Russell Spread A Sector Bet

One of the sales pitches for alternative investments is they do not rely on a bull market to generate gains. Many strategies, such as long-short, convertible arbitrage and market-neutral are designed to exploit relationships designed to convergence of related assets.

Spread trades are staples in the worlds of futures and options. The rules for long and short positions are symmetric for futures, as they must be if the instruments are to serve their purposes of price discovery and risk management, but they are asymmetric for stocks. A spread involves taking a short position, and this is considered un-American in many quarters. Who, after all, ever heard of a downtick rule for buying stocks, and can anyone tell me what the circuit breakers are for shutting the market during a big rally?

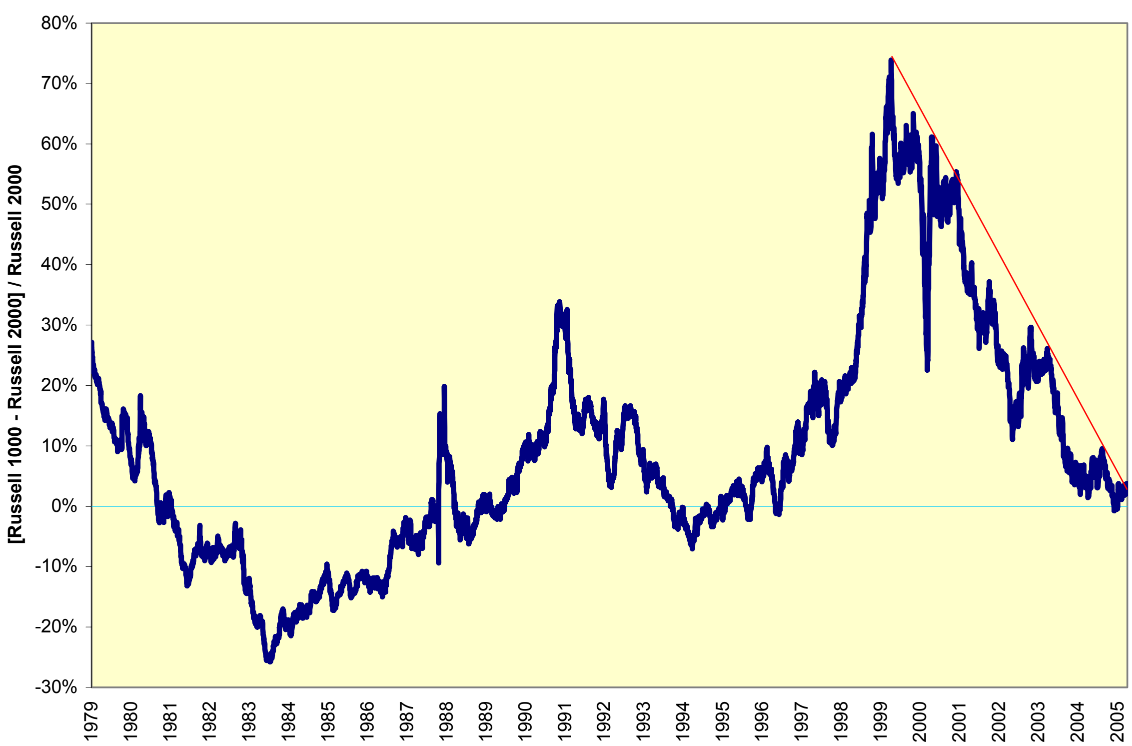
Isolating Sectors

If investing gains going forward are going to be as tough to come by as some think, it may be time for all of us to start trading like a hedge fund. This means working to achieve specific returns through specific trading opportunities and not relying on a bull's tailwind to push you forward. Can we exploit the spread between the large capitalization stocks, as represented by the Russell 1000 (RIY) index and the small-capitalization stocks, as represented by the Russell 2000 (RTY) index as one of these strategies?

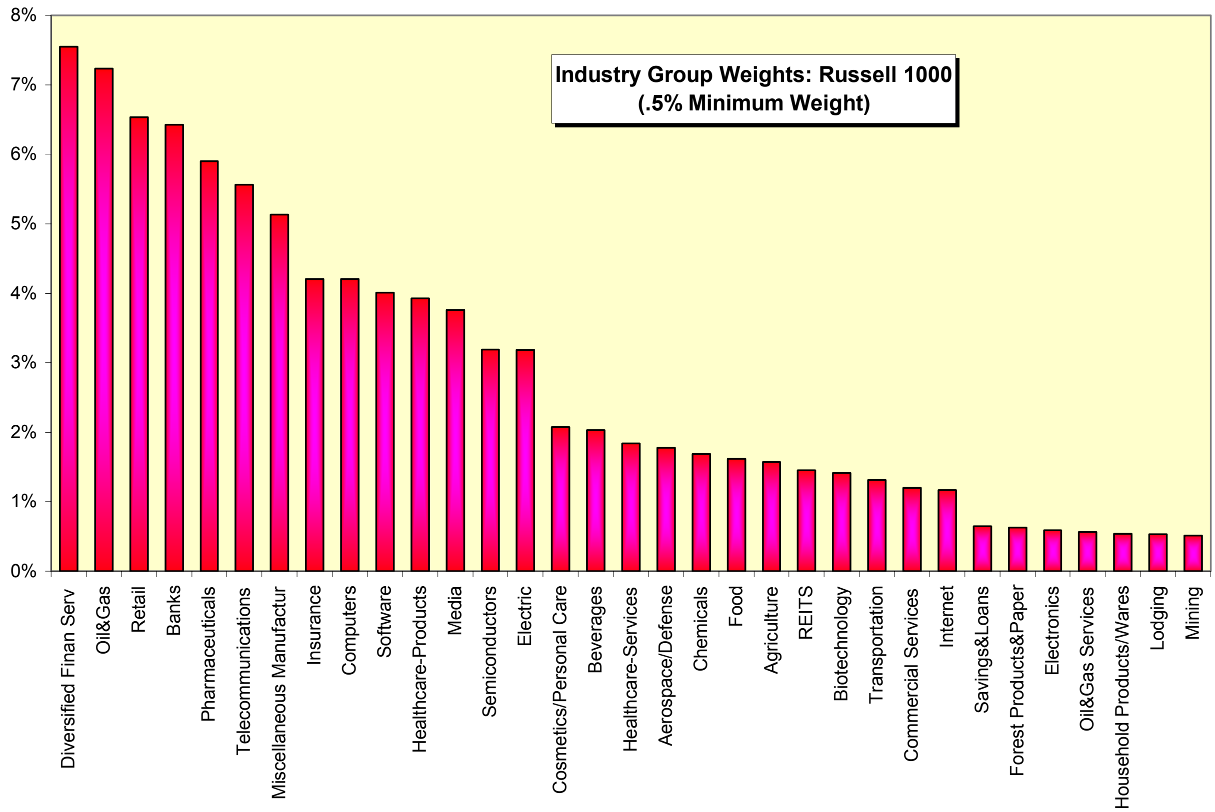
The Russell indices are used here instead of, say, the spread between the S&P 500 and the Nasdaq 100 because there is no overlap between the two indices. The Nasdaq 100 accounts for 13.37% of the S&P 500's weight.

Over the course of time, the spread between the RIY and RTY has exhibited some long and persistent trends punctuated by some gut-wrenching short-term reversals. The reversals usually represent singular events such as the October 1987 crash or "Microsoft Monday" in 2000. The trend since early 1999, highlighted with a channel line, has been for the RTY outperformance. We have to look behind the gross numbers and into the sector detail to see why this may be happening.

A Trending Spread

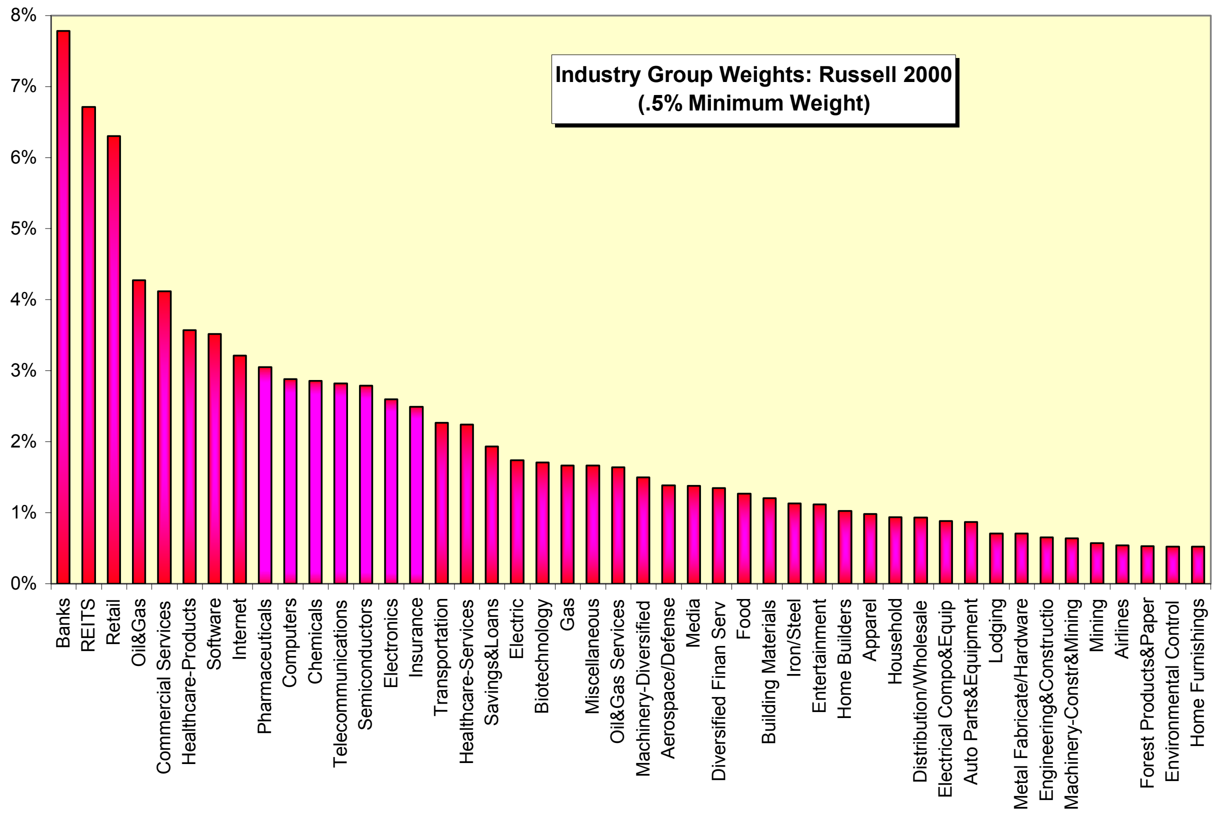


Different economic sectors and industry groups respond differently to macroeconomic factors. If we take a look at the sector distribution of the RIY, we find it is dominated by Diversified Financial Services, Oil & Gas, Retail, Banks, Pharmaceuticals and Telecommunications. These six sectors along account for 39.2% of the RIY's market capitalization.



Banks and financial services tend to prosper when the yield curve is steep and when interest rates themselves are stable to falling. Neither has been happening of late; the yield curve has flattened along nearly all maturities as the Federal Reserve continues to raise short-term interest rates, and the overall level of interest rates has risen as well. The Oil & Gas sector has done well, but as I noted two weeks ago, we should not expect a linear response by energy-related stocks en route to that magic price of $105 per barrel for crude oil. The Retail sector, if Wal-Mart is any indication, is not celebrating the combination of high interest rates and high energy prices. The Pharmaceutical sector, as discussed here last December and as confirmed by recent exploding cigar episodes by Elan and Biogen-IDEC, needs to rethink its entire business model.

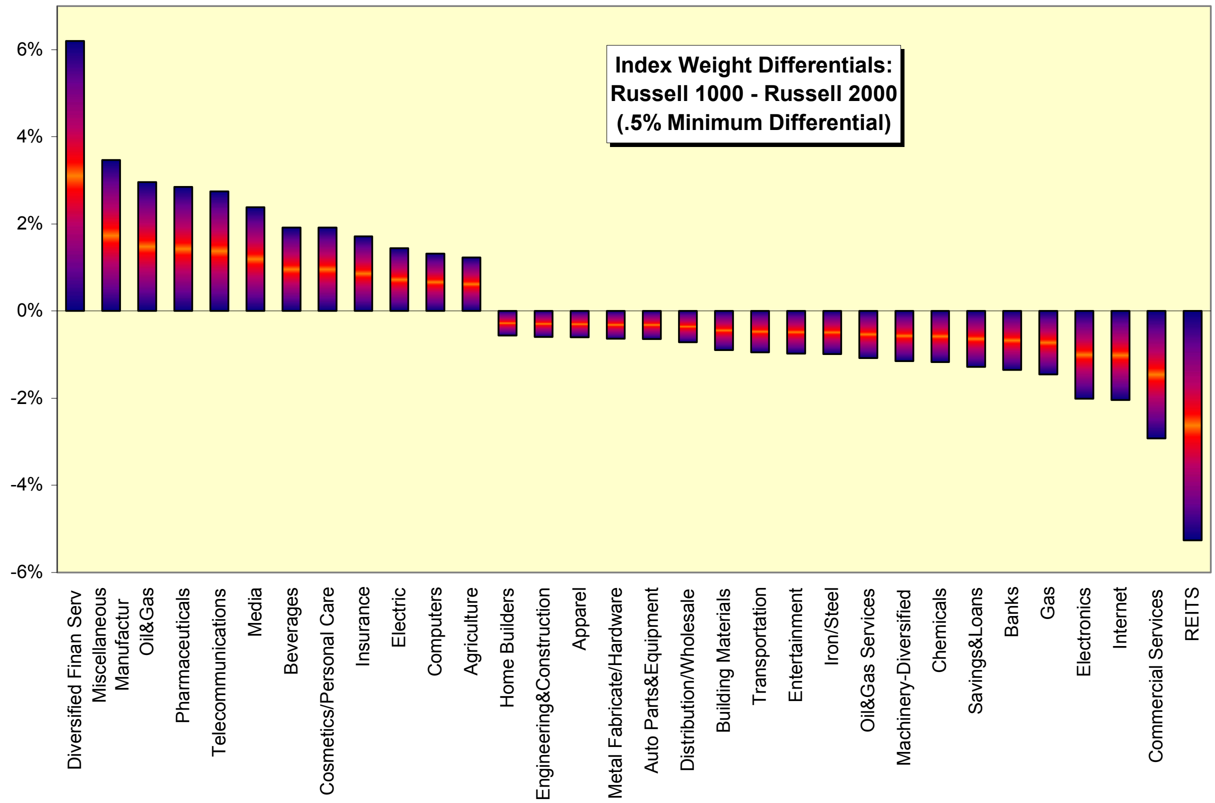
What about the sector distribution for the RTY? We have to get eight sectors deep into the index to reach the same concentration level as seen for the RIY. The dominant sectors are Banks, REITs, Retail, Oil & Gas, Commercial Services, Healthcare Products, Software and Internets.



The real estate market has been marching to the beat of an amphetamine-laced drummer for several years, and this has direct implications for the performance of REITs themselves. Software and the Internet sector tend to have surprising sensitivities to factors as diverse as the euro and industrial commodities.

Tracking The Differences

Where are the biggest differences in the sector distribution of the two indices? The RIY is weighted more in Diversified Financial Services, Miscellaneous (yes, that's an actual sector name), Manufacturing, Oil & Gas, Pharmaceuticals and Telecommunications. The RTY is weighted more in REITs, Commercial Services, Internets, Electronics, Gas Utilities, Banks and Savings & Loans.



Recall the Wall Street aphorism about how common opinions are. You can now employ your own opinion on the behavior of key macroeconomic factors to assess which of these sectors is going to be helped or hurt the most and base a spread trade between the RIY and the RTY accordingly. The trade can be executed either in the futures markets - the Russell indices are traded on several competing futures exchanges including the New York Board of Trade, the Chicago Mercantile Exchange, Eurex US and the CBOE futures exchange - or by using the index ETFs in a stock account. The RIY trades under the ticker IWB and the RTY trades under the ticker IWM.