CastleMoore News

Buy, Hold... *and* Know When to Sell™

THE ROLE OF FEAR IN ROR

By Ken Norquay, CMT, Partner

It's still like Halloween 2009. The media still has us in the grip of fear. Every day we hear a new swine flu story: we're running out of vaccine; you have to line up for 6 hours to get the injection; the injection may be more harmful than the H1N1 virus; a healthy child has died from it. Every day there's a new story. And what is the effect of this barrage of bad news? Fear. Canadians are becoming more and more fearful.

We have noticed a sharp contrast in the population. Although we all have the same chance of getting sick, some people are way more afraid than others. When we were kids we used the term "'fraidy cat" to refer to kids who seemed more afraid than the rest of us. The Greek philosopher Aristotle noticed a similar phenomenon nearly 2300 years ago. He wrote about people who had too much fear, too little fear and just the right amount of fear. Too much fear makes us behave like cowards; too little fear makes us cavalier, failing to take reasonable precautions; just the right amount of fear makes us courageous, getting on with our lives in full recognition of real danger. As the second wave of swine flu starts, the media is reporting story after story of the ones with too much fear.

Think back to Halloween 2008. Do you remember last year's fear story? It was the stock market, the economy, the banking system, the collapse of your RRSP. Those with too much fear were predicting depression and failure of the world's banking system. Those with too little fear were singing the old refrain "Don't sell your stocks – we're in for the long term. Everything will be fine." Those with the right amount of fear had sold out and were patiently waiting for the end of the crisis.

We have studied the effect of fear on investors' rates of return. We observe that fear comes in waves. There are times when the majority of investors have too much fear and times when they have too little fear. I have documented this phenomenon in my book, Beyond the Bull, noting that the peaks and valleys of too much or too little fear coincide with the peaks and valleys in the stock market. The majority of investors feel too little fear at important stock market tops and too much fear at important bottoms. This phenomenon translates into a low long term rate of return on your stock portfolio.

The reason is simple. If we are too afraid of the financial future, we sell our stocks. And the majority feels too afraid after they've lost a lot of money and the newspapers are full of layoffs and bankruptcies. This is the stuff of important stock market bottoms. And if we are too cavalier, we blindly continue to buy and hold, oblivious to top-of-the-cycle financial danger. Newspapers are full of optimistic stories about an ever-rising stock market and an ever expanding economy… the stuff of market tops. The human animal tends to invest more at tops and sell out at bottoms. It's easy to lose money when you ride the waves of fear.

Aristotle was right. Proper investing involves holding the correct amount of fear: his so-called Golden Mean. It takes courage to buy into the stock market after a huge decline when the majority of investors are running scared. It takes courage to sell out after a long run up when the crowd is over-optimistic and scrambling to buy the penny stocks. Aristotle's ancient truth, when applied to modern financial markets, has real impact on our long term rates of return.

At CastleMoore we hold the position of yellow alert. [White alert is like our cavalier investment friends who buy and never sell. Red alert is when they are so scared they won't buy at all.] We like to hold investments when they are in up trends and not when they are in down trends. CastleMoore likes to stay alert to the possibility that what we do hold could go down and we'd lose money; and what we don't hold could go up and we'd miss out. We consider ourselves to be financial warriors: courage without foolhardiness. Buy, hold and know when to sell.

ken@castlemoore.com
1.905.847.8511 or toll free: 1.877.289.5673 www.castlemoore.com

A LITTLE BIT OF THIS, A LITTLE BIT OF THAT

By Robert 'Hap' Sneddon, FCSI, President

Generational Memory

Generational memory is the recollection and maintenance of aggregate experience within an age group. Generational memory has significant impact on collective memory which is the aggregate memory of all people whether we are talking about a small community, city, country, or the globe. As members of a generation die, the memory of a particular event or experience gradually fades too, to the point where it becomes a known fact of history but a dwindling force that actually shapes decisions and behaviours. In short, it has come down to what Santayana coined, that "those who cannot remember the past are condemned to repeat it". Today, market overseers and politicians somehow think that those actions or policies that got us into the fiscal mess are the ones that will get us out. Twenty plus years of "economics are different now" is hard to shake but time moves on, and it's not different this time.

Generational Consumption Habits

Excesses of the consumer over the past 20 years have led to some rapid behavioural changes in just 12 months to date. Consumer debt has shrunk 5% and the trend of -2.8% YoY is the biggest drop in 50 years! This theme has been accelerating since June which saw $21b paid down against expectations of around $8b. Such actions if the trends persist have a negative impact on growth-based equity prices, and very positive one on securities that focus on cash-flow and general yield. Post 1990 the Japanese savings rate returned to historical high levels, leading the equity depreciation and bond appreciation. Mentioned here before, this is what Keynes referred to as the paradox of thrift. An increasing savings rate is good for income-orientated strategies, but hard on growth ones. Today, average investors have a little less than 7% in fixed income.

Bob Farrell's 10 Rules of Trading

Mr. Farrell, Merrill Lynch's chief market strategist from 1967-1992 penned some pretty decent "Rules to Remember"…

1) Markets tend to return to the mean over time.
2) Excesses in one direction will lead to an opposite excess in the other direction.
3) There are no new eras – excesses are never permanent.
4) Exponential rapidly rising or falling markets usually go further than you think, but they do not correct by going sideways.
5) The public buys the most at the top and the least at the bottom.
6) Fear and greed are stronger than long-term resolve.
7) Markets are strongest when they are broad and weakest when they narrow to a handful of blue chip names.
8) Bear markets have three stages – sharp down – reflexive rebound – a drawn-out fundamental downtrend.
9) When all the experts and forecasts agree – something else is going to happen.
10) Bull markets are more fun than bear markets

Employment and The Raising of Interest Rates

All the easy money appears to warrant concern by investors and economists over inflation even if you try to discount that credit is still contracting at 4-5% YoY. Hence you get bond bears at the extreme readings we have today. But the fact is interest rates have never been raised until after the employment rate peaks. After a two month bounce in the unemployment rate in August and September, the rate from youth and part-time jobs in the Canadian economy moved up again 8.6%. In the US, the rate is 10.2%. This week the true rate or U-6 number was released. According to CNBC "the government's broadest measure of unemployment, some 17.5 percent are either without a job entirely or underemployed. The so-called U-6 number is at the highest rate since becoming an official labour statistic in 1994. The number dwarfs the statistic most people pay attention to – the U-3 rate – which most recently showed unemployment at 10.2 percent for October, the highest it has been since June 1983. Economists and the White House said the rate would peak at 8%. I am glad Canadian soothsayers just kept quiet.

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GMAC Bond Yields

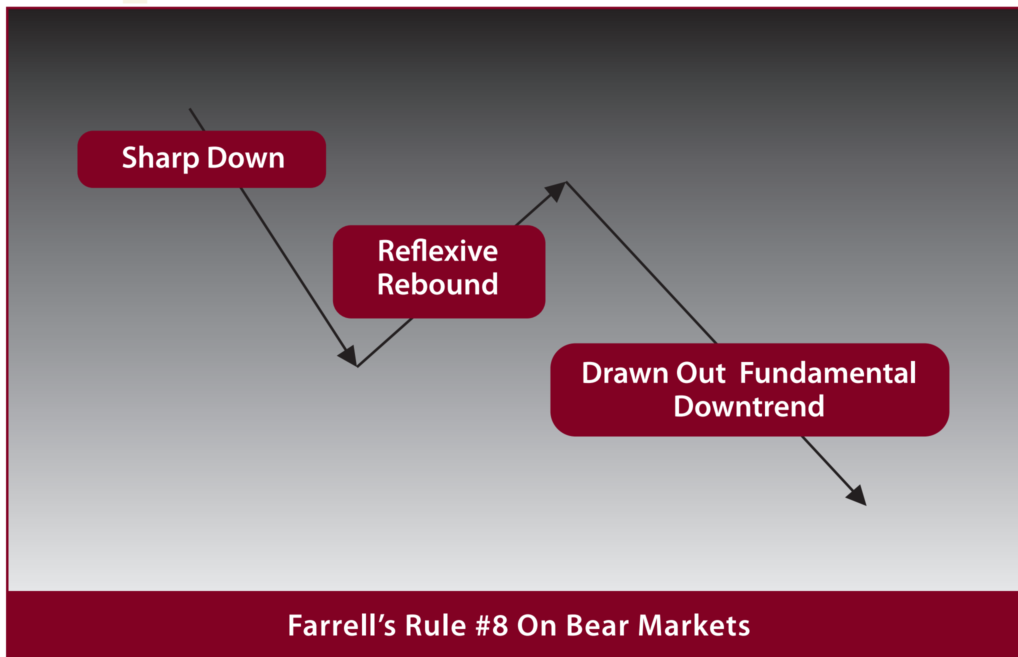
Ken ran with an article a few years ago about the demise of the US auto industry. He paid special attention to GM and was spot on about the gravity of the situation at that time. I saw a bond issuance by GM a couple weeks back (7.00% 15OCT12 price 90.00) yielding over 11.05% for 3 years. That's a juicy yield but chasing yields can be dangerous and they are often foretelling of events yet unknown. I wish the domestics well, but the overhaul was years and years in the offing. Looks like Ford made the painful choices and will be around for a while still. At 11% the market's pricing of GM's debt is saying maybe they won't make it. Stay tuned.

Déjà Vu All Over Again

We have proposed that what we are seeing in the markets – a strong surge in stock prices, albeit with lower volumes since the March lows accompanied by less bad economic news – happened in the 2001-2002 recession. Calls to the recession's end were made in mid to late 2001 as the market bounced off spring lows and the data was improving, yet the true market bottom was not made until prices were 22% lower than those initials lows. We came across this quote from Milton Friedman's The Great Contraction: 1929-1933 which suggests that our reading of 2001-2002 was not so unique.

"…after the turn of the year, there were signs of improvement in those indicators of economic. No doubt partly cause and partly effect of the contemporaneous minor improvement in the monetary area. Industrial production rose from January to April. Factory and employment, seasonally adjusted, which had fallen uninterruptedly since August 1929, continued to fall but at a much reduced rate … Other indicators of physical activity tell a similar story. Personal income rose sharply, by 6 per cent from February to April 1931, but this is a misleading index since the rise was produced largely by government distributions to veterans. All in all, the figures for the first four or five months of 1931, if examined without reference to what actually followed, have many of the earmarks of the bottom of a cycle and the beginning of revival."

Government stimulus does really cloud things doesn't it?



Farrell's Rule #8 On Bear Markets

robert@castlemoore.com
1.905.847.1125 or toll free: 1.877.289.5673 www.castlemoore.com

THE CHART PAGES

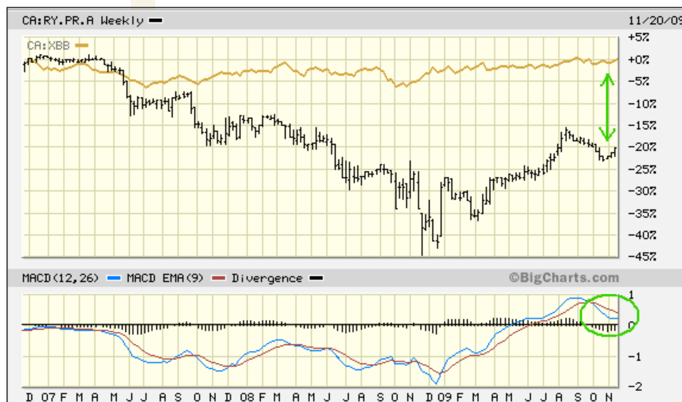
GOLD BULLION

Gold bullion appears to have broken out to the upside, despite being a crowded investment space today. The stochastic reading (lower graph) indicates gold is overbought at the present time. Statistically, gold bulls – determined by intent and position – are at historically high levels with a reading of over 82%. We have exited according to our sentiment model, preferring to repurchase when bearish sentiment ramps up.

US LONG BONDS

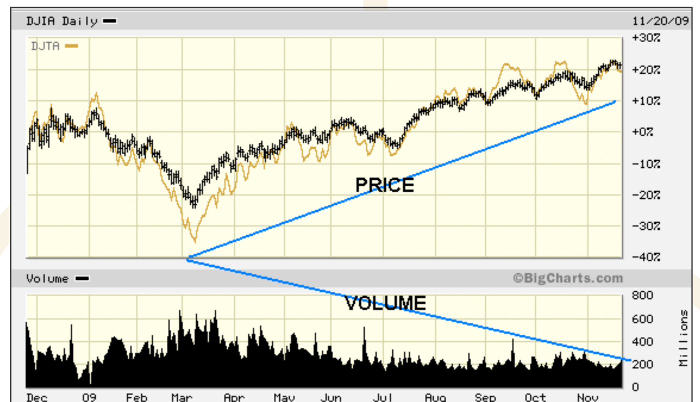
US Long term rates peaked in June – prices bottomed. Since then it has been a bumpy road. The market is exceptionally concerned about inflation growing as a result of global government stimulus. While the market still worries about what has not happened yet, reality is that deflation is here, particularly within the biggest components that affect GDP: US homes prices, wages, the work week and debt repayment. The lower graph shows that money is quietly flowing into fixed income.

PREFFERED SHARES VS BONDS



The relationship between representational preferred shares (black line) and a Canadian bond basket (gold), has moved slightly further apart. Preferreds, since last publication, have lost 5% and are down 20% on the year. Why is this relationship important? It reveals investor confidence in receiving corporate dividends which may be subject to company success vs. income from debt securities which must be paid. Along with the Shanghai Index, Copper, and the NASDAQ, preferred shares bottomed in November well ahead of the March 6 lows for most of the global stock markets. Its movements may help, in part, to determine what's next for the markets. It is trying to reaccelerate now.

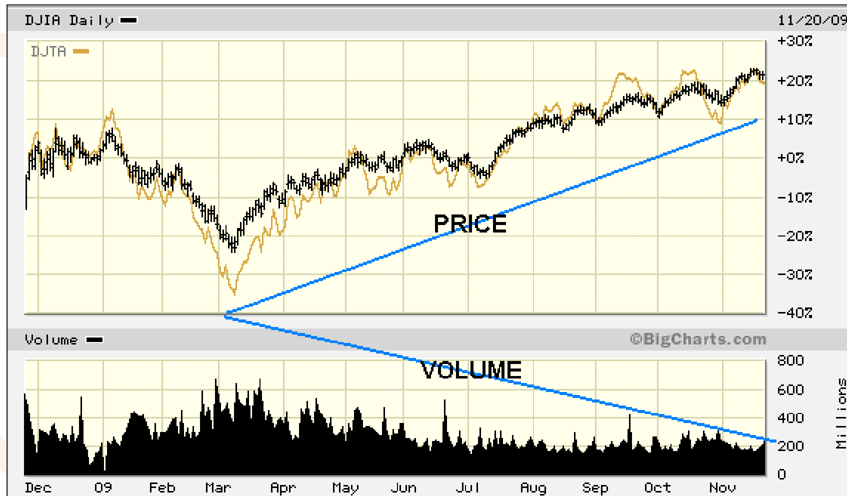
DOW THEORY



Both the Dow Industrials (upper black line) and the Dow Transports (lower gold line) are moving in the right direction. This is a good sign. According to the theory, if goods are being transported, there should be real end demand. The run since March has not had confirming volume. When breaking out or starting a new cycle, volume confirms the new trend. The increasingly lighter volume suggests that much of this move may have been part of a distribution phase from strong to weak hands.

THE CHART PAGES

US DOLLAR AND THE GLOBAL STOCK MARKETS



The story of the markets now is nothing more than the US greenback. The chart above shows Chinese, European, US and Canadian shares plotted against a basket of global currencies vs. the greenback. The G20 finance ministers recommitted in mid November to continuing accommodative policies. The intent is to maintain a weak US dollar. Governments effected by the rise of their own currency, such as Canada or Europe, will not have endless support to do so as their trade numbers will deteriorate as we have seen with Canada recently.

A plot of the US dollar index alone shows that several times the dollar tried to hold support but failed. At present, the index is coming off a bottom and will break its down trend if it closes above 76 with some momentum. The prior periods of support breaks coincide with new mini up legs in stock markets. This is now the most important chart to watch to determine what will/is happening with global equities.

NO RESPECT AT ALL

By Sheldon Liberman, Portfolio Manager

My father, of Blessed Memory, was a hard-working family man, who was taken from us too soon. But he had another distinguishing characteristic: he bore an uncanny resemblance to the late comedian Rodney Dangerfield. In fact, there were those who, without asking for verification, asked my father for autographs. To this day, there are those who must believe that Rodney Dangerfield's real name was Sydney Liberman.

Perhaps surprisingly, they weren't too far off. Rodney's birth name was Jacob Cohen. "Cohen" is the Hebrew word for "priest", and in the vast majority of cases, those with that surname are descendents of Aaron, the first High Priests of the Hebrews, and the brother of Moses. The name "Liberman" is Yiddish for "beloved man", who also refers to Aaron, and so the Libermans and Cohens share that common – and uncommon – lineage.

Rodney was the model of perseverance. He wanted to be an entertainer but got no respect at all. He kept at it – taking day jobs to support himself and family –until he finally found his niche: gaining respect by talking about how little respect he gets.

What do portfolio managers know about "no respect at all"? Recall the following quote from Lou Holtz, legendary football coach at Notre Dame, as it appeared in the January/February 2009 edition of the CastleMoore News:

I've been on the top and I've been on the bottom. At Arkansas my first year, we won the Orange Bowl. Then everybody loved me. They put me into the Arkansas Hall of Fame and issued a commemorative stamp in my honor. The next year we lost to Texas, and they had to take away the stamp, because people kept spitting on the wrong side of it.

The inference here is that respect often comes and goes with the tide. On the one hand, as the Coach suggests, respect has no guarantee of continuation. On the other hand, by Rodney's example, the attempt to gain respect is never wasted effort.

Portfolio managers are, it seems, respected or disrespected on the basis of their most recent performance. Methodology that works most of the time can bring about a torrent of disrespect to its practitioner should it fail for a quarter, or even a year. I've seen this as a portfolio manager. Clients who should never have been accepted as such due to short-term thinking have left during a period of underperformance, as if such periods were not inevitable. The ones who eventually look back on a long and rewarding career are those that persevere.

Clients can be a tough audience, but investing, to those unqualified; can be a real danger-field.

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Rodney Dangerfield quotes:

• I could tell my parents hated me. My bath toys were a toaster and a radio.

• I get no respect. The way my luck is running, if I was a politician I would be honest.

• I haven't spoken to my wife in years. I didn't want to interrupt her.

• I told my psychiatrist that everyone hates me. He said I was being ridiculous – everyone hasn't met me yet.

• My uncle's dying wish – he wanted me on his lap. He was in the electric chair.

• Some dog I got too. We call him Egypt because in every room he leaves a pyramid.

• Once, somebody stole our car. I asked my wife if she saw who it was. She said, "No, but I did get the license number".

• I'm so ugly... I worked in a pet shop, and people kept asking how big I'd get.

• Boy what a hotel that was, why they stole my towel!

• The football team at my high school, they were tough. After they sacked the quarterback, they went after his family.

sheldon@castlemoore.com
1.905.847.1400 or toll free: 1.877.289.5673 www.castlemoore.com

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Head Office
12 – 2441 Lakeshore Road
Oakville, ON L6L 1H6

Phone 1.905.847.1400
Fax 1.905.847.8511

Toll Free 1.877.289.5673
Email info@castlemoore.com

www.castlemoore.com