The IDExtreme Approach: A New Alpha Source in the U.S. Stock Market

A Tactical Allocation Methodology Created by KLD Capital Management, LLC

Vision:	Generate steady, superior risk-adjusted returns through all market environments based on "Strength is Risk"
Strategy:	Deploy a consistent, repeatable market edge by applying a non-traditional perspective (Inside Out Risk Analysis) to proprietary information (KLD Sector Risk Gauge) to create actionable context (Market Phase Analysis)
Tactics:	Measure market risk by tracking market strength stock by stock and sector by sector, to buy when market risk is lower and sell when market risk is higher (Long/Short Multi-Index Strategy)

KLD Capital Management, a Registered Investment Advisor (KLD), is creator and sole user of the IDExtreme Approach to the U.S. stock market, based on the concept that "Strength is Risk" ("Approach"). When most stocks and sectors are strong, market risk is higher. When most stocks and sectors are weak, market risk is lower. The Approach measures individual stock and sector strength to determine market risk, increasing long portfolio exposure when market risk is lower and decreasing long portfolio exposure when market risk is higher.

Based on the Approach, KLD can generate alpha through custom long/short, long-only, and short-only U.S. equities strategies, using index-level vehicles such as mutual funds and ETFs (see Long/Short Multi-Index Strategy below); sector-level mutual funds and ETFs; individual stocks; and combinations of these.

KLD Long/Short Multi-Index Strategy ("Strategy")

Systematic, Risk Management-Focused Absolute Return Approach: The Strategy is a daily program deploying a unique, quantitative, systematic methodology that seeks to generate positive annual returns regardless of market environment. The Strategy attempts to match up-and-down market movement based on tracking and measuring the continually changing strength of the individual stocks and sectors that comprise the overall market. The Strategy segregates historical market action into distinct phases with mutually exclusive stock and sector strength characteristics, and attributes potential risk and reward by phase based on relative performance during each phase of five major U.S. stock market indexes (Dow 30 Industrials, Nasdaq 100, S&P Mid-cap 400, S&P 500, and Russell 2000, collectively "Indexes"). In turn, the Strategy identifies the currently prevailing market phase and adjusts portfolio exposure based on expected risk and reward for such phase, taking long or short positions in the Indexes as dictated by historical phase performance.

Investment Process Summary

1. Define stocks as strong or weak.
2. Track a) total strong stocks and b) direction of change in number of strong stocks (up or down).
3. Define market Phases based on differing historical conditions using 2a) and 2b).
4. Determine historical risk/return profile for each Phase, including volatility and both absolute and relative returns for five major U.S. market indexes.
5. Determine current market Phase.
6. Allocate long and short capital to money market or index mutual funds as dictated by 4 and 5.
7. Repeat daily.

Uses Mutual Funds: For execution, the Long/Short Multi-Index Strategy uses ten ProFunds mutual funds specifically designed for active portfolios and which replicate long and short exposure to each of the Indexes. The five ProFunds funds used to replicate long performance of the Indexes seek to provide investment returns that correlate to 200% of the daily performance of the individual Indexes (if the Dow 30 rises 1%, the relevant ProFunds 2x Dow 30 fund should rise 2%). Such funds are used for those indexes expected to rise during the prevailing phase. The opposite applies to the five inverse ProFunds funds used to replicate short performance of the Indexes, which are used for those indexes expected to fall during the prevailing phase.

Changing Allocations/Exposure, Short-Term Holds: Fund allocations range from 0% (all in money market) to 100% (all allocated to funds replicating the Indexes). It is possible for all funds to be 100% allocated with 0% net market exposure (i.e., 50% allocated to long-oriented funds and 50% allocated to inverse/short-oriented funds). Using 2x and 2x Inverse ProFunds funds allows for greater than 100% net long or short market exposure when phase conditions signal higher-than-normal conviction regarding market direction – a key feature for generating alpha, along with long and short and intra-index adjustments. However, in practice, exposure is typically between 50% long and 50% short, and allocations can be reduced for clients seeking lower market exposure. The Strategy changes allocations up to daily, and can remain the same for two or more weeks. Thus, there will be significant activity in accounts, and all gains will be short-term.

"Law of Large Numbers": The Approach is similar to that used by well-known fund manager John Hussman, who separates market action into "bins" with distinct, observable conditions (including fundamental and macro-economic factors) and then aligns investment position with the currently-observed set of conditions, shifting investment position as evidence shifts. Both rely upon the Law of Large Numbers, an idea that Mr. Hussman describes as "if we follow our discipline period after period, over time our inevitable errors will average out, and our long-term results will be largely as we expect." *(http://www.hussman.net/wmc/wmc091011.htm)*

Client Benefits

Portfolio-wide

1. Offers objective market risk measurement to improve overall portfolio performance.
2. Provides true strategy diversification with low correlation to other strategies via unique approach, leading to enhanced capital protection and growth.
3. Offers additional alpha via continued system improvement and development of new strategies.

Strategy-specific

4. Takes the right actions at right times (long or short, aggressive or conservative, mean reverting or trend following) through a logical process that makes sense and is applicable in all market environments.
5. Protects from the worst case (large drawdowns), positions for the best case (steady absolute returns).
6. Offers potential for superior risk-adjusted returns with lower volatility and smaller drawdowns vs. other methodologies and strategies.
7. Eliminates emotions.
8. Offers low correlation to market index performance.
9. Offers transparency, scalability, and liquidity.

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