CastleMoore News

Buy, Hold... *and* Know When to Sell™

PENSION PLAN BLUES

By Ken Norquay, CMT, Partner

The buzz words of the 1990's mutual fund and high tech boom were: "Buy and hold blue chip stocks for the long term." Baby boomers were saving and investing and driving the stock markets higher and higher. And soon the boomers would be inheriting "the biggest transfers of wealth in the history of the world," as their aging parents passed on. And, of course, all this money was destined for the stock market too. Do you remember those days?

My, how times have changed. In those days, we were told that governments would not be able to pay for the Canada Pension Plan and we had to rely on ourselves. Now we are told that many pension plans are no longer able to meet the retirement needs of the contributors. In those days, we were told that we needed to rely on the ingenuity of corporate America to provide for our needs when we retire: we should buy stocks of those corporations and hold them for the long term. Now, taxpayers and governments are bailing out America's ingenious corporate dinosaurs. And the long- term return of a typical portfolio of blue chip stocks is near zero.

The stock market game has changed and we have to change with it.

One important structural problem with today's stock market relates to Canadian and US corporate pension plans. The 2009 demise of America's auto industry shone the spotlight of public scrutiny on some pension plans' inability to meet their obligations to pensioners. But it goes beyond the auto industry. The Ontario Teachers' Pension Plan is the biggest pool of private money in Canada: in 2008 they lost over $20 billion. OTPP is no longer in a position to pay out all the benefits to which Ontario's retiring teachers are entitled. By inference, the same is probably true for all other multi-billion dollar pension plans in Canada and the USA. Their problem is they had too much exposure to the stock market in 2008. The American stock market has provided a negative rate of return for the past 10 years for buyers and holders of corporate America. The Canadian stock market has been modestly positive for 10 years.

These sophisticated mega-bucks pension managers use a mathematical technique called the efficient market frontier to help them decide what percentage they should hold of the various investment classes. And right now the asset class of "blue chip stocks" is a 10-year under performer. During these next few years, every time the stock market rallies, the pension plans of Canada and the USA will be scaling down. They need to reduce the percentage of stocks they hold in their accounts. This long-term selling pressure will dampen future bull markets until the pension plans' allocation to stocks is lower. Pension plans will be abandoning their old strategy of buying and holding equities for the long term and coming toward CastleMoore's approach of buying, holding and knowing when to sell.

The buzz word of the 2000s and beyond will be: "Buy low, sell high." Or ***Buy, Hold and Know When to Sell***. The investing world will have come full circle.

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DEFLATION OR INFLATION? IT REALLY MATTERS

By Robert 'Hap' Sneddon, FCSI, President

Lately, we've sat on a fair bit of cash, been in and out and back into bonds, analyzed a great deal of economic research for trends and scanned industries and securities, top down, all since March. We've been very busy thinking about strategy. Here's why:

We developed a hypothesis several years ago that we would head into a strong period of deflation at some point in the future. Our methodology calls for us to move a hypothesis to a thesis and finally to action, as data and trend, either supportive or destructive, comes to the fore.

Even before this notion formed, we were anticipating a large stock market correction. This could be a single deflationary event or it could beget more deflation like the tip of an iceberg. Last year about this time we were 95% cash and 5% gold bullion. The action served our clients well. Today, we are seeing a battle between deflation and inflation (or growth) play out and it really matters who wins. How it plays out determines what asset classes you should shift towards to profit.

For example, the stock market, a leading indicator of the economy, has risen substantially from the March 9th lows and bonds yields have conversely moved higher. One point for growth. On the other hand, housing, employment, real wages and corporate revenues have continued to deteriorate. Commercial real estate could be next. One point for deflation. Though these examples are brief they are representative of the to and fro that we are seeing.

I recently read an interesting exchange between two well known market strategists, David Rosenberg and Dennis Gartman. Rosenberg thinks economic data will continue to deteriorate, even if there are positives at the fringes, eventually producing somewhat of a double dip for both the data and the equity markets. He rightly alludes to the 2000-2002 recession which appeared to show an end to the recession in 2001, only to have both truly bottom in 2002 at much lower levels. Gartman, on the other hand, points to the market upswing and the slowing of decline in data, including jobless claims and the Conference Board's Coincident-Lagging indicator uptick last month, when he called an end to it in early July. Who is right?

Market commentators started calling an end to the 2000-2002 recessions mid 2001. Markets shot up for short powerful stints, but things didn't actually improve until late 2002. Bonds did well, stocks did not at the end of it all.

An old adage we adhere to at CastleMoore is "prices don't lie". Meaning, markets usually know things that market players don't know. This basic rule simply applied required us to sell all our financials in February 2007 and all equities last year. Could "prices" mislead this time? What is different in applying the maxim now is time frame and sentiment. The markets have rebounded quickly from a desperate state and there is a plethora of comments in the investment media, or institutional or fund management that talk of green shoots. It is clear that people want and need to be bullish. Most investors and advisors have suffered dearly and feel they must recoup losses.

But has the market moved higher since the spring because it had fallen so much that a move up commensurate with the original fall was due? This is what the pros call a dead cat bounce (I hate the term as I have three feline sentinels prowling my property). Or have the markets called the end to the recession?

Often, economic data can continue to deteriorate as the market moves higher, eventually bottoming some 6 to 9 months after the markets do, so one has to be careful waiting for a complete economic trend picture before committing to equities. We have and continue to allocate much energy and time on understanding this despite the global stock market resurgence, despite the call of the sirens.

Understanding the trend of deflation or inflation is one of the most prominent factors managers and investors should be considering

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before making strong commitment either way in what would be two divergent strategies. A balanced or hedged approach will not be a great solution as the loser will draw from profits in an atypical fashion. Normally a balanced approached should produce a moderate return. But the downside risks to the "loser" are great and will be a substantial drag on assets in this circumstance.

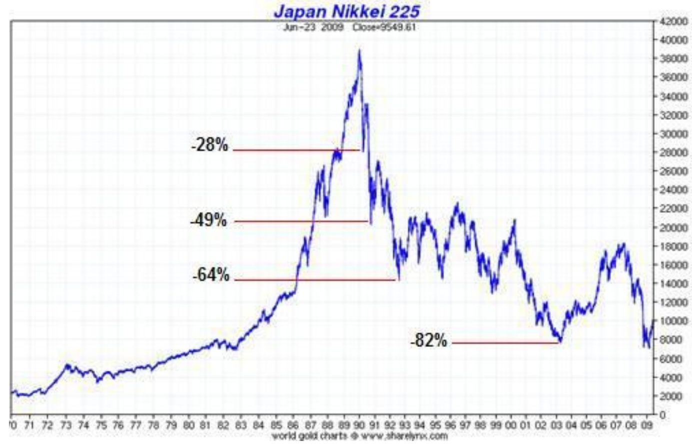
The Japanese experience with deflation illustrates the significance in determining the best approach, whether equities or fixed income represent the best risk-to-reward. While history does not repeat in the same way each time, for each generation, the lessons are relevant.

If we look back at the Japanese experience with deflation we can see several things. First, it can have a deep impact on equity prices. The Nikkei from peak in 1990 to troughs in 2003 and 2009 dropped 82%. The initial 8 month down move from the peak to the first weigh station was 28%; the next and largest portion of the entire move was down 64%. Within the initial downdraft from 1990 to 1992 there were a couple of very brief rallies of 18% and 35%. The Japanese struggle with inflation is now in its 20th year.

The ancillary or complimentary affect of deflation on real assets, such as equities, and the Japanese experience is that portfolio growth can be found in currencies, gold or as the chart lower right shows, bonds. The 20 year government of Japan bonds delivered a stellar return to investors. Initially and at several points along the way inflation talk brought a great deal of volatility and of course opportunity.

Though investors today would receive low interest payments, say in the 3.5% to 4% range, they would make substantial returns on the capital value, both of which contribute to a profitable investment, if deflation is what's really going on down in the deep.

You'd be right if you guess that we are slightly tilted towards the deflation camp today. The other side of the boat is very crowded –all the inflation talk, the US dollar bashing, the green shoots. Whatever the outcome of the debate, the trend of deflation or growth needs to be clear so that investing, free of wishful thinking or hope, can ensue. The winner and the implications will persist for a long while into the future.



The Japanese stock market and its participants took a long time to realize that deflation was afoot but……..

…those who looked to bonds (and currencies, golds etc) did very well while most were consumed with stock market hope. When bond yields drop investors receive capital gains, plus interest payments.

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THE CHART PAGE

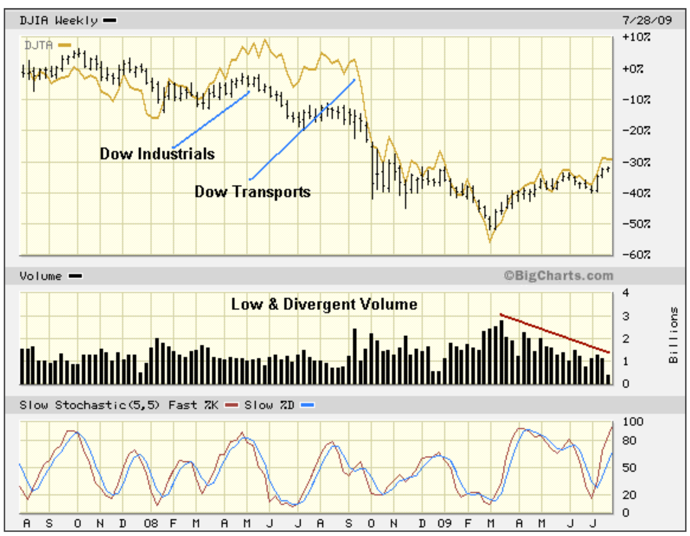
GOLD BULLION

Gold is in a long term, albeit volatile, up trend. It briefly touched just under $1000US/oz in late February. It tracked the market upside move into late May at which point it began weakening. We will reacquire it in the low $800 range, or on a significant break out above the formidable resistance at $1000. Gold bull sentiment is still very high yet slowly eroding.

PREFFERED SHARES VS BONDS

The relationship between preferred shares (a bank-issued one is shown to represent the group) and the bond basket has improved alongside the stock market. The relationship between the two reveals investor confidence in corporate dividends vs. income from debt securities. As the preferred-share advance has recently waxed (and waned), the questions now are: Will the preferred share market hold and provide a positive return from here, despite what equities or bonds do? What do the largest holders of preferreds, institutions, think?

DOW THEORY



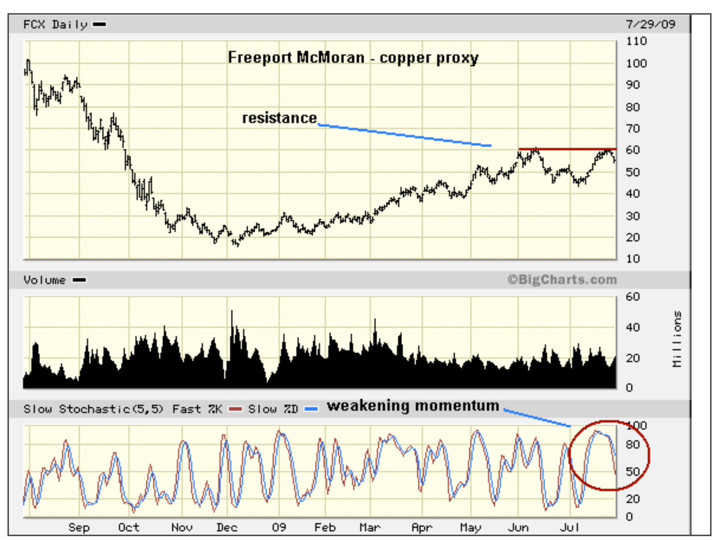
The Dow Theory is a leading indicator that reveals the overall health of the economy. If things improve the Transports will lead the Industrials as produced goods need to be moved. The action between the two of late (mid-July) is positive as the Transports passed the Industrials. This has occurred a few times since the start of the downturn.

US LONG BONDS

Long term interest rates have started to move down again. The notion of utter and complete inflation being created by all the global government stimulus has given way to talk of deflation, an idea that we have maintained for several years. Despite the headline focus on inflation the investment is starting to show strong momentum divergences as price bounces along a bottom.

COPPER

Freeport McMoran is a good proxy for materials, and copper, in particular. In fact, the charts of copper and Freeport are identical. Copper, which can give a primary indication of economic health for its widespread use, and Freeport have just turned down. How it corrects will help fill in part of the inflation/deflation debate. If growth (or slight inflation) is occurring it should not drop too much before ascending again.



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

By Thomas Kleinschmidt

Let me begin with a summary of Part I from the May-June newsletter starting at the end: (5) the most important point is that in order to turn the paper profits into real capital you must sell and sell higher than you purchased. (6) the most critical point is that protecting capital is imperative or else you are selling lower. And the aqua line investor would now be out of the TSX. Again.

Now Part Two – effectively, only bond investors who hold to maturity in the same currency are rewarded for risk.

Said differently, without a selling strategy outside of bonds, you're a gambler not an investor. "Ah, but with greater risk comes greater reward", says the voice. This may be true in the long term, and/or with a thorough study of all the data and the requisite visit to the fortune teller, but there are no guarantee. The funny thing is that the more study and surety, the less risk! Sure the fortune teller might be questionable, but my point is that after a lot of study the true "risk" then comes from not hitting the brakes and relying on your air bags to stop.

Think about it… if you knew for sure that Mugwump Mines was about to hit pay dirt then where's the risk if not in the execution of getting out if wrong when chaos strikes…the 'hitting the brakes' part? When all defined risks are subsequently tossed out the window that 'investment' seems more like a coin-toss, at least to me. Said differently – effectively, only investors who sell to protect profits/rates of return/capital are rewarded for risk. Investors are by definition sellers. Sir John Templeton did just that: buy low, sell high. Without the selling, paper profits are meaningless. You've got to think like an accountant: profit can only be recognized after the sale. That's investing.

But what about selling at a loss? Ah, this half of the equation is actually sad but true. Investors can view their portfolio holdings (not real estate or art) in real time so what you see is what you get. What you do with what you have is all about investing. For the love of capital, just don't subject your investments to any more undetermined risk for an uncertain reward. Choosing to not sell at a loss is a tax issue, not investing. And ego.

But I know that you are an investor because I know you care about your money, your family, and your retirement. Gamblers wouldn't read this, they would read about how to mathematically increase their odds of winning. So, what's an investor to do? What are you going to do? You are either sitting on some significant losses, or significant cash, or are able to go with the flow of the market and could stop reading here (please note that our low management fees mean you could be out playing _____ right now). Some of you are learning fundamental and technical analysis. Some are actually going to roll up their sleeves and get some understanding about what the heck a sell strategy really is and how it fits with them.

Below is an updated chart on the TSX Composite (BigCharts.com "ca:ISPTX" as a monthly/linear plot). A key stance of ours is that economic data is out of timing phase, fundamental data is old and not readily compared and is biased to make things look good always, and that 'investor sentiment' has a stronger pull on prices. Yes, it is 'sentiment'…the fear and greed in the market…that governs how prices move in the shorter term of being investors and not pension fund managers (what they need to do is similar). Without tools that identify the risks and rewards and a methodology to act, true investing cannot take place. The key point for all investors going forwards is that you must let go of the 'hold' when you start to lose profits, rates of return, capital and confidence. The 'efficient frontier' is theory, not effective portfolio management.

Oh yes, some investors are looking for a better advisor – as luck would have it, we're looking for clients! CastleMoore manages clients' life savings across the asset classes of cash, maturities, equities and precious metals. In order to do so we also look at interest rates and currencies. Our highest fee is 2% (much lower for large accounts) and affords clients our expertise and discretionary action on a daily basis. 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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DI-WORSE-IFICATION

By Sheldon Liberman, Portfolio Manager

In the field of physics, an area in which I have more than a passing interest, it would be difficult to argue against the notion that the two most important developments over the past century or so are the Theory of Relativity and Quantum Theory. Relativity, among other things, equates mass and energy, something that is apparent to me every time I try to get out of bed in the morning; the lack of energy is usually accompanied by feeling of extra mass. It deals, if you will, with objects of large mass (incorporating what is claimed to be the only constant in the universe: the speed of light). Quantum theory, on the other hand, deals with how physical particles behave on an extremely small scale.

The two theories say conflicting things and one might think, therefore, that they cannot both be true. And yet Relativity gave us nuclear energy, without which the Allies might never have won the Second World War, and Quantum Theory gave us the revolution in microelectronics, a benefit just about everyone enjoys.

The point is that theories need not be true, at least not in all situations, in order to be useful. If that's true in the case of science, how much more must it be true in the case of an art? Portfolio management is a case in point.

When the stock market suffers a serious decline, as it did in 2008, financial theory comes under close scrutiny. Investors, and in particular the media, start to wonder how portfolio managers could have ever embraced certain ideas in the first place.

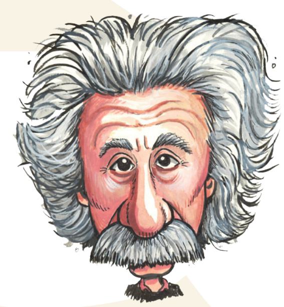
The most venerable, and hence most vulnerable, of these is Modern Portfolio Theory. "MPT" is easily the most acclaimed theory in the history of investment finance. Why then did it fail to protect investors from the ravage of 2008?

We take for granted the idea that more risk = more return, less risk = less return, mass = energy, energy = mass. MPT says that, on average, a portfolio should do no better or worse than the overall market (however you define that), since its components are securities which collectively are the market. Markets are assumed to be efficient enough not to compensate investors for risk other than that associated with investing in the overall market. In other words, don't take on more risk than the market is willing to pay for, for to do so makes your portfolio inefficient.

The key point here is that MPT does recognize market risk, but offers no method of eliminating or ever reducing it. If you want to earn the market rate of return, diversify your portfolio enough to eliminate non-market (unsystematic) risk.

Of course, you are free to challenge the assumptions upon which the theory is based. For instance, are the markets really that efficient? Much evidence suggests that they are not. Contact me to discuss this topic. Is the method of estimating risk, i.e., the standard deviation of portfolio returns, the best yardstick out there? The recent popularity of "value-at-risk" suggests that there are indeed better methods.

Most importantly, MPT does not speak to the issue, at least not directly, of superior vs. inferior portfolio management skills. On average, we earn the average for all portfolio managers, which is the return earned by the overall market, less fees and transaction costs. So it could easily be that there are superior managers and inferior ones; collectively we are average by necessity.



My take on investment management is relatively straight forward: control risk not by diversification, or, as I call it, di-worse-ification, but by seeking out the best opportunities and adhering to strict sell discipline when the markets conspire against me.

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