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

EXTREME REVERSION IS NOT AN OUTLIER

By Robert 'Hap' Sneddon, FCSI, President

Managing money with a strong or primary filter in the analysis of security price action has changed over the last 5 or 6 years. While the tenants or tools of trend identification remain fixed, proven over many decades of empirical evaluation, and while new indicators are continually being created, markets and their constituent securities dwell more and more at the extremes. The extreme nature of markets is also impacting a pure value or fundamental approach

Why does it matter? It matters because, liner regression analysis, a central resource for all managers, whatever their style and one of a few tools that broadly overlap technical and fundamental analysis, is less effective, diminished. Prior to high frequency or algorithmic trading, ubiquitous hedge fund market participation and declining trading volumes, standard linear regression helped define for managers – value, growth or momentum - whether a security was presently investible or not.

Why would a manager, whether they have a dominant technical or fundamental inclination, buy a security for client portfolios that is "overbought" or "overvalued"? In reality securities do not have the bias that Managers do, and they can exist at whatever price level they find equilibrium between buyers and sellers.

There is no necessary, eventual, justice in market action, no necessary reversion to the mean. They care not a whit whether anything makes sense.

In theory a return to the mean is expected (absolute). That is to say, when a security exhibits "x" number of standard deviations from its mean it should snap back. The thinking is that a down and out security will eventually become a profitable one if enough patience is shown. This expected security behaviour is depicted in the first box showing a text book sine wave oscillation. Securities rarely act in such a way. Today markets exhibit dynamic or extreme reversion tendencies as the norm. As the right three boxes illustrate, from the second box on the left through to the last, respectively, a beaten down security can become more beaten down, a strong one can begin to show slight weakness then quickly resume its uptrend or one can never correct at all really.

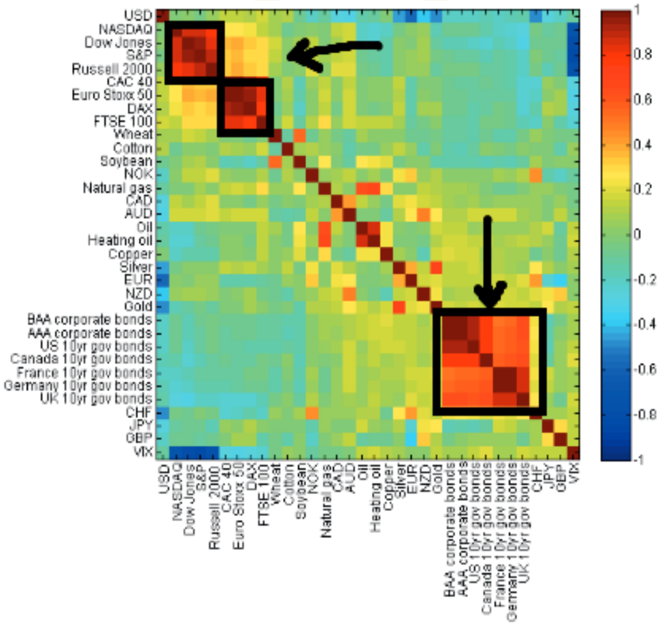
At CastleMoore we made a slight but significant shift to exploit the dynamic nature of security pricing. The first adjustment came when we launched our two equity portfolios, the Toronto 10 and the US

DYNAMIC VS ABSOLUTE MEAN REVERSION

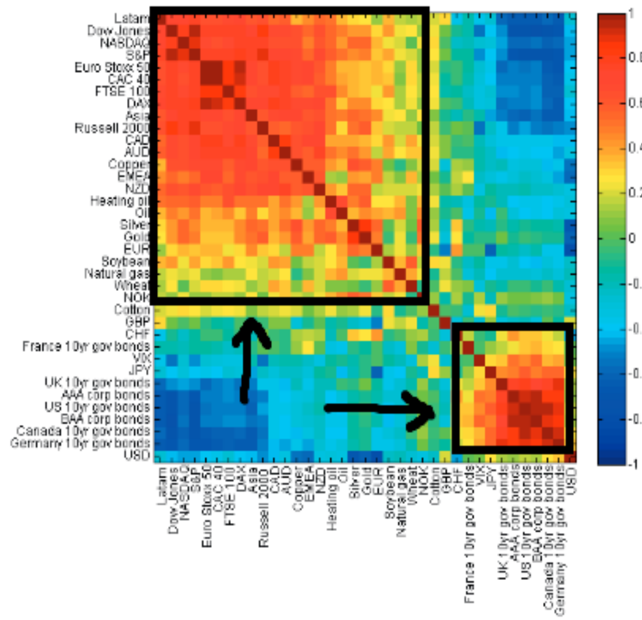
ABSOLUTE MEAN **DYNAMIC MEAN**

10 two years ago; the second occurred in December 2013, for our broader asset allocation portfolio - a blend of stock, bonds, cash and gold - the Class, Focus and Two-Way portfolios.

After calling the market top within 5 months in 2008 and moving to 95% cash for client separately managed accounts (SMA) CastleMoore began to notice this change in mean reversion. Overbought and oversold conditions had become far less relevant. The tools that we still use today to assess large systemic danger are far too blunt to navigate in the short to intermediate term (from a few months to several years) In addition,other attributes of markets, such as security correlation, began to exhibit new states. A typical, healthy market has securities and asset classes that move divergently in relation to each other where some move up, some down, and some sideways.



2005



POST-2012

The table on the left shows a clustering of red boxes where correlations amongst asset classes is almost "1" or almost perfectly correlated. Notice the size of the dark blue or uncorrelated areas as well. This analysis from 2005 paints a generally diversified market, but with smaller differences between correlated and uncorrelated assets. The chart on the right shows the state of correlation of assets and securities since 2012. Initially it is obvious that the area of correlation has significantly increased (red), but also the area of non-correlation (dark blue). What this means is that markets or securities have not only flocked together in greater numbers but also shown a greater display of "extremeness" (in pricing) or difference with investment areas that have little correlation. Thus there is a greater risk to portfolio decisions for managers who underestimate the dynamic (vs. absolute) condition of mean reversion. This has led to increased manager confidence in doing more of what has worked.

One example of this distortion can be seen in the inter-market relationship between interest rates and equities. While the S&P touches new highs the yield on the US 10 year bond is on a downward trajectory from just over 3% to 2.40% in early September. While equities are implying improving economic and corporate conditions bonds, despite the US Federal Reserve's impending end to its stimulus program, are suggesting at least caution in that thesis. Why would rates fall if things are improving? Can bond yields continue to fall while stock prices rise? Can bond yields rise substantially and it not impact economic conditions? Knowing the answer to either scenario is not what is important. The investor risk in this situation, as one example, lies in the potential for capital loss from a substantial change in this relationship as is the growing case today.

Doing more of the same will work until it doesn't. Using extreme or dynamic mean reversion analysis, along with additional risk management processes, such as a robust exit strategy, in the investment decision process while in the midst of increasingly correlated securities markets removes manager uncertainty and missed opportunity.

robert@castlemoore.com
1.905.847.1125 or toll free: 1.877.289.5673
www.castlemoore.com

Will Your Portfolio Protect Its Gains This Time?

RMI ® TSX 10 – JUNE 2014

Investment Objectives

• Objective of account management is relative outperformance of the portfolio's benchmark, the S&P TSX Composite Index.

Investment Strategies

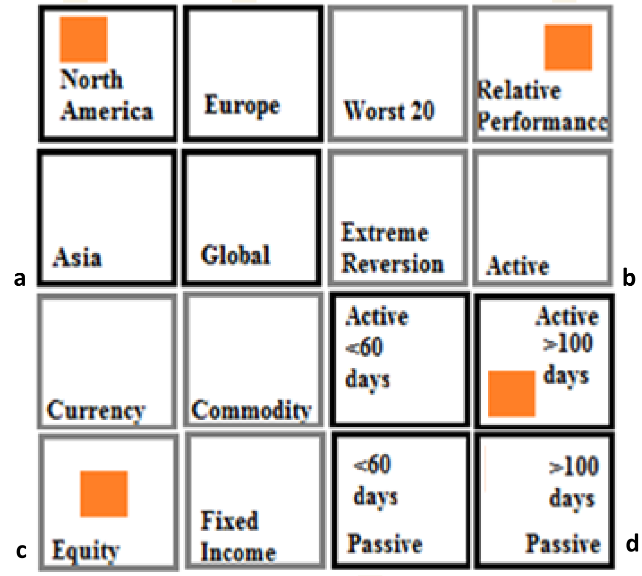
• The portfolio is constructed of a maximum of 10 stocks selected from the S&P TSX Composite Index universe using a model based on the theories of dynamic reversion to the mean and multiple investment cycles.

What are the Risks?

• Main risks of the portfolio are Market Risk, Liquidity Risk, and Equity Risk.

Who Should Invest?

• This portfolio is appropriate for investors with previous active equity management experience and/or a moderate level of risk tolerance and return objectives.



RMI Classification a: regional; b: style; c: asset; d: holding periods

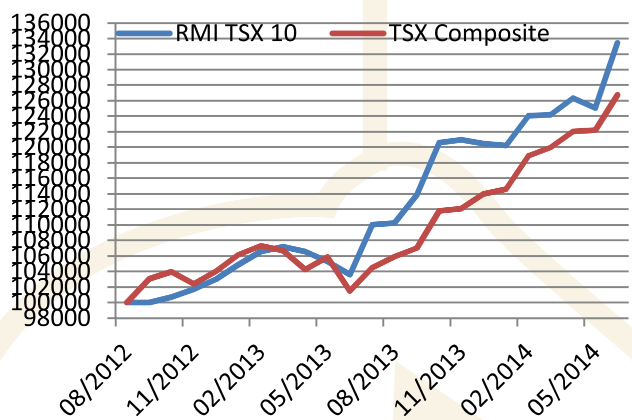
Performance

• **Returns.** The RMI ® TSX 10 delivered 28.8% return over the last 12 months compared to 24.9% on the comparable benchmark S&P TSX.

• **Volatility.** RMI® TSX 10 annualized volatility (measured by standard deviation) is 8% compared to the S&P TSX volatility of 6.8%.

• Average **Drawdown.** Average drawdown is average fall of the RMI TSX 10 from any new high. This percentage drop was at -1.3% compared to the average drawdown from peak of -3.4% for S&P TSX.

• **Rebalancing.** Since RMI ® TSX 10 is an active portfolio, it is monitored on a daily basis.



Statistics	RMI TSX 10	S&P TSX
MoM %	6.70%	3.71%
QoQ %	7.43%	5.66%
YoY %	28.80%	24.87%
Annual RoR	18.23%	14.59%
Annualized Volatility	8.00%	6.81%
Mean Drawdown	-1.32%	-3.44%
Mean Recovery (months)	3	5

Disclaimer

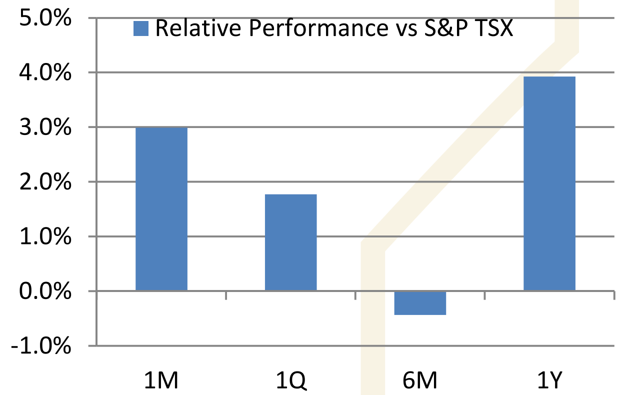
• All performance figures and values are net of management and performance fees. Returns are calculated using a time weighted calculation, include currency effects and consolidate all accounts under the portfolio model which may include off-model holdings. Data is provided by Ndex Systems Inc.. Past performance is not an indicator or guarantee of future performance.

Monthly and Annual Return Table

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total
RMI Toronto 10 - 2012									0.0%	0.7%	1.0%	1.3%	3.0%
S&P TSX - 2012									3.1%	0.9%	-1.5%	1.6%	4.0%
RMI Toronto 10 - 2013	1.8%	1.6%	0.6%	-0.6%	-1.2%	-1.6%	6.2%	0.2%	3.3%	5.9%	0.3%	-0.4%	16.9%
S&P TSX - 2013	2.0%	1.1%	-0.6%	-2.3%	1.6%	-4.1%	3.0%	1.3%	1.1%	4.5%	0.3%	1.7%	9.6%
RMI Toronto 10 - 2014	-0.2%	3.2%	0.1%	1.7%	-1.0%	6.7%							10.8%
S&P TSX - 2014	0.5%	3.8%	0.9%	1.7%	0.1%	3.7%							11.2%

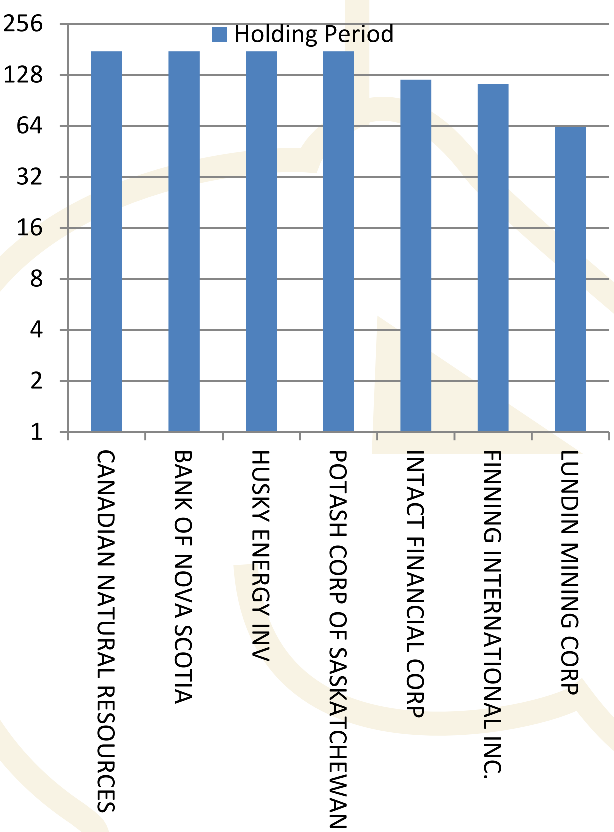
Relative Performance

• **Relative Performance.** Here we have illustrated the relative performance of the RMI® TSX 10 vs. the benchmark S&P TSX.



Components as at June 30, 2014.

• **Weighing Methodology.** The RMI ® TSX 10 is an equal weighted portfolio. These are the current running components according to their respective holding periods.



FUNDAMENTAL FLAWS

By Jason Dubbeldam

he vast majority of investment analysis, output, and history have been based on fundamental analysis - the study of a company's operations. From it analysts extrapolate various investment predictions, opinions, and decisions. However, the last quarter century has brought strong criticism against fundamental analysis for its many assumptions. From this examination there has been amendment and replacement of long held beliefs of many market participants who are raised exclusively on the school of fundamental analysis. CastleMoore's portfolio methodology, which is broad, encompassing multiple disciplines, accommodates for this weakness.

One of the main pillars of fundamental analysis is the Efficient Market Theory (EMT). It assumes that market participants are rational utility maximizers and that prices always fully encapsulate all public information. Under such conditions it is highly unlikely, if not impossible, to outperform the market. Why waste the time, energy, and resources trying? Indeed, research has shown that more than two-thirds of professional portfolio managers underperform the S&P 500 and that there is little year-to-year correlation between those who outperform. As both investors and researchers would tell you, however, the problem lies in the assumptions made by EMT the crowd.

Behavioral economists attribute what fundamentalists would classify as anomalies in financial markets to a combination of cognitive biases such as overconfidence, overreaction, representative bias, information bias, and various other predictable human errors in reasoning and information processing. These errors in reasoning lead most investors to avoid value stocks and buy growth stocks at expensive prices, allowing those who reason correctly to profit from undervalued value stocks and overvalued growth stocks. The most recent evidence shows that low P/E stocks have greater returns and that these higher returns were not simply attributable to higher betas (or how security behaves vs. its index), an explanation which had been accepted by efficient market theorists as explaining the anomaly in neat accordance with modern portfolio theory. If we call stocks that have had poor returns over some number of past years the "losers", then stocks that had high returns over a similar period would be the "winners". Recent studies have reached the conclusion that over the following period of the same number of years, losers have much higher average returns than winners and that beta cannot account for this difference in average returns. This tendency for returns to reverse over long horizons is another EMT contradiction. The data simply doesn't contain the betas required to confirm EMT.

peculative bubbles are markets that appear to be driven by escalating market sentiment and irrational exuberance, which take little notice of underlying, fundamental value. Bubbles are a recent example of another weakness in fundamental analysis. Frantic selling is usually the painful overreaction to the end of a speculative bubble, creating bargains for shrewd investors. It is difficult, however, for rational investors to profit from shorting irrational bubbles because, as John Maynard Keynes commented, "Markets can stay irrational longer than you can stay solvent." Because of the failure of EMT to explain these periods of escalating sentiment and irrational exuberance, from bubble creation to bubble burst, they are dangerously written off as mysterious market anomalies and, while allowed as a rare statistical event by weaker forms of the theory, are therefore often woefully under accounted for in investment models and decisions built on fundamental pillars exclusively. This leaves traditional portfolio management based on fundamental analysis without other means of price discovery unprepared to deal with the irrationality of markets and their participants.

As the investment world becomes quickly smaller, investors must also acknowledge that there are entire emerging markets that are not empirically efficient either. Unlike more mature markets in North America and Europe, there is considerable evidence of serial correlation (price trends), non-random walk, and evidence of manipulation in emerging market indices. Even the godfathers of market theory, Smith and Keynes, believed irrational behavior had a real impact on the markets.

In light of the incongruences contained in the assumptions made by EMT, when behavioral finance theories and technical analysis are blended with fundamental analysis a higher probability of positive returns are achieved. Technical analysis is the study of a company's share price over time. Using various measures, equations, and patterns, technical analysis offers a method of analysis that natural fully encapsulates and accounts for all market activity including, and importantly, periods of irrational exuberance and pessimism and the highs and lows to which they push prices. This is of great value to investors, because in the end the price is all that matters. Technical analysis too has its shortcomings, and Hap in his article this issue mentions the failing of overbought or oversold conditions as an example. At CastleMoore, we incorporate all disciplines to balance what price is saying, particularly when it's contradicting the good story and assumptions of the fundamentals.

For proper disclosure, Jason is in Level III of the Chartered Financial Analyst Program, the fundamental industry standard.

jason@castlemoore.com
1.905.582.7350 or toll free: 1.877.289.5673 www.castlemoore.com

FROM KITCHEN TABLES PAST

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.
Pressed for time I dug through some old Articles, pulling out JAN-FEB 2011 and MAR-APR 2011. Here's a current chart of the TSX Composite to show where we are today and where we were sitting at those Kitchen Tables Past.

Below are the relevant parts from the previous articles, written just before the peak in early 2011. Back then I made references to Ken Norquay's book Beyond the Bull, where he described us as 'warriors' in the financial 'jungle' and to watch out for tigers in the grass. Also, since then I've studied a dozen more "biases" – cognitive and emotional – that muddle rational thoughts and actions, allowing those tigers to eat portfolios.

So, we're back again with market highs and with many opinions and theories as to what is going to happen next!

Challenges and Considerations for 2011 (Jan-Feb 2011)

Seek gains but for gosh sakes worry about losses!

Don't think that since the TSX is almost back at where it was 2 years ago your retirement is 'back on track' as now is the time to worry about losses and put an action plan in place to deal with the next slumping. This might entail switching managers, advisors, or taking the plunge to self-management.

All told, with the corrections of the equities markets, most readers of this newsletter lost at least 10 years of gains in the equities markets. 1987 had a setback of 25%, 11 years later a 30% sale, 2 years after that a 45% slide and the final 2008 sell off was another 45% sucker punch. So, as a self-managed investor or one who utilizes professional help, what do you do? Stand pat or switch or something in the middle?

Behavioral finance sheds some light on why individual investors do so poorly with equities; to this list I added my own 'Bentley Theory' (I used the analogy of a Bentley automobile as a physical representation of a $300K+ portfolio). No one is walking around with a hammer looking to dent the hood of your current car but most investors leave their keys in the ignition of their Bentleys. Using the behavioral points I mentioned, I think investors do poorly with investment managers or advisors because of the same human shortcomings.

PROSPECT THEORY – they chase the current funds based on past performance ignoring current economic cycles and conditions and forget that mutual funds have prospectuses that hand-cuff the managers actions. Most of us have little more than Econ 301 and thus have little business trying this ourselves.

OVERCONFIDENCE – they overestimate their goals and/or the returns they can make in the markets and act as if the markets care what they think but believe in the buy-and-hold approach or that this-time-will-be-different, which sadly implies that the market will recover during their investment time-frame.

CONFIRMATION BIAS – they only listen to hopeful stories instead of ignoring such opinions and seeking facts from their advisors. Unfortunately, facts are hard to come by for the future and thus are limited to being 'historical facts' of probabilities and deviations from the norm of the performance of the markets. Why are investors compelled to listen to the siren's song? Hope gets in the way of logic as we are put in the position of 'what can we do but persevere?

NOISE TRADERS – they switch advisors when the current news finally triggers their fear-or-greed reflex.

ESCALATION BIAS – this is a bit tricky…some advisors historically recommend that their clients invest more with them during the tops and bottoms of markets (e.g. the "Smith Maneuver" story) and some investors do this on their own. Neither approach looks at diversification through methodology as a plan

BENTLEY THEORY (new!) – now that their Bentley is returned to them – two-and-a-quarter years later, without an explanation – they again love their current advisor. This must follow the 'hope' idea, that we get put into the position of 'what can I do but wait and see'.

Before you would even consider doing anything differently please consider the idea of diversification between methodologies – as you remember when the market sells off diversification in equities doesn't quite help. Pareto would argue that 80% of all methodologies work only 20% of the time and that 20% of the methodologies work 80% of the time. Since we now talk about Chaos Theory, perhaps Pareto would consider that statement as 80% usable but admit that 20% of the time he expects to get sucker punched. How to do both, safely?

Challenges and Considerations for 2011 – A Follow Up (Mar-Apr 2011)

Hope's place in your investment strategy is the 500 Level bleachers, not on the field.

And there's nothing like a nice 800 point market pullback to make the point, eh? During that period how did you respond? Did you jump out? Did you hold on? Did you pare down positions and reallocate assets? Were you able to remain objective and weigh both sides of the coin? Or did your brain selectively screen the information in the news/tv/web for proof that you were doing the right thing?

I recommend that investors focus on a few strategies, rather than on the news. Why? Simply put we cannot predict and should not react to every rustle in the grass. First, strategies are above these daily events. Second, as generals in a financial battle our job is to focus on the overall movement of our dollars to accomplish the current objective. As we walk through the financial jungle we have to be on our guard at all times, so having a number of strategies to deal with the time that the rustle in the grass is really a tiger about to eat us is a really good idea.

Right now we are walking on such a trail…half way up from the valley of the shadows and half way up the mountain of fear. The rustle in the grass most likely is a stalking tiger.

Most investors are nervous, some are oblivious. Some are quick and some are slow.

But all are on the menu.

Thomas Kleinschmidt, Associate Advising Representative

thomas@castlemoore.com 1.905.847.2713
or toll free: 1.877.289.5673 www.castlemoore.com

RECENT MEDIA

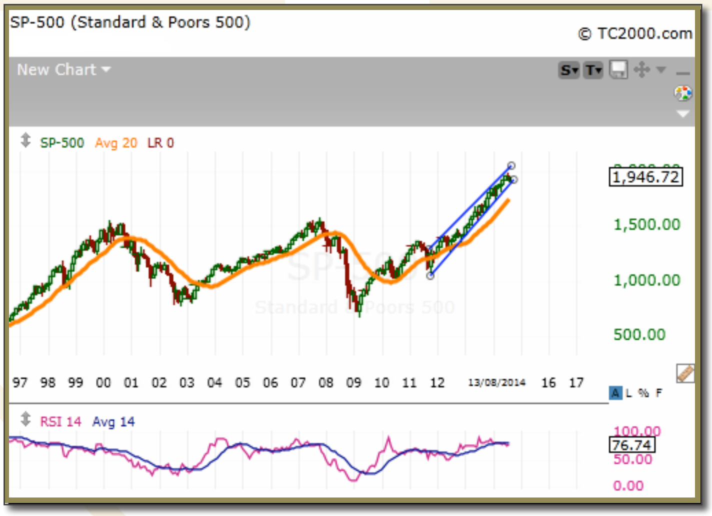
PLEASE CLICK LINKS FOR VIDEO

MARKET CALL TONIGHT	Wednesday August 27, 2013	**http://www.bnn.ca/Video/player.aspx?vid=422805**
MARKET CALL	Monday, July 14, 2014	**http://www.bnn.ca/Video/player.aspx?vid=395772**

BNN BUSINESS NEWS NETWORK

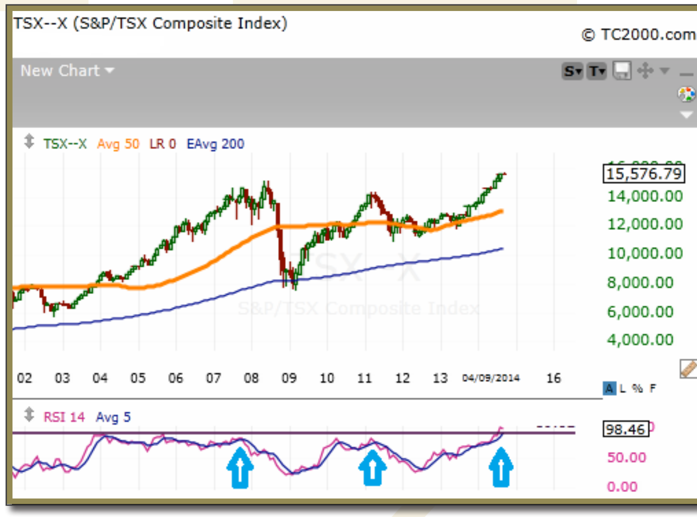
THE CHART PAGES

US EQUITIES



US equities, as represented here by this long term chart of the S&P, have been in strong up trend since the announcement of unlimited Quantitative Easing in 2012. There have been periods of weakness in the interim but there has been no significant correction since 2011. The market is now coming to terms with an end to monthly US Fed asset purchases by October. Second half expectations for strong corporate earnings and GDP are high. While many indicators are showing weakness there is no perceivable catalyst at this time that suggests the trend is susceptible to change.

CANADIAN EQUITIES

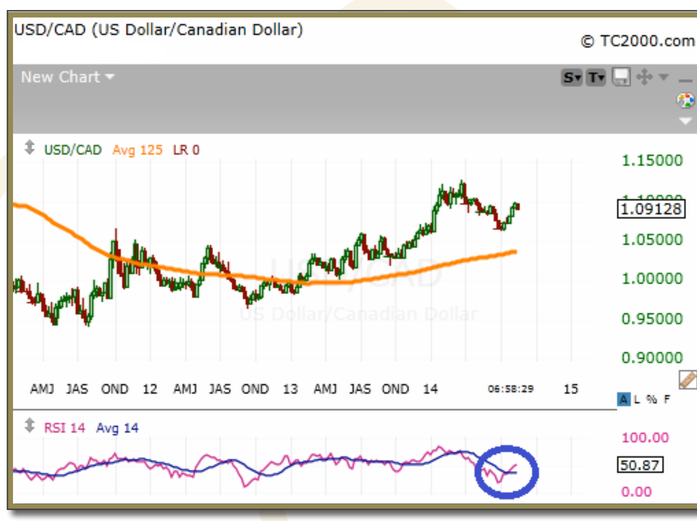


The TSX has lagged the S&P since 2008 primarily from weakness in energy (-30%) and gold stocks (-50%) which make up a significant portion of the index. Since the bottom in 09' industrials, financials, healthcare and consumer staples have done most of the heavy lifting. At present the index is pausing as the RSI indicator in this long term chart is at a level last seen in 2000. Five of six models are on 35% cash; the sixth, our pure AAA bond portfolio is more fully invested.

INTEREST RATES

We maintain significant client holding in Canadian government bonds in asset allocation portfolios and recently added a US long bond position in another portfolio type. This intermediate term chart of US bonds is illustrative of the downtrend in AAA yields and uptrend in their prices. The majority of analysts and investors expect rates to rise with improving corporate earnings and macroeconomic conditions. The 2.40% level in the US 10 year Treasury has become a focal point for traders; a sustained break below implies 2.00% yield target with potential to 1.50% (again).

CANADIAN/US DOLLAR RATE

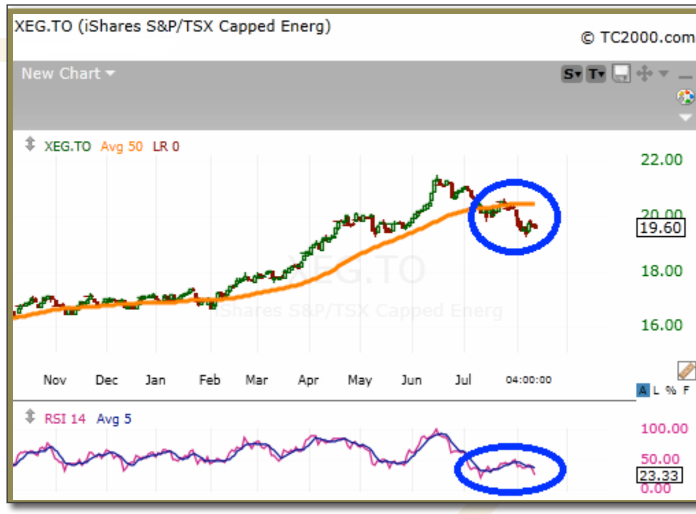


The Canadian dollar has been in a downtrend since 2011 commensurate with weakness in the resource sector and strength in the US dollar against the global basket benchmark. This chart, which depicts the cost to buy one US dollar, shows an intermediate uptrend resuming after brief seasonal strength in the spring. At present the Loonie is trading in a band between $1.06-$1.10 USD/CAD. A break below the June low at $1.06 would signal a trend reversal and strength.

RUSSIAN EQUITIES

All things Russian are topical for sure. This multi-year chart of Russian equities as depicted by an ETF unit shows a strong downtrend in prices and money flow. A concurrent chart of crude oil would also show a peak in 2008 ($145/WT). Maybe President Putin is causing mischief to distract citizens from the realities of an economy whose exports are almost entirely energy-based. Further downside is expected after a brief respite from the peaceful end to the annexation of the Crimea.

OIL SECTOR



The Canadian oil sector has shown significant weakness recently. In one of our pure equity portfolio, the TSX 10, 80% of energy names (which made up 40% of the total portfolio) were sold in mid-July after being purchased in early spring. The decision to sell and realise substantial gains was based on stretched valuations and the price trend break. The historical summer period of strength did not materialise this year. This second seasonal trade may yet appear (but unlikely) if support 5% lower holds.

WHAT MAKES CASTLEMOORE UNIQUE AND VALUABLE?

- Management of Client Life Savings
- Not Stock Brokers or Mutual Fund Salesman
- Discretionary Asset Management
- Methodical and Disciplined
- Unemotional, Unbiased Decision-making
- Low Loss Tolerance
- All-Inclusive Fee Pricing
- Focused Approach – No "Super-Market of Services"
- Pre-Existing Portfolio Transition Option
- Effective Portfolio Management – Plain & Simple
- Broad & Deep Industry Experience
- Managed Asset Classes – cash, maturities, ETFs/stocks, precious metals

HEAD OFFICE
4275 Village Centre Court
Suite 201
Mississauga, ON L4Z 1V3

Phone 1.905.847.1400
Fax 1.416.352.0190

Toll Free 1.877.289.5673
Email info@castlemoore.com

www.castlemoore.com

WHY CAPM IS NOT CRAP

GUEST COLUMNIST

by Mukul Pal

A simple performance ranking can be a good proxy to explain value, growth, momentum, reversion, low beta, high beta, volatility, etc, in a certain universe of assets prices or simply any natural data set.

The Capital Asset Pricing Model (CAPM) of 1961 says expected return on any portfolio (or stock) should earn a premium above the risk-free rate. In simpler words, low risk meant lower return and vice versa. William Sharpe, Harry Markowitz and Merton Miller got the 1990 Nobel Memorial Prize in economics for work on this.

James Montier rechristened CAPM as Completely Redundant Asset Pricing (CRAP) in a research paper. No doubt, behavioural experts had insights into the market behaviour, but somewhere there is an "academic bias" that creeps in, making academicians more positively biased about their body of work. History is full of literature where new academic theorists have not been very objective about the previous body of work. Mandelbrot called the bell curve nonsense; Fama asked how this stuff (behavioural finance) ever got published among others.

Montier's take

Apart from the fact that Montier wanted to justify the "academic bias", the author strengthens his case against CAPM assumptions by illustrating the low-beta and high-beta portfolio behaviour. He illustrates Fama and French's 2004 review of CAPM.

"Each December from 1923 to 2003 they estimate a beta for every stock on the NYSE, AMEX and NASDAQ, using two to five years of prior monthly returns. Ten portfolios are then formed based on beta and the returns, and tracked over the next 12 months. The figure plots the average return for each decile against its average beta. The straight line shows the predictions from the CAPM. The model predictions are clearly violated. CAPM woefully under predicts the returns in the low beta stocks and massively overestimates the returns in high-beta stocks."

This might suggest that investors might be well advised to consider a strategic tilt towards low-beta and against high-beta, a strategy first suggested by Fishcher Black in 1993. Suggesting simply that low-risk could deliver higher return and vice versa.

Do Fama and French make CAPM redundant?

Fama and French improved the model by adding value, size (capitalisation) variables to the CAPM variables. Though testing suggested that the new variables enhanced the understanding of the market behaviour, the model was still offering better guidelines to understand asset prices but was still not unequivocal in its findings. Even newer models with momentum as a variable failed to establish rules and relegate CAPM into redundancy. The model still worked in a few cases and was still valid.

Is it not all about divergence?

A lot of our financial models are still looking at snapshots of data, rather than studying any dynamic evolution in market behaviour. A lot of data interpretation focuses on causally explaining mean reversion failures, or simply putting divergence from idealised cases. This is why a divergence from CAPM made CAPM a poor idealisation. We continue to seek better idealised scenarios, but somewhere we forget that markets are not made of one idealisation, but a set of idealisations. In this case both CAPM and Fama and French being two sets of idealisations.

If it's about mean reversion failure, it's all about models failing to explain divergence. Could it be that simple? This is what we explained in our retake on Thaler's "End of Behavioural Finance" that this was a psychological explanation of cases of mean reversion failure.

The power of proxy

In our paper on data universality, we explained the power of proxy and how data behaviour is universal, irrespective of the variables, be it financial or non-financial. A simple performance ranking can be a good proxy to explain value, growth, momentum, reversion, low beta, high beta, volatility, etc, in a certain universe of assets prices or simply any natural data set. We took a proxy percentile performance ranking of worst (bottom fifth) and best in a group of assets (top fifth) for the S&P 100 components. The test was made for 20 days to 1,200 days. And, even after 1,200 days of holding nearly 20 per cent of the worst losers and best winners, they continued to remain worst and best, respectively.

This proved that though there was a tendency for the worst to outperform and for the best to underperform, this was not a rule. This could be extended to the idea of how low-beta stocks could continue to stagnate. Which, in other words, meant low-risk could continue to deliver low-return or simply suggesting that CAPM was not crap but a relevant case of market behaviour.

mukul@orpheus.asia, Orpheus Capitals
Orpheus Capitals' vision is to revolutionize the world's understanding of TIME and build research analytics around it.

HERE WE GO AGAIN

GUEST COLUMNIST

By Ben Hunt

From an Epsilon Theory perspective, the scariest, most market risk-creating event of the past 48 hours had nothing to do with Iraq, nothing to do with Israel, nothing to do Russia. **It was Mario Draghi's press conference.**

Yesterday {August 7th, 2014] Draghi re-launched the Great Fiscal Consolidation War of 2012, a multi-level game where the ECB attempts to force spendthrift sovereigns to undertake structural reforms while ostensibly going about their business of maintaining their single mandate of price stability. It's a neat trick if you can pull it off, as Draghi kinda sorta did with the PIIGS two summers ago, but … geez, do we really have to go through this all over again?

Multi-level games live at the intersection of politics and economics. I wrote about them earlier this year in the Epsilon Theory note "The Play's the Thing", and the basic idea is that public communication policy has a recursive, strategic nature. That is, while there's an ostensible meaning and an ostensible audience for any performance, there are almost always one or more deeper levels of real meaning and real audience for any political performance. And Mario Draghi is one heck of a political performer.

The press conference delivered two ostensible messages yesterday.

First, Draghi called out Italy and France. Why is Italian GDP back in the red? Why is France threatened by deflation, the Great Satan of modern monetary policy dogma? "It's mostly the lack of structural reforms", something "that has nothing to do with monetary policy".

Second, Draghi put the kibosh on monetary easing beyond what was announced months ago. Why not do more to force credit into the European economy? "If one can't open a new business [because of structural impediments], there's no point in giving more credit. You won't know what to do with this."

The linkage of the messages is the real communication here. Memo to France and Italy: you want more easy money? Then stop spending so much and pass meaningful labor and tax reform legislation. **It's a giant game of Chicken, just like in 2012, and the big question now is who will blink first, ECB/Germany or Italy/France.**

What do I think is going on? Why do I think that Draghi felt compelled to pull this stunt now?

I think that the looming conflict with Russia is a big problem for the German economy, which means that Germany's degrees of freedom to accommodate bad actors in the EU club are dramatically reduced, which means that Germany's overwhelming macroeconomic focus – a weaker euro and fiscal consolidation in the periphery (and France) – is now Draghi's overwhelming macroeconomic focus.

I think that the ECB's asset quality review and stress test of major EU banks has revealed just what a bitter pill it's going to be to assume regulatory control (see "The Red King" for more). Does anyone else find it odd that Espirito Santo [one of Portugal's largest bank and family-owned], which has been under troika supervision for years, is only now revealed as a basket case, right before the ECB becomes its primary regulator? Sorry, but it seems like a kitchen-sink quarterly earnings announcement to me, where new management comes in and blames everything on the prior gang of incompetents. The last thing in the world these undercapitalized, over levered, and stuffed-to-the-gills-with-sovereign-debt banks need is more pressure to finance their sovereigns, but that's exactly what they will face without structural reform and fiscal consolidation.

I also think that Draghi believes he's mastered the Common Knowledge Game, that he is confident he can always save the day if markets get too squirrelly by invoking the magic spell of the OMT or some other phantom policy. The difference between 2014 and 2012 is that Draghi believes he has established a safety net of sorts, at least to prevent a sovereign-level liquidity crisis as in 2012, with his command and control of the Narrative.

And trust me, the Narrative of Central Bank Omnipotence is alive and well. Want to read a really terrifying article? Take a look at this August 6th Op-Ed piece in the FT by Draghi's former colleague, Lorenzo Bini Smaghi: "The ECB Must Move to Counteract Market Turbulence". Are you kidding me? **This is what we have come to … that the proper role of a central bank is to counteract "market turbulence" before it happens?** I'd laugh, but then I remember that Yellen means exactly the same thing when she refers to "macroprudential policy", and I want to cry.

Draghi is playing a variation on this theme. He's intentionally injecting "market turbulence" in order to achieve larger political goals, but only because he is of one mind with Bini Smaghi and Yellen and the rest of the Central Banking nomenklatura – central banks can control market outcomes. Period, end of story. And so far he's been absolutely right. Will the winning streak continue? I have no idea.

What I am certain of, however, is that this is a very dangerous game. It's obviously a disaster if the game spirals out of Draghi's control, if he's unable to put the inevitable market freak-out genie back in the bottle as he was in the summer of 2012. But it's a different kind of disaster, at least to my way of thinking, if Draghi succeeds, because then the Narrative of Central Bank Omnipotence will just be stronger than ever. **If you like the notion of capital markets transformed into public utilities, then this is great news. For everyone else, not so much.**

W. Ben Hunt, Ph.D, Chief Risk Officer
SALIENT
4265 San Felipe, 8th Floor, Houston, TX 77027
Direct: 713.548.2627 | Fax: 713.993.4098
Twitter: @EpsilonTheory, bhunt@salientpartners.com

2013 FOREIGN INCOME VERIFICATION STATEMENT

By Ed Arbuckle

The complete revision of form T1135, Foreign Income Verification Statement for the 2013 tax year is a good example of complexity gone wild. CRA has backed away a bit by allowing some transitional provisions. The filing date for the T1135 is moved to July 31 for 2013 on a transitional basis but for this year only. CRA has also indicated that electronic filing is not available this tax season.

There is little point in comparing the old rules with the new ones so we will jump right into the new ones. We will not cover all details in order to avoid getting into complexities that many taxpayer's may not see so if your situation is at all complex, you should seek professional advice.

DO YOU HAVE TO FILE?

If you add up the cost of all of your specified foreign property (SFP) and if the total exceeds $100,000 at any time in the year, you must file the T1135. Individuals, trusts, partnerships and corporations must all file the form. Prior to 2013 you only had to indicate the cost of foreign assets within ranges but starting this year, the reporting is on an asset by asset basis. You must report details of every foreign property that you owned at any time during the year. Foreign property held within RRSPs, Canadian mutual funds and exchange traded funds do not have to be reported but of course foreign ETFs do need to be reported.

WHAT IS SPECIFIED FOREIGN PROPERTY

A SFP includes the following six types of assets according to form T1135:

1. Funds held outside Canada - money on deposit in foreign bank accounts, money held with a foreign depository for safekeeping, money held by any other institution

2. Shares of non-resident corporations – shares of non-resident corporations whether or not they are listed on a stock exchange or are physically held inside or outside Canada

3. Indebtedness owed by non-residents – all amounts owed to you by a non-resident person includes all promissory notes, bills, bonds, commercial papers, loans, mortgages and indebtedness issued by a non-resident person.

4. Interest in non-resident trusts – any interest in a non-resident trust. You do not have to report your interest in the following – a trust that is governed by a US Individual Retirement Account (IRA), a non-resident trust that neither you nor a person related to you had to pay for in any way, a non-resident trust principally providing superannuation, pension, retirement or employee benefits primarily to non-resident beneficiaries.

5. Real property outside Canada – any real estate holdings that you have outside of Canada, other than real estate used in an active business or for personal use. If you own a property outside of Canada that you rent it will need to be included if it is predominantly a rental property.

6. Other property outside Canada – precious metals or bullion, precious stones situated outside Canada, commodity or future contracts, copyrights, patents, options or derivatives including the following: An interest in any foreign entity not resident in Canada

- An interest in a foreign insurance policy
- An interest in a partnership that holds a SFP
- An interest in a property exchangeable into a SFP
- Transitional filing method

INVESTMENT DETAILS YOU MUST REPORT

The reporting of asset details is more detailed this time around. Here is a list of the required information shown under the six categories:

- Name of security, institution, etc
- Country code
- Maximum cost amount during the year
- Cost amount of funds at year end
- Income (loss)
- Gain or loss on sale

Generally, the cost amount of an investment is what you paid for it expressed in Canadian dollars at the time of purchase. In no place (except under the transitional rule) are you reporting the current value of assets.

SEPARATE PROPERTY REPORTING – NOT RANGES ANY MORE

For most of the six categories, there will probably be only one or perhaps two properties to report. However, in the case of assets in category 2 (your investment portfolio for example) there may be several properties to report because each security is a property. There is an exception to asset by asset reporting under the transitional rules discussed later.

EXEMPTIONS FOR SECURITIES COVERED BY T3s AND T5s

If a T3 or T5 covers income from a security, it doesn't need to be shown on the T1135. But, if a security does not pay dividends or interest you wouldn't get a T3 or T5 so you must report the property. The T3/T5 reporting exemption is not available if the transitional reporting method has been used for any other account with a Canadian registered securities dealer.

2013 FOREIGN INCOME VERIFICATION STATEMENT

2013 TRANSITIONAL REPORTING FOR DEALER ACCOUNTS

For 2013 only, you do not need to report each security that is in an investment account with a Canadian registered securities dealer – instead you report the aggregate amount of all SFPs.

The reporting is done under Category 6 – Other Property. Reporting details are changed as follows:

NORMAL	CHANGED
Country code	CAN
Maximum cost	0
Year-end cost	Fair market value of all SFP property
Income (loss)	Total income for the year
Gain (loss)	Total gains for the year on SFP owned any time in the year

PENALTIES

Failure to file the T1135 return on time will subject you to penalties. Unlike the IRS in the United States which cancels penalties because of lack of taxpayer sophistication, reliance on a tax preparer, or the inability to understand complexity, Canada does not accept any of these reasons for non-compliance. In fact, the CRA has aggressively sought penalties in the past when taxpayers had quite good reasons for not filing a T1135. Penalties not only apply for late-filing but also apply if a SFP is not properly identified on the T1135 form.

The penalty for failure to file is $25 per day to a maximum of $2,500. If gross negligence is involved, the penalty moves to $600 per month for up to 24 months. After 24 months it changes to 6% of the cost of SFP less penalties already levied. That's a huge potential cost that taxpayers shouldn't have to face just to help CRA locate tax cheats.

Failure to file the T1135 or to complete it correctly can sometimes be remedied without penalty under the CRA Voluntary Disclosure Program. However, the qualifying rules can exclude you from this opportunity so is not something you should do without professional advice.

SUMMING UP

This legislation and its complexity is unfair to average taxpayers and even sophisticated ones. People are much more into global investing these days so the T1135 will often apply to even modest portfolios.

Ed Arbuckle CPA, FCPA, TEP, Personal Wealth Strategies - Fee based family wealth planners, 205 - 30 Dupont St. E., Waterloo, Ontario Phone: 519-884-708
www.finplans.net