

By Dan Weiskopf
Access ETF Solutions
Portfolios

Interview series: Investment Factors that drive ETF performance

In this interview I am pleased to be speaking to David Brown of Sabrient Systems LLC an index provider for both Guggenheim's Defensive Equity ETF (DEF) and Insider Sentiment ETF (NFO) as well as Direxion's All Cap Insider Sentiment ETF (KNOW). David's background brings an interesting background to the the ETF space. Previously to founding Sabrient he was a NASA scientist on the lunar landing project and then the CEO of two public companies, including Telescan, a financial information firm that he ultimately took public.

We believe readers will find this interview constructive in how it presents the case for what an index provider does in terms of developing the Intellectual Process (IP) that runs the methodology, how certain driving factors work together to screen for qualitative and or quantitative outcomes and insights.

Date: August 10, 2015

Title: The insider sentiment gauge as an investment factor

Dan Weiskopf: David, your firm seems to have a theme going with your focus on insider buying and sentiment. What are the different aspects to your screening process for the sentiment factor and how are the two ETFs that run on your model different in how they use this factor? What statistical aspects to insider buying make it a good predictive factor?

David Brown: Hi, Dan. Thanks for taking an interest in the Sabrient approach to thematic multifactor modeling. In the case of our Insider/Analyst model, I had long observed that insider accumulation appeared to have some predictive qualities, and of course there is a history of academic research that has shown such relationships. Moreover, isolating just the open-market purchases from the total Form 4 filings further improves the predictive power of insider buying data. In addition, our sentiment studies found that there is not only an initial positive impact on a stock price after recent positive earnings revisions from Wall Street analysts, but also a longer-term upward drift that continues to persist for a while thereafter.

But when we combined these factors, we discovered some interesting synergies that created even stronger predictiveness. In particular, we look at insider buying activity, i.e., both the *number* of corporate officers, directors, and major shareholders who are buying on the open market over the past few months and the *magnitude* of each executive's increase in beneficial ownership, as well as Wall Street analyst upgrades, i.e., both the *number* of analysts who have issued positive earnings revisions over the past three months and the *magnitude* of each analyst's EPS increase. For example, did it increase from \$0.50 per share to \$0.52 or to \$0.75? Both groups of people are essentially insiders in a broad sense because they are more or less "in the know" due to their intimate knowledge of the company and its industry. In effect, positive analyst sentiment can serve as a confirmation of insider optimism.

Dan Weiskopf: Insider buying can be an indication of a management relatively short term outlook. What can investors gain from current insider buying patterns across sectors and market cap sizes?

David Brown: In all of Sabrient's models, a bottom-up aggregation of scores for individual stocks can create relative rankings among sectors, or any stock basket for that matter including market caps or ETFs. This can provide insights into which sectors are displaying, for example, relatively strong positive sentiment and therefore might be poised to outperform.

Dan Weiskopf: Your sector weightings across the Guggenheim (NFO) and Direxion Insider Buying (KNOW) ETFs is substantially different except for an overweighting in consumer cyclicals. What factors have led to these ETFs having different weighting?

David Brown: Two key differences between the two Sabrient indexes underlying those ETFs is the limitation on sector concentrations and turnover. NFO enforces strict limits of 20% from any given business sector and 10% from any given subindustry, while KNOW has no limits at all. KNOW can essentially take larger sector bets, so to speak, whereas NFO ensures broad diversification. In addition, NFO has a 25% turnover limitation on each *quarterly* rebalance to reduce transaction costs, while KNOW has no turnover limitation at all and it rebalances *monthly*, which can lead to faster rotation in sector weightings.

Dan Weiskopf: Can you speak about the other factors that make up your process in the indexes underlying KNOW and NFO? I don't see a lot of overlap in the holdings. How does the screening process work beyond the insider buying?

David Brown: The two underlying indexes both select from a range of capitalizations from small to large, and both employ the same basic underlying Insider/Analyst model to identify 100 stocks. However, there are significant differences in how we arrive at the final portfolios.

For NFO, we start with a broad universe of over 4,000 eligible stocks that we track in our database, and the Insider/Analyst model is run to identify the 100 highest ranked stocks, subject to the sector and turnover limitations. All 100 stocks are *equally weighted*. Overall, the process is pretty straightforward.

On the other hand, Direxion's KNOW selection process is more complex and active. It essentially combines aspects of both Insider Sentiment (NFO) and Defensive Equity (DEF). Our Defensive Equity Index employs a proprietary model that ranks how well a given stock holds up on particularly weak market days, i.e., an investor sentiment metric that also translates into relatively low volatility, as well as our Earnings Quality Rank (EQR), which is a model we developed with Sabrient subsidiary Gradient Analytics to measure the relative aggressiveness of a company's accounting practices.

For KNOW, we start by selecting only from the S&P 1500, but we eliminate the bottom 20% of stocks as ranked by our Earnings Quality Rank, leaving about 1200 eligible stocks. We then run the Insider/Analyst model to identify the 100 highest ranked stocks for the final portfolio—again, with no limits on sector concentrations or turnover. Next, we apply our Defensive Equity model to rank these 100 stocks according to their tendency to outperform during periods of market weakness, and each stock's relative ranking is used to determine a *modified exponential weighting*. As a result, the KNOW portfolio seeks to provide a strong combination of earnings quality, insider buying, analyst upgrades, and defensive investor sentiment.



As you can see, KNOW is more complex, active, concentrated, and unrestrictive in its search for the most compelling stocks for the coming month. Although some investors prefer such an aggressive approach, others prefer the process underlying NFO as it is more conservative regarding turnover, transaction costs, and diversification.

Dan Weiskopf: David, thank you for the time and the explanation of how sentiment can be used as an investment factor.

Disclosure: For Institutional Investors Only.

Dan Weiskopf is a portfolio manager of Access ETF Solutions LLC, whose third-party ETF strategies are offered through IPI Wealth Management, Inc. (IPI). IPI is an SEC-registered investment adviser, with its principal office located at 226 W. Eldorado St., Decatur, IL 62522, 217-425-6340. Access ETF Solutions LLC was established in 2013 with a focus that structure matters in selecting ETFs. Access ETF Solutions LLC is not affiliated with IPI.

References to specific securities or market indexes are not intended as specific investment advice. The manager may directly or indirectly hold a position in the Direxion Insider Sentiment ETF (KNOW) ETF. This interview should be viewed as an educational piece and not a recommendation.
