CastleMoore News
Buy, Hold... *and* Know When to Sell™

WHAT WOULD YOU DO IF...

By Ken Norquay, CMT, Partner

This is a chart of the S&P 500 stock index from 1999 to 2013.

Big American pension fund managers have a problem: after 12 years of holding a portfolio of America's 500 largest stocks, they are only breaking even. On the bright side, at least their stock portfolios are outperforming their mortgage portfolios! (LOL) Question: What would you do if you were them? Answer: reduce your exposure to the stock market: sell. Question: When would you start your selling program? (Big investors can't just sell out in one day or one week: it sometimes takes months for them to reduce their giant positions.) Clue: in 2000, the high for the S&P 500 Index was 1553. In 2007 the high was 1576. In January 2013 it poked up over 1500. Do you think they'll start selling soon?

Large institutional investment managers have to act in secret: stealth selling. If 'the street' were to get wind of the fact that Goliath Pension Fund wanted to sell a few million shares of ABC, those who had been considering buying ABC would postpone their purchase, knowing that Goliath's big sale would depress ABC's share price. When big sellers want to off-load a few million shares, they need hundreds of buyers. That's why they act in secret. In fact, some managers will sing the praises of ABC even as they sell shares out the back door. Deceit and stealth are a legitimate part of the action of the stock market.

But every once in a while, it becomes easier to see through the bullish fog of institutional rhetoric and discover what they are really up to. NOW is one of those times. Those pension fund managers who are trying to reduce their holdings will do so now, near the old highs, and that selling will stop the current up trend. Those who are optimistic about America's future will continue to buy stocks, in full confidence that the banking, real estate and mortgage problems 5 years ago have passed and America is back on track. Their buying will cause the current up trend to continue. By waiting for the US market to 'make up its mind,' Canadian investors can add to their stock holdings if the market moves above the 1500 – 1600 level and reducing their holdings if it turns down. This is the main way CastleMoore manages investments. We determine the direction of the various financial markets and invest in the direction of the trend.

But not everyone operates in the same way. Some managers try to forecast what direction the market will go, rather than waiting for it to start moving in one direction or the other. They might analyze the economy or the companies and base their buy or sell conclusions on their perceived health of the economic environment. These practitioners use financial analysis or fundamental analysis to make their forecasts: it is a wondrous art form when used skillfully.

Others listen to what the biggest investors are saying and follow that tack. As you can see from my earlier comments on institutional stealth, the intelligent approach is to do the opposite of what large institutional investors are saying. When the big guys are all bullish, we should become bearish. And when the big guys are talking panic, we should buy. This is called 'the theory of contrary opinion' and is the single most reliable buy and sell rule-of-thumb.

But, whatever one uses to make investment decisions, it is important to make both buy AND sell decisions. Look back at that chart at the beginning of this article. If those big American pension funds had sold somewhere near the tops and bought somewhere near the bottoms, they'd have a good rate of return instead of just breaking even.

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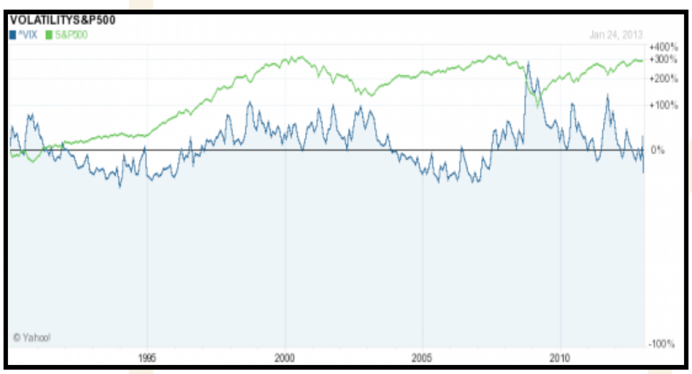
TELLTALES SUGGEST NO IMMINENT MARKET STRUCTURE CHANGE

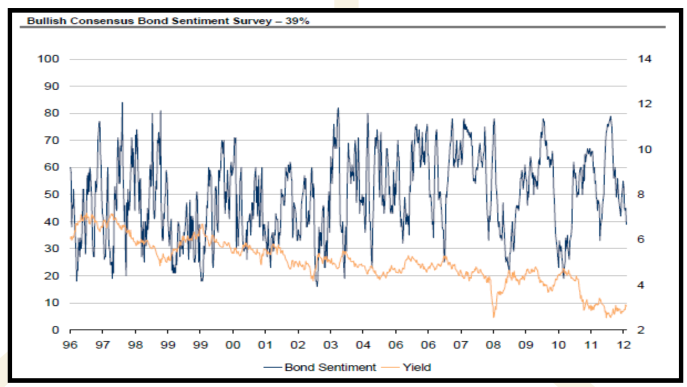
By Robert 'Hap' Sneddon, FCSI, President

SENTIMENT

By the accounts of Wiarton Willie and Punxsutawney Phil, both of whom didn't see their shadows, spring is just around the corner. While you can make the case for a change in the structure of financial markets after a four year period, which is the length of the business cycle incidentally, or after the more recent "risk on" run since November and the post QEternity announcement by the US Federal Reserve in September, the case for imminent change in equity markets is not present yet.



This chart of volatility (VIX, blue) measured against equities (S&P index, green) shows that we are not at extreme readings. The VIX has been a red herring over the last few years pounded down by traders at every opportunity. Today, despite the VIX being in the low 12's and the S&P pushing again against all-time highs seen in 2000 and 2007 bullish sentiment is only at 48%. The most recent significant market corrections in the spring of 2011 and the fall of 2008 printed bullish sentiment readings of 51.54% and 53.29%, respectively. It is noteworthy too, that margin levels are at the highest levels since 2008 and non-commercial speculative positions in the Russell 2000 Mini contract just hit an all-time high in January.



courtesy of Dennis Mark (NB Financial, mid-January) shows bond sentiment in the mid 30's (blue line and left access) vs. 30 yr. US Treasury bond yields (orange line and right access) at 3.00%. Historically, bond buys occur when sentiment readings move into the low 20's. We currently hold 20% of our asset allocation portfolios – The Class and Two Way portfolios – in long term AAA government bonds. In 2011 we had 40% but pared off half our holdings in late 2011 after substantial gains. We are prepared to add to these holdings on certain conditions being met, and in spite of universal calls by economists for certain inflation arriving soon..

CURRENCIES

Over the last few months, and in particular since the New Year, the US dollar has been especially against the Euro. This would suggest an equity market that begins to focus more on energy and base metals as we move into late Q1 and early Q2. We currently own and have been building positions in these two sectors as they too show seasonal strength over the same period. Downside for the greenback appears to be 5%-6% lower. The Euro despite all the troubles in Europe is marching toward a 40% premium to the US dollar. After bottoming in the summer around $1.20 first resistance has been broken at $1.34. Next resistance is just over $1.40. The premise of our investment decisions and company ethos really is that prices don't lie. You shouldn't argue with them: follow them. That said, I still long for a detailed exposure by some crack journalist into Chinese surreptitious support of the Euro. A falling US dollar is good for them as the Yuan is pegged, but a falling Euro not good. All is well for Chinese exports though the fundamentals do not match the price action. Last the Yen has weakened dramatically in what's known as "Abenomics". New Japanese Prime Minister Shinzo Abe has been advancing aggressive monetary policy and fiscal expansion to combat 20 years of deflation. The structures of the currency markets are pointing to a continuing bullish profile for stocks.

FUNADMENTALS

The bears point to a negative Q4 US GDP (-0.1% vs. expectations of +1.1%) print, falling consumer confidence, lower corporate earnings guidance and an US Fed still on the gas pedal from what it sees.

The sanguine case says US job numbers are modestly rising, housing appears to be bottoming and actually increasing some pockets, and auto sales are doing very well. As alluded to above economists are uniformly bullish on the global macro picture primarily due to a stabilising of Europe, green shoots in the US and a resurgent China. By June, we will have a clear picture of both the price and economic trend, until then keep on keepin' on. Just don't be surprised if things change sooner.

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RECENT MEDIA

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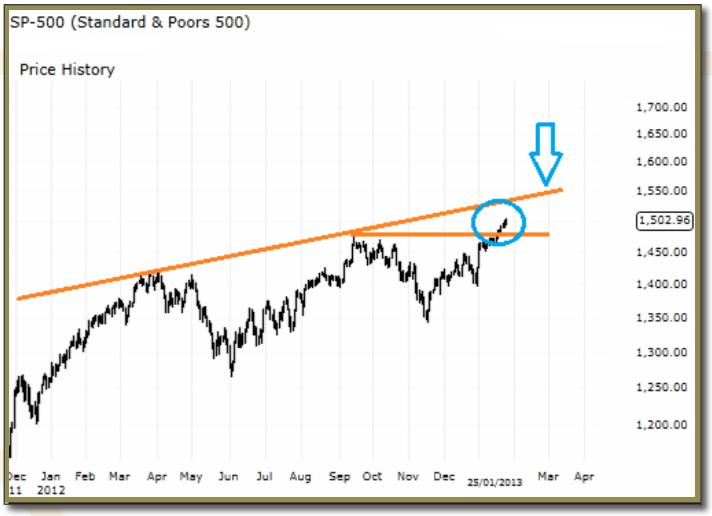
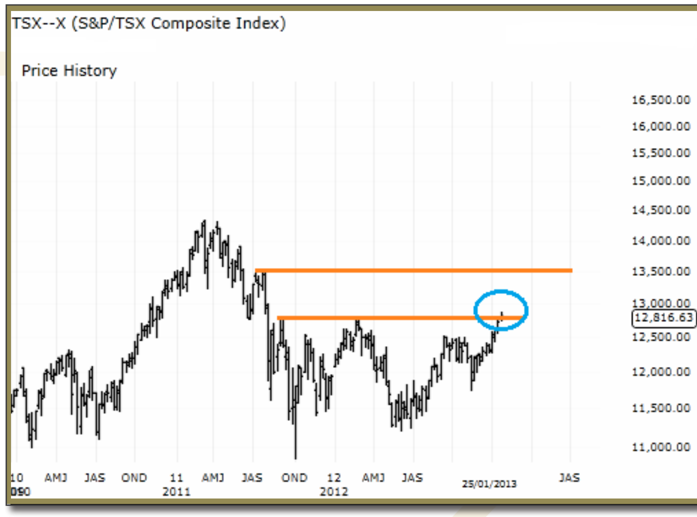
THE CHART PAGES

US EQUITIES



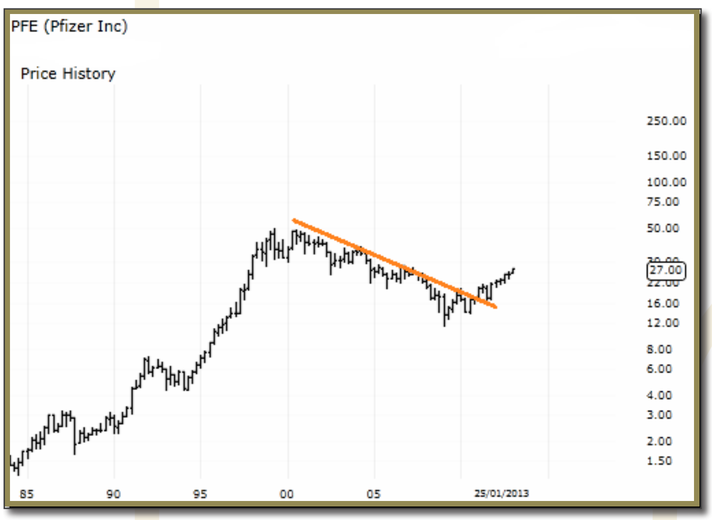
US equities recently broke above resistance. Near term resistance is overhead at the 2000 and 2007 peaks. Strength today is seen through to Q2.

CANADIAN EQUITIES



The TSX too is showing strength having recently broke above resistance. Seasonal strength in energy, base materials and financials appear to be ready to propel the TSX higher with the next resistance at 13,500 then 14,500.

PFIZER INC.



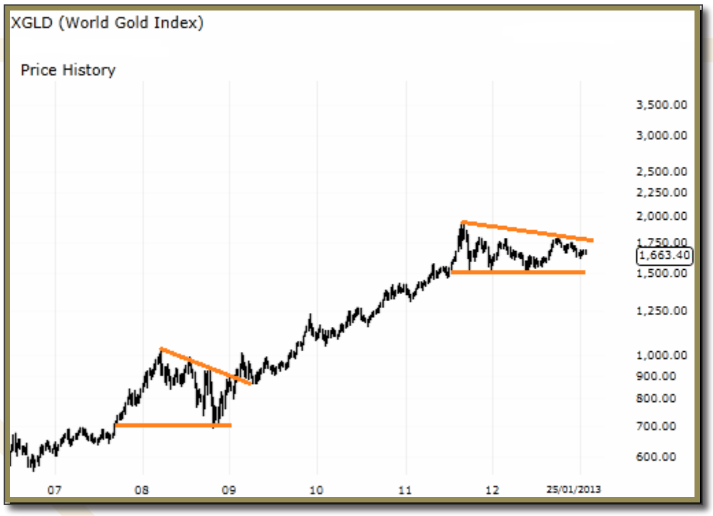
This long-term chart of Pfizer shows a break out after 10 years of underperformance. Healthcare in general is at the beginning of a secular bullish trend. We currently own positions in Pfizer, Abbot Labs and AbbVie. Any pullbacks in this sector will present opportunities for further allocations.

GEORGE WESTON LTD.

George Weston Ltd., whose baking division is performing well and investment in Loblaws increasing due to the grocery's management unlocking real estate value, was purchased for a long downtrend break. The Loblaws reit plan announcement provides support around $68.00.

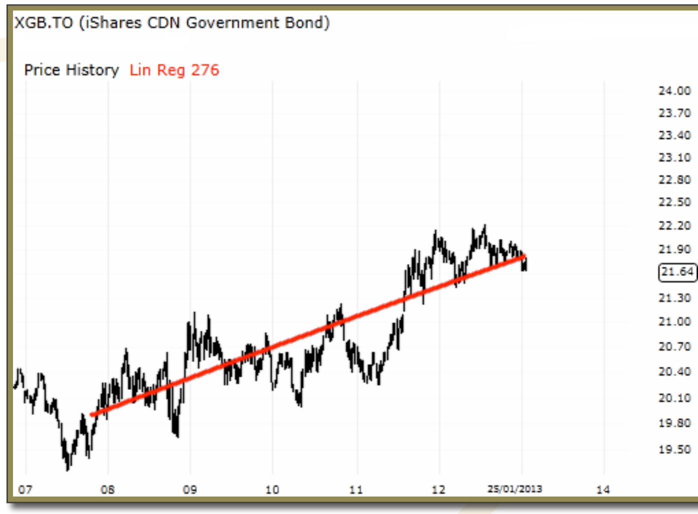
THE CHART PAGES

GOLD BULLION



Inflation, stagflation, it doesn't matter. Gold is responding to currency wars going on behind the scenes and the "bid" from governments reserves underinvested in bullion, particularly China. Historically gold does move more during deflation which happens to be characterized by devaluations to foster exports.

CANADIAN AAA GOVERNEMENT BONDS



This long term chart of government bonds (ETF: XGB) with a linear regression line reveals a clear trend from the lower left to the upper right. Further bond weakness appears to be expected into spring. A preservation of the secular bull would cap any downside in prices to 4%-5%, a similar deviation from the mean as seem since 2007.

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FROM THE KITCHEN TABLE…
WHAT MAKES A GREAT DINNER?

By Thomas Kleinschmidt
Executive Liaison, Assoc.
Portfolio Manager

Often, financial advisors meet prospective clients at their kitchen table. Perfect place…that's where most of the important family decisions take place, so it is from that perspective which I write.

What makes a great dinner? Preparation? Number of courses? Not spilling the beans? All the above and more? I think that a great dinner has to do mostly with the experience, not the particulars. I want to finish feeling very satisfied, happy, well nourished. I wish the same for you for the end of 2013 -- Happy New Year!

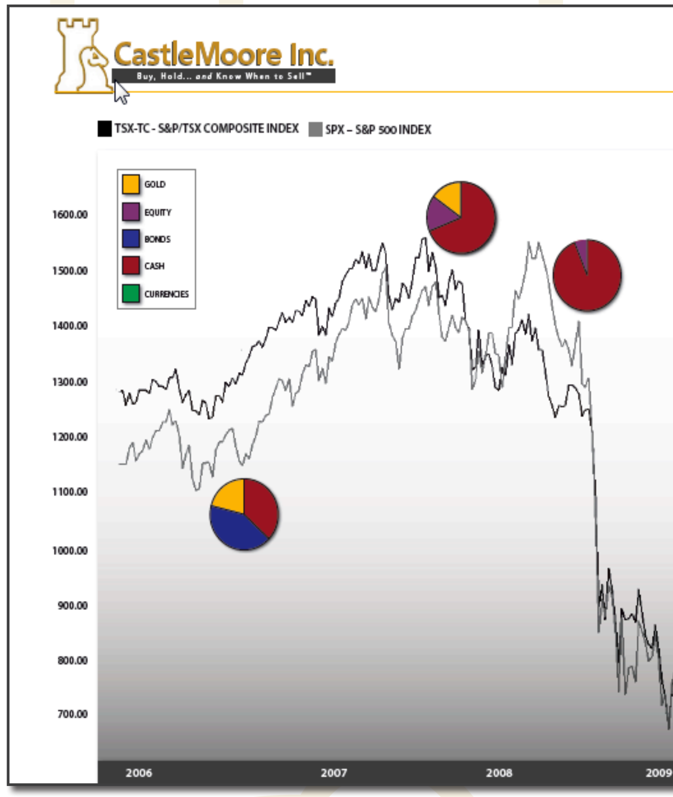
Now, special for readers, I'm going to save you some time. Here is the #1 Resolution if you have some of your hard earned savings doing you proud in any of the bond, bullion or equity markets: Don't Lose Your Capital.

Wow. Really profound. Deep, even.

Common sense says, "If it ain't goin' up get the heck out and put your money to work somewheres' else". And yes, that something else needs to be going up. It's all about (a) avoiding the wrong asset classes and (b) not sticking around losing more than 10% of your capital! If the broad equity markets are falling off a cliff do not try catching falling stock knives! Sure, some folks can but most simply just end up in hospital.

Any good resolution is not complete without a good mantra. Here's one you can say to yourself when you are working on your portfolio. Sitting quietly, rubbing your temples, repeat after me: "I am not a pension fund manager…my portfolio is not a pension fund…I am an individual investor…my portfolio is my life savings…I must not lose capital…". Say about 15-20 times every time. Unless you are a pension fund manager, in which case just leave out the first two parts and double up on the rest.

Corollary: when ALL asset classes are going down cash really IS king. It's good to remember that diversification doesn't work at all during a broad crash. Things are getting revalued…your portfolio does not have to participate.



This graphic shows CastleMoore's asset allocation in 2008.

Next say, "My edge in the markets is that I can sell in a heartbeat…I only need to hold a small number of positions." Tailor these to suit your own vernacular but you get the idea. Unless you are a pension fund manager, in which case, sorry.

Now the "how" requires that you use whatever system works for you. I know of only a few, the best will be yours, and most likely you might need a few years figuring yourself and it out. Which brings up an obvious conundrum…if most financial advisors insist that every client is unique then how can they insist on using the same system on every one of them? I surely am not the one to ask for a calm, unbiased answer, sorry.

Your system should asset allocate first amongst and move between the broad equity ETFs, bond ETFs, bullion ETFs, and cash ETFs. IFF you have time, then delve into specific and more numerous positions. Said differently, if and only if you really love your computer and are good at finding uptrends and trading, it most likely is best to only pay attention to a few positions and information. As for what information, I have not spoken with anyone who has made specific money on any specific "news" federal, fiscal, or otherwise. Well, except for Martha Stewart (we're in the kitchen, right?).

Do your homework before watching TV and Best Wishes for 2013!

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OFF MODEL MANAGEMENT: HOW CASTLEMOORE TRANSITIONS YOUR EXISTING POSITIONS TO OUR PORTFOLIOS

By Jason Dubbeldam

One of the advantages of a relationship with CastleMoore versus many other investment management providers is real, active risk management of all of your holdings, with no middle man. This includes of course all of our on-model holdings (those that our clients own because we purchased it according to our model portfolios) but also off-model holdings (those that our clients purchased before starting their relationship with CastleMoore).

Off-model management is very important. It is not very often that a client's account is funded purely with cash so that we can bring them on-model immediately. It is far more likely new accounts are funded by an in-kind transfer. The effective and responsible transition from those off-model holdings to CastleMoore's on-model holdings can have a large impact on the overall performance of the account. The two biggest issues we face in the on-model transition are finding an optimal exit price while managing risk, and dealing with any fees that may be associated with the sale of any holdings.

Finding an optimal exit point, while managing risk, has the largest impact on the performance of the on-model transition process. While we make our own picks for our model portfolios and believe we make good investment choices, we aren't the only managers with good ideas. If somebody joins CastleMoore with a holding that is performing, we will let it continue to run while monitoring regularly for a trend reversal and therefore the time to sell. Not all the holdings we receive, however, are likely to be in such strong positions. For those that aren't we apply the same risk management levels to all off-model holdings as we do to our on-model holdings.

Avoiding penalties for getting out of any particular holding is the other consideration. Often, the majority of new CastleMoore clients' assets come to us in the form of mutual funds. Unfortunately, many of those funds were purchased as Deferred Sales Charge (DSC) funds, a mechanism that reduces or even eliminates the sales charge associated with those funds provided the investor hold them (or at least stay within the fund company's products) for at least seven years. This makes the decision of what to sell and when a little more complicated, since the impact of the loss due to remaining DSC fees must be weighed against the likelihood for further price losses.

When clients join CastleMoore, all of "their" positions immediately become "our" positions and we monitor and treat them with the same level of management and attention to detail as we do all of our other holdings. Thus you can rest assured that your portfolio is being managed for no other agenda than optimal, risk-adjusted performance. The goal being all clients fully on-model remains, but the process is thoughtful and methodical rather than arbitrary.

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THE STRANGE ATTRACTORS

GUEST COLUMNIST

by Mukul Pal

The phenomenon in which one regular cycle locks into another is called entrainment, or mode locking. Entrainment explains why stock market components are like flocking birds and herd behaviour of land animals

Scientists were wondering why miracles exist and then they realised, miracles were more frequent than random. It was like life on earth. It seemed like a freak accident, but there were more life systems in the universe. Nature forms many such miraculous patterns.

James Gleick's award-winning book, Chaos – Making a new science' details the phenomena. Christian Huygens, the Dutch physicist behind the pendulum clock and the classical science of dynamics, stumbled upon an observation. One day, a set of pendulum clocks placed against a wall happened to be swinging in perfect synchronised chorus. Nothing in mathematical description could explain this propagation of order from one pendulum to other; clocks could not be that accurate. Huygens surmised the clocks were coordinated by vibrations transmitted through the wood. This phenomenon in which one regular cycle locks into another is now called entrainment, or mode locking. Entrainment also explains why stock market components are like flocking birds, shoaling behaviour of fish, the swarming behaviour of insects and herd behaviour of land animals. Entrainment is also the scientific explanation for inter-market analysis, why the Dow 30 performance is connected to the TSX 60, gold is connected to dollar and a host of other flocking performances in the capital market.

Though there is a pattern in the flocking of birds in the sky, the form is not always predictable. But there is a difference between random and unpredictable. The weather is unpredictable but not random. Unpredictable events or systems can be described as those we are unable to forecast or only able to partially forecast, due to a lack of information. Random systems are systems in which no deterministic relationship exists. Stock markets are non-random dynamical systems; you can partially understand and forecast these.

Goose 1: *Where are we going?* Goose 2: *Does it matter?*

Looking at stock markets as dynamic chaotic systems can change our approach to investment. One, we accept noise as a part of the unpredictability. Second, we accept that the idea of average is redundant. If weather over the long term does not have an average, the idea of average return for the stock market is redundant. This means it's the group (the flock of birds) that is more important than the index itself, which can sleep or be driven by the group.

Third, entrainment suggests that 'in sync' and 'out of sync' performances can happen between asset classes, correlations can get positive and negative, conventional relationships can work or fail, and cause and effect can be humbled. Hence, working on extrapolations or simple trends can increase risk rather than decrease it. Fourth, data mining, pattern identification and looking for universality becomes a mother lode not just for science but for stock markets, too. Fifth, the very fact that chaos is mathematical allows us to model stock markets.

Is the universality we see in nature also witnessed in stock markets? Yes. Lorenz's sensitive dependence, Feigenbaum bifurcation constants and Mandelbrot fractals are a part of chaotic systems. Stock markets are sensitive and clearly depict the butterfly effects. The very fact that equities around the world crash together exhibits sensitive dependence.

Technicians swear by proportion. And, the fact that market data are replete with statistical fits and Fibonacci proportions suggests overlap with Cantorian Figenbaum constants. Finally, we know of the famous debate Mandelbrot avoided regarding Elliott's work. The master technician talked about fractals 30 years before Mandelbrot.

Another universality seen across data assets is extreme reversion. Whenever the bird separates from the flock, it is strangely attracted back into the fold. The outliers don't remain outliers; the attractor keeps them together. Call it a miracle but the worst outliers invariably deliver.

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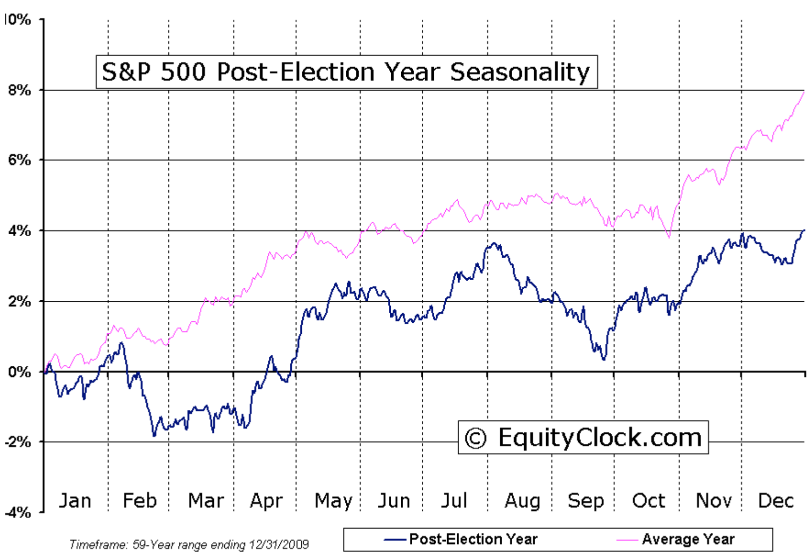
AN OUTLOOK FOR NORTH AMERICAN EQUITY MARKETS IN 2013

GUEST COLUMNIST

By Don Vialoux, CMT



HISTORY IS ABOUT TO REPEAT. Historically, U.S. equity market enters a corrective phase in February and March in the year after a U.S. President is elected. That is the period when the U.S. President tries to enact many of the most difficult promises from his election platform. Thereafter, U.S. equity markets tend to move higher and close near their high for the year. Canadian equity markets have followed a similar pattern.

What about 2013? North American equity markets will benefit in January from moderate fourth quarter earnings gains on a year-over-year basis. Consensus for S&P 500 companies and TSX 60 companies is a gain of 6%. Weakness in North American equity markets in February and March likely will be triggered by tough negotiations in the United States on the debt ceiling, budget talks and the Sequester. If uncertainties related to these issues are reduced by spring, the stage is set for a significant gain in equity markets through the remainder of 2013. Corporations are sitting on huge cash positions that await greater political stability in the U.S. before making capital commitments. S&P 500 companies alone have over $1.5 trillion and major Canadian companies have over $560 billion of cash equivalents. Capital spending beginning in the second quarter will set the stage for accelerated economic growth starting in the third quarter.

Investors can benefit from equity trends in 2013 by taking seasonal profits near the end of January when equity markets show signs of a correction and by watching for a re-entry point near the end of March.

Jon and Don Vialoux are authors of free daily reports on equity markets, sectors, commodities and Exchange Traded Funds. Reports are available at www.timingthemarket.ca and www.equityclock.com . Follow us on Twitter@EquityClock