CastleMoore Investment News

Uniquely Superior Portfolio Management

Market Psychology: Challenges of CastleMoore's Contrarian Style

By

Ken Norquay CMT, Partner

The stock market is not solely about good news or bad news. It's really about the *context* of the news. Sometimes, bad news can be good. Let's review the first quarter of 2008.

The New York stock exchange had peaked in mid-autumn 2007. In January 2008 the sell off started in earnest.

And there was good reason to sell. First there was the US Junk Mortgage problem. Millions of Americans could no longer afford the mortgages on their houses, banks were foreclosing and home prices were falling. Banks were in trouble all over the world. Was the banking system at risk because of this messy mortgage mega-problem?

As if that were not enough, a prestigious Merrill Lynch economist was forecasting a recession. Before long, a chorus of economists were all singing the same song: negative growth for the first two quarters of 2008; the mortgage problem had spread to the economy.

These events threw big money investment managers into a serious tizzy. Having ushered in the year 2008 with their portfolios significantly over-weighted in bank stocks, now they were all rushing for the exit. The Dow Jones Industrials dropped over 11% in three weeks. Investors were scared. The Federal Reserve Board took dramatic action by lowering interest rates several times.

Then there was a sharp stock market reversal on January 22 and an immediate bounce straight back up in what we market technicians call a *spike reversal* or *selling climax*. Volume of trading was very high and volatility was exceptional.

Selling climaxes are bullish because they indicate a reversal of supply. Usually a selling climax is followed by a so-called "test" in which the stock market drops back down to the low prices of the selling climax.

Then it starts to go up again and a new bull market has begun.

The test happened on St. Patrick's Day. The brokerage firm Bear Sterns was in trouble with its stock having dropped from over $163 a share to under $3 a share in only 14 months and from $80 a share to $3 in three weeks! The "serious tizzy" of January had become even more serious. Economists' forecasts of a recession were being backed by hard data such as automotive industry layoffs and declining consumer confidence. Those who were worried in January were right! The economic reality of March was even worse than the economic reality of January.

In the context of all this bad news, the market rallied again and by early May the stock market averages had chugged their way back to the bounce levels of early February. The test had been successful. Did this mean that the new bull market had begun? Let's see if there is a logical explanation for this seemingly illogical phenomenon. Why would the stock market rise when the economy got even worse?

Look for a discrepancy between investors' moods and attitudes and stock prices. When the actual prices of stocks do not match the mood and attitude of investors, we have what's called a *divergence*.

In January, stock prices went down dramatically and investor mood became sceptical so the two were in *harmony.* Stock prices and psychological indicators were more or less in line. In March, however, investor mood became even more sceptical as investors were seriously concerned about the US economy, the housing crisis and a wide variety of deteriorating economic statistics.

But stock market prices did not deteriorate. The averages held at more or less the same levels as the January lows. The mood of big money investors had deteriorated but the stock market had not, thus creating the *divergence* we were looking for. This is what happens at stock market bottoms.

- Ken

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The Big Picture: Some Great Summer Reading

By
Robert "Hap" Sneddon
FCSI, President

I don't read the business section that often. By and large, to me, most of the news reported isn't useful in making investment decisions or charting a course. It can help one sense the flavour-de-jour or investor sentiment: What are the masses reading? What are they thinking? What is the theme the papers are running with? In fact, the business section alone can often parade as an investment strategy when it should be read as a topical side bar to one's game plan. Let me briefly explain.

As many readers can attest themselves, more reading can get done when flying. It's an opportunity to have some undivided time. On a recent trip to see an institutional client in Montréal, I took the household paper, a rare event as I usually leave it for my wife. Shemakes me read the horoscopes when it's a good one as we're the same sign. I do like sports, editorials, letters and op ed's. It was a short flight so a book was out. It was me and the paper.

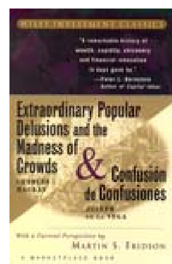
Well I came to the business section and read it front to back, excluding the pages of security prices. Some articles were useful but more so on a corporate, not investment level. For example, I read about things that may improve our client service or help sharpen some of our processes. But my reading about this stuff doesn't matter to our clients or readers.

Mid way through I came upon two articles that were back-to-back on sequential pages. They advanced opposite points. One talked about more pain to come for global markets, as more credit/mortgage related write-down's – the real numbers – came out. The next talked about the great value today in the financial sectors. Hunh? They can both be true, but "value" may become even more valuable still.

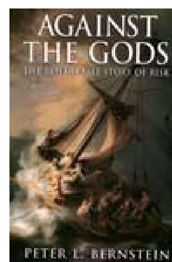
I believe that entertaining diverse views is necessary for a healthy "economic ego". But often investors expect to glean themes in papers from which to profit from. This scenario reveals the possibility that papers aid investor curve-fitting. That is, searching out the story that validates their own intentions and disregarding the rest. The business section should be read through an objective lens to gauge investor sentiment after you or your counsellor, in the cold clear light of dawn, as we like to say, has considered an investment thesis from which a plan is built.

Holding a secular or generational view on about where we are financially takes time to develop and cannot be accomplished by reading page B1-B9. In addition, developing a thesis is an on-going process that evolves and adjusts. The point is to develop a general methodology which then operates in the real world on a monthly or annual basis.

Here are two books that allow investors to pull up and away from the daily noise of life in 2008.



Madness of Crowds **(Mackay, 1841)** tells the story of schemers, alchemists, crusaders, duellers et al through modern history, and how they turned something small and bad into something large and bad. It "shows how easily the masses have been led astray", particularly when money and wealth are involved.



Against the Gods **(Bernstein, 1996)** uncovers why humanity which has possessed complex math skills for thousands of years did not understand risk until people wrestled it away from "the choke hold of superstition and fatalism." Until Leonardo Pisano, better known as Fibonacci, answered the Marquis' riddle, man had let religious figures answer all questions about tomorrow, including profit.

Whether one is developing some serious perspective or just passing the time on a hammock this summer, these two books are excellent reads. There are many more great books out there that will assist investors in formulating an investment thesis or bearing whilst providing a newspaper defence.

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

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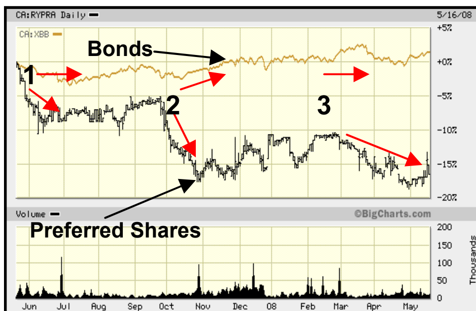
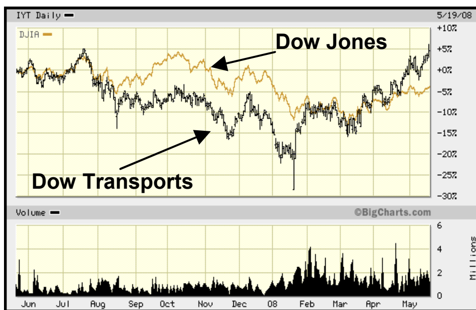
Canaries in the Coal Mine — Life In the Markets

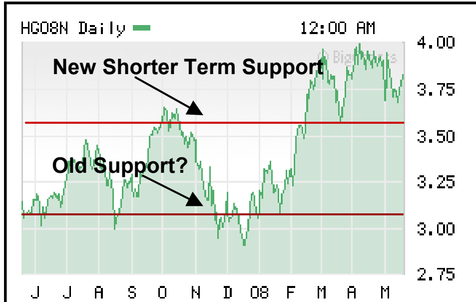
Because of continued market volatility and speculation this section, initially introduced as a "one-off", will carry on indefinitely in our attempts to monitor key signals about the nature of security prices and the economy they reflect. These little birdies and others to come tell us what's going on in the deep.



BONDS/PREFERRED SHARES: Since the divergence was first tracked a year ago it has undergone two more "legs" of separation, the third starting in early March. These roughly correspond to news about more credit/mortgage problems. Because preferreds are issued by companies, often without specific collateralization or accumulative features, the continuing divergence still tells us that large institutional investors are worried about repayment and/or the future direction of interest rates. Year-over-year broad bonds made 2%; preffereds lost 15%. Most preferreds are financial issuers.



DOW THEORY: Today this Canary looks healthy. The transports did diverge from the Dow last summer, but then the two tracked in tandem until March. In March the transports broke away from the Dow possibly confirming that the general business conditions (with exception of the financial sector-see above) are not too bad. If things are okay then goods made must get moved by the transports.



COPPER PRICES: Copper gave a scare at the end of December but beyond the "new normal" volatility we now live with day-in, day-out not much to say again. The longer we stay above the $3.50 range the less the old line at $3.00 matters. If we start to fall below the new support the China/India story—infrastructure and technology— may have some challenges. All-in-all this bird's doing okay too.

-Hap

My Choice of Careers

By
Sheldon Liberman
Portfolio Manager

They say that a man is known by the company he keeps. A portfolio manager is known for the compan***ies*** he keeps.

Being a Portfolio Manager is, for the most part, a satisfying occupation. Very few professionals give their clients back more money than was originally given them.

Of course there are challenges: managing the life-savings of others can be stressful (see chart). At our shop, we deal with it in several ways. I write. Two guys in our shop practice karate. We seem to make out all right.

The other challenge in our business is to force smiles on our faces, politely nodding while chatting with people who have convinced themselves that they are better at our jobs than we are. I often hear from people who doubled their money on this stock or that. That happens frequently during bull markets.

I hear less frequently from those who sold just before the downturn.

A few weeks ago I went to hear a rabbi lecture on the spiritual dimension of having, and not having, wealth. And he would know. As retirement age approached, and the need for a larger nest egg was felt, he decided to invest his savings in the stock market.

This was during the internet investment frenzy. He took $30,000 and turned into—I'm not making this up—$7 million. And then he lost it all! (and I very rarely use exclamation points).

Now, this particular rabbi is quite well known, has authored many books and articles, and is often asked to lecture in front of gatherings of CEOs of Fortune 500 companies. We were told, in fact, at one such gathering, upon revealing how he made, then lost a fortune, he was ask to give only the first half on the lecture. This was

obviously said tongue-in-cheek; the real lesson would have been in the second half. I would agree.

Two related points can be derived from this story: 1) that when things are good the tendency is to assume that they always will be, and vice versa, and 2) "sell" is not a four letter word. (yeah, I know, but I've never been a great speler).

The ability to internalize these concepts is what, among other things, separates the portfolio manager from the amateur investor.

Other jobs I've had (or tried to get) before this one:

I got a job at Pepsi, but was fired after my company physical. My blood test turned up traces of Coke.

I got a job in a library, but was quietly asked to leave.

I was once hired to bake bread. Before long I was toast.

I got a job at a company that makes calendars, but before long I realized that my days were numbered.

I once taught history in school. Alas, there was no future in it.

I interviewed for a job at an accounting firm. I tried to explain what an asset I'd be to the firm, but he could only see my lie-ability.

I applied for a job in a funeral home. They told me that hiring me would be too risky an undertaking.

I tried my hand at acting. My first audition was for the role of Hamlet. It was not to be.

I was hired to assemble luggage, but I couldn't get a handle on it, so they sent me packing.

Then I tried photography. Nothing developed.

After that I tried giving massages. People told me I rubbed them the wrong way.

-Shel

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