MAY–JUN 2007

CASTLEMOORE INVESTMENT NEWS

Uniquely Superior Portfolio Management

Going Looney for the Loonie

By
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Every once in a while, we get to see a classic: all the forces come together in a "text-book" example and we get to test our theories. The chart of the Canadian Dollar has given us just such a chance.

For the last 4 months, the CD$ has been "on a tear." It has risen from about 84 cents US to about 94 cents US. And this week [May 28 to June 1], it has added over 2 cents! 12% in four months!

This spectacular surge has drawn out all the bulls. It seem that almost all of the most prestigious analysts and economists in Canada are calling to parody with the US$ this year. If the short term up trend continues at the same pace, PAR will be achieved by mid-July!

But, what about the US$: what do investors think about its prospects for the future? Well, if we read foreign investment research, we find an almost unanimous consensus that the US$ is heading lower. Most believe that the US$ is going down against the Japanese Yen and the Euro. And they offer this opinion even though the US$ is so low that during the past 15 years, it has always risen when it got this low. [We market technicians call this "support." The US$ is "at support."]

So, what about this "classic" event we mentioned… what is "classic" about the current price trend of the CD$?

<u>On the other hand…</u>
The theory of contrary opinion is a classic theory that states: "Price trend will reverse when the majority of investors believe it will continue." Let's look at what the majority of investors might be thinking about the prospects for the CD$ these day.

The bulls are out in full force, and they are right. The Canadian dollar is in a roaring up trend. Artificially high demand is coming because of the spate of takeovers of Canadian companies by foreign investors. When foreigners spend billions of Canadian dollars to buy companies like BCE, Alcan or Stelco, they convert their foreign currency into CD$ for the purchase. Add these forces to the normal mix of international trade, and you will see an extra, non-reoccurring event that is, perhaps, pushing the CD$ a little higher than normal right now. Imagine being part of a foreign consortium who wants to buy some Canadian company for $50 billion CD. The CD$ went up over 2% last week alone. What's 2% X $50 Billion? So, by converting your US$ to CD$ a week late, you will pay an extra $1 Billion US. That's the kind of pressure the market is feeling right now.

Which way will the Loonie blow?

<u>There's a time for every season…</u>
Add to that, the normal seasonal factors that have affected the price of CD$ in the past. Normally, CD$ is strongest between February and June. Normally the price action is "mixed" between July and October, and weak between November and January. In 2007, the normal season of strength for CD$ was juiced even more by a serious rash of take over bids from foreign investors. So much so that the price seems to be going straight up!

Based on these two factors, [seasonality and contrarianism], we offer the following possibility: the Canadian dollar will likely reverse this month, June 2007, from an up trend to a down trend. The price will fluctuate dramatically over the summer with no real progress. Then it will swing into a down trend in the fall through to winter 2008.

If I were an economist who made investment decisions based on their forecasts, my forecast would be that CD$ is going back down to 84 cents US, the exact opposite of what most current forecasts predict.

<u>Can we both be right?</u>
Can the CD$ reach par in 2007 AND be at 84 cents by mid winter? It certainly can! CD$ can hit par this month, in a blaze of speculation.

<u>Now what?</u>
At CastleMoore, we do not rely of forecasts to manage our clients investments. We rely on mathematical economic models. Right now, our US$ model is positive AND our CD$ model is positive. We are maintaining a balance between the two. And we will adjust that balance if/as/when our CD$ model turns negative.

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Prices Don't Lie...

By
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"Prices don't lie!" she stated confidently while scanning the large room, seemingly to see who might raise a challenge or to maybe just to see who really looked confused. They were the first words out of her mouth.

Huh? *Prices don't lie* I thought to myself? What the hell? I just paid $350 to attend a professional financial conference and one of the keynote speakers opens up her lecture with this bunk?

I was in the first row. I'm not sure if she pencilled me in as one of the bewildered, but I was thinking "yeah prices do lie"—like the price I paid for this conference.

Unknown to me, the woman was Linda Raschke, a well-regarded and very successful US-based equity options specialist. She's lectured all over the world to a plethora of institutions, companies, societies and governments. She knows the markets.

Those words then, and today, still echo in my mind. She was right. Prices don't lie—they are the only thing in the investment business that's not nuanced. They are what they are. The price a market or security closes at is the sum of the aggregate perception of it. Participants buy and sell things at what they think they should be worth.

I ultimately realised this truth - that prices don't lie— and that I needed to add in price analysis to the management of my clients' accounts from a particular situation. When I was a broker at RBC, I called our technology analyst to ask what was up with Nortel. It was 1999 and the stock, which still had a $140 target, was dropping like a stone—$90, then $80, then $60. Crap!

We weren't supposed to talk to analysts. Access to them was strictly reserved for the institutional crowd. They were not there for me or my clients, but advisors use their research reports to make investment decisions. They are the same reports all retail brokerage clients get. Breaking that rule never bothered me. I gladly took the flack I got from management for scrapping for my clients.

What I didn't like was the answer he gave me. "Look, I don't know what to tell you. I don't follow the stock much." "Really?" I said with chagrin. I thanked him for the time and ended the call.
Fortunately, I can only think of one

What fundamentally changed from the left side of the peak to the right? For sure the price did.

client for whom I bought Nortel. I still don't know what Nortel really does. I used to see the name on my telephone, but I can't point to their product in my everyday life. Switches or something? Fibre optics as well?

I did have quite a number of clients who got Nortel as a freebie for owning BCE. This is why I called the analyst. Most were retired or close to retirement: I needed to figure out if I should sell or hold. The cost base was around $7 or twice what the price it is today! True to his craft the analyst was only doing what he was trained to do—follow companies, not the stock prices of those companies.

While teaching the Canadian Securities Course this past fall, an experience that is a great refresher for me, I came across this definition of fundamental analysis: "Fundamental analysis means studying everything and anything other than the trading on securities markets in order to determine how securities' prices will change" (CSI 8-1)

The next page had the definition for technical or supply and demand analysis: "It's the study of historical stock prices and stock market behaviour to identify recurring patterns in the data...the study of price movements, trading volumes, and data on the number of rising and falling stock issues over time." (CSI 8-2)

The traditional or fundamental approach is the underpinnings of the vast structure that are the capital markets. It fuels the investment banking relationships, the regular research recommendations, and, of course, the advice from advisors. It's the stuff of Bay Street lunches. You've heard me or Ken say this before: they tell great stories. Price analysis, on the other hand, doesn't. And because the analysis is so clinical, no one asks the price analyst out to Canoe for a 'chi chi' snack. It's like dealing with a statistician. They just give you the bare, raw facts. The data is the data.

Having some regard for each of fundamental, price and even, seasonality (yes there is a further sub division that sees regularity in the calendar) broadens out the resources available to managers. At CastleMoore we

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Prices continued

bring all three into the mix. The price action is the final arbiter— the truth.

Fundamentals tell us what consensus is, what everyone is thinking, prices tell us what investors have actually done based on their thinking, and seasonality shows when they typically act within a 365 day period.

So the staggering drop in Nortel in and of itself meant nothing to our analyst, or to be fair, most analysts. They weren't wired to see any truth from price, when, indeed, price was trying to tell us something. The problem, unfortunately, is that as humans we need answers to events.

A good buddy of mine and I go through this dance off and on. "Hey Hap (my nickname), I don't understand why this went down. What do you think?" "Well, I'm not sure, the fundamental story is good, right? ".

In the end, it always comes down to investor perception. For example, how can investors accept high valuations at times, comfortable in substantiating further increases, but then turn full circle in a matter of weeks or days, claiming that things aren't so rosy? Yes fundamental elements change, and they do turn, but not on a dime. As humans, full of emotion, only we can do that.

A great benefit to using price analysis is that it more readily lends itself to working with "models". Based on your parameters you can dry-run your ideas to see how well they work. Moreover, you can see how often the transactions are unprofitable and what these unprofitable transactions cost.

Our CastleMoore models sometimes generate transactions that lose money; when we lose, it's usually only 5-6%. We learned a big lesson from Nortel.

We get much comfort from knowing that some of our models are back-tested over 40 years! All our models significantly outperform the buy and hold approach. And, the most important component of our models is price.

Prices don't lie.

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CastleMoore Inc.
Uniquely Superior Portfolio Management

Notes From the Trader's Forum

By
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It had been quite awhile since I had attended an industry gathering of equity traders. The sponsor had billed it in advance as a conference for trader *and* portfolio managers. The latter part was evidently the result of some license on their part, but it was still worthwhile to check out the latest developments in this area which is crucial to the efficient function of the portfolio manager.

My first reaction, having stepped in into the conference from the street was that I had walked into a cliché: almost every trader in attendance had a Blackberry in front of him or her. In the art of trading, one's success rests not so much in what information is received but by the speed at which it is received. Presumably, if the CEO of a publicly-traded company were to stumble, the information would be on some trader's Blackberry before he hit the ground. If the CEO were to sneeze, he would be reading the word "Gesundheit" on his Blackberry before hearing it from someone in his presence.

I admit to being an owner of a Blackberry myself (as well as having its manufacturer, Research in Motion", in one of my model portfolios) but that day it remain firmly in its holster, as if I knew how to get it out.

The institutional trader is, in certain respects, an extension of the portfolio manager; he or she works to insure that the PM's desire to accumulate or shed investment positions is done efficiently, discretely, and with minimal market impact.

By way of illustration, assume you were a small investor, and your investment portfolio contained, among other things, 100 shares of Microsoft. Assume further that you just installed Windows "Vista" on your computer and you're ready to try it out. You're initial reaction might be, "{colourful expletive}…this is what Microsoft's future is resting on? I'd better call my broker and sell these shares!"

Now, if you were to take out an ad on a billboard on the Hollywood Freeway announcing your mere intention of selling 100 shares of Microsoft, nobody seeing it would give it a second thought, other than to wonder what kind of mishuginah would do such a thing (don't ask me how I know this).

On the other hand, if you were the manager of a mutual fund or a pension account, and had to sell, say, 10 million shares of Microsoft, that would be an entirely different matter. You would not simply call your broker with an order to sell 100 million shares. Were you to do so, you might well eat right through the entire floor market order book and then some, and would impact market price so severely that you would damage your client's interest, not to mention the interests of any investor with Microsoft in their portfolio. You might also have a host of other portfolio managers lining up for the opportunity to tar and feather you (again, don't ask me how I know this).
Nowhere do the economic principle of supply and demand work as effectively as they do in capital markets.

The job of the trader, therefore, would be to execute your large order with minimal price impact, typically by trying to find other investors wish to buy large quantities of what the PM is trying to sell. He or she might alternatively try to find investors willing to buy large quantities of a stock at a price slightly discounted from the current market price.

Of course, confidentiality is of paramount importance. Should the "market" figure out who is doing the selling, it would also likely be able to figure out how many shares are coming available, and bids would take a turn for the worse.

These days, much of institutional trading is done via "dark liquidity pools," an electronic, generally internet-based platform designed to match buyers with sellers, and you need to have certain credentials as an investor, trader, or portfolio manager to participate. The "dark" aspect of it refers to the fact that no participant knows who the other participants are, or how many shares any participant wishes to buy or sell in addition to that which is being shown on the system. That information just isn't made available, even on your Blackberry.

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