August 2010

Beyond Stocks and Bonds

On December 18, 2008, the yield on a 30 year treasury bond went down to the unbelievably low 2.55%. Mass fear brought investors to the same conclusions Mark Twain had when he famously said, "I am more concerned about the return of my money than the return on my money." By June of 2009, the yield had sky rocketed to 4.7%; crushing investor's returns in just six short months. I believe that December 2008 was the secular peak of the bond market and that bond investors have a 15-30 year headwind to contend with. There will certainly be good trades along the way, but we have to accept that the Federal Reserve cannot lower interest rates below zero.

As of April 30, 2010 a record $122 billion has flowed into bond mutual funds. 2008 and 2009 saw only $82 billion and $61 billion in net flow for the entire years![1] Investors have voted with their feet and moved into the only asset class that has just enjoyed a 28 year secular bull market. I think these late-comers will soon learn the painful lesson that bonds can lose money too.

I can appreciate why the herd has plowed into bonds. They are certainly a lot less volatile than stocks and investors are starved for yield thanks to our central planner's back-door bailout of the banks. To add insult to injury, the average savings account at an FDIC insured institution is only paying .2%[2]. The rule of 72 tells us that, it will take you 360 years to double your money getting that kind of rate!

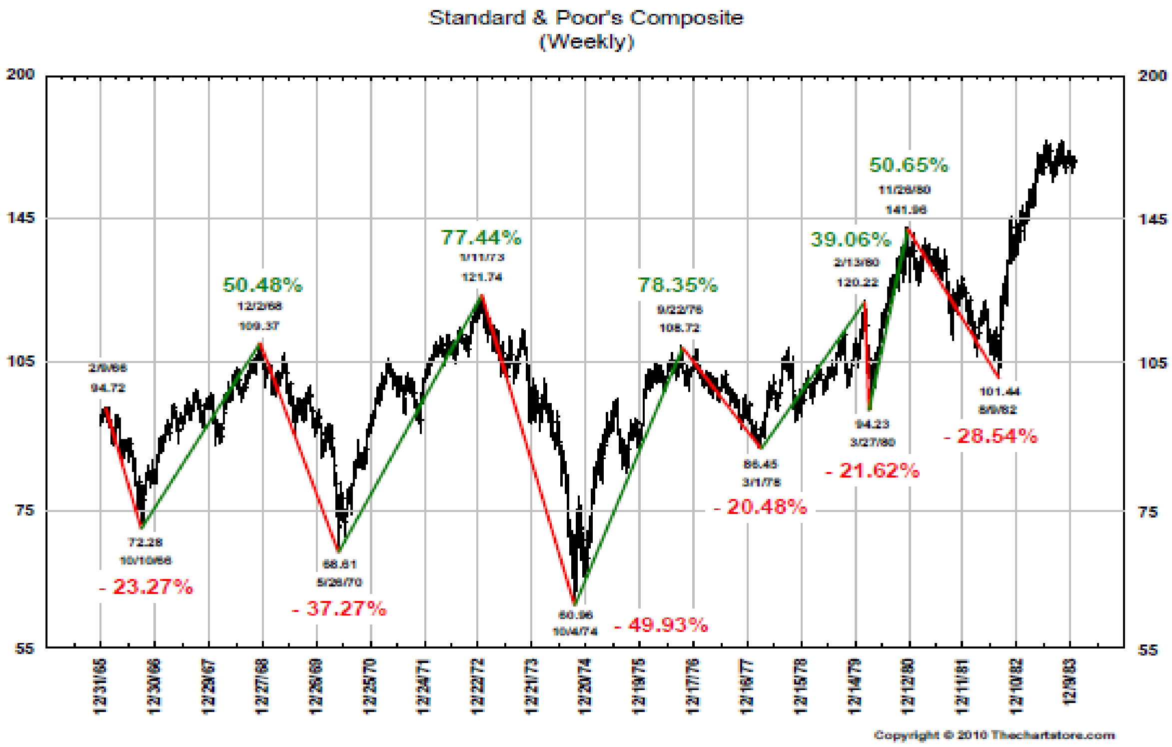
Look what a former advisor to China's $2.45 trillion foreign exchange reserve had to say:

> "I do not think U.S. Treasuries are safe in the medium-and long-run," Yu, a member of the state-backed Chinese Academy of Social Sciences, wrote yesterday in an e-mailed response to questions. China is unable to sell the securities in a "big way" and a "scary trajectory" of budget deficits and a growing supply of U.S. dollars put their value at risk, he said.[3]

What about stocks? From the March of 2009 bottom to the April of 2010 stock market high, the S&P 500 enjoyed an 83% return. Even after correcting hard to the July 1st low, the general stock market is not cheap based on my valuation metrics. As I mentioned in the May Newsletter, stocks entered a secular bear market in 2000 and probably have 6-10 difficult years ahead of them. Below is a chart of the last secular bear market that the S&P 500 went through. Take a moment to review all of the rallies and declines. Did you catch that the index started at 94 and 16 years later, it was around 100? I concede that the index does not count dividends paid out, but it also has not been

[1] http://www.leutholdfunds.com/advisors
[2] http://www.fdic.gov/regulations/resources/rates/index.html#one
[3] http://www.businessweek.com/news/2010-08-03/treasuries-lack-safety-liquidity-for-china-yu-says.html

adjusted for the horrendous inflation of the late 70s. The majority of U.S. stock investors lost purchasing power during this difficult 16 year period.



If cash is a guaranteed way to lose purchasing power over time, bonds have gone up for 28 years, and stocks probably have a 6-10 year headwind—what should an investor do? Here are two alternatives.

Managed Futures

Managed Futures, also known as Commodity Trading Advisors (CTAs), are funds that are managed on a discretionary basis for clients that can invest long or short in commodities, interest rates, currencies, and equity indexes. Many of the best CTAs have created a disciplined model that follows short, medium, or long-term trends in the futures market. These "trend followers" do not sit and watch financial television all day or concern themselves with the drought in Russia. Instead, they manage solely based on their disciplined models. John W. Henry, famous trend follower and owner of the Boston Red Sox, had this to say about his strategy:

> I don't believe that I am the only person that cannot predict prices. No one can consistently predict anything, especially investors. Prices, not investors, predict the future. Despite this, investors hope or believe that they can predict the future, or someone else can… We rely on the fact that other investors are convinced that they can predict the future, and I believe that's where our profits come from.[4]

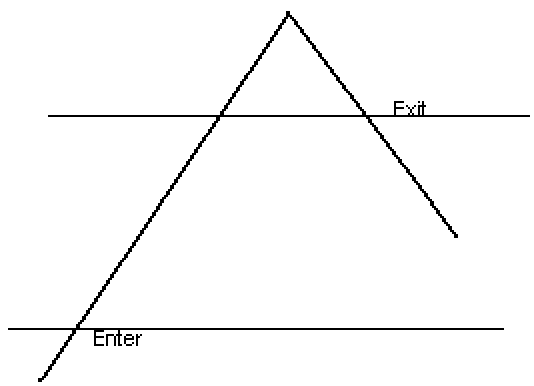
Trend following systems buy or short after a trend is established and exit the trade after the trend ends. They often get whipsawed, or stopped out of a trade, right after making it for small losses

[4] Michael W. Covel, *Trend Following* (Upper Saddle River, NJ: Pearson Education, Inc., 2009), 47.

often. Much of their returns come from the really large gains they get on long-term trends. When Jim Little of Campbell and Company was asked how it was possible to make money when only 40% of his trades are winners he replied:

> Say, for example, on the 60 percent, you lose 1% of your capital, but on the 40% winning trades you make 2%. Over longer periods of time, say a year or more, this would net 20% on a broadly diversified program.

Trend following requires managers to have nerves of steel and trust their trading system. They usually lose money at major turns in a trend because they buy after something has already gone up and then they sell after it has turned down. Most of their returns come from the middle of the trend. Below is an example of when a trader may enter and exit a trade using a trend following system.



As you can see in the figure, the trader made a profitable return and captured the meat of the trade. This system allows traders to reap enormous gains every once in a while when a trend goes on longer than most would expect. Who could have anticipated that West Texas Intermediate Crude (WTI) would start 2008 at $100 per barrel, take a moon shot to $148, and then finish the year at $37 per barrel? Trend followers were able to play the long side on the way up and then profit on WTI's collapse.

According to the CME Group, if you invested $10,000 into the CASAM CISDM CTA Equal Weighted Index in January of 1980, it would have grown to $513,467 by February of 2008. $10,000 invested in the S&P 500 grew to $287,890 and $10,000 in the MSCI World Stock Index grew to $111,850 during that time period.[5]

Managed futures offer portfolio diversification, the potential to lower your overall portfolio risk, and the opportunity to make money on appreciating and depreciating markets. From my experience, the biggest draw backs are:

1. You can only access your funds once a month and they are priced once a month
2. Their returns bear little to no resemblance to the stock market. Most CTAs did very poorly during 2009 while most stock markets soared. Conversely, many CTAs made a fortune during the stock market crash of 2008.
3. You have to believe in your manager(s) and have a long term perspective.

Traders

Have you ever heard someone say on T.V. that this is a "traders market" and the average investor should not be in the market? Well if they are right, maybe you should look at hiring a trader to handle a portion of your funds. There are a million different trading techniques out there. Many of

[5] CME Group "Managed Futures: Portfolio Diversification Opportunities" page 8
http://www.cmegroup.com/education/modules/managed-futures/resources.html

them employ a trend following system like the CTAs use. Rather than go into minutia on different strategies, in this section I will focus on two traders that I like.

The first trader has created a quantitative model that determines the primary long, intermediate and short-term trend of the S&P 500. He overlays this model with an overbought/oversold indicator. He waits for a down day in an up-trending market or an up day in a down-trending market and buys a mutual fund that is supposed to track twice the performance of the S&P 500 or twice the inverse of the S&P 500. Trades are typically held for 1-3 days and he often sits in cash patiently waiting for the stars to align for another high probability trade. This strategy has the ability to make money in up, down, and sideways markets and can be very volatile.

The second trader I would like to profile has created two indicators: one that tells him whether he should be in stocks or cash and one that tells him which two sectors of the S&P 500 he should own. Each year, there is a wide difference between the best performing sectors in the stock market and the worst. The industrials sector is currently up 9.81% and the worst performing, health care sector, is down 6.11% year to date.[6] He attempts to reduce risk by going to cash and add value by being in the right sector at the right time.

Allocating a portion of your funds to a trader provides diversification and gives you the chance of making money in any market environment. I recommend that you fully understand the trader's style before you invest with them so that you can stick with them when their strategy inevitably goes through a bad patch.

Markets

2010 has been a very difficult year for investors because of the many trend changes. The S&P 500 peaked on 1/19, up 3% year to date. It then quickly dropped 9% by 2/5 to give investors a -6% ytd return. After the correction, the index took a moon shot till April 26, making investors up 9% for the year. Then came May and June, two of the worst months in modern history, and the S&P 500 went from being up 9% to being down 8% from January 4. Since the powerful July rally, the S&P 500 is now about flat for the year. It has been a very difficult ride to nowhere in the last seven months.

Bulls and bears are in a fierce fight over whether we have a sustainable recovery or go right back into recession (if we ever left one). Over 70% of companies that have reported 2nd quarter earnings have been able to beat their earnings expectations.[7] Overall, earnings and sales have been very good and many CEOs have had positive comments about the 3rd and 4th quarters.

The bears argue that today's earnings are yesterday's news and are hyper-focused on the economic data being released. We still do not see employment picking up and since the tax credit ended in April, home sales have been dismal. One of the most talked about data points has been the ECRI Weekly Leading Index turning to -10.7% growth rate.[8] According to the Economist, January 2005, "ECRI is perhaps the only organization to give advance warning of each of the past three recessions; just as impressive, it has never issued a false alarm."[9] Every single time we have seen a -10 or

[6] http://www.standardandpoors.com/indices/sp-500/en/us/?indexId=spusa-500-usduf--p-us-l--
[7] http://www.bespokeinvest.com/thinkbig/2010/7/29/sector-earnings-beat-rate.html
[8] http://www.businesscycle.com/resources/
[9] http://www.businesscycle.com/

lower, in the growth rate, we were in recession or just about to go into recession. No indicator will be correct 100% of the time, but it is hard to make the bet that this will be the first time the indicator will be wrong.

The other thing that is concerning me is the divergence between the 10 year Treasury-note yield and the stock market. The bond market is larger than the stock market and it is often the dog that wags the stock market tail. As you can see on the chart below, the 10 year-note yield peaked about a month before each of the last two corrections in the stock market. During the month of July, the stock market has rallied significantly, but the 10 year yield has refused to budge from its July 1st low. Either the stock market or the bond market is wrong right now.

Courtesy of StockCharts.com

September is historically the worst month of the year and there have been some very famous stock market crashes in October. I think there is a good chance the S&P 500 trades in the 900s this fall. The problems in Europe are not fixed; they are just on hold until "holiday" is over. I am also becoming increasingly concerned with the tensions in the Middle East. In the last two weeks we have seen an "attack" on a Japanese oil tanker,[10] a possible assassination attempt on Ahmadinejad,[11] and a border skirmish between Israel and Lebanon.[12] The markets could also continue their uptrend. I am quite content to protect my capital with all of these cross currents. History has taught us that the time to panic is before everyone else does.

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[10] http://online.wsj.com/article/SB10001424052748704017904575408624038183854.html
[11] http://www.msnbc.msn.com/id/38552172
[12] http://edition.cnn.com/2010/WORLD/meast/08/04/israel.lebanon.hostilities/?hpt=T2#fbid=na3fohJXR3y&wom=false

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