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ETF FOCUS

An ETF Built to Time the Market

Blair Hull has created an ETF based on research showing that market signals can predict market moves.

The following has been excerpted

By Chris Dieterich

This year has proved humbling for prognosticators. British soccer club Leicester City, given 5,000-1 odds to win its league, clinched the title. Bookmakers at one point last summer gave Donald Trump 80-1 odds to seal the Republican presidential nomination.

Add another unlikely candidate for beating the odds: Blair Hull, a mathematician and electronic trading pioneer whose $45 million Hull Tactical US exchange-traded fund (ticker: HTUS) debuted last June. He claims to predict the future with the trading equivalent of reading tea leaves—the Baltic Dry Index of sea-shipping rates.

Hull, who cut his teeth counting cards from Reno to Lake Tahoe in the 1970s, made his name as a renowned trader in the 1987 crash, when he correctly called the market bottom. His firm, Hull Trading, was launched in 1985 based on an options-pricing model he had developed a decade earlier, and staffed with physicists and computer scientists in the early days of computerized trading. It operated in nine countries when it was purchased by Goldman Sachs in 1999. Hull later founded Ketchum Trading, an elite electronic trading firm, and has dabbled in politics. (He was defeated in the Illinois Democratic primary for U.S. Senate in 2004 by Barack Obama.) Hull, 73, looks every bit the politician, with straight silver hair and rimless glasses, but admits to being more suited to science than art.

For instance, when a Barron's columnist accidentally referenced his poker-playing history, Hull quickly interjected: "It was blackjack, not poker. There's a big difference. In poker, you've got to be able to read people and bluff—neither of which I do very well."

HULL'S MOST RECENT OBSESSION has become predicting market outcomes. A paper he and a colleague published last year found that blending 20 market signals—including the aforementioned Baltic Dry Index, short interest, moving average, and other more-esoteric measures—can reliably forecast where U.S. stocks are headed on the whole six months into the future. This research is the basis for the ETF, which can dial up or down positions in Standard & Poor's 500 index futures or the SPDR S&P 500 ETF (SPY) each day based on market-return forecasts.

There's more to consider: Frequent trading makes the ETF a poor fit for taxable accounts; investors would do better to own this inside an IRA. Expenses are high but far less than hedge fund strategies; at 0.91%, fees are slightly lower than the largest alternative ETF on the market, the $1.1 billion IQ Hedge Multi-Strategy Tracker (QAI), which charges 0.97%.

In some ways, this opaque-sounding strategy is relatively transparent. Daily forecasts from the predictive indicators are published on Hull's website, and enterprising investors could trade off his information on their own. The strategy will evolve over time, Hull says. In November, the ETF tweaked its strategy to incorporate predictions of one-day stock price moves; in its current configuration, positions are based on one-day and six-month forecasts.

As of Thursday, for instance, Hull's cryptic model, which is currently favoring "Proprietary Variable X," indicates that stocks are likely to be down six months from now, but up in the next few days. The ETF, which can be 200% long or 100% short, adjusts its exposure to the S&P accordingly.

WHILE THE STRATEGY IS COMPLEX, Hull says the aim is to beat the market but also enhance risk-adjusted returns. Simulations in his academic paper show annualized returns double that of the market, and a Sharpe Ratio four times as large, indicating one-quarter of the risk. This year's trading shows how that can work. The ETF's median daily price move this year is just 0.03%. It plods along when signals are mixed, but should bound higher when the coast is clear.

The strategy has returned 3.9% since its June inception, versus 1.2% for the S&P 500 in the same period, according to Morningstar.

This ETF is clearly not for everybody. Hull even acknowledges it's essentially a pet project he created for friends to invest in what he considers to be the next frontier—the interplay between the flood of new and readily accessible sources of data and cutting-edge advances in the field of statistical learning.

"It's been ingrained that timing the market is a bad idea," he says. "The combination of data and predictive analytics, these two tools, can make it possible." Hull contends that market-timing models could eventually become as commonplace as index funds. Any stigma, he says, will fade as the machines prove their worth: "Just as in the past 30 years it's been considered irresponsible to time the market, in the next 30 years it will be considered irresponsible not to time the market."