



# CASTLEMOORE INVESTMENT NEWS

*Uniquely Superior Portfolio Management*



## The Second Shoe



By

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In the Sept 06' issue of CastleMoore Investment News, I wrote about the woes of General Motors, the once-powerful auto manufacturer whose only remaining talent is making obsolete V-8 engines. They had announced cut-backs, layoffs and huge losses.

And in February, it was Chrysler's turn. 2000 people to become unemployed... production cut-backs. The second shoe has dropped. I wonder when Ford will announce the obvious.

Isn't it pitiful? The big three can't make hybrid cars. They can't make high quality 4-cylinder small cars. Fuel efficiency? What's that?

The technology exists: the Japanese auto manufacturers are doing just fine. European auto makers are doing just fine. Why can't The Big Three survive? What's wrong?

Maybe it's us who are wrong. Maybe our expectation that "Big Is Beautiful" is the problem. Maybe our expectation that the "Way of the Big" is the correct way is the problem. Maybe reality is contained in the slogan "When you're green you grow; when you're ripe you rot."

That's our philosophy at CastleMoore. The big brokerage firms and the big mutual funds are financial dinosaurs. "Buy and Hold for the Long Term" is obsolete. The long

term is over. Today's financial markets are the sum of a series of short term and intermediate terms. It started in the year 2000 and may run for another 10 years.

In the same way that GM and Chrysler are talking merger, the big mutual funds will soon be merging. In the same way that GM and Chrysler are talking layoffs, the big brokerage firms will be talking layoffs.

The Age of Financial Giants is over: the Age of the Individual Investor is here.



*David and Goliath, Caravaggio, 1599*

### THEY DROPPED OFF THE KEYS

We haven't seen this for a while: a friend of mine is a personal banker for one of Canada's big banks. In the third week of February, two homeowners visited the bank and dropped off the keys. Imagine their dismay. They could no longer afford to make ends meet and had to give their homes back to the mortgagor. My friend tells me that the last time this happened was in 1981. Remember 1981? Interest rates of 20%?

What followed 1981 was a recession and a big drop in the stock market. And, if you lived in Calgary, the price of your house fell too. It's not a good sign when homeowners are dropping off their keys.

Imagine that you are a big mutual fund manager or a big pension fund manager. You manage billions and billions of dollars worth of stocks. What would happen if you observed the same phenomenon that my friend, the banker, observed? What would happen if you concluded that the "dropping off of the keys" was a warning of tough times ahead? What would happen if you decided to sell a few billion dollars worth of stocks? And what would happen if some financial reporter asked what you were doing about the economy and the stock market? And what would happen if you told that reporter [i.e. the whole world] that you were selling several billion dollars worth of your portfolio? Who would buy?

Your selling would depress the stock market.

That's why we never get a warning when the top comes. No one from the big financial firms tells us what they really think. They always tell us about the favourable parts of the economy. They never talk about the "dropping off of the keys."

At CastleMoore, we watch for the signs. We watch for the technical equivalent of the "dropping off of the keys." And when we see it, we sell out. And, since we do not manage billions and billions of dollars of stocks, no one even notices that we have sold.

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By  
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"Prices don't lie!" she stated confidently while scanning the large room, seemingly to see who might raise a challenge or to maybe just to see who really looked confused. They were the first words out of her mouth.

Huh? *Prices don't lie* I thought to myself? What the hell? I just paid \$350 to attend a professional financial conference and one of the keynote speakers opens up her lecture with this bunk?

I was in the first row. I'm not sure if she pencilled me in as one of the bewildered, but I was thinking "yeah prices do lie"—like the price I paid for this conference.

Unknown to me, the woman was Linda Raschke, a well-regarded and very successful US-based equity options specialist. She's lectured all over the world to a plethora of institutions, companies, societies and governments. She knows the markets.

Those words then, and today, still echo in my mind. She was right. Prices don't lie—they are the only thing in the investment business that's not nuanced. They are what they are. The price a market or security closes at is the sum of the aggregate perception of it. Participants buy and sell things at what they think they should be worth.

I ultimately realised this truth - that prices don't lie— and that I needed to add in price analysis to the man-

## Prices Don't Lie...

agement of my clients' accounts from a particular situation. When I was a broker at RBC, I called our technology analyst to ask what was up with Nortel. It was 1999 and the stock, which still had a \$140 target, was dropping like a stone—\$90, then \$80, then \$60. Crap!

We weren't supposed to talk to analysts. Access to them was strictly reserved for the institutional crowd. They were not there for me or my clients, but advisors use their research reports to make investment decisions. They are the same reports all retail brokerage clients get. Breaking that rule never bothered me. I gladly took the flack I got from management for scrapping for my clients.

What I didn't like was the answer he gave me. "Look, I don't know what to tell you. I don't follow the stock much." "Really?" I said with chagrin. I thanked him for the time and ended the call.

Fortunately, I can only think of one



What fundamentally changed from the left side of the peak to the right? For sure the price did.

client for whom I bought Nortel. I still don't know what Nortel really does. I used to see the name on my telephone, but I can't point to their product in my everyday life. Switches or something? Fibre optics as well?

I did have quite a number of clients who got Nortel as a freebie for owning BCE. This is why I called the analyst. Most were retired or close to retirement: I needed to figure out if I

should sell or hold. The cost base was around \$7 or twice what the price it is today! True to his craft the analyst was only doing what he was trained to do—follow companies, not the stock prices of those companies.

While teaching the Canadian Securities Course this past fall, an experience that is a great refresher for me, I came across this definition of fundamental analysis: "Fundamental analysis means studying everything and anything other than the trading on securities markets in order to determine how securities' prices will change" (CSI 8-1)

The next page had the definition for technical or supply and demand analysis: "It's the study of historical stock prices and stock market behaviour to identify recurring patterns in the data...the study of price movements, trading volumes, and data on the number of rising and falling stock issues over time." (CSI 8-2)

The traditional or fundamental approach is the underpinnings of the vast structure that are the capital markets. It fuels the investment banking relationships, the regular research recommendations, and, of course, the advice from advisors. It's the stuff of Bay Street lunches. You've heard me or Ken say this before: they tell great stories. Price analysis, on the other hand, doesn't. And because the analysis is so clinical, no one asks the price analyst out to Canoe for a 'chi chi' snack. It's like dealing with a statistician. They just give you the bare, raw facts. The data is the data.

Having some regard for each of fundamental, price and even, seasonality (yes there is a further sub division that sees regularity in the calendar) broadens out the resources available to managers. At CastleMoore we

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**“Buy, Hold...And  
Know When To Sell”**



CastleMoore Inc. helps investors manage their life savings. We are not stock brokers or mutual fund salesmen. We are discretionary investment managers specialising in “buy low, sell high” strategies instead of “buy and hold” strategies like the other guys.

At CastleMoore we manage our clients’ investments through a methodical and disciplined set of systems that virtually removes any individual bias and emotion from the investment process. What we do works. We rely heavily on loss avoidance techniques when making investment decisions.

Our clients are investors that pay particular attention to asset prices, have little tolerance for investment losses, and strong expectations of getting their money’s worth. Clients appreciate CastleMoore's all-inclusive, comprehensive fee schedule. If we are required because of volatile markets, to be more active within our client accounts CastleMoore bears all the costs associated with more frequent transactions.

Our team’s previous experience in national and international firms and small boutiques provides us the ability to deliver a high quality and cost effective professional portfolio management service. A CastleMoore client enjoys the benefits of having focused portfolio management without the distractions of also providing a “super market” of financial services. We just manage investment portfolios effectively – plain and simple. CastleMoore is uniquely superior portfolio management. To know more, including how we gradually and gently transition your existing portfolio to our models please contact us at:

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**Prices continued**

bring all three into the mix. The price action is the final arbiter— the truth.

Fundamentals tell us what consensus is, what everyone is thinking, prices tell us what investors have actually done based on their thinking, and seasonality shows when they typically act within a 365 day period.

So the staggering drop in Nortel in and of itself meant nothing to our analyst, or to be fair, most analysts. They weren’t wired to see any truth from price, when, indeed, price was trying to tell us something. The problem, unfortunately, is that as humans we need answers to events.

A good buddy of mine and I go through this dance off and on. “Hey Hap (my nickname), I don’t understand why this

went down. What do you think?” “Well, I’m not sure, the fundamental story is good, right?”.

In the end, it always comes down to investor perception. For example, how can investors accept high valuations at times, comfortable in substantiating further increases, but then turn full circle in a matter of weeks or days, claiming that things aren’t so rosy? Yes fundamental elements change, and they do turn, but not on a dime. As humans, full of emotion, only we can do that.

A great benefit to using price analysis is that it more readily lends itself to working with “models”. Based on your parameters you can dry-run your ideas to see how well they work. Moreover, you can see how often the transactions are unprofitable and what these unprofit-

able transactions cost. Our CastleMoore models sometimes generate transactions that lose money; when we lose, it’s usually only 5-6%. We learned a big lesson from Nortel.

We get much comfort from knowing that some of our models are back-tested over 40 years! All our models significantly outperform the buy and hold approach. And, the most important component of our models is price.

Prices don’t lie.

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## Overweight's the Norm



By  
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Portfolio Manager

Coach: What's shaking, Norm?  
Norm: All four cheeks and a couple of chins, Coach.

—from TV sitcom "Cheers"

Let me begin this column by apologizing... for last column, which many of you, due to a server hiccup, received up to eight times by email. And to those of you who did receive it that many times and didn't read ANY of them, this apology does not apply.

Still and all, it's nice to know that most of you have a sense of humour; otherwise you might not be reading my columns at all.

Speaking of my last column, I briefly touched upon the idea that, in certain situations, being overweight was not necessarily a bad thing, "a waist being a terrible thing to mind" and all. I'm old enough to remember the inflationary '70s, when food was so expensive that being overweight was a status symbol.

But I digress.

Most investors have seen research reports from investment dealers which recommend that certain sectors of the market be "overweighted", "underweighted", or "market perform." What these terms mean is certain sectors of the market were expected to outperform the broader market (or index), certain sectors were expected to under perform, and certain sectors to perform about the same.

I recall from my days as an analyst at a firm then known as Nesbitt Thomson (now "BMO Nesbitt Burns") that we would rank sectors from "1" (worst) to "5" (best) based

on how that sector was expected perform relative to other sectors in the market. We would also rank individual stocks from 1 to 5 based on each stock was expected to perform relative to other stocks in its unique sector. I must say that both sectors and stocks ranked "4" and "5" consistently outperformed those ranked "1" and "2". Overweighting the former would certainly have been a profitable strategy.

That idea hasn't been lost on me throughout the years. What we do for our Focus clients at CastleMoore is an expression of that very thought, although implemented somewhat differently: we "Focus" our clients investments in what we believe will be the best performing sectors of the market (or countries) we expect to outperform.

Incidentally, if you're a fan of legendary investor Warren Buffet, you might be interested in knowing that he too follows a focused approach. He believes that spreading one's money over too many investment opportunities only dilutes the effects any one of them, including the one's expecting to outperform the others.

And speaking of Buffet, it's time to eat. Here's more from Norm, starting with my personal favorite:



Hey Norm!

"Hey Norm, how's the world been treating you?"

"Like a baby treats a diaper."

"Can I draw you a beer, Norm?"

"No, I know what they look like. Just pour me one."

"How about a beer, Norm?"

"Hey I'm high on life, Coach. Of course, beer is my life."

"How's a beer sound, Norm?"

"I dunno. I usually finish them before they get a word in."

"Beer, Normie?"

"Uh, Coach, I dunno, I had one this week. Eh, why not, I'm still young."

"What's new, Normie?"

"Terrorists, Sam. They've taken over my stomach. They're demanding beer."

"How's it going Mr. Peterson?"

"It's a dog eat dog world, Woody, and I'm wearing Milk-Bone underwear!"

"What will you have, Norm?"

"Well, I'm in a gambling mood, Sammy. I'll take a glass of whatever comes out of that tap."

"Oh, looks like beer, Norm."

"Call me Mister Lucky."

"How's life treating you?"

"It's not, Sammy, but you can!"

"Can I pour you a draft, Mr. Peterson?"

"A little early, isn't it Woody?"

"For a beer?"

"No, for stupid questions."

"Pour you a beer, Mr. Peterson."

"Alright, but stop me at one...make that one-thirty."

"How about a beer, Norm?"

"That's that amber sudsy stuff, right? I've heard good things about it!"

"What's going on, Mr. Peterson?"

"The question is what's going in Mr. Peterson. A beer please, Woody."

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