CastleMoore News

Buy, Hold... *and* Know When to Sell™

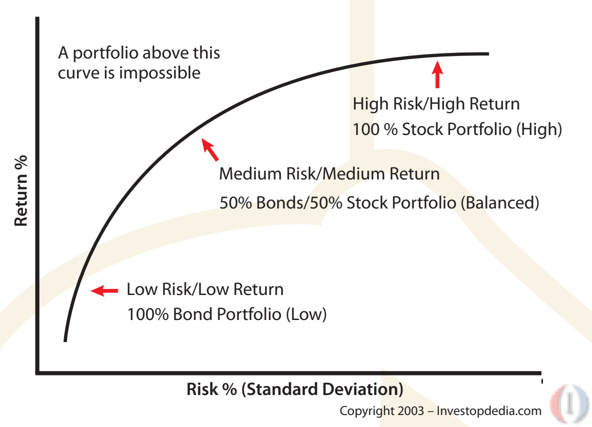
WHAT DOES BUY AND HOLD TRULY MEAN?

By Robert 'Hap' Sneddon, FCSI, President

The March-April newsletter was closed out with a brief synopsis of a complex topic: Modern Portfolio Theory and specifically how it actually has faired over a long study based on the data. The mea culpa here is that the subject really needs more attention than a half page affords. After all, the "buy and hold" approach is the conventional investment methodology, the methodology used by most investors through their defined benefit pension plans, advisory relationships with large financial institutions and most mutual funds they hold.

To begin filling in the discussion on the topic, first, let's define and understand the principles behind Modern Portfolio Theory (MPT), examine again in more detail how it has worked in the past, and last, examine why it may not be the best strategy for today's investment climate.

Modern Portfolio Theory was a put forth by Harry Markowitz back in the mid 1950's in the Journal of Finance. The theory addresses inherent investment risk through the diversification of a portfolio across sectors and or across asset classes. Any one security alone is risky. When you put several together you reduce the risk. If one security performs less than the average return expected of it, you have others to pull up the slack the theory goes. The graph shown to the right is a visualisation of risk vs. return expectations from a properly diversified portfolio, whether 100% bonds, a balanced mix or 100% stocks. Any point on the arc represents a portfolio of securities that has the risk and return in harmony, and any portfolio landing on the arc is described as "efficient". For example, if you are a moderate investor your portfolio of securities should land on the arc somewhere around its midpoint. The medium return/medium risk arrow implies that an investor has assumed the appropriate risk (lower axis) and accordingly, should be able to receive the appropriate return (vertical access) for assuming such risk. Any mix for the same investor that falls below the actual arc reveals that they have assumed too much risk compared to the reward potential, and hence, the portfolio would be deemed inefficient. No portfolio can be placed above the arc as it is an impossible scenario. The arc can be used to measure this relationship amongst or within any one class of investment as well. There are efficient all-stock or all bond portfolios. For example, if an investor only wanted to invest in equities, the lower end of the arc would be where utilities, pipelines or prosaic staples like Proctor and Gamble, would lie; small cap, emerging industries or emerging market securities would fall on the arc at the far right.



What we are most concerned with and how MPT has been mostly applied in investor asset management, is a complete portfolio approach that looks at cash, bonds and stocks in aggregate. In this case the most conservative efficient portfolio would be 100% cash or shorter term bonds at the lower left on the arc and a 100% equity portfolio at the far right on the arc. A balanced portfolio approach – our primary objective at CastleMoore – would be 50% bonds/50% equities and would, like the above stock example, land in the middle on the arc. One of the guiding principles of the buy and hold methodology is that the correlation between cash/bonds and stocks is inverse. That is to say, when cash/bonds are doing well providing positive returns equities are probably going in the opposite direction, or at least, treading water. They do for periods also move in the same direction.

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The benefit of the modern portfolio theory is that by grouping securities of cash, bonds and stocks, investors do not have to get every individual selection right. The principle says that there is safety in numbers. The graph depicts empirical evidence of how the data came out over a very long period of time. The academic or ideal efficient frontier discussed earlier to illustrate the basic of MPT comes out in reality as the navy blue arc in the centre of the graph. The other differently coloured arcs depict different time periods for a balanced asset mix. For example, the yellow arc shows that during the entire 1970's the arc was very flat, with little difference in return (-2.5% for bonds, 0.0% for stocks) between stocks and bonds, but a very high standard deviation or risk measurement. The red arc shows the distribution of returns between 2000 and 2005. Bonds were the best asset class earning on average 7.5%, while stocks returned -2.5%. Bonds were also far less risky than stocks. In fact, this efficient frontier was turned upside down inverted by comparison with the model arc we discussed and the navy one.

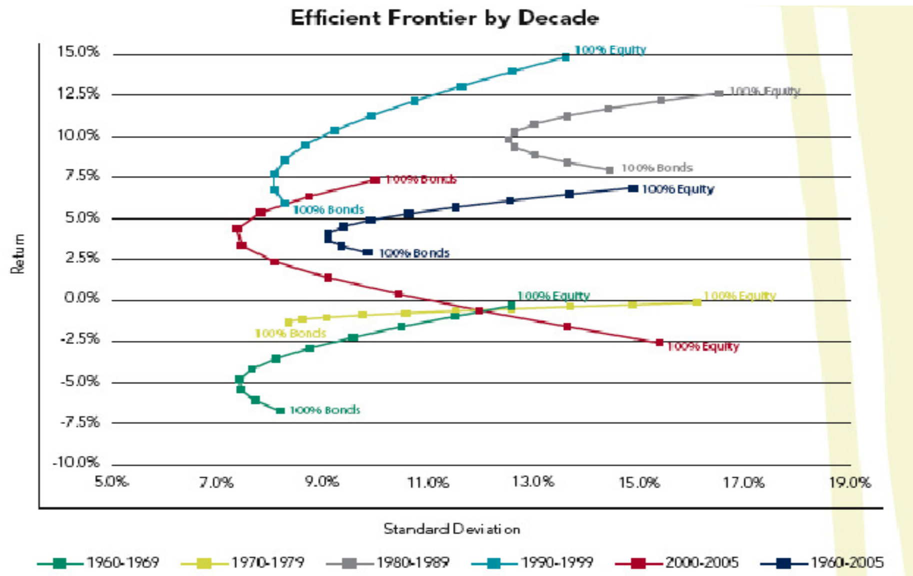
In relying on an efficient and diversified portfolio alone, investors have several hurdles to jump to reach a successful investing conclusion. The most obvious challenge to today's investors being served well by the theory is the time requirement. The navy frontier spans 45 years, the time required to match the historical rate of returns for the various asset classes. The average 50+ investors do not have the time required to complete the full cycle. If you are in your 20's a good balanced portfolio makes great sense, but not when you are close to or in retirement.

Second, a balanced portfolio approach that utilises the power of the efficient frontier assumes that the advisor has constructed the portfolio properly, and has not skewed the "balance" towards equities, as equity transactions pay better commissions, trailers and management fees. Back in the January –February newsletter, I quoted the following on this topic from Peter Bernstein:

"Professional managers, who by 1969 had pushed client portfolios as high as 70% in common stocks, felt like fools. Their clients took an even harsher view. In the fall of 1974, the maiden issue of The Journal of Portfolio Management carried a lead article by a senior officer of Wells Fargo Bank who admitted the bitter truth:

Professional investment management and its practitioners are inconsistent, unpredictable and in trouble…Clients are afraid of us and what our methods might produce in the way of further loss as much or more than they are afraid of stocks… The business badly needs to replace it cottage industry operating methods.[2]

Lastly, the investment climate for the foreseeable future seems that it will be primarily characterized by volatility: large price swings, dramatic shifts in focus from one asset class to another and periods where you should just sit out. Could we see above average returns as depicted by the two upper arcs on the Efficient Frontier graph (light blue and grey) reappear over the next 5 to 10 years? I don't know the answer, but I do know if you have an adaptable, conservative and principled methodology you



Calculated by Rydex Investments using Ibbotson Investment Analysis Software (1/31/2006)

can recognise such an environment. I do not mean a short-term rally, I mean an intermediate trend.

And that's the point. I founded CastleMoore because I believe that how ever the data falls out over the next 10 years, it will most likely not be a reversion to the mean or the average. The mean was the 1980', 1990's and early 2000's. The mean meant you bought a mutual fund or security without close regard for the overall methodology. We are now and in the future living outside the norm. A period that will present excellent investment opportunities only if you are not blindly stuck in letting diversification and time do the heavy lifting.

Much like people responding during difficult times by being thrifty, disciplined and steadfast, investors, and moreover, their advisors must be prepared to shrug off passive and easy fee collection by working harder and smarter, seeking returns through focussing on what is working, jettisoning what is not, and being able to know when to just be patient on the sidelines. The premise of "buy and hold" still underpins proper portfolio management – we just need to know when we are using "hope" instead of proper selling, buying and allocation of assets within our portfolio. It's okay to be wrong, its not okay or, more importantly, financially prudent to stay wrong.

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GUEST COLUMNIST

SEARCHING FOR A SUMMER SEASONAL TRADE

By Don Vialoux, CMT

A favourable outlook for grain prices in the second half of 2009 is setting the stage for an interesting seasonal trade this summer.

Seasonal influences

The agriculture sector has a period of seasonal strength from the end of July to the end of December. According to Thackray's 2009 Investor's guide, the sector has gained in 11 of the past 14 periods for an average increase per period of 17.4%. Fertilizer stocks such as Potash Corp and Agrium are notable for their seasonal strength during this period.

Fundamental influences

Key influences during the period of seasonal strength are grain prices and taxation. Farmers buy more agricultural products (e.g., fertilizer, tractors) during years when grain prices are high and incomes are above average. The seasonal peak in December is related to additional purchases of agricultural products prior to yea-rend partially to reduce taxable income.

Current scenario

The stage is set for a significant rally in grain prices in the second half of 2009.

Grain prices virtually collapsed from July to October last year, down 40%. Since October, grain prices have moved sideways. Farmers responded by cutting back spending, including a reduction in the purchase and use of fertilizer and a reduction in farm equipment purchases. As a result, grain yields are expected to decline significantly in the current crop year. Lower than expected yields from the Argentine crop this year - partially due to a decline in fertilizer use- is likely to repeat in North America. In addition, weather cooler and wetter than average in North America this spring is raising concerns about this year's North American crop. Lower yields come at a time when demand for grains is growing. The Chinese are a major buyer of soybeans. In addition, the Obama administration is studying the possibility of raising ethanol content in U.S. gasoline from 10% to 15%. More corn will be needed if the proposal becomes law.

Higher grain prices will prompt farmers to use more fertilizer during the 2010 crop year. The lower use of fertilizer during the 2009 crop year cannot be repeated in 2010 without a significant reduction in yield. Fertilizer sales are expected to spike as year end approaches.

Investment opportunity

Preferred investments for the seasonal trade are Agriculture Exchange Traded Funds and a basket of fertilizer stocks.

Don Vialoux is a Chartered Market Technician and analyst for www.dvtechtalk.com. He is a frequent guest of *Business News Network* and a business columnist for *The National Post*.

FYI...

By Sheldon Liberman, Portfolio Manager

I have a friend who asked me about the advisability of buying the stock in a particular company. My friend had a friend in the company who informed him that the company was going to exceed its profit forecast for the quarter, and that we should own the stock before that knowledge became public. As he put it, this information came "straight from the horse's mouth."

I told him that horses have two ends, and it's often easy to confuse the two when one's vision is obstructed by dollar signs.

[Note to securities regulator: this didn't really happen. I was illustrating a point.]

Of course, trading on insider information is illegal in most circumstances, as well as being unethical, and unnecessary. It's also often unreliable, as the story of the Rothschild's illustrates, a story which I wrote about in a previous column. Contact me if you wish to peruse that column or you can register on our home page for the complete archives.

Why would I say that inside information is unnecessary? Consider the case of a company exceeding its sales forecast. Who would be the first to know about this? Would it be the accountants who calculate this figure? No, ostensibly it would be the sales rep writing the orders. Even the cashier at Wal-Mart would know ahead of most other people if the company was about to report a good month, and she/he would be perfectly ethical in using that information to buy or sell Wal-Mart stock.

If you see a for sale sign on the lawn of one of your neighbors, you probably wouldn't think much of it. If you see several of them popping up in a relatively short time span, then, assuming you aren't the Addams Family, you might conclude that a trend was forming in housing prices.

If you want to know how the economy is going, count the number of trucks on the highway. Goods being produced need to be shipped.

We used to live in an era when information was difficult to come by, and it usually came at a great cost. These days the biggest challenge is managing the onslaught of information we receive everyday, usually without seeking it. What is fact, and what is fiction? What is news and what is noise? And the same technology that makes this information available also increases the number of self-proclaimed experts on what this information means.

Which end of the horse?

I believe that the ability to manage information – and commentary – is what makes a good portfolio manager more valuable now then ever before. And, speaking of information, I hope you enjoy this newsletter.

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A COMMON-SENSE APPROACH TO RISK AND REWARD – PART ONE

By Thomas Kleinschmidt

Your portfolio's rate of return is improved by NOT participating in the major downtrends. Additionally, calculable risks rise and fall according to a selling strategy – thus the timing of selling is more important than the timing of buying. As proof, when financial planners suggest that not staying in the market for the bottoms hurts portfolio returns, their suggestion comes after the major downtrends when no risk-adjusting selling has been done.

Risks: The basics are that if you BUY a stock your risk is a maximum 100% of your investment, and your potential is theoretically infinite. If you SELL SHORT a stock, your risk is theoretically infinite and your reward is a maximum 100% of your investment. More advanced thinking knows that opportunity risk is not the same as reward risk, which is definitely not the same as capital risk. However, it is most interesting that what does not get included in 'the basics' is that investments without a selling strategy have a real risk on profits and capital of 100%!

Rewards: Stressing that we, as investors, expect a positive return on our investment proportionate with the time and the risks involved, we need to both minimize the risks to profits and capital and also realize that it is the timing of our exit that determines our reward. You've got to know when to fold 'em

Technical analysis in its simplest form says that by simply extending a line between two confirmed low points we get a 'supporting rate of return line', where steeper lines have greater rates of return. The chart is of the TSX: as we get confirmed low points we can adjust our stance to walk up steeper trendlines. A "sell strategy" uses either individual lines or combinations of these. (Note that a "buy strategy" can indeed utilize the same lines and, typically, lines are supportive or resistive.]

As you can see, a selling strategy can: (a) minimize risk on entry, (b) effectively maintain the initial expected rate of return, (c) improve returns if the stock increases its rate of climb, or (d) prevent a significant capital loss from occurring. This is risk and reward in graphical form.

(a) Using one trendline as a selling strategy effectively minimizes risk at purchase and (b) over time, continues to consider that initial implied rate of return (although returns actually fall over time). For example, consider a purchase of the TSX in 1995 following the Green line to today you could still be holding it and perhaps be content to do so. Next, consider a purchase in 2003, now off the Blue trendline…again you could still be holding.

(c) In order to turn paper profits into real capital you must sell and sell higher than you purchased. As shown, steeper and steeper exit lines can indeed be drawn, thus increasing the rate of return on exit. Horizontal lines can also be utilized. Get into your head and gut that selling to protect profits is actually converting what was 'on paper' into capital.

(d) Protecting capital is imperative – otherwise you are gambling. You can also use horizontal lines here also, but see how the same base trendline (or horizontal line from purchase) can prevent a significant capital loss from occurring. For example, consider the aqua line: if you were buying in mid 1998 after the financial crisis of LTCM, the crossing of the aqua line would have signaled a sell. Once above that line a year later a buy would have been signaled. Today, you can see that investor considering re-entering the market again.

Of course, selling strategies don't sell stocks, people do. Drawing a trendline with 20/20 hindsight is quite different than being in the moment. So, if you do not have the time, patience, temperament or desire to define a selling strategy – or more importantly being able to set aside your fear/greed/ego emotions in the moment – then please consider doing business with us. Our highest fee is 2% and affords clients our expertise and discretionary action on a daily basis. Discretionary money management is not for everyone, but our clients don't worry about their investments as do typical investors. …And clients benefit with our buying strategies too, strategies that are based on seeking capital gains in asset classes that are in uptrends.

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WANT TO BECOME A BETTER INVESTOR? GET BRAIN DAMAGE.

By Barry Ritholtz

Reprinted from a few years back due to popular demand.

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.

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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 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 tocontrol the impact our emotions have on us as investors.

Investors who do that achieve much better returns.

A frequent commentator on CNBC, Barry L. Ritholtz is a regular guest on Kudlow & Company, Power Lunch and Fast Money. He has guest-hosted Squawk Box on numerous occasions, and also appears regularly on Bloomberg, Fox, and PBS. Mr. Ritholtz was profiled in the Wall Street Journal's Quite Contrary column. His market perspectives are quoted regularly in the Wall Street Journal, Barron's, Forbes, Fortunes, and other print media. Mr. Ritholtz is CEO and Director of Equity Research at Fusion IQ, an online quantitative research firm. Fusion makes its comprehensive number crunching available to institutions, traders and individual investors alike.

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