Nov-Dec 2008

CastleMoore Investment News

Uniquely Superior Portfolio Management

Stop the Bubble Machine

By

Ken Norquay CMT, Partner

Okay, you're an investor. The family next door bought their house for $400,000 a few years ago with no down payment and a 40-year amortization. Now the house is worth $360,000 and the owner has been laid off. They can't make the payments. The bank is foreclosing.

You could go to the bank and buy that mortgage. You know the family and you know the value of real estate in that neighbourhood. Let's say you bid 60 cents on the dollar for that mortgage: you offer to buy the $400,000 mortgage debt from the bank for $240,000. The bank might consider it and you might make a deal. Both you and the bank understand the risk and can make a deal at some price. That's NOT the problem in the US subprime mortgage mess.

The problem is that some slick broker put millions of these mortgages together creating "mortgage-backed paper." Then they sold the paper to naive banks all over the world. And now those banks are trying to sell that paper. But who will buy? All the banks are aware of the U.S. mortgage situation are trying to sell. Problem is there are no banks who want to buy. No-one will bid 60 cents on the dollar. No-one knows home prices in the neighbourhoods and no-one knows the family who is struggling to make the payments on their dream home. And the only ones with enough cash to bid on multi-billion dollars of mortgaged-backed paper are the big banks who are trying to sell! And there's no bid.

So what's the paper worth? Zero? I'm afraid so.

Any bank who owned $1 billion of this stuff is now worth $1 billion less. Because banks are allowed to lend 15 or 20 times their capital, they now have to call $15 to $20 billion of loans. And the borrowers from whom they call the loans will have to find the money somewhere else. But, if all the banks are in the same jam, the borrowers won't find the money anywhere. The borrowers have to sell assets to pay off the loans that have been called. Borrowers may sell stocks, real estate, business inventory – whatever it takes to raise the money to pay the bank who called their loan.

That's the melt-down scenario they are trying to avoid. First the Americans passed a bill authorizing the government to buy $700 billion of this paper. That will at least give the banks a bid on their junk mortgage portfolios. At least they won't be worth zero. Then a variety of international central banks agreed to buy bank stock directly from the banks. That way, banks will have capital to replace the loss they took when the junk mortgage paper went to zero value. Even Warren Buffet bought preferred shares from GE to help their financial arm hold up in all this.

We can easily understand the jackpot that the banking system is in when we follow it through in this way. But it's not so easy to see what caused the problem in the first place.

The problem started when the big brokers pooled millions of mortgages together. When that happened the problem became too big to solve. As long as some little bank in some little town managed its own little mortgage portfolio it could sell its mortgages through the local mortgage broker; the problem had a solution. Investors with free capital could make intelligent bids on investments that they felt comfortable with. But when the problem was multiplied by umpteen million, the work-out solutions disappeared. Instead of a large number of small solvable problems, we had a smaller number of gigantic unsolvable problems. And now we need the governments to bail us out.

Modern economies need liquidity. They need to be able to buy and sell financial assets with ease. The underlying problem is that the banks have grown too big. Mutual funds are too big. Pension plans are too big. When these giant pools of money all decide to sell, who will buy? Who CAN buy? When the players get too big, their ability to buy or sell is impaired. That's the problem with the liquidity squeeze we are in right now.

The age of the financial dinosaur is over. Bigger is NOT better.

At CastleMoore we are small. That's our edge. When we decide it's time to sell out of the stock market, it might only take a few hours. Liquidity is no problem for us or for our clients. And it should be no problem for you either. It only becomes a problem for you when you remain allied to a large financial dinosaur.

That's why they tell you to buy and hold: because they're too big to sell. Their selling is the main cause of the markets going down.

- Ken

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What Now? How Do You "Recover"? What's the Strategy?

By Robert "Hap" Sneddon FCSI, President

Though we seem to have some stability in the markets at the time of writing with the VIX, a measure of volatility (see Sep/Oct 08 and VIX update for more on volatility), coming off historic highs, the last few months have been a tough stretch. Not on our portfolios. We've have treaded water during the worst of the decline by going to 90-95% cash but have done quite well for clients on a annual basis with a modestly positive return in registered and a decently positive return in taxable portfolios (transferred CDN cash to US cash at high conversion rate). The last few months have been tough on our hearts.

At CastleMoore, all of us have spoken to many investors who have suffered tremendously. Many financial plans have come undone. Most are in need of new targets and expectations, as well as an appropriate portfolio methodology to navigate the future. The challenge I see today for investors is to adapt now lest they assume even more risk and capital depreciation. Waiting is not the answer. Let me explain.

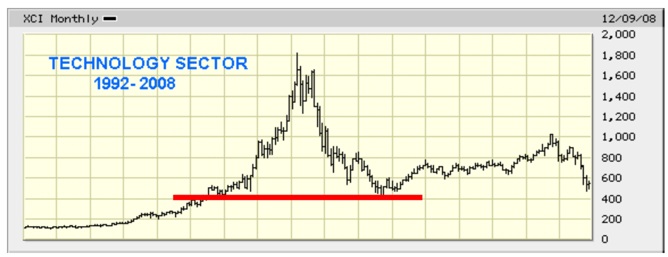
During these times there are two strong investor tendencies that we regularly encounter. One is to be quite emotional. We know that losing serious capital ranks up there with other stressful life events. Most *want* to do something but many have lost confidence in themselves, their advisors or the markets or some combination of all three, preferring, in some cases, to deal with the situation by simply not opening their monthly statements.

The other tendency is to remain true to the buy and hold discipline. This is an intentional or chosen course of action that has experience and logic underpinning it. Historical data shows there is a regression to the mean. Investors, in varying degrees, may share aspects of both groups. .

The commonality between the two tendencies or impulses is that their current portfolio approach is to do nothing, hoping or expecting, as the case may be, that the market, through time alone, will right things. As we've written many times in the past, we believe this is a new investment era; one that we hope isn't understood only in hindsight. The big hurdle is that the *efficient frontier* or the underpinning of the buy and hold methodology relied on 40 year cycle.

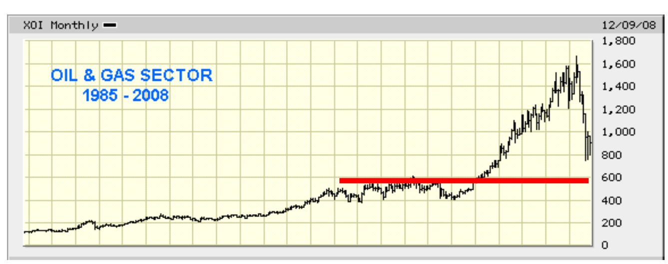
Through looking at one secular market movement from the recent past one may get some help in adjusting more rapidly to the weight of the evidence that supports the premise that this time its different..

By comparing the general price action of the technology sector from 1992 to 2008 and the oil & gas sector from 1985 to 2008 we see a similarity in patterns possibly developing. From peak (2000) to trough (2002) the technology index was down 78%. In the 6 years since the trough the index has managed to recover some of the loss, but it is still down 68% from the highs in 2000. The oil & gas sector peaked in May 2008. Since that time the index is down 43%.



The tech wreck has still not recovered 50% of the loss

I am not suggesting that there is an economic parallel between the two sectors. At the apex of the technology bubble there were may publically traded technology companies that were never going to have a positive P/E ratio, yet all roads to the future were only paved with tech stories. Most oil companies, whether producing, refining or exploring, are much more pragmatic investments that have real earnings, assets and prospects compared to the etherealness of technology shares. Despite this, the resource story has captured people's attention (greed?) in the same way that technology did. True, the world needs oil (and base met-



"We are in a resource *super-cycle* you know" Really?

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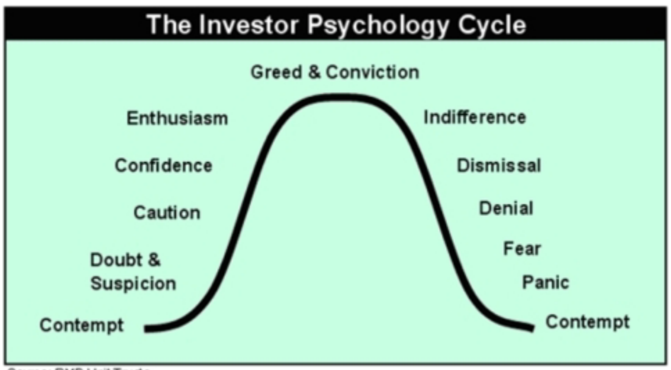
"Buy, Hold...And *Know When To Sell*"

***Recovery* continued**

als) to function today and tomorrow. That will not change.

The point is that the two areas became a focus for the markets. They became a *story* that could be told and understood easily, that would be spread across the investment advisory community. Both were a driver on the way up and on the way down. Both had deep and complex answers by analysts et al to justify prices. In the end, both reveal beyond being economic indicators 6 months to 1 year out, that prices are only a function of market perception. Perception has changed.



Source: RMB Unit Trusts

Investors can get off the roller coaster if they want to

Will Petro Canada, or Suncor, or Tech Cominco come through things better than Nortel or 360 Networks did? I don't know for sure, but I think they will. Some companies poorly managed during the bull run will fail or be acquired. The biggest number will continue to be long term going concerns. The point then is only that many investors cannot afford to wait for an equity recovery.

If we refer again to the tech/oil comparison, tech investors are still waiting to recoup losses. Why should today's investors holding oil (or resource or banking) positions maintain false hope when there are always new areas to invest in?

The first step in *transitioning* a portfolio for our clients is to analyse each security for near and mid term price appreciation potential. If a security looks to be a sink hole then the decision is made to sell immediately. If the security may have some upside then the security is managed upwards, raising the trailing stops with the price action with the intent to sell.

The goal should be to allow some amount of time to get "on model". The most significant element is that investors make the decision that they will act and not be a victim again by waiting.

VOLATILITY UPDATE

As was alluded to in the previous article, the VIX, a measure of market volatility, is coming off historic highs. On October 24th the "fear indicator" which moves based on option premiums peaked intraday at 89.53. Since then it has shown a steady decline to the

low 40's where we stand today. If we are to have any kind of sustained rally, albeit a brief one, the VIX needs to continue to decline into longer term support. Despite this, the long term chart shows we can expect more wild swings. This near term change may help

investors with a reprieve to make those portfolio adjustments, including methodology.

- Hap

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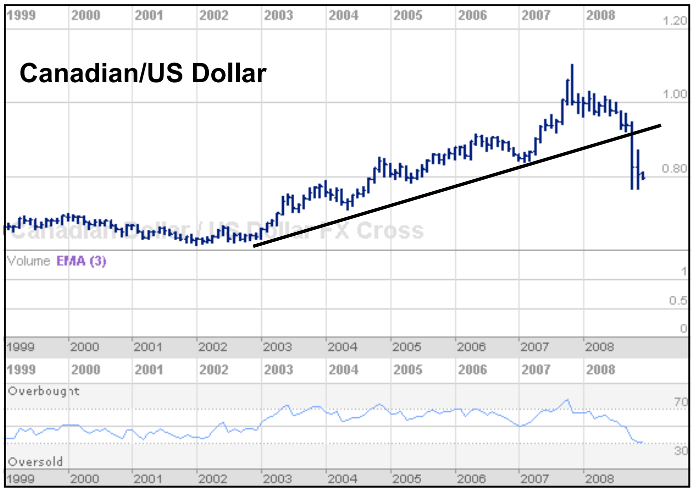
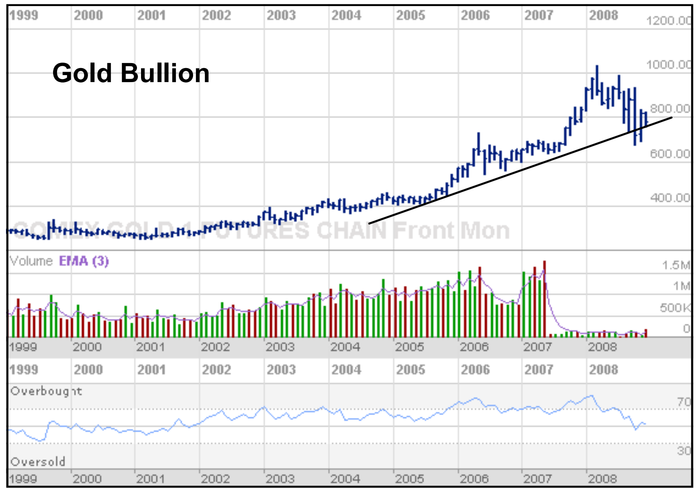
The Chart Page





The C$ has fallen 30% from peak to present. The intermediate term trend is was broken. The chart really tells the story of the strength of the US$, a currency that has moved up against all currencies. At present we are becoming bullish on the C$. We did raise US cash levels when the C$ was much higher for taxable portfolios.

Gold bullion appears to be in an long term uptrend still despite all the deflationary pressures. The price action of bullion seems to be reflecting either a hedge against all the stimulus or a breakdown in the US$, or both. We have a small position in bullion and may add to it in the future. The seasonal period for gold is also upon us.

Canaries in the Coal Mine — Life In the Markets

Because of continued market volatility this section, initially introduced as a "one-off", will carry on indefinitely in our attempts to monitor key signals about the nature of security prices and the economy they reflect. These little birdies and others to come tell us see what's going on in the deep.

BONDS/PREFERRED SHARES: The representational preferred share/bond basket spread had widened further. The bond basket has risen slightly while the preferred share has lost 15-20% more. The market still does not have faith that issuers can pay the dividend or return capital. This one being a bank issue carries some extra risk. Once this indicator stabilises there should be some good dividend investments to be had in preferreds.

DOW THEORY: I think it's no secret that business conditions are not good, particularly in the US. The relationship between the Dow Industrials and the Transports confirm this state; however it was most useful when the divergence was apparent in May (circled area). This is when we sold our US equities. I will shelf this indicator and introduce another, more relevant one in the next issue.

COPPER PRICES: Sometimes when you cross a line in the sand you get a chance to step back and say "just kidding" . Well that's what we are hoping for now— a redo. Since paying more close attention to this indicator it has continually deteriorated. This chart is a 5 yr. In previous issues I used 1 yr. The 5 year gives us perspective we need now. To suggest that we can build economically from here means we hold somewhere around $2.00/lb USD.

-Hap

Holiday Wishes, Ode to the New Year

December 2008

To our valued clients and friends:

The year 2008 is about to give way to a new, and hopefully profitable, investment year. Although our clients have come through the current crisis well, we at CastleMoore nevertheless look forward to a fresh start, rife with the opportunity almost always present in the wake of market capitulation. Lots of cash is a good place to start.

As for the year itself, I doubt I can add significantly to the insight and rhetoric that came to you in a seemingly endless stream since the crisis began to unfold. What I can say is that we have witnessed a structural change in worldwide capital markets the likes of which have never been encountered in the combined experience of your CastleMoore portfolio management team. This is a testament to our robust investment methodology and discipline. A quick calculation reveals that the Dow Jones Industrial Average, still the world's most widely cited investment benchmark, showed an average daily point swing of 0.75% from its inception to the end of August 2008—and about 3% per day since. Similar numbers ring true for Canada's TSX/S&P 60, though obviously over a much abbreviated history compared to its U.S. counterpart.

Where does one turn for guidance in a market that has seemingly been in crisis mode since the year began? It doesn't help that those supposed stalwarts of financial reason, the banks and investment houses, were themselves amongst the most who suffered from what we now know to be a dire dearth of reason on their part.

At CastleMoore, all we can do is to continue to be true to the founding principle of the firm, to which we're always adhered: Know when to sell, and stay sold until there is compelling evidence to be otherwise. Cash is an investment decision.

We expect continued volatility in the long term, but we lie in wait for the opportunity to deploy such cash reserves, and are busy compiling a list on attractive candidates for inclusion in client portfolios.

We at CastleMoore would like to wish all our readers the best for the holiday season, and may the new year bring peace, health, and prosperity.

Sincerely,

Shel

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