CastleMoore News

Buy, Hold... *and* Know When to Sell™

TWO BIG THREE'S

By Ken Norquay, CMT, Partner

The Dow Jones Industrial Average entered January 2009 4.4% lower than in January 1999. The S&P 500 is down 26.5% over the same 10-year period.

This is a chart of the huge Royal Bank Canadian Equity Fund for the past 10 years. The compound annual return is just under 2.5%

Amidst all the auto bail out bumph of late 2008, we heard the phrase "Gradual Bankruptcy." Some US politician was commenting on the inevitable failure of one or more of the Big Three US auto manufacturers; he was hoping it could be done in an orderly way so as not to overly disturb the delicate US economy.

The Senator had missed the boat; the US auto industry has been gradually failing for a long time. Wasn't it only a few years ago we learned that GM's car business was losing money? Wasn't GMAC, the auto financing arm, the only profitable part of GM? It was supporting the whole company. Hasn't GM been losing market share for years and years? Aren't Big Three's unionized auto workers making 25% higher wages than non-union North American auto workers in Japanese and German companies? Didn't Lee Iacoca save Chrysler a few years ago… and now it needs to be saved again?

All companies need to be reinvented from time to time. The computer business is a great example of the positive results of continually re-inventing products, and manufacturing fascilities. American car companies are a tragic example of what happens when self re-invention does not happen voluntarily.

But the car business is not the only businesss that needs to be re-invented. The Big Three of the investing business are in trouble too. In 2008 the world's biggest stock broker [Merrill Lynch], insurance company [AIC] and bank [Citibank] needed to be bailed out too.

How about you? Do you or your friends need to be bailed out? How are your investments holding up? Are you experiencing gradual financial failure? Don't get caught like the auto industry or the investment industry.

"Buy-and-hold-for-the-long-term" is not working. It hasn't worked since the year 2000. The Canadian Mutual Funds industry needs to re-invent itself. Otherwise, they will wind up on the corporate scrap heap beside The Big Three auto and The Big Three financial firms.

In the 1970s, John Templeton used to tell us: "We shop the world looking for unrecognized value [in the stock market]. We buy these stocks and hold them for three or four years until the value is recognized." Perhaps modern mutual funds should be managed the way Sir John once managed his funds. Nowadays CastleMoore tells us to Buy, Hold and Know when to sell. Perhaps modern mutual funds should adopt the Tempeton way or the CastleMoore Way.

In both cases, stocks are bought AND sold, not just bought.

But, in any event, no government is going to bail you out. You have to bail yourself out. Rather than wait for the Canadian Investment Industry to re-invent itself, reinvent yourself. Take a good hard look at your 10-year investment returns. Take a good hard look at the financial people in your life. Are your trusted advisors adapting to the financial reality of the 21st century? Or are they still clinging to the old ways, hoping the market will come back. The markets shifted 9 years ago, in the year 2000. Have your advisors shifted? Senior managers in failed "Big Threes" of auto and finance need to be fired and replaced. Do your investment managers need to be fired and replaced? 2008 was a tough year: a year of harsh realities. Investors need to learn from those harsh realities. 2009 is a good time for you to engineer your own personal financial bail out.

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6 OR 7 OUT OF 10 IS GOOD

By Robert 'Hap' Sneddon, FCSI, President

Good portfolio management, like many things in life, is about managing your mistakes, about managing your investment misses. Another way of looking at it is through the process of risk management. Risk management considers the inherent danger to capital or income from investing and lays out an investment plan, or more specifically, creates portfolio attributes that attempts to deal with that danger. Of course, before one invests a degree of risk is necessary; without it there is little potential for wealth creation.

In the year 2000, the process of managing risk changed. Selling is the best way to reduce investment risk for the world we live in today and for a long time into the future. When investors adopt a sell discipline they can expect a different portfolio management experience from the one the one that they are familiar with.

For many years conventional thinking by the investment community held that risk was simply controlled through diversification. In 1952 Harry Markowitz, brought the industry modern portfolio theory in his article "Security Selection", published in the Journal of Finance. Markowitz's theory advanced that portfolios were protected through the grouping of uncorrelated assets. This meant investment advisors or financial planners, based on a client's age, net worth and risk tolerance, managed portfolios only by allocating between cash, bonds and equities. For example, if you were a modestly conservative 60 year old investor you might have a portfolio of 50/50, 60/40 or 70/30 bonds to equities. The cash level would rarely get above 5% and so is really inconsequential. This relationship would be adjusted back to the original allocation when prices changed. If stocks grew, a portion would be sold and reallocated back to bonds and vice versa. *Diversification* across asset classes and within the asset class themselves was supposed to provide the protection.

There are serious flaws with this model today in these times.

First, as we have seen in the last year, and as I have mentioned ad nausea on national television and newspapers, all stocks and stock mutual funds revert to "1", a measure of perfect market correlation, during periods of violent declines. In other words, there really is no safe stock to hide in, common, preferred or otherwise.

Second, the diversification approach is predicated on the fact that advisors stay with the original portfolio allocation and do not tilt more towards stocks because stocks pay them more commission or because having more stocks taps into their self image and importance of what they think being a broker is about (Think of the movie, *Wall Street,* as an example). On this point consider Peter Bernstein's reference in his seminal book *Against the Gods (1996 Wiley)*: "Professional managers, who by 1969 had pushed client portfolios as high as 70% in common stocks, felt like fools. Their clients took an even harsher view. In the fall of 1974, the maiden issue of *The Journal of Portfolio Management* carried a lead article by a senior officer of Wells Fargo Bank who admitted the bitter truth:

> *Professional investment management and its practitioners are inconsistent unpredictable and in trouble…Clients are afraid of us and what our methods might produce in the way of further loss as much or more than they are afraid of stocks…The business badly needs to replace it cottage industry operating methods.*

This was written 35 years ago during the last secular bear market, which, at the time those comments were made still had 8 years to go and much more damage to wrought. In addition to any ethical compromises by advisors, actions may be undertaken at just precisely the wrong time. Whether investors could have held a properly managed buy and hold strategy or simply one that masqueraded as such, it is obvious that since the late 70's, the memories of such mistakes have all but faded from industry and society's consciousness. Time has a way of lulling the masses into forgetting previous generations' self inflictions.

Last, because typical advisors are stock market centred, many good "non-stock" positions are never considered. For example, a good bond or currency strategy can provide quite profitable returns while other participants are distracted, glued to their stock market quote screens. The same could be said of gold. And certainly, off the beaten path is doing nothing. One of the best investment strategies is often to do nothing (cash or safe money markets).

continued on next page

What the investment industry does not want to come to terms with is that investment risk is about odds. Because of the way the industry compensates its salespeople and is generally structured it cannot deal with this reality. Risk is the balance of weighing success against failure and determining how an investor should be rewarded for assuming the risk. While you must understand the relationship investments have to each other, each investment must stand on its own merit. This is the chink in the armour that purports investors are always protected by diversification.

Controlling risk through *selling* defines a maximum allowable risk prior to any security purchase. This risk has some relationship to the historical variance of the security in question, and more importantly, to the over all portfolio capital value. In other words, (a) you must establish a maximum allowable risk that accounts for a security's particular behaviour, and (b) you also set loss limits based on an acceptable absolute loss. At CastleMoore, whatever the security, we have a general rule that when an investment is down 10% we are on sell watch regardless of overall portfolio performance.

Such an approach acknowledges up front a certain amount of misses or errors. Our clients understand that decisions are made on their behalf based on the totality of all decisions made for them. A good benchmark is 65% profitable decisions or 6/7 out of 10. The 35% unprofitable decisions are very manageable; it is easy to live with small losses when large losses are mitigated. In addition, because success is determined by the totality of decisions both client and manager have more relaxed modus operandi. Not every decision has to be right; bad decisions do not have to be glossed over, shoved under the rug or explained away with some babble.

If we accept the premise from the start that errors will be made, securities may be bought only to have them sold due to a breach of the maximum allowable risk and then subsequently repurchased at a higher price once downside risk has been cleared. To conventional "buy and hold" investment managers, this method may appear illogical. But over the long term the point is to identify up trending securities and remain in them as long as the trend persists. In some instances it may take a transaction or two for an investment in a security to "catch". Similarly, positions can be undertaken that are never profitable yet serious loss is avoided. Loss avoidance is the most significant determinant to positive long term rates of return (see or request CM Newsletter JAN-FEB 07).

Buying, holding and knowing when to sell will produce superior returns over the coming years. The investment industry has grown too large, too inflexible and possibly dangerous; they wish for the old bull market days to return.

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WHAT MAKES CASTLEMOORE UNIQUE AND VALUABLE?

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GUEST COLUMNIST

INVESTING IN EXCHANGE TRADED FUNDS (ETFS)

By Don Vialoux, CMT

Exchange Traded Funds are simple and valuable investments with strange sounding names! ETFs essentially are mutual funds that trade like a stock. They are baskets of securities held in a trust (just like mutual funds) and trade as a listed security on a stock exchange (just like a stock).

Why strange sounding names?

The names frequently are an acronym for an Exchange Traded Fund:

- **SPIDERS**: Standard & Poor's 500 index Deposit Receipts
- **DIAMONDS:** Dow Jones Industrial Average tracking unit.
- **VIPERS:** Vanguard Index Participation Equity Receipts
- **Qubes:** based on symbol for the NASDAQ 100 tracking units: QQQQ.
- **HOLDRs:** Holding Company Depositary Receipts

Types of Indices Tracked by ETFs

Seven types are available:

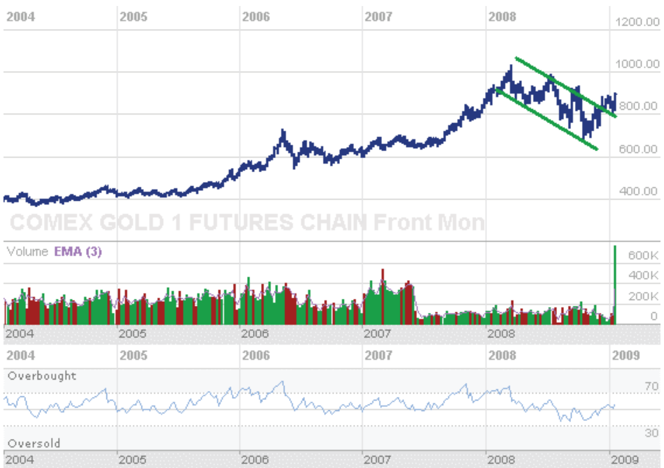
- ETFs on broadly based indices (e.g. S&P 500 Index, Dow Jones Industrial Average, S&P/TSX 60 Index)
- ETFs on sector indices (e.g. health care, high tech, financial services)
- ETFs on style indices (e.g. growth, value, small cap, medium cap)
- ETFs on indices of countries or regions outside of North America (e.g. the Euro 350 Index, the EAFE Index)
- ETFs on bond indices.
- ETFs on commodities and currency indices
- ETF on leveraged and inverse leveraged indices
- Currently, 385 U.S. equity based ETFs, 33 U.S. bond based ETFs, 147 international, 34 commodity-based ETFs, 21 commodity based ETNs, 12 currency based ETFs, 7 actively managed ETFs, 71 Canadian equity based ETFs and 8 Canadian bond based ETFs trade on North American exchanges.

Reasons to own ETFs

- Easy to understand and to follow. Many track well known equity indices such as the S&P 500 Index, Dow Jones Industrial Average and TSX 60 Index
- A convenient way to build a diversified portfolio. Most hold a diversified basket of securities that track an index.
- A low Management Expense Ratio (MER) relative to actively managed investments. The average MER on a broadly based Canadian or U.S. mutual fund actively managed by a Canadian based investment firm is 2.50%. Most Exchange Traded Funds have MERs of 0.65% or less.
- More tax efficient than actively managed investments. Capital gains distributions at year-end from U.S. traded ETFs currently are nil due to their legal structure. Capital gains distributions at year-end from Canadian traded ETFs are low and frequently are nil.
- Easily bought and sold on stock exchanges.
- Better performers relative to most actively managed investments.

Don Vialoux is a Chartered Market Technician and analyst for www.dvtechtalk.com. He is a frequent guest of *Business News Network* and a business columnist for *The National Post.*

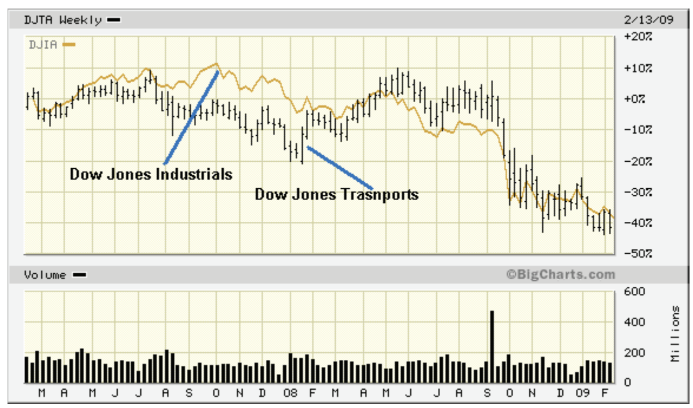
THE CHART PAGE



Gold bullion, like many assets, has been volatile. We bought, then sold, then bought again as a result of extreme volatility. As the chart indicates, gold appears to have broken above the upper range of a pennant formation. This pattern is usually a continuation move of the major preceding move. In this case the last week's action, especially as it was accompanied by high volume confirms the long term trend in the asset despite short term pull back possibilities.

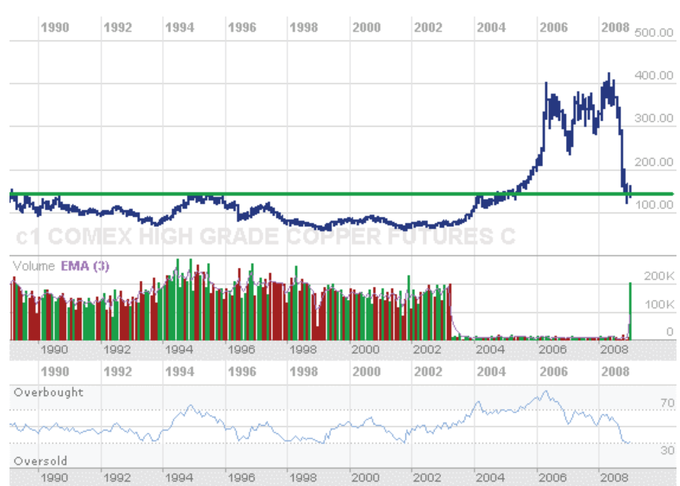
For Canadian (and Euro-based investors too) the case for gold is clearly compelling. Coincident with the pennant break out in USD terms, is the break out of gold in Canadian dollars. After spending much of 2008 building a base the metal finally punched through in the trading week ending January 23rd. The upside would appear to be much higher from here. Why gold with the buzz of deflation talk all around is moving is anyone's' guess. We'll learn it later.

The bond/preferred relationship has tipped towards preferreds since our last publication. While government bonds have faired well corporate "income-based" obligations have not until recently. The market may be discounting the worst already and looking around for better yield opportunities in good quality corporate issuers who were taken down with the whole market.



No good news here, not yet anyways. The Transports have now fallen below the Industrials. Is this relationship telling us that there are fewer goods to ship hence the heart of the economy is weakening? In order for us to become generally bullish about the equity markets on an intermediate term view the Transports must get above the Industrials and climb.

Much like the previous relationship chart Copper is suggesting economic weakness. Because copper and the base metals are used in the most essential elements of the global economy we cannot forecast good times until we see more of a bid in Copper. The good thing about this very long term chart is that it appears to be holding, something even the best economists may wish for now until some traction can be seen whether from global infrastructure build out or general Chinese growth.



LESSONS FROM COACH HOLTZ

I've been on the top and I've been on the bottom. At Arkansas my first year, we won the Orange Bowl. Then everybody loved me. They put me into the Arkansas Hall of Fame and issued a commemorative stamp in my honor. The next year we lost to Texas, and they had to take away the stamp, because people kept spitting on the wrong side of it.

(Lou Holtz, legendary football coach of Notre Dame)

By Sheldon Liberman, Portfolio Manager

I've always found sports analogies to be particularly applicable to the business of investment management. For instance, in a recent blog article **http://sheldonliberman.blogspot.com/** I discussed how much investing was like playing tennis, in the sense that they are both losers' games:

The idea is not that only Losers partake in these activities. Indeed, that cannot be the case in tennis unless one's opponent is a brick wall. Rather, the author espouses the notion that it is the actions of the Losers, not the Winners, that determines the eventual outcome. In other words, you win by making the fewest mistakes. In tennis, it means not double-faulting, not slamming an opportunity for a power shot into the middle of the net, and not trying to be too precise into the placement of a lob.

In investing, it could be argued that the best way to come out ahead is not to lose capital, even if means foregoing the advice of bartenders, cab drivers and hairstylists. It means recognizing that losing capital means, quite possibly, being out of the game, whereas losing an opportunity still means that the game is afoot.

This has always been our approach at CastleMoore, and was always a personal value for me as a portfolio manager and investor. It is, in so many words, why we were able to preserve – even to enhance – client wealth in a year the country's most widely followed index lost 35% of its value.

This brings me the crux of Coach Holtz's point as expressed in the above quote: we are all aware – often painfully aware – of the challenges associated with periods when successes are, shall we say, a little difficult to come by. The year 2008 was such a period.

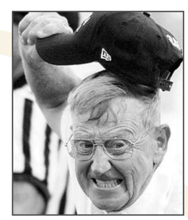
But how many of us stop to consider the challenges of success?

How do we remain true to our humility? Stock markets have a way of humiliating those who were previously unwilling to do the jobs themselves.

One need not look very far into history to see examples of this in abundance, whether they be in the guise of portfolio managers with stellar track records or of CEOs of Wall Street's behemoths.

To quote the American Henry Courtney, who fought and died in World War II and who received the Medal of Honor posthumously, "the bigger a man's head gets, the easier it is to fill his shoes." That said; don't take our caricatures too seriously.

Personally, I believe the way to keep ego in check is to avoid relying too heavily on my own judgement, to always be within reach of wisdom of others, especially wisdom not specific to investment management, and to always be mindful of how we got here in the first place.



More from Coach Holtz (my comments in brackets):

- A lifetime contract for a coach means if you're ahead in the third quarter and moving the ball, they can't fire you.
- When all is said and done, more is said than done. *(My favorite)*
- The problem with having a sense of humor is often that people you use it on aren't in a very good mood.
- On this team, we're all united in a common goal: to keep my job.
- If you try to fight the course, it will beat you. *(substitute "course" with "market").*
- If he's got golf clubs in his truck or a camper in his driveway, I don't hire him.
- The man who complains about the way the ball bounces is likely the one who dropped it.

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ASK THE RIGHT QUESTIONS.

By Thomas Kleinschmidt

Last month Ken gave a presentation at the Financial Forum in downtown Toronto to some 400 investors and professionals. The point of Ken's presentation was to show how the large losses experienced by investors were indeed 'traumatic'. He further explained that investors had to go through the Kubler-Ross cycle of "denial-anger-bargaining-depression" before they could get to "acceptance" and thus think clearly enough to make the best decisions for their portfolios now.

Attendees were invited to stop thinking and to feel what Kubler-Ross steps they had gone through and were now in. But when the audience was given two question- and-answer periods not one asked, "How do I get through to Acceptance so that I can indeed make the right decisions to get back on track?"! They asked the standard questions as to where the market was going, when it would get there…they could not get out of the Kubler-Ross trap.

As humans our brains usually get in the way. We get stuck in patterns and get caught up in fear and greed, between ego and hope. Phrases like "you are a long- term investor", "the market will recover" and "your portfolio is built for these ups and downs" sing to our feelings of fear/greed and ego/hope. Being in a bit of a rally right now "proves" all this to us, and we feel better. Besides, it was only a paper loss anyway………

I have every hope that investors will get back on track in a timely fashion. Let us not forget, as investors, for every $100 we put to work in the market we want $100 + back, or it was not a good investment. When we actually get our principle and our return on capital back we can actually calculate our rate of return. Anything else is not sound investing. Buying and holding stocks is not investing, even if they pay a dividend. Investing means that you have a pretty good idea of what you'll get for your $100 for the time it is out of your wallet and working for you. It means that you'll get the original $100 back and a positive rate of return on your money.

That's an example of getting your capital back plus something else. To me, a rate of return means something here-and-now, not a promise or a speculation as in being a long-term investor or waiting until my portfolio recovers. To me, it's too little, too late.

What is required is an active selling strategy. We take our money off the table when our profit is maximized and we also take our money off the table when we start having capital losses.

So we're in a rally now. Great. Great time to sell the lame horses and stable up on the ones ready to run. This is investing! Know that we're running a portfolio, not a petting zoo. Keeping lame positions is unwise.

And for those of you thinking that your loss is only a paper loss, consider this: those paper losses came from paper gains. If you bought for more than a position is worth now, then, yes, you took a real loss. If you were on track for a certain rate of return on an investment/portfolio and you are now negative, then, yes, you took a real loss. Real losses come from the mistake of not selling.

But losses of opportunity are also real. Not selling near the top means losing potential profits you could have made by buying near the bottom. Remember profits become part of your capital. They do if you have a sell strategy. If you do not have a sell strategy then you really did not take 'real' losses.

If you still are wrestling with these statements you most likely are in one of the steps of denial, anger, bargaining or depression.

You know what happened to your portfolio and you know what we do. You know that we don't really care where the market goes because we are global asset allocators with a sell strategy bolted to every one of our buy strategies. What you need to know is that you need to think clearly in order to make the decision to either stay with your current advisor or cross the moat over to us. Being caught in the Kubler-Ross cross fire is not an option if you are a true investor.

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