The Rampart

CASTLEMOORE INC.

Bah, Hummer Bug?

Oil Wins– SUV's Lose

It's the story of the stock market, isn't it? There are winners and there are losers. The chart on the left below shows the price of XEG, a TSX traded closed end mutual fund representing Canadian Oil Stocks. You could have bought it for $30 in 2001, 2002 and briefly in 2003. Earlier this year it went over $80! This was a winner.

The losers were those who bought PICK-UPS and SUV's. The high price of fuel makes them expensive to drive...and harder to sell. And, of course, there are those who manufacture and sell the gas guzzlers…check out the chart of General Motors.

One of the most important tenants of investing is being in the right place at the right time. Even more important is NOT being in the wrong place at the wrong time.

George Bush Did It….

All politics aside, U.S. President Bush takes a lot of political flack from Canadians and from Democrats. The story of oil has nothing to do with whether you're a Liberal or a Conservative—its about a story!

When US forces entered Iraq, the story was that this would bring stability to oil prices. Wrong! Those analysts who predicted stable oil prices for years to come got it exactly backwards, and at the right time too. Politics can unfairly take credit and blame for events already "baked-in".

….No, It Was Martin!

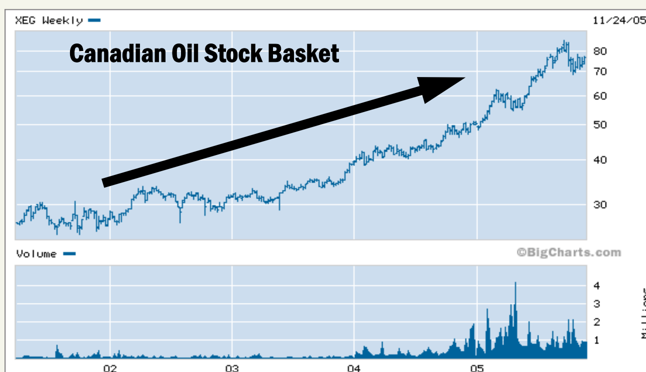
With Canadians now in a winter election, I'm sure someone will try to blame the Liberals for the big oil price increase. Or for cut-backs at General Motors. Or for the collapse in the re-sale value of your SUV. Or for your high winter fuel bill.

The "Story"

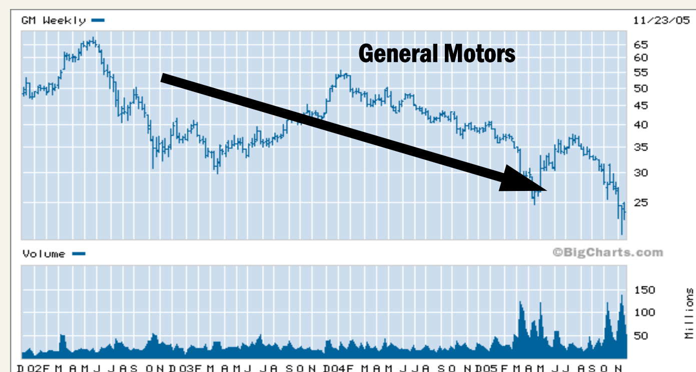
The stock market loves a good story. Journalists love a good story. Salesmen love a good story. But investment success is NOT about the story... Successful investing is about good investment technique. Good investing technique means participating in what's going UP and not participating in what's going DOWN.

Check out the two charts below. There was a time to buy oil stocks... and the story at that time was the US invasion of Iraq and the prediction of oil price stability. There was a time to sell GM... and the story at that time was the US economic recovery. Now the story is the pending bankruptcy of the worlds biggest auto manufacturer. Beware of the story. ***Ken Norquay, CMT.***

Ken is undergoing his Nidan grading for his 2nd degree black belt in Karate—no one at CM argues with Ken.



THE MARKET GIVETH...



...AND THE MARKET TAKETH

Curb Your Enthusiasm

Want to become a better investor? Get brain damage.

That's the finding of a rather unusual study by researchers from Carnegie Mellon University, the Stanford Graduate School of Business and the University of Iowa. It was published in *Psychological Science* in June, and its conclusions were reported in *The Wall Street Journal* last week.

But don't start playing football without a helmet just yet: It's not any type of brain damage that helped investors in the study, but rather, a very specific form: a site-specific lesion (a kind of tissue damage) in the region of the brain in charge of controlling emotions.

The investors who have these lesions are unable to experience fear or anxiety. It turns out that lacking the emotionality ordinary investors exhibit leads to better investment decisions. It is not at all surprising that the emotionally limited investors outperformed their peers. We know from experience that when investors allow their emotions to unduly influence them, they tend to make foolish -- and expensive -- decisions.

It was not simply a lack of emotions that caused the improvement in performance in the study. When presented with a high risk, higher return possibility, the participants with these site-specific lesions lacked the fear the other investors had. The more emotional participants failed to capitalize on these opportunities. In other words, they were greedy at the right time. That accounted for nearly all the difference in their performances.

But the basic lesson from the study is simple: Investors who learn how their emotions impact their investing -- and can get them under control -- stand to significantly improve their returns.

Emotions Undercut Performance

As discussed previously, human beings just weren't built for capital markets. We have numerous design flaws that work against us in the investment process. But once you become aware of *how* they impact your thinking, you have a chance at avoiding some of the more damaging behaviours. At the very least, you can try to work around some of these hard-wired foibles.

There are three broad categories in which emotions work against the investor: ego, flawed analyses and the derailed plan. Let's look at some examples within each category.

The ego issue may be subtler than you would expect; certainly, a prideful trader who is unable to admit he or she is wrong ends up holding losing positions longer than he or she should. That's an expensive flaw, and it's why investors who anticipate being wrong can more quickly -- and therefore less expensively -- cut losses.

But ego has an insidious impact on our analytical abilities as well. It is a subtle form of bias inherent in our thinking process. Ego is why we selectively perceive data, why we emphasize that which confirms our prior views.

It helps us ignore new data that may contradict our preconceived notions. It even facilitates our forgetting information that is inapposite to our viewpoint.

That's a pretty powerful analytical flaw hardwired into our brains, damaged or not.

We have other analytical flaws that are emotionally related. Why do we over-emphasize the most recent data point in a series? Each new economic report generates a giddy excitement, almost as breathless as a child the night before Christmas. When we consider the volatility of these data series, and the hedonic adjustments each one must suffer through, it's apparent that they are of more limited individual value. Smart traders focus on the trend of these releases, and not any one data point.

And yet...

We might have enjoyed 10 good GDP reports in a row, but let one bad one slide out and we become fearful and nervous. Or consider the opposite: we've just had over two years of data suggesting that inflation is resurgent, yet the first monthly report (June 2005) showing CPI and PPI as flat caused the Greek chorus to sing that inflation has been defeated in our lifetime. That's hardly the case.

Then, there are fear and greed. These are the best-known market emotions, and they cause all sorts of problems for investors. Our passions have an unfortunate tendency of getting the better of us -- and at exactly the worst possible moment, too. It's not merely chasing hot stocks at the top or getting panicked out at the bottom that's so problematic: It's the impulsive destruction of our investment strategy and long-term plan.

Decisions vs. Decision Making

One of the reasons that emotionally restricted investors have an advantage over everyone else is that they eliminate emotional decisions. It's a battle between impulsive choices, vs. a process for making rational decisions.

Without the tug of adrenaline and dopamine, you can stick to your original investing plan. That's actually the key problem with biochemical or hormonal decision-making: It's not that the decisions are necessarily so bad -- although they often are -- but even more significant, they derail your original

continued next page

WE'RE ON THE WEB!
WWW.CASTLEMOORE.COM

First Canadian Place
100 King Street West, 37th Floor
Toronto, ON M5X 1C9

Phone: 1.416.306.5770
Toll Free: 1-877-289.5673
Fax: 1.416.664.8801
E-mail: info@castlemoore.com

"We Buy & Sell, not just Buy & Hold"

CastleMoore Inc. helps investors manage their life savings. We are not stock brokers or mutual fund salesmen. We are discretionary investment managers specialising in "buy low, sell high" strategies instead of "buy and hold" strategies like the other guys.

At CastleMoore we manage our clients' investments through a methodical and disciplined set of systems that virtually removes any individual bias and emotion from the investment process. What we do works. We rely heavily on loss avoidance techniques based firstly on supply and demand analysis of an investment class; and secondly, on the traditional approach.

Accordingly, our clients are investors that pay particular attention to asset prices and have little tolerance for investment losses. Our clients have similarly strong expectations of getting their money's worth, and appreciate CastleMoore's all-inclusive and comprehensive fee schedule. If we are required, because of volatile markets, to be more active within our client accounts, CastleMoore bears all the costs associated with more frequent transactions.

Our team's previous experience in large national brokerage firms and both small investment dealers and investment counsels provides us the ability to deliver a high quality professional portfolio management service while adding truly independent and custom-tailored advice to our clients for reasonable costs. A CastleMoore client enjoys the benefits of having focused portfolio management without the distractions of also providing a "super market" of financial services. We just manage investment portfolios effectively – plain and simple.

Robert Sneddon, President
Fellow of the Canadian Securities Institute

investment plan.

As investors, you need a plan that allows you to save an adequate amount of money for retirement. We'll delve into this further in a future column but, suffice to say, the biggest problem with fear and greed is that in the blink of an endorphin, they can derail a well-thought strategy.

Think of this in terms of food: Imagine you are on a carefully crafted diet. You eat only healthful meals from a list of ingredients that have a good balance of carbohydrates and protein, with a limited amount of fat. Now consider an impulsive snack. What are the odds that this cheat will fit into your planned diet?

That's the key problem with emotional decision-making. When carefully designed strategies are supplanted by an impulsive choice, you have a recipe for poor performance.

As Malcolm Gladwell's best-selling book Blink: The Power of Thinking Without Thinking makes clear, unless you are an expert with decades of experience, instantaneous reactions can often have disastrous consequences.

To be sure, the study has an inherent bias in it: The experiment was designed so "risk-taking was the most advantageous behaviour." The less-fearful participants made higher return investment decisions. In reality, people have a tendency toward risk-averse economic decision-making.

That aside, there are important lessons to be learned:

Do not allow your emotions to derail you from your plan;

Learn when risk-taking is an appropriate course of action;

It's not just the decisions, but the decision-making process that you can control.

Short of brain damage, there are ways to control the impact our emotions have on us as investors. Investors who do that achieve much better returns.

Barry Ritholtz is chief market strategist for Maxim Group, where his research and market analysis are used by the firm's portfolio managers and clients in the U.S., Europe and Japan. This is reprinted with permission from Barry Ritholtz. britholtz@maximgrp.com The series can be found at http://www.thestreet.com/tsc/landingpages/apprentice

NOTE: The longer I am in this business, in many ways, the less I know, or at least, the less I am inclined to become married to my opinion. Jokingly, we tell clients and colleagues that we are a bit dim. Now we can boast that our "dimness" is at the cutting edge. I would like to thank Barry for letting us reprint his sage words. *Robert Sneddon*

ITS' THE EARNINGS, SCHMENDRIK!

"The Stock had a P/E of 500, but the analyst recommending it said that it was too low, that it should have a P/E of 1000. If you had invested in the company back when King Arthur first roamed England, and the earnings had stayed constant, you'd just be breaking even today. I wish I had saved the report., to put on the wall alongside the one that read, "due to the company's recent bankruptcy, we're removing this stock from our buy list".

Not all investors hold to Peter Lynch's views, obviously, but few will ever take issue with how those views are expressed.

Peter once headed the world's largest mutual fund, until one day decided that watching the growth of clients' assets somehow didn't measure up to watching the growth of his own children. Hence, he acted on his own version of "selling at the top" by retiring while still likely the most sought after money manger on Earth.

His allusion to the Price/Earnings (P/E) ratio as an estimate of breakeven period serves as a useful illustrative tool—Lynch also advised against investing in any idea you couldn't illustrate with a crayon, perhaps an idea for a future column—but hardly represents the most popular use for this time-honored value measurement rod.

"LYNCH ALSO ADVISED AGAINST INVESTING IN ANY IDEA YOU COULDN'T ILLUSTRATE WITH A CRAYON".

Everybody agrees that every company, at some point, should start generating profits, though there is generally a wide range of opinions as to what those profits should be, and, more importantly, at what rate they will grow in the foreseeable future.

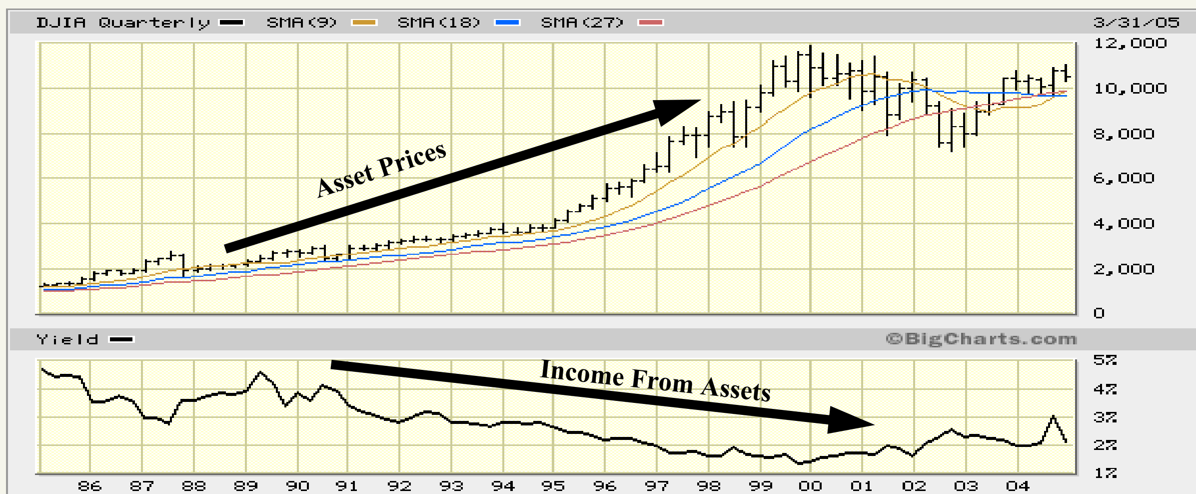
A stock's current P/E reflects a consensus view of what its future growth in earning is expected to be. Two companies can have different P/Es because one is expected to grow more rapidly, perhaps by expanding into new markets the other firm considers too risky. Thus we see that the higher the P/E, the higher the risk.

Interestingly, historical analysis reveals that, over time, it has been the lower P/E stocks that have outperformed their riskier counterparts.

I find it useful to flip the P/E upside down, and look at the E/P, earnings to price ratio, or "earnings yield". This is expressed as a percentage, and is now directly comparable to other types of investments, such as the current yield on bonds or Treasury bills. Occasionally, investment opportunities are found when the earnings yield is high relative to the yield on T-bills or Canada bonds.

Sheldon Liberman,
Portfolio Manager

To reach Sheldon send him an e-mail or ring him: sheldon@castlemoore.com 1.416.306.5770



Rolling Dividend Yield of the Dow Jones Industrial Average

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