NOV–DEC 2006

CastleMoore Investment News

Uniquely Superior Portfolio Management

Fed Up, Fed Down

By

Ken Norquay, CMT & Partner

The US Federal Reserve Board ["The Fed"] is the single most influential economic force in the world.
Its mandate is to maintain growth and stability in the biggest economy in the world.

"Fed watchers" are economic analysts who try to forecast various economic trends by interpreting the constantly changing policies of the US Federal Reserve Board. This is what they observed in 2006:

1. The US housing market had become an arena for speculation. Prices were soaring. People were paying record high prices, buying with HUGE mortgages. It was a buying and mortgaging frenzy.
2. The Fed wanted to prevent this speculative housing boom from exploding into a bust. They increased US interest rates 17 times in a row in an attempt to cool things down.
3. Finally the Fed succeeded. [They always succeed.] US house prices are cooling down to more "normal" levels.
4. Spin-off effect. It is very difficult [impossible?] for the Fed to cool off just one segment of the economy. In the economic world, everything is connected to everything else. Now Fed watchers are worried that the stock market might cool off too. And, worse yet, the whole economy might cool off too. [A "too cool" economy is a recession: a "way too cool" economy is a depression.] Note for Canadians: if the US economy cools off, our economy cools off too – in a big way. Their problem is our problem.]
5. In January 2007 the Fed watching economists will be out in full force with their annual forecasts for the New Year. What will the economy do, and what will the stock market do? Some will forecast a "soft landing:" the economy will cool off a little, but will not slip into a recession. Other forecasters will predict a "hard landing:" the economy will cool off a lot and a recession will ensue. Both soft and hard landing forecasters will predict that the economy will recover in 2008, just on time for the presidential election.
6. Then they'll create a forecast for the stock market based on their forecast for the economy.
7. Based on these forecasts, traditional investment managers will decide what percentage of their clients' assets should be in the stock market, the bond market, or in cash.
8. Problem is they are thinking backwards: the stock market is a lead economic indicator. The stock market predicts the economy, not the other way around. And the economy is a lead indicator for Fed policy. The Fed uses economic indicators to decide how it should act. The Fed tries to cool down an over-heated economy and warm up an over-cooled economy.

The Feds: Bernake, US & Dodge, Canada

9. The correct sequence is: [a] the stock market trends up or down. [b] The stock market's trend is a lead economic indicator and can be used to forecast the economy. [c] Economic growth trends up or down. [d] The trend of the economy can be used to predict Fed policy. The key to it all is to have a handle on the direction of the stock market.

That's why CastleMoore manages investments based on the trends of various financial markets, not based on economic forecasts. We're trying to keep the horse before the cart.

For example, the stock market has been going up quite strongly since early July 2006. This can be used to predict that the economy will be reasonably strong this winter and into spring 2007.

If the economy proves to be too strong in this period, we may use that data to predict that the Fed will re-commence its tough money policies and interest rates may rise again.

This is the correct sequence to use when thinking about the economy. If you are running a large company, you may plan on a reasonably strong economy for at least six more months.

But, if you are speculating on real estate prices, or if you sell furniture or household appliances, you had better plan your future differently.

On the other hand, if you are trying to manage your RRSP investments, you won't need all that economic data. Just make sure you have a good handle on the direction of the stock market.

Ken can be reached at:
ken@castlemoore.com
1.416.306.5770 or toll free

Financial Planning, Investment Decisions: Keep Them Separate

By
Robert Sneddon
FCSI, President

Financial planning is certainly a growth business with baby boomers wondering how much dough they'll need for retirement. What's not as obvious is the potential conflict of interest inherent in the relationship with one's financial planner.

Pitfall #1

The conflict comes when financial planning is used as a sales tool for mutual funds or insurance. What I mean by this is that the deficiencies in your financial plan are being addressed by the same person who has done the analysis. The "planner" solves your financial problem by selling you his particular financial product. Though most professional planners are probably decent, educated and hard working, they are simply part of a structure that can be flawed from the get go.

If I am the same person that highlights shortcomings in your plan AND also sells you the solutions, isn't the planning process nothing more than a step that leads the product sale? And commissions on product sales are usually the only way planners get paid. Deficiencies are most often met by increasing one's exposure to equities, be they mutual funds or individual stocks. Purchases of equity funds or stocks pay an advisor/planner the highest trailers and commissions.

Pitfall #2

Another seductive tidbit to be mindful of is "dream-based." This is a common selling technique used by salesman/financial planners when determining what an investor's wealth goals are. Just how much money will you need when you retire? If we succumb to thinking about a too-early retirement or a retirement without a reduction in income and expenditures, we play a role in this distortion. Setting retirement expectations is an entire topic unto itself. Our advice? Be realistic.

One approach to retirement planning is to do something you like doing until they bury you. Instead of imagining how much money you might need, imagine what you'd really like to do. Retirement might mean starting a new job that you do for love, not for money. Well, maybe you could bring home a little income. This approach helps to mitigate the effects of the "dream-based" selling angle. It helps you think of your life first, then your money.

Me? I'd love to be a golf course marshal with a bit of drill sergeant in him. The marshals now-a-days seem like they just drive around the course looking for golf balls instead of moving along the slow pokes.

Another way to avoid conflict is to try and separate the two functions: financial planning and portfolio management. Most accountants can provide a good financial plan. Or, there are professionals solely dedicated to financial planning. Both will charge a flat-fee for their service.

At CastleMoore we have the tools, experience and accreditation create a financial plan for our clients. But we do not market this service on purpose. We prefer our clients to complete the critical financial planning step with their accountant or fee-based planner. That leaves us to portfolio management, plain and simple. No conflict of interest.

Income Trusts: Where to Start?

We rarely talk about individual securities in our newsletters or to our clients.

Its like this because we manage their assets with discretion. This means we pick what securities to buy, how much and when to sell for them. We're hired to make all the moves and let our clients relax.

We don't talk about individual securities in our newsletters because there can be a lot of risk in any individual security. We don't encourage our readers to take risk. And besides, we don't want to known as great stock pickers. Talking about an individual stock doesn't really help investors. It entertains investors.

Having said this, income trusts as subset of the TSX have been whacked pretty hard these past few weeks. They have come under some significant upheaval and price depreciation. To say it's topical is an understatement: many investors were caught off guard by the news that taxation of income trusts was being changed. Thousands of individual investors lost money.

A proper broad look at trusts reveals something useful. If you still own income trust units as you read this article, take your time about deciding whether to keep them or sell out. You or your advisor should do more homework before coming to any terminal decision. Throwing the baby out with the bath water can be regrettable. Too much emotional in making a decision can result in even more loss.

Too much emotion produces too much adrenaline. Adrenaline is that hormone that is squirted into our blood stream when we get excited. It's the "fight," "flight" or "freeze" hormone. In the investment world, "freezing" means doing nothing… hold and hope. "Flight" means you sell without thinking… your critics would say "panic selling." And "fight" means you vote NDP next time…

What income trusts to jettison and what to keep? A good starting

Continued on next page

First Canadian Place
100 King Street West, 37th
Toronto, ON M5X 1C9
www.castlemoore.com

Phone: 1.416.306.5770
Free: 1-877-289.5673
Fax: 1.416.644.8801
E: info@castlemoore.com

"Buy, Hold...And *Know When To Sell*"

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 when making investment decisions.

Our clients are investors that pay particular attention to asset prices, have little tolerance for investment losses, and strong expectations of getting their money's worth. Clients appreciate CastleMoore's all-inclusive, 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 national and international firms and small boutiques provides us the ability to deliver a high quality and cost effective professional portfolio management service. 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. CastleMoore is uniquely superior portfolio management. To know more, including how we gradually and gently transition your existing portfolio to our models please contact us at:

info@castlemoore.com OR 1.877.289.5673

Income Trusts continued

point is to classify your trusts. Are they an Energy, Real Estate (REITs), or Business income trusts? Once you know this you will then be able to properly see how the tax changes affect each type as a category.

For example, when you look at data for REITs on the whole, going back to 1998 the recent events have not violated their long term upward trend in prices. But when you drill deeper there are differences in prices between the residential, commercial, retail and managed care trusts.

On the other hand, energy trusts as a class are in down trends, searching for a bottom. This sector actually began rolling over in May of this year—the fiscal policy change announcement on Halloween was just an extra little push. Again, if you look at the subsets—production, services and infrastructure—the data is not uniform. Some appear to have stabilized and others not yet.

When you look at the "business" trusts, they are all over the map. These trusts represent all the sectors of the whole equity market: financials, utilities and materials etc. Some have broken down and others are merely experiencing a correction within a longer term up trend.

Properly classifying your trust in general terms—energy, REIT or business– is relatively easy. Many investors understand this point already. The next step is to find where your trust falls within the sub sectors of income trusts. Once you are there, you will be able to see some remarkable differences.

Do like we do: keep the ones in up trends, jettison the ones in down trends.

For the record

CastleMoore has never purchased an income trust for our clients. Our clients may own them vicariously through their small percentages in some Exchange Traded Funds [ETF's.] As an industry group, the income trusts have been underperformers for a year. One of our investment principles is to identify those industries and sub-industries that are outperforming the overall stock market. If the overall stock market goes up, say 10 %, we hope our portfolio of out-performers will go up, say 15%. During the past year, the income trusts have gone up less than the overall stock market: they were under-performers for a long time before the recently announced taxation changes.

Robert can be reached at:
robert@castlemoore.com
1.519.635.8723 or toll free
1.877.289.5673

Napoleon Blown-apart

By
Sheldon Liberman,
Portfolio Manager

Imagine being an investor in London, England, on fifteenth of June, 1815. If that date sounds familiar, it should; it was the day that the European forces, led by the Duke of Wellington, defeated France's Napoleon Bonaparte in the Battle of Waterloo.

True Story:

Before the outcome of that battle was announced, investors knew that it would have a profound impact on the values of their "consuls": a victory by Wellington would send the market to unprecedented heights; the plunge would have made cockney flower girls out of duchesses.

This was the thinking as well of a certain investor—let's call him Mr. W.—whose shrewdness as an investor was so well known that others investors would use his actions as the sole bases of their own investment programs.

And Mr. W knew it.

Of course, back then, there was no CNN, and thus pertinent information tended not to be disseminated to all interested parties simultaneously. Thus, the earlier one obtained information, the greater his or her advantage in the business of buying or selling on the London Exchange.

Back to Mr. W.: he actually paid to have trained runners at the battleground, who were then able to deliver the news of Wellington's victory before it became public knowledge. Mr. W had knowledge of the markets inevitable rise before everyone else.

So, of course, he started selling.

Do not adjust your set; I said he started selling.

Mr. W. knew that the other investors were awaiting his cue, and had he started buying, there would have been such a mad rush to consuls that he would not have been able to buy enough at current prices to make his information valuable.

The Consequential Napoleon Bonaparte

When the others saw him sell, there was such a panic on the exchange that Mr. W. was able to accumulate consuls at a fraction of their true values. Of course, when the news of Wellington's victory was reported, the market soared to levels previously envisioned in the victory scenario.

This story may well have been the basis for the film, "Trading Places".

Bad news is sometimes the catalyst for panic, which is usually good news for those who don't.

But lest you think otherwise, let me state that a precipitous drop in the value of a financial asset won't always be a springboard to opportunity either. Now imagine being a wealthy investor in Holland in the 1630s. The hottest investment of the day was—of all things—tulips. Despite having no intrinsic value other than as status symbols, and, possibly, aesthetics, tulips nevertheless became to the subject of rampant speculation at the time. They even began trading on the Amsterdam Stock Exchange (which is why I grudgingly call them "financial" assets).

Unfortunately for the speculators, Dutch courts came to view the craze as a form of gambling, and would not enforce contracts in which the delivery of tulips was a term. This was a major factor in the demise of the tulips craze, leaving some with losses as high as $30,000 per tulip in today's dollars. These prices were not about to rebound, since there was no underlying value to them.

A panic sell of stocks can be viewed as a transfer of ownership in millions of shares from speculators to investors, the latter group driven by the knowledge that stock will always make new highs sooner or later. This is an important point to consider in the aftermaths of such events.

Sheldon can be reached at:
sheldon@castlemoore.com
1.416.306.5770 or toll free
1.877.289.5673