CastleMoore News

Buy, Hold... *and* Know When to Sell™

DINOSAURS LEAVE TRACKS

When we talk about investing, we usually think of the stock market. But when modern portfolio management text books were being written in the 1950s, they recognized several different classes of investments: equities, bonds, cash, precious metals, real estate, commodities, and currencies. But today, we think investing is mostly about the stock market.

And that's the problem.

Let's try to think more like big pension fund managers. They try to hold large amounts of investment classes that are the top performers and only small amounts of the underperforming classes.

In June 2010, the investment manager Gluskin Sheff released their calculations of the 10-year rates of return of a variety of US investment classes. The return for the US stock market was -2.3%. Big American pension plans have lost 2.3% per year in the stock market over the past ten years.

The ten year returns for US bond portfolios have been +11%.

Based on the math, it's clear that the big US pension funds should be heavily invested in the US bond market and only slightly invested in the stock market. It's called efficient market theory and it's simple and logical.

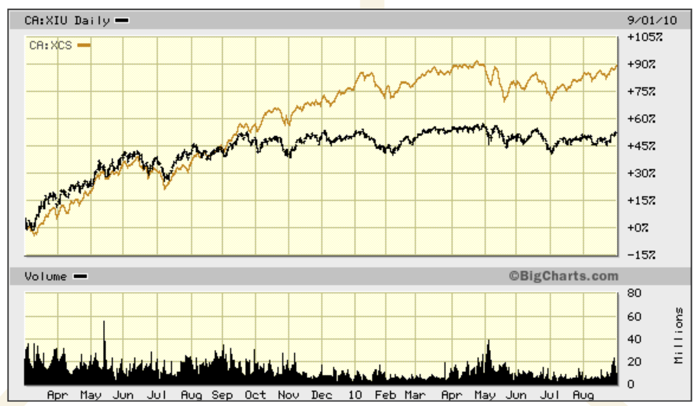
If it's so simple and so logical, why are US pensions over 50% invested in the stock market? And why do they hold under 7% in bonds? They have it exactly backwards! Why are stocks their biggest asset class and bonds one of their smallest? How could they make such a monstrous mistake?

Most of their portfolios are invested in stocks that gave them a -2.3% return for 10 years. They will correct this glaring mistake by methodically re-balancing their portfolios until most of their money is in the better performing investment class (bonds), and the least of their money is in the poorest performing investments (stocks). In other words, US pension funds will be collectively selling billions of dollars of stocks and buying billions of dollars of bonds. Because of the huge size of these positions, it will take years to complete this adjustment. We refer to this giant inventory of under-performing stocks as the overhang. The US stock market will be "over-hung" for years. Until American pension funds work off this overhang there won't be a long term bull market in US stocks.

And what about the Canadian market? Are Canadian pension fund managers as far off base as their American cousins? Are Canadian pension funds selling out of the stock market and switching to bonds? Is the Canadian stock market over-hung like the American?

Let's do a bit of stock market detective work to see if we can track the actions of these giant investors.

We know that pension funds have a penchant for large cap stocks and individual investors often invest in small cap stocks. Let's compare the performance of small cap stocks to large cap stocks since the March 2009 stock market low. If Canadian pensions have been systematically selling their large cap equities since March 2009, their selling would have dampened the rally for blue chip stocks. But small cap stocks would not have been dampened. This is what we found:



The upper line is the price of the ETF of Canadian small cap companies and the lower line is the ETF of Canadian large cap companies. From the March 2009 stock market low to the end of August 2010, the large cap ETF is up 55%, while the small cap ETF is up 90%. Canadian pension funds have been systematically selling their large cap stocks and putting a damper on the TSX.

The Toronto Stock Exchange (TSX) has over-hang hang-over too. How long will the TSX be hung over? Until the big pension plans have systematically reduced their exposure to the stock market. They need to realign their portfolios so that most of their assets are in the better performing investments (currently bonds) and only a small portion is in underperforming assets (currently large cap stocks). This will take years.

Light at the End of Our Tunnel

The June 2010 Gluskin Sheff study tracked the 10-year performance of several other classes of investments. The top performing asset in their study was gold. Second place went to long term bonds. At CastleMoore we focus on those investments that are in up trends. The stock market isn't the only way to earn a good rate of return on your money.

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HOW DO INVESTORS MAKE MONEY IN BONDS: A BRIEF FIXED INCOME PRIMER

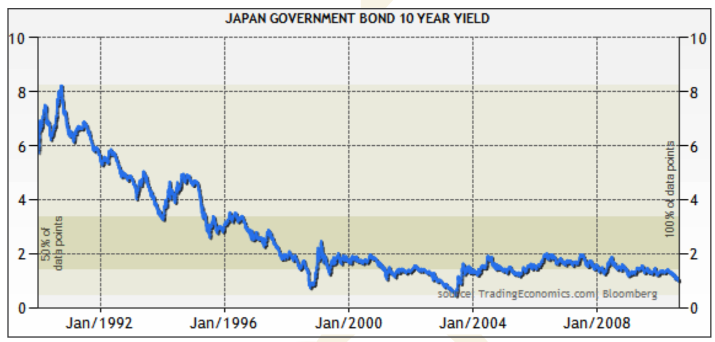
By Robert 'Hap' Sneddon, FCSI, President

Setting aside the macro economic debate for a moment – growth or slower historical growth vs. deflation or disinflation –many investors wonder how you can make a decent profit in bonds when say the 10 year Government of Canada benchmark is only yielding 3%. Or, how can one lock up your money for 10 years at that rate? Or, if fixed income is where it's at why shouldn't investors just purchase bank guaranteed deposits (GICs) and be done with it?

Let's have a little **bond primer** and answer these questions in the reverse order.

If fixed income is a desirable asset class why not purchase a GIC at the bank and just collect the interest income? Investors won't profit beyond the rate set at signing and they are locked in to the term. If a $100,000 straight 4% 5yr GIC is purchased one will receive $4,000 per year or $20,000 over the life of the certificate. Now if the same investor chose a tradable government or corporate bond with the same interest and maturity, they are entitled to hold it to maturity or sell it at any time. Why sell? …for various reasons such as: interest rates have fallen raising the capital value of the bond: and capital gain gives us a higher overall return and lower taxes. Or, we may sell because interest rates are starting to rise, reducing the capital value making it better to sit on the side lines waiting to purchase at a higher yield. Or, we may sell because the funds are required for liquidity reasons. So it's flexibility tradable bonds provide over bank GIC's.

Let's answer the question: *"How can you lock up your money for 10 years at that rate?"* (The rate or yield used was 3%). Investors know that if you purchase a 10 year government or corporate bond it does not mean you have to hold it for 10 years or to maturity. One may do so, but it's not required as it is of a GIC. The reason an investor



Falling Government of Japan bonds yields have provided decent capital gains for investors, especially if bond allocations are adjusted for the peaks and valleys over multi-year periods.

would hold a 10 year bond at 3% is because it is profitable. In this instance I am referring to the yield and herein lay the rub of it all. In understanding how yields work we are also answering the first question: How can you make a decent profit in low coupon bonds?

Yield is determined by dividing the cash flow (interest payment or coupon) by the capital value. If one buys $100,000 of the same 10 year bond at issuance paying 3%, then the yield for the 10 year period would be 3% ($3,000/$100,000=3% yield). Here it is important to note tradable bonds are usually issued close to par where par equals 100. This is a pricing mechanism for the markets to adjust the yield to the prevailing interest rate levels. For example, if markets push down longer term interest rates for the same term to 2.5% the capital value will rise, producing a capital gain in addition to the interest payment. The example would then change to: $3,000 (interest payment does not change) / $120,000 (bond capital rising) = 2.5% current yield. The price of the bond

continued on next page

has now gone to 120 from 100 and the yield has dropped. Investors select longer dated bonds with low interest rates to seek out capital gains in addition to cash flow. Of course, if rates increase the opposite effect, capital loss, is possible.

Holding long term bonds in times of falling interest rates is very profitable.

Bond Primer Part 2

There are two basic types of fixed income: ***government bonds*** and ***corporate bonds***. Within the corporate space there are also two types: bonds which are backed by an ***asset pledge*** and ***debentures*** which are backed only by the credit-worthiness of the issuing company. There is also another sub-category of corporates called ***convertibles***. Convertible bonds are exchangeable for common shares of the company at certain ratios. For example, each $1000 of face value is convertible into 20 shares. Here if the company shares are trading above $50.00 (20x50=1000) an investor may wish to switch into the common; if they trade below this they may prefer to collect the income payment from the bond until it makes sense to switch.

Corporate bonds prices are influenced by inflation expectations and corporate profitability. Inflation expectation is the most critical factor in determining prices. If the market expects inflation to rise or to continue to rise bond prices will fall. For example, if a bond you are holding is yielding 5% and inflation is running at 2% your true yield is close to 3%. The other primary factor is corporate profitability, specifically as it relates to interest coverage. It's fine to buy a high yielding corporate bond, but if the company runs into cash flow problems they may elect to hold off paying interest or in severe cases go bankrupt. Often, an increasingly higher yielding bond is telling you of impending problems.

All bonds - government and corporates - like borrowers walking into a bank branch have different credit scores. Some are A's, some are B's; bonds graded beneath these are usually called junk bonds. The whole Greek and European bond crisis centred on sovereign nations' ability to meet the interest obligations. During the crisis the yields on those troubled countries' bonds sky rocketed to account for the increased risk of default (Spain, Greece, Italy, Portugal, and Ireland – now apparently Finland is the new kid on the block). Investors holding these bonds before and through the market "adjustment" lost capital. Investors purchasing after would receive the new higher yield accounting for the increased risk being taken on. The market reacts and sets the new yield according to the conditions surrounding the issuer and does so quickly and efficiently.

Government of Canada bonds and lesser government bonds, such as provincials or municipals will often perform poorly during periods of economic strength due to rising inflation expectations or preferential profit opportunities. For example, throughout the booming 90's such bonds performed poorly largely due to hot equity markets, particularly high tech, and modestly rising inflation.

Government bonds can get into trouble when it appears the country in question is considering a default, such as the situation in Greece. Yields rose dramatically but the price of Greek bonds eventually stabilized due to the backing of the IMF, the larger European Money Union and Greek financial reform.

Default is the exception. The norm is that countries muddle through rough patches as Canada found herself doing in the last decade. The reason: taxation. The global investment community considers this sacred cash flow supreme in meeting bond obligations. Companies do not have such sources of cash flow.

To summarize, all bonds are modestly affected by inflation expectations, by the ability to pay interest and return capital and by the allure of better markets elsewhere. As these factors change, bond prices change. It's these changes in bond prices that give rise to capital gains in the bond market. CastleMoore's bond strategies are designed to produce capital gain, not just interest. That's why it makes sense to hold bonds that appear to be only paying a small interest payment by comparison with periods of actual inflation, and unlike the current disinflation or deflation.

An Excerpt.....The Great Depression: A Diary, Benjamin Roth

> ***People who bought "bargains" in stocks in 1931 now find they were too quick and these same stocks are now selling at 1/3 of 1931 prices. If they can hold on long enough they will come out alright but it is a soul-trying period of waiting. It might be best to wait until the upturn actually begins.*** March 8th, 1933

I cannot recommend highly enough this book, not because it is a map of things to come, but because it shows that things do change beyond normal comprehension. It also shows that patience when it comes to investing always pays off.

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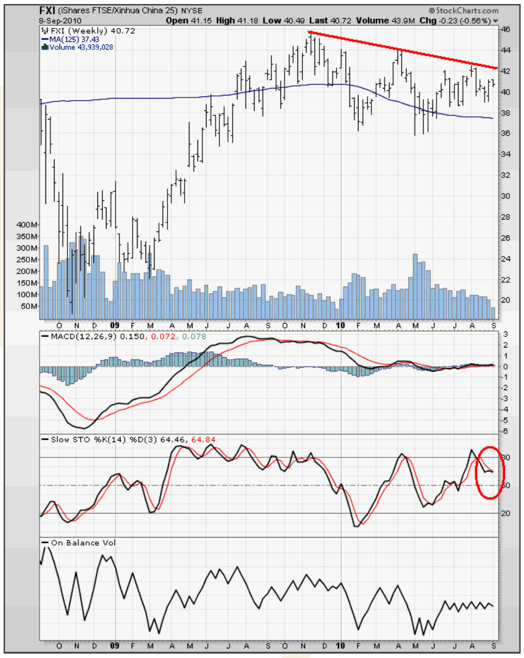
THE CHART PAGES

GOLD BULLION

Gold bullion like many markets has been extremely volatile – in fact I'd like to know what market has been nice and pastoral. We parted with our position in the precious metal on a trading basis. That is, we believe that it is in a long term up trend. We may yet get a new entry point on a break above resistance (which acknowledges that sometimes you pay more for insurance of a continuance of an uptrend). The larger probability is that a lower price purchase point will present itself. Bullish sentiment is high and seasonal strength ends beginning of October.

CHINESE STOCKS (XINHUA 25)



Chinese equities have muddled around, weakening since last November. During the depths of the crisis in global stock markets Asian shares were the first out of the gate, moving higher (November 2008) several months before the rest of the market did (March 2009). The underperformance against Western markets does suggest the global recovery in stock prices anyway, may be further muted. From the indicators it appears that prices will roll over or at best modestly push higher. On-balance volume – up day volume less down day volume – suggests there has been deep pocket selling or what's know as "share distribution".

LOONIE

The Canadian dollar is one of the most excitable currencies having a direct correlation to the global growth story. Are we growing or pausing here for a little while? Over head resistance near par, in fact near $0.98 USD is formidable. The stochastic oscillator (second panel from the bottom) suggests as does the anaemic on-balance volume panel (lower) that the move off a bottom in early May has been on less and less conviction. Downside targets can range to from $0.92 to $0.85USD.

CANDIAN EQUITIES

The Canadian stock market has gone no where in a year and is now hitting strong over head resistance. We prefer break-outs (along with a few other prime price patterns). Break outs resolve previous conflicts like a vanquishing army. With sentiment indicators such as the stochastic at highs and the rounded top formation (top panel) it appears that we will at least have a pause in prices over the next month or too. A push higher under these conditions would not be favourable. On-balance volume has shown a great deal of Canadian share accumulation.

THE CHART PAGES

US EQUITIES

US stocks, represented above by the S&P, too shows a stock market "reaching" to try to move higher. The head and shoulders topping formation would be confirmed on a break below the red support line. Sentiment suggests that we could see more of an upside move, or at worst a holding state for US stock prices. In addition to economist confusion as to whether slow growth or deflation is afoot, this price condition may reflect the up-coming US mid-term elections. The longer term 125 week moving average is still turning down though its pitch appears to be moderating. Another popular moving average, the 200 day (not shown) has been resistance since May.

LONG BONDS (US)

Long government bonds are still one of the most hated asset classes by the media, portfolio managers, investment bankers, equity research departments, syndication et al, mostly because bonds don't pay enough people along the way like a perma bullish stock stance does. Bonds also don't really tell any kind of interesting story, well except one of profit. We have done rather well in bonds year-to-date and now expect prices to soften as the growth/deflation debate becomes clearer – or not. Volume shows larger deep commitments (Boomers? Pension funds who got caught chasing stocks for the last 15 years?). We have noticed the gap in trading which can be a new breakout move or exhaustion. We recently tightened up our risk management levels.

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BEHAVIORAL FINANCE: THE BENTLEY THEORY

By Thomas Kleinschmidt

Whether you are talking about an equity index, sector index, metals index, stock, currency or interest rate the answer to "what direction will it go" is always the same…up, down or sideways. 100% of the time. Guaranteed.

A long time ago, soon after the bursting of the equity market bubble of 2000, I became acutely aware of how important positive investment rates of return were to a retirement portfolio. Not only were years of growth hacked off, but the growth on that amount was now gone forever. At the time there were some bulls and some bears on the corner soapboxes – same as always, I suppose – but since the investment analysis rhetoric of the day of buy-and-hold was so obviously questionable – simple compound-growth arithmetic proves it – I took some time and did some research. What I discovered was shocking and, yet, not enough for positive portfolio returns.

The first was that neither of our family's investment advisors had a clue about any trouble. In fact, one was still recommending "The Smith Maneuver" because of the now-even-better-ROI we could get. Having no clue neither of them gave us a call to recommend even a temporary shift in the portfolios. What exactly are MER fees for?!?

The second shocking thing was that the evidence was there if you knew where to look and what to look for and, perhaps more important, the answer was not rocket science.

Now, after a decade of learning to invest in bear markets, I can say that there is something even more shocking. The study of behavioral finance points to why – even if you knew of trouble in whatever market you were invested in AND you had evidence of a breakdown AND especially if your holdings were getting hammered and smashed – MOST LIKELY YOU STILL WOULD NOT SELL TO PRESERVE YOUR CAPITAL.

Here are a few of the main investor biases that shed some light on why we just watch the barn burn:

- **Prospect Theory** – fearing losses more than valuing gains; selling winners too soon, holding losers too long
- **Overconfidence** – overestimating news, analyst forecasts, etc. and acting to affirm the level of confidence
- **Confirmation Bias** – only listening to new info that supports the prior decision and ignoring opposing info
- **Noise Traders** – the uninformed amateur investors who are often late to the party and stay too long
- **Escalation Bias** – averaging down and not cutting losses…what you hear from financial advisors as well.

At this time I add another…the Bentley Theory to these behavioral biases that cause major damage to our portfolios way too often. It goes like this: (a) most of you have at least $300,000 invested in the equity markets; (b) my guess is that your most expensive car is worth significantly less than a new Bentley at $300,000; and (c) most likely you would get upset with me if I dented your car with a hammer. Bentley Theory says that the average investor will get MORE upset over a ding in their current car OVER the effect of someone driving their Bentley-portfolio into a wall. Said differently, you would get more upset at me walking over to your car and putting a dent in your hood with a hammer than you would at your advisor telling you that your new Bentley has a 'few dents' resulting from 'an incident with a wall' but that the dents are 'not so bad' and will, over time, repair themselves.

Luckily, there are some good discretionary portfolio management body shops like ours who turn every one of those typical investor biases upside down for your benefit. We react to trouble by looking in the right places for the right evidence on a daily basis without having to call you (typical advisors must dump the sell decision in your biased lap ;-). So, if the person who walled your Bentley during the last market crash is still driving it… Enjoy the ending weeks of summer and safe driving!

p.s. Bentley Theory also says drivers blame the wall and think that one was the only one. Guaranteed.

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GUEST COLUMNIST

HOCKEY PLAYERS SHOULDN'T GIVE TENNIS LESSONS

By Ed Arbuckle, CA, FCA, TEP

Why don't golf pros teach scuba diving? Or why don't hockey players give tennis lessons? They are all athletes, so what's the problem. It should work out okay, no?

There is a parallel in the financial services industry, but it's a little more serious than trying to hit a backhand with your skate guards on. Investment advisors sometimes claim they can give tax advice (and some have been known to do a tax return or two) and banks advertise estate planning on the branch door. What does it matter – these are all financial services so everyone should be qualified to do everything …. well maybe not.

Now, obviously, the analogy between financial institutions who say they can do most everything and hockey players who can give tennis lessons is not quite fair. Why? Because maybe some larger financial institutions and financial advisory firms really do have specialty departments that can provide the services they claim to have. That may be true, but sometimes it's just pushed too far. Staff at head office may well have a broad range of special expertise but that simply may not hold up at branch level. Yet some financial services institutions take a pretty generous approach in claiming they can do almost everything for their clients – a sort of one-stop financial shopping. Most of us in smaller firms hear this claim from pretty disgruntled clients who end up seeking our cost-effective, specialized services.

This brings to mind the ***"financial planner"*** designation. Seems to me that a financial planner should be someone who does exactly that – someone whose main job is to plan. But how can the person providing investment advice also call himself or herself a financial planner? I suppose for the same reason that a golf pro can claim to be a fitness expert – it's just not true. There's nothing wrong with financial services organizations backed up with a broad range of skills to claim expertise in specific areas of financial planning as long as they deliver. The problem for the family or individual who needs a solid, conflict free plan is that this claim is a stretch and doesn't hold up in practice.

Why does this happen? Could it be because it's another way for an organization to sell its main line products and services by claiming expertise in almost everything under the sun? Or could it be to limit competition and prevent clients from being pulled away by a competitor who really does provide a specialty service? There is just too much of this going on in the financial services industry and it's not helpful to our clients. Clients should expect more honesty from organizations handling their life's finances – their hard earned savings.

Is there a solution to this dilemma? Yes! Certainly there are many professionals and professional organizations playing by the rules and only claiming to do only what they are qualified to do. When they can't, they refer clients to someone else. From what I have seen, the number of referrals varies inversely with the size of the organization and that says something. Clients are often swayed by the promises of everything but the kitchen sink that in the end just doesn't work out to be the case. Often they end up going to smaller organizations that really do have a single specialty service.

In this age of mass marketing and a sell, sell, sell syndrome, it's difficult for consumers to identify levels of expertise by organization. The information load out there is exhausting. It behooves all of us to help our clients as best we can and pass on the rest. We will all be better off and so will our clients.

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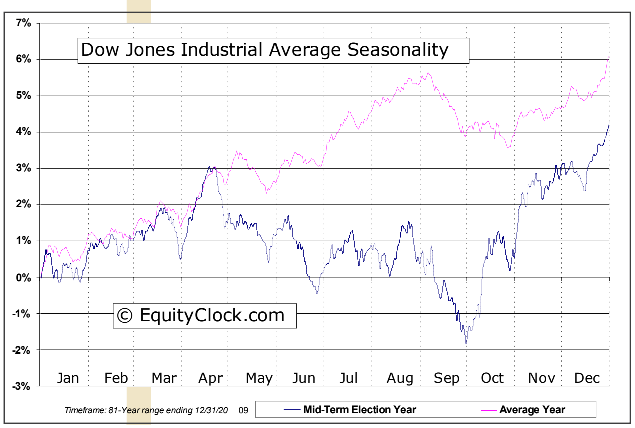
AN OUTLOOK FOR NORTH AMERICAN EQUITY MARKETS FOR THE REMAINDER OF 2010

By Don Vialoux, CMT

North American equity markets have a consistent history from September to December during a mid-term U.S. election year. They normally move lower during the month of September and higher until the end of the year. The enclosed chart courtesy of www.EquityClock.com shows trends for the Dow Jones Industrial Average during a mid-term election year based on data for the past 81 years.

This year North American equity markets have tracked the trend closely to the end of August and are expected to continue to track the trend until the end of 2010.



Weakness from the third week in April to the end of September is attributed mainly to political uncertainty related to Mid-term U.S. elections. Political uncertainty is triggered by questions about control of Congress and questions about government policy following the election. Political uncertainty raises economic uncertainty which raises stock market uncertainty.

Weakness this September could continue into October unless the Bush tax cuts are extended beyond the end of the year. U.S. investors holding equities for more than one year have a strong incentive to take profits before the end of 2010 in order to reduce their tax bill. Capital gains in 2010 are taxed at a 15% rate. Capital gains next year are taxed at a 20% rate. Selling of equities for tax purposes will intensify as year end approaches.

And now the good news! Selling pressures are likely to be so intense by October that equity markets will be significantly oversold and set for a classic buying opportunity. Historically, the bottom of the four year Presidential cycle occurs in the fourth quarter of a Mid-term election year. The highest performing period in the four year cycle is from the October in a Mid Term election year to August in the following year.

This year, the Mid-term elections to be held on November 2nd are likely to result in political gridlock. Less political interference in the economy and private enterprise is likely to be greeted as a positive event for equity markets well into 2011.

The bottom line: Use weakness in North American equity markets into October as a buying opportunity. Look for equity markets to move significantly higher into 2011.

Don Vialoux, Chartered Market Technician is the author of a free daily report on equity markets, sectors, commodities, equities and Exchange Traded Funds. Reports are available at www.timingthemarket.ca