CastleMoore News

Buy, Hold... *and* Know When to Sell™

FINANCIAL MORALITY

By Ken Norquay, CMT, Partner

"Love of money is the root of all evil."

When we think of good and evil in investing, we usually think of whether we make money or lose money. Making money is good: losing is bad. In the investing world, good and evil are defined in dollars and cents.

But that's not what our opening quotation says. Its author seems to think a different definition would serve us all better. Here's what I mean:

I talked to a mutual funds salesman / financial planner last week. He has become a fan of CastleMoore because of the way we manage investments by avoiding financial down trends. During the conversation, he revealed a very disturbing idea about the love of money. He told me that if he had switched his clients from stock mutual funds [fully exposed to the stock market] to money market mutual funds [cash equivalent], his personal income would have dropped from $100,000 per year to $25,000. If he had switched from stocks to bonds, his income would have dropped to $50,000. In addition to the initial commission they receive, mutual funds salesmen / financial planners are paid a "service fee" by the mutual funds companies: their goal is to keep their clients invested in stock mutual funds, and they are paid handsomely for doing so. This is how the mutual funds business is structured. And this is why that mutual funds salesman / financial planner wanted to talk to me.

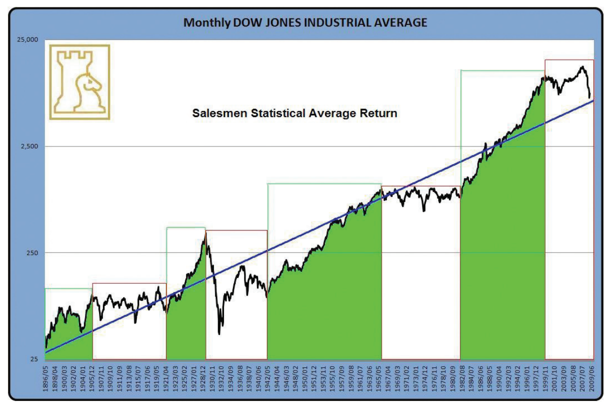
He is a moral person who wants to do the right thing. He wants to help his clients be financially better off because of their relationship with him. He is a good man.

But when he pondered his contribution to his clients' financial success, he realized that he was acting irresponsibly toward them. He realized that by continuing to recite the mantra "don't sell," he had done serious financial harm to those who trusted him. And, because of this, he felt deep doubt about the way he earns a living.

After chatting with him for a while, I began to see what his problem was. He was almost ten years behind the times.

This chart shows the Dow Jones total return index for the past 100 years. This is the study that mutual funds salesmen / financial planners use when they tell you the stock market has had a rate of return of almost 10% over the long term.

At CastleMoore we have drilled down into the numbers. We have discovered that there are long periods when the market performs much better than the 9.8% average and other long periods when the market performs much worse. On the chart we have coloured the "much worse" periods in pink. As you can see, the markets shifted from white to pink in the year 2000.



In the 'white periods,' buy-and-hold works just fine. In the pink periods, buy-and-hold does not work. When he started in the investment business in the 1990s, he and his clients were in harmony with the long- term trend of the stock market. For the past 9 years, he has been out of sync with the realities of the stock market. His dilemma is not at all a moral dilemma: it's a strategic dilemma.

In the pink periods, successful investing involves both buying AND selling, not just buying.

Once he realized this fact, his problem became even worse. He realized that the whole investment industry, dominated by banks, insurance companies and mutual fund companies, had all become entrenched in the "buy only" approach. Today's investors have no choice. There are no mutual funds that use buying AND selling as a strategy. Only buying.

This was not always the case. During the 1966 to 1982 pink under-performance period, John Templeton used to advertise that the Templeton Growth Fund shopped the world for unrecognized value. They would buy these stocks with a view to holding them for three or four years until the value was fully recognized. Mr. Templeton's approach involved both buying and selling, not just buying. During the 1966 to 1982 pink period, his mutual funds made good gains.

CastleMoore is entering the mutual funds business. We will buy AND sell. We hope to do as well as Mr. Templeton did in his difficult time in the 1960s and 70s. We hope to offer an alternative to today's "buy only" mutual funds. It's not about good or evil: it's about having a choice.

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VOLUME AND MARKET TREND CHANGES

By Robert 'Hap' Sneddon, FCSI, President

"It would be a mistake to assume that most changes in trend are very abrupt affairs. The fact is that important changes in trend usually require a period of transition. The problem is that these periods of transition do not always signal a trend reversal. Sometimes these sideways periods just indicate a pause or consolidation in the existing trend after which the original trend is resumed" (John Murphy, Technical Analysis of the Financial Markets, 1985)

"Volume reflects the intensity of change in investor attitudes. For example, if stock prices advance on low volume, the enthusiasm implied from the price is not nearly as strong as that present when a price rise is accompanied by very high volume" (Martin Pring, Technical Analysis Explained, 1985)

"Volume should expand or increase in the direction of the major trend" (Charles Dow, C.A Nelson, The Wall Street Journal 1903)

Lately, much time has been spent by investors and the media trying figuring out just what has been going on out there in the capital markets. Stocks have been on a 6 week ascent. There is talk of economic "green shoots"; the pace of the decline of some negative indicators is slowing a bit. Today, in late April, the compulsion to be in the markets is very strong, when only 7 weeks ago the exact opposite was true.

Can things change this quickly? Do markets turn on a dime? What can we glean about the state of the markets from price and volume, particularly over the last six months?

As Murphy who is one of the canonical technical analysis writers, explains change in trend is usually a long, gnashing, bubbly affair. There can be many fits and starts, and usually, the longer the set up the more pronounced the subsequent move is.

The up moves in the S&P have been on declining volume; the down on rising volume

If we look at the chart above of the S&P over the last few years we can readily see that volume has been picking up on price declines and receding on price advances. The current advance (approximately 25% from the March lows) has been accompanied by very bullish investor sentiment. Sentiment, which can be composed of many different factors, is best distilled as an expectation indicator. That is to say, based on what action investors have taken or how they think they are expectantly bullish. If you make a purchase you are bullish and see things that way.

While it's true that I am suspicious of this recent short term move because there has been light volume it does not mean that we are not preparing the slate for another bull market move. This sideways move since October in one way or another is the set up for the next market move. If its new secular bull market we need confirmation.

We have to pass some fundamental hurdles such as the US bank "stress test", bank balance sheet deleveraging (which could take some time) and improving economic indicators, particularly those offered by the US Conference Board (due next May 14th), but these too can be monitored for improvement, thereby increasing the conviction.

If we pull back a bit on the chart above and look at volume from September 2008 to March 2009 in aggregate the volume has been relatively high while the price was trying to find support. Though we need accompanying upside volume on a break out to give an investible (intermediate term) move some legs, the turning and gnashing or sideways pattern in the market during this period is in fact a way station. The question is, is it a resumption of the downtrend or the beginning of a new bull market.

Fighting the greed imperative to be in these markets here, right now is important. However things change for the better, if and when they do, they won't go straight up. Patience today is still the most important thing we have and it gives investors the advantage.

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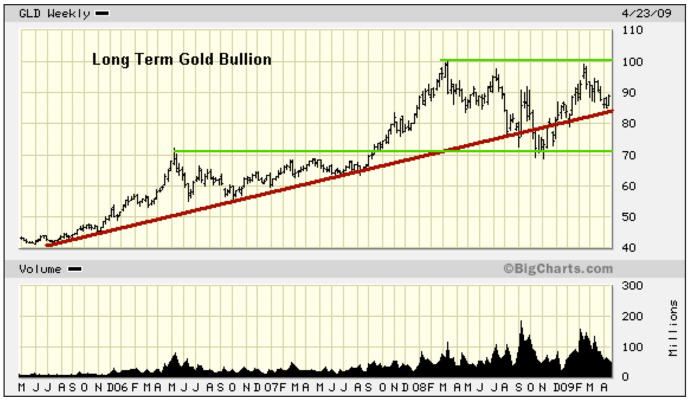
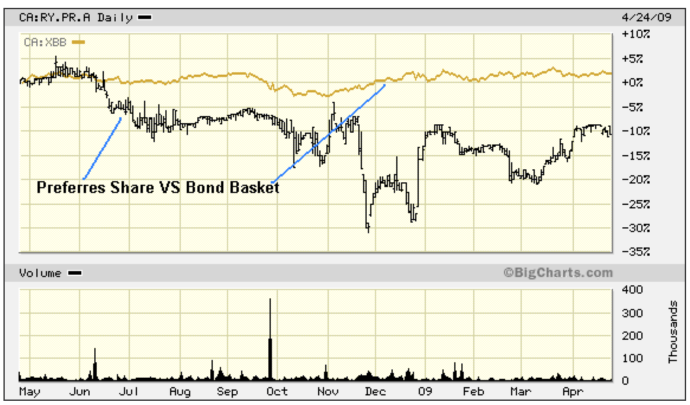
THE CHART PAGE

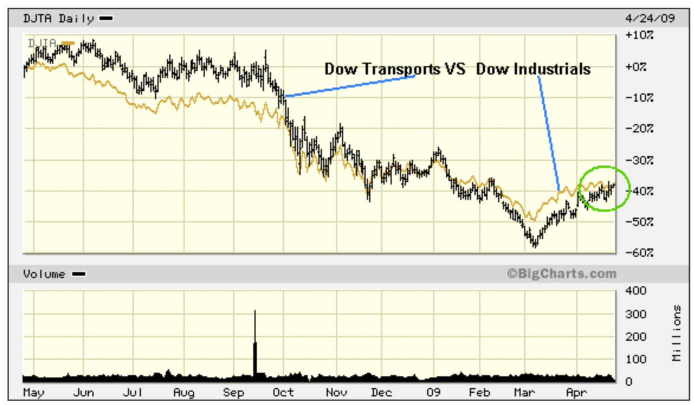


Gold is in a volatile but long term trend. It briefly touched just under \$1000US/oz later in February, and has since tracked the market upside move. We booked decent profits and will reacquire in the mid \$700 range (low green support line) or should it break out above the formidable resistance at \$1000 (upper green resistance line). Gold bull sentiment is very high.

Like Gold, US 20 YR US Treasury bonds are in an up-trend, albeit an up-trend that is being put to the test here in late April. Bond bearish sentiment is extremely high as is the short-interest ratio. Together, the two suggest a spring-like powerful up move should is possible if sentiment begins to reverse and short investors are forced to cover.

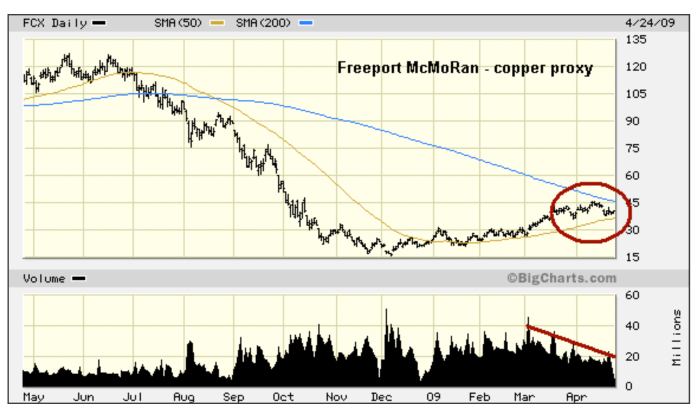


The relationship between preferreds (a bank-issued is shown to represent the group) and the bond basket has improved, with the preferred regaining lost price since early March. The relationship reveals investor confidence in corporate dividends vs income from debt securities. Like corporate bonds, preferred share securities are generally still in a downtrend.



The relationship between the producers of goods (Industrials) and the transporter of goods (Transports) has improved in the last month and a half (green circle highlight). This would be an encouraging development if the trend continues. The Dow Theory is an indicator that reveals the overall health of the economy. If things are improving the Transports will lead the Industrials.

Freeport McMoRan is a good proxy for materials, and copper in particular. In fact, the chart of copper and Freeport are identical. While we have a seen a good pick up in price of the basics building blocks of the economy, the move must be confirmed by a substantial pick up in volume which has been declining and a push through overhead resistance, in this case around \$45.50.



CHANGE

By Sheldon Liberman, Portfolio Manager

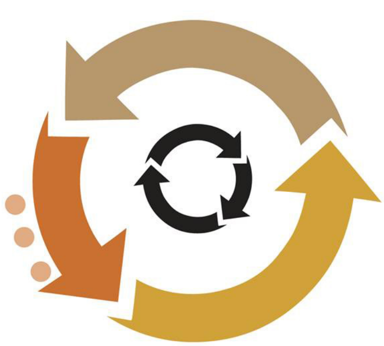
Progress is impossible without change, and those who cannot change their minds cannot change anything. (George Bernard Shaw)

Action and reaction, ebb and flow, trial and error, change – this is the rhythm of living. Out of our over-confidence, fear; out of our fear, clearer vision, fresh hope. And out of hope, progress. (Bruce Barton)

Change is inevitable – except from a vending machine.
(Robert C. Gallagher)

I was having a conversation with a friend the other day – this a person who is also 90% out of the stock market, though not yet a client of ours – and he remarked how cheap the market seemed to be currently. The example he gave was that of GE. Who would have thought that it would ever be selling at under $10 a share? I replied that it would likely have been the same people who couldn't accept that Citibank would sell for under $2.00, which, of course, it does as I write this. In fact, it touched 97 cents.

The last time Citi traded over $10/share was November 11th, and people who bought it then must have thought the same way my friend did: how cheap can it get. Well, now we know.



Citibank and General Electric are cases in point of a much broader phenomenon. GE was not too long ago the largest corporation in the world by market cap. Its share price indicates that many shareholders were left in the dark. Citi was the largest U.S. financial institution.

By extension, GM was for many years the biggest company in the world by sales, and what's good for General Motors may no longer be what's good for America. Once the country's largest investment bank, Merrill was Lynched and is now neatly tucked into a corner of Bank of America. And Wal-mart, the nations largest retailer, has seen its shares get cheap enough, well, to be sold at Wal-mart.

And then there's Nortel, which once represented almost a third of Canada's most important stock index. Imagine if it still did.

The point is that investors, or their advisors, who were unable to discern change in the system itself were likely the one's buying shares at systemically low prices in anticipation of immediate revisions to the norm. A stock that historically trades at 15 times earnings and that can be had at 10 times is considered a bargain. It will never trade at 7 times.

Many investors who thought this way are now clients of ours, having previously been ill-advised to remain in the markets or even to average down into it. These actions may well be vindicated in the long run, but I increasingly find that the long run is not a viable time horizon for many investors.

Truthfully, I myself might have been one of those portfolio managers who would have tried to buy stock at cheap levels last summer, before they became much cheaper, were I not open to change. I started out in the investment management side of the business by working for a manager who built up an enviable reputation as a value manager (not that I condone envy). I therefore started out as an independent investment manager with a bias towards value investing. It served me well – for a while. I never stopped believing in the concept of continuing education, however, and the continuation of mine led me into the exploration of the technical side of market analysis. My willingness to grow as a manager, to be adaptive in my thinking, is one of the reasons I write to you today as a Portfolio Manager for CastleMoore Inc.

No, I haven't abandoned a belief in value. Call me to discuss.

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DIVERSIFICATION WORKS BEST IF INVESTORS HAVE 40 YEAR TIME HORIZON

Modern Portfolio theory is based on diversification of one's assets across the major asset classes of cash, bonds and equities. It is a "a theory on how risk-averse investors can construct portfolios to optimize or maximize expected return based on a given level of market risk, emphasizing that risk is an inherent part of higher reward.

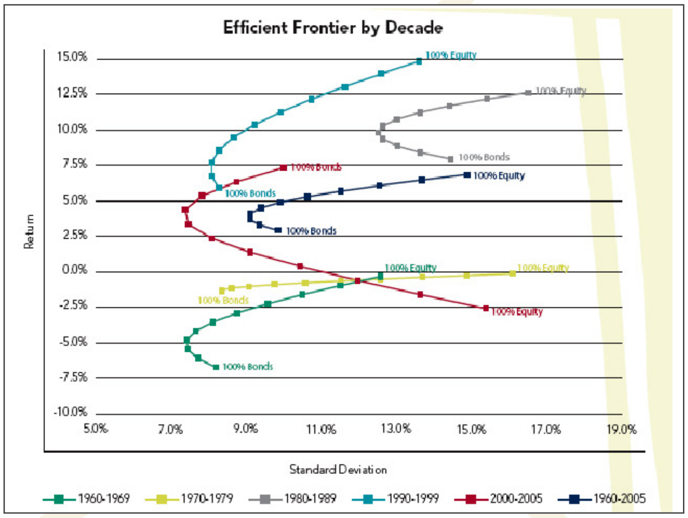
"According to the theory, it's possible to construct an "efficient frontier" of optimal portfolios offering the maximum possible expected return for a given level of risk. This theory was pioneered by Harry Markowitz in his paper "Portfolio Selection," published in 1952 by the Journal of Finance. " (Investopedia, 2009)

The challenge with this strategy employed by pension funds, large institutions and balanced mutual funds for their clients, the average conservative to moderate investor, is that the theory requires 43 years to be true. Meaning a diversified portfolio will produce superior returns onl;u if subject to a 43 year time period.

The dark blue curve in the chart is the ideal efficient frontier. It plots portfolios from 100% bonds at the very conservative end to 100% equities at the most aggressive end and every combination in between, the middle being an equal balance of both. The vertical access measures return potential. The horizontal access measures how much a portfolio fluctuates or its volatility. Ideally you would like to capture the highest return for the lowest amount of assumed risk.

Now look at the other curves and the time span they represent. For those periods the mix of asset classes that was most rewarding dramatically changed. For example if you look at the red curve, 2000-2005, the most profitable portfolio was 100% bonds despite have a much lower volatility level that equities. It actually inverted the optimal efficient frontier curve. Investors took on too much risk for the return potential

The point is that the typical diversified portfolio can be very disappointing and unrewarding to investors. Unless you have 40 years to pass through the whole cycle investors had better be focussing on the asset classes will reward them.



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**

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