MurphyMorris ETF Fund in January, 2004, and later merged into the PMFM family of funds.

Morris graduated from the University of Texas at Austin in 1971, has a BS degree in Aerospace Engineering, has authored numerous investment-related articles, speaks at numerous seminars and investment groups, and appeared many times on Financial News Network (FNN).

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typically volatile. For trend followers, these aren’t good times, but they are relatively rare.

It’s hard to know why investors act in a certain way. Noise, obviously, affects the markets because it affects some investors, who make buy and sell decisions. But I don’t think that it is worthwhile to follow, track, and fine tune it. That’s why trend following works well for us.

**Could you give more understanding of your strategy? How do you implement this thinking into a day-to-day process?**

We have a technical model, which consists of a number of price-based components, market breadth indicators, and an interest rate measure. Together, all these indicators provide a way to evidence trends. Each indicator carries its own weight, which is assigned based upon past performance since the 1970s. Our combined weight of the evidence measure moves between zero and 100. Whether the price, the relative strength, or the breadth kick in, our weight of the evidence starts building. It doesn’t matter which of our measures is building; they all carry a certain number of points.

The evidence measure has to reach a certain level before we start committing assets. We have broken

it into four color coded levels - red, orange, yellow, and green. In our more aggressive strategies, we move in with about 20% during the early moves of the evidence measure. As the weight of the evidence increases, we start adding equity exposure. We also have growth and moderate strategies that come later in the trend.

**What are the asset classes that you invest in? When and how do you keep switching between cash and other assets?**

In our mutual funds and separate accounts, we only invest in ETFs or cash. Of course, the ETFs are equities, but they allow participation in all the styles, including internationally. There are precious metals, oil, agricultural, and commodity-related products. There are interest rate and the credit products.

So, the ETFs provide access to all the asset classes. We typically stick to the major styles, and the bulk of our investments is in equity-related ETFs, but our model allows us to take advantage of gold, for example, if the gold ETF is surfacing in our ranking formula.

We don’t buy bond ETFs, because bonds are much more volatile than stocks. Many people have the misconception that bonds are a location for safety, but they are not, especially in a low-rate environment.

**Do you stick to certain buy and sell rules?**

We have a set of requirements that the ETFs have to meet, including a ranking system. We have rules that refer to price performance, relative performance, volatility, and trend measures. In other words, we try to rank the ETFs based upon their very recent past and our expectations for the future. We want to invest in ETFs that have started a good uptrend and are leading the pack.

As we go up through the levels, our buy rules loosen, and we open the field to a broader selection of ETFs with looser stops. When our weight of the evidence has just started to move up, we have unbelievably tight stops because we want to be sure we are right. We are just starting to test the waters.

As we get into the upper levels of the weight of the evidence, we allow trading up. If something that we own doesn’t perform, or if we think that something else in our ranking system will perform better, we’ll replace that current holding. We always try to make sure that we hold the best performing ETFs.

**In terms of portfolio construction, how many ETFs do you typically hold?**

As we start to get in, we start with only two or three ETFs. By the time we’re 100% invested, we could hold anywhere from 12 to 15 ETFs. Typically, we wouldn’t invest more than 15% or 20% in any single ETF and we have rules that prevent us from owning more than a certain percentage of an ETF’s assets.

Our rules are designed to keep human emotion out of the decision making process. We can’t change the model if it doesn’t work today. Human beings are subject to fear, hope, and greed, and every investor knows how these emotions have failed them, so we stick to our rules. Another benefit of that strategy is that everyone in the investment department can handle it. It is not just my selection process; the entire department is on board on how to do this.

**How often do you change or redesign your set of rules? What would lead to such a change?**

If we believe that there is a need for a change, we implement it outside of the arena of being invested. As a hypothetical example, if I have a feeling

that we should be fully invested, but our model says differently, I can't just change the model. The change should happen when we're fully invested or fully defensive, because then it can be determined with adequate testing and very conservatively.

Obviously, we know that markets will change over time and that the process needs to be reviewed periodically. We do that and we have an investment committee that has to approve it. It has to be run through some very critical thinkers before anything could be changed. PMFM has used this approach since 1991, and the only change is that the model has evolved over this period. Some of the components and the parameters have changed, but the process is still the same.

### What's the importance of breadth as an indicator? How do you leverage it to your advantage?

We have quite a few breadth components in our weight of the evidence, because breadth arrives at the party on time, but always leaves the party earlier. As the market bottoms and then starts up, breadth starts improving just like the price-based indicators. Breadth is not capitalization weighted and if the large caps continue to hold on as the market tops, breadth will start to deteriorate because it also includes mid and small-caps. This is a very good early indication and an early warning shot. Breadth is probably the best existing picture of liquidity.

### Does that mean that you follow the breadth but you don't try to anticipate it?

Yes, definitely. I've been doing this a very long time and I think that forecasting is just folly. We are trend followers and we are not picking tops and bottoms. Rather, we are identifying up moves and jumping on board. When those up moves end and start down,

we get out. But breadth only can't take us to cash; it takes the whole weight of the evidence, which is price, breadth and relative strength. These are the three major components. We also have a small interest rate component that looks at the non-Fed controlled rates.


### What's your view on risks and how do you control them?

We believe that risk is critically important. For example, if you examine the Dow Jones Industrial Average index annual performance for the last 110 years, you will see an almost normal distribution, skewed to the right. The Dow was up 67% of the time in the last 110 years. At first site, that chart supports the notion that the market is up more often than it is down, but the probability isn't high enough. In other words, you can bet \$10 on the probability to win, but you wouldn't bet your life on it.

Once you shift your focus from probabilities to risks, that percentage doesn't look high enough to play the game of buy and hold, or to use a strategy that will lead you to sitting and holding on during a bear market.

We deal with risks by having stops. We never own a position that does not have a stop. It's not a simple price stop, but a dynamic stop based on price movement. It follows it along and as our weight of the evidence gets better, our stops get looser. We can't have really tight stops because good markets still have daily volatility and we have to live with it. Overall, we address risks by rules that I cannot break.

### Do you consider yourself a relative-return investor or an absolute return investor? What's the targeted performance?

It would be fruitless to set targets when our process is controlled by the market. If we can participate in most of the uptrends, we will do well. We strive for equity-type returns with lower beta, lower volatility. We don't set targets. 

## PMFM Managed Portfolio Fund

Symbol	<b>ETFFX</b>
Website	<a href="http://www.pmfmfunds.com">www.pmfmfunds.com</a>
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Inception	09/15/2006

PORTFOLIO	
Total Net Assets*	\$93.9
Avg Mkt Cap (\$ Weighted) *	N/A
Average Price/Earnings Ratio	N/A
Average Price/Book Ratio	N/A
Turnover Ratio	346%

INVESTMENT INFORMATION	
New Investment	Open
Min Initial Investment	\$1,000
Min Subsequent Investment	\$250
Min Initial IRA Investment	\$500

RISK (AGAINST S&P 500 DAILY REINV IX - 3 YEARS)	
Alpha	N/A
Beta	N/A
R-Squared	N/A
Ann. Std Deviation	N/A
Sharpe Ratio	N/A

RETURNS VS. S&P 500 DAILY REINV IX INDEX		
	ETFFX	Index
1 Year (Cum.)	-0.47%	-6.70%
3 Year (Ann.)	N/A	7.57%
5 Year (Ann.)	N/A	9.77%

FEES AND EXPENSES	
Max Sales Charge - Front	5.75%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee	0.00%
Total Expense Ratio	1.95%

PORTFOLIO MANAGER	
Gregory L. Morris	2006

\* millions

Data through: 05/31/2008; Source: Company Documents; Lipper

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