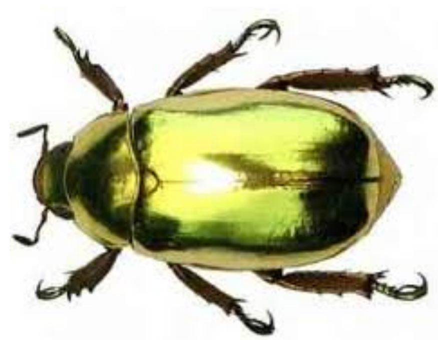
CastleMoore News

Buy, Hold... *and* Know When to Sell™

GOLD BUG LOGIC

By Ken Norquay, CMT, Partner

In 1975 when I joined with Merrill Lynch Canada, US President Nixon had recently signed a bill permitting Americans to invest in gold. US citizens had not been able to openly invest in gold since the 1930s, when it was pegged at $35 an ounce. In the1970s, gold bulls were bewailing the US Dollar as fiat currency and gold as the safe haven alternative. Gold moved rapidly from $35 to $100 an ounce. Now, thirty seven years later, gold has risen to over $1600 an ounce and gold bugs continue to tell the same fiat-money stories. On the surface, it appears that they were absolutely right! The US dollar IS in trouble and gold IS going up. But, as usual, the devil is in the details. Gold has gone from $35 (1930s to early 1970s), up to over $800 (1980), then back down under $300 (1999), up to $1900 last year. In that 19 year period from 1980 to 1999, gold bugs were losers. During the 19 years from 1980 to 1999, their story stayed the same and they became losers. Today, they are winners. From 1975 to 1980, they were winners.



It reminds me of the financial planning industry. They too have a never-ending story: financial planners are trained to believe in the stock market and in American capitalism. Their master plan for the stock market is "buy and hold for the long term." And they have been telling this same story for as long as there have been mutual funds. At first it seems quite boring. But if you look beneath the surface, a fascinating pattern arises.

The financial planners' continuing theme is the exact opposite of the gold bugs'. One group, the eternal optimists: the other, gloom and doom pessimists. If we compare the performance of gold in the periods mentioned above, to the performance of the Dow Jones Industrial Average in those same times, we see that when one does well, the other does poorly. From 1975 to 1980 when gold was going well, the Dow Jones Industrial Average went nowhere, bouncing along under 1000. From 1980 to 1999, gold eased down from the high 800s to under $300 while DJIA rose from under 1000 to over 11,000. And for the last 12 years, gold has soared and US stocks have been mediocre. The beat of these two drums seems exactly opposite.

The problem faced by ordinary investors is that these two groups of investment professionals never change their stories. Wouldn't it be great if we could decide which one to believe at any given time? Is the financial world really coming undone and gold is the only safe investment? Or is corporate America still the dominant economic force in the world and all we have to do is buy blue chip stocks? If we knew which story was true at any given time, we'd know what investment to buy.

Maybe the investment world needs a third group of story tellers: one who can choose from these two opposites at the right time - a story teller who can stay with the story that supports the up trending investment and switches stories when that investments starts to go down. Maybe that's what we need, more story tellers!

Maybe not

At CastleMoore, we call that "methodology." We rely on mathematical models to help us decide whether we should hold stocks or gold or bonds or cash.

On the other hand, 2012 IS the end of the Mayan Calendar: after 37 years, maybe those doomsday gold bugs will finally be proven out! (I feel another story coming on!)

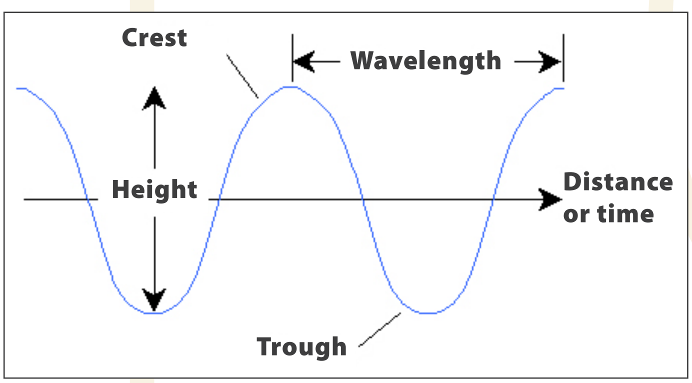
ken@castlemoore.com
1.905.847.8511 or toll free: 1.877.289.5673 www.castlemoore.com

INVESTMENT CYCLES MUST MATTER FOR INVESTORS

By Robert 'Hap' Sneddon, FCSI, President

Every day, all about us, there are cycles at work. Cycles can be found in weather patterns, in birth and death rates, in the frequency of war, and in the human body itself, just to site a few. Cycles lengths can be consistent and indivisible, such as the lunar cycle which with some adjustments for the moon's orbital proximity to the earth or the sun occurs every 29.5 days. Other things reveal cycles within cycles. Time for example, can be measured in millennia down to milliseconds.

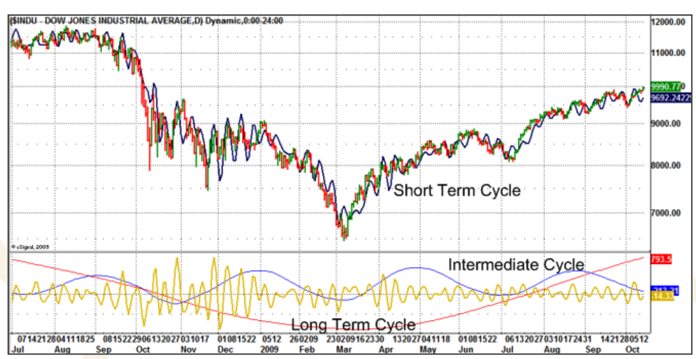
The basic components of a cycle, as the chart indicates, are the crest, the trough, the height and the length. Together they create a sine wave. The crest and trough are determined by the highest and lowest measurements of whatever unit is being used. The height refers to the spread between the highest and lowest unit, and the length is almost always a measurement of time.



Whether referring to climate patterns, birth/death rates, or investments, the principles of cycles are all the same.

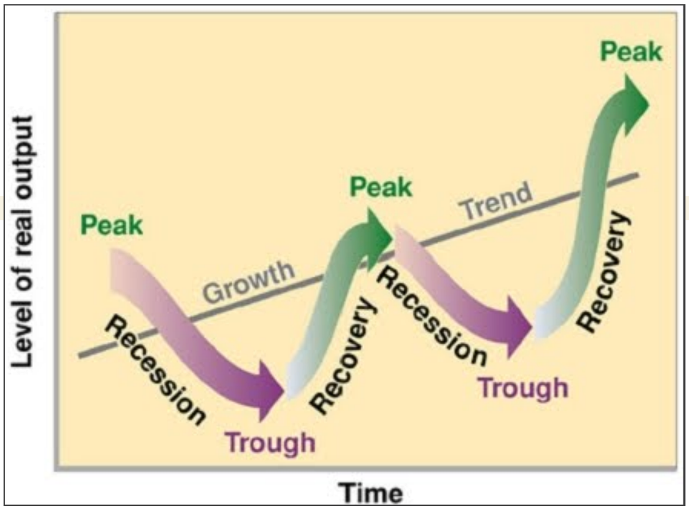
Stock markets have a pulse and rhythm too. Stock prices, or any security price such as bonds, real estate or gold, wax and wane in regular cycles. Like time, their cycles are divisible. Traders using algorithms as in high frequency trading rely on ticks or each and every trade of a security. The wavelength of the cycle would be measured in minutes. That is, the trader would be seeking to determine the length of that particular cycle to profit from buying at the low end of the cycle and selling at the high end. Similarly, investors can use the totality of all price movement in a month, and combine several years' worth of months together to get a picture of a decade long or more cycle. Essentially the process is the same for both; just the investment timeframe is different. Neither of these time frames – minutes or decades – is appropriate to CastleMoore. We invest in cycles, for now, that may last from several months up to two years or what is called an intermediate term timeframe.

Most financial cycles have a trend to them, unlike other, natural cycles. The lunar cycle always moves between no moon and a full moon, but financial assets, over time, increase in value as they go through their cycles. For example, a stock in its current intermediate term cycle may move between \$10 and \$20 per share, but the next cycle it would move between \$16 and \$24.



Investors can choose from many cycle lengths to underpin their investment decisions.

continued on next page

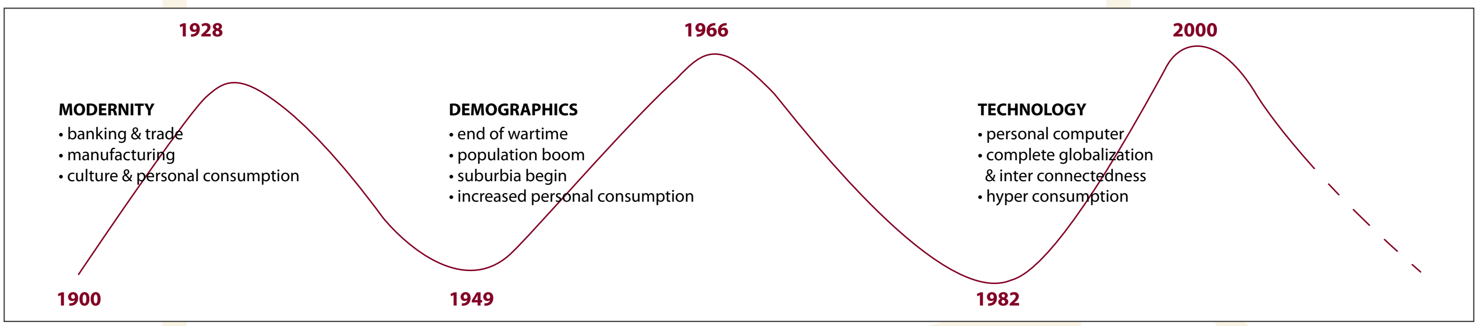


Economies move upwards as they go through cycles.

As the chart of the Dow Jones on the previous page reveals, there are many cycles at work simultaneously. Economies too move in up trending cycles of growth, characterised by recession, troughs, recoveries and peaks.

The challenge to the conventional investment community is acknowledging that markets do move in cycles at all, such that they alter their investment choices, including portfolio cash levels. The traditional approach to investing always must need reasons or understanding for price movements. While yes, sometimes, there are reasons that support price movements, in many instances only "perception" changes. In the late 90's technology companies earnings per share were non-existent or negative, yet the market bid up stocks to astronomical values. Today, some of the same companies who now have legitimate earnings are trading at a fraction of their old prices. If you are a pure value investor you may purchase those assets today and simply wait for the potential appreciation. The catch is if you are trying to realise portfolio returns year in and year out this strategy may not match up with your investment horizon; it may take too long.

When we look back at history it's easy to identify cycles and their predominant economic and social traits. Examining the last hundred years or so of market history we see three distinct and large or secular cycles in stock prices beginning at or near the turn of the century. The first cycle is characterized by modernity, the second by changes in post-WWII demographics and the last, and most recent, by technology. Forecasting what the economic and social traits will be of the next secular up cycle in stocks is a difficult task. We have seen that futurists, more than not, often get it wrong. Hmm, will it be some human biotechnological advancement? Or will it have to do with Nano technology? Maybe it won't have anything to do with technology, but to do with human social organisation or politics.



The application of cycle analysis and advantage to investing is simply in understanding where you are at in the cycle or timeframe that concerns you the most. If you are near or in retirement, or place asset protection high on your investment priorities, looking at the hundred year up-and-to-the-right trend of the stock market does you little good if you are also exposed to a dramatic period of underperformance as we are in now. Similarly, adopting a minute by minute trading strategy is unsuitable as well. The intermediate cycle is the most valid timeframe, and knowing where you are at within it.

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

RECENT MEDIA

We've been busy lately. Investors and the media are looking for answers to what ails the global economy, and well, they've been calling us. If you missed our recent TV appearances on BNN or would like to watch the playbacks click on the link below.

Any technical difficulties: call **Matt 1.877.289.5673**

Here's an article we did with Bloomberg: **http://www.bloomberg.com/news/2012-01-05/canadian-stocks-retreat-as-demand-for-french-bonds-declines.html**

BNN Appearances **http://www.castlemoore.com/businessnewsnetwork.php**

THE CHART PAGES

GOLD BULLION

At the time of publication we are considering our re-entry into gold bullion after having been out of the precious metal since late summer, and after having "shorted" it briefly thereafter. As this 3 year chart of gold indicates in the lower three panels, many of the indicators we look at for position entry and exit have become extended to the downside. While there is still a potential for the metal to fall further on a spike down, the long term trend is in the process of re-establishing itself.

CANADIAN BONDS

Most portfolio types still hold a 20% weighting in long term Government of Canada Bonds, down from over 40% as of mid-November 2011. The long term trend is up though bonds could still drop more than 10% and remain a very profitable investment. Our 3 part bond model – one larger "master" model and 2 shorter models – has had one shorter term component move to "sell".

LOONIE

The Canadian dollar has moved in lock step with global equities over the last two and a half years. It had become a "risk on" currency; meaning when investors began taking on more risk it benefitted commodity-related currencies such as the Loonie. Going-forward, it's not as clear by the technical evidence that this correlation still exists. We may have entered a period where global stocks appreciate and the currency moves sideways.

US DOLLAR

This 3 year chart US dollar index, a depiction of the price of the US dollar as measure against a basket of global currencies, reveals that a bottom was made in the spring of 2011, the same time that stock markets were peaking. As with the Canadian dollar, the correlation between global stocks and the USD may be over; global stocks and the USD can rise together, especially when considering the weakness of the Euro. For client portfolios we added a bullish USD positions in November. All investments at CastleMoore are priced, monitored and reported in C$'s. We expect the USD to strengthen more than any potential strength in the Loonie.

THE CHART PAGES

CANADIAN EQUITIES

The Canadian stock market on the whole peaked in February and has been moving sideways for the last few months trying to recoup the -15% loss. CastleMoore has positioned portfolios in securities that have significantly outperformed the TSX and provided positive returns over the last year. A break above resistance overhead allows for index-based investments for **Class** portfolios and additional sector and individual equity securities for **Focus, SVA** and **Two-Way**.

US EQUITIES

US stocks which peaked in March are off only 7% from their highs, owing to much less exposure to the resource sector and troubles in Europe. Like the TSX, overhead resistance if crossed will then act as support, indicating higher price levels for US stocks. Today the top sectors for US stocks in order are utilities, consumer staples, healthcare, biotech and consumer discretionary.

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
- Managed Asset Classes – cash, maturities, ETFs/stocks, precious metals

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

Phone 1.905.847.1400
Fax 1.416.352.0190

Toll Free 1.877.289.5673
Email info@castlemoore.com

www.castlemoore.com

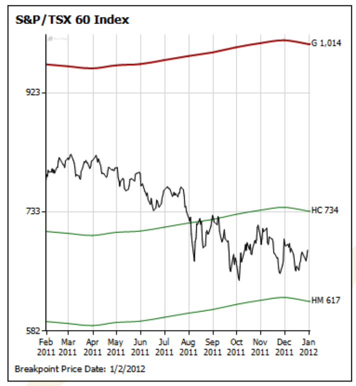
LOWER RISKS FOR HIGHER RETURNS

By Thomas Kleinschmidt

My best wishes for a happy, healthy and prosperous new year for you and your family. Let's review 2011 together and see if there are any lessons to be learned while we see if our portfolios are on track for this RRSP season.

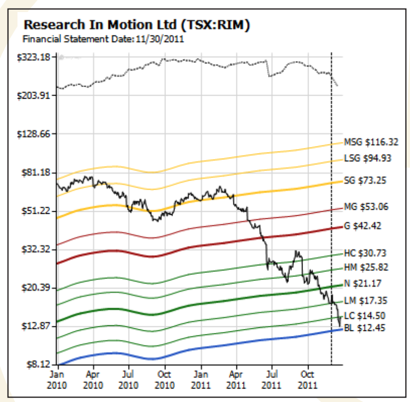
At the year's half way point both bonds and equities were dead flat. A lot of bobbing and weaving didn't do much more than see traders make money and make investors queasy. The second half ended with Bonds up 6% and Stocks down 12%...a 20% difference…but unclear if traders beat investors or vice versa. Hard to predict the split? Not really. For one we had a major buy signal on our bond model in early July and equities failed twice to regain their lost ground by late July, but you could have just went with the trends that were established from April to August which showed by then an uptrend in bonds and a downtrend in stocks.

For those that don't subscribe to interest rate timing here is a simple methodology to at least avoid the 12% penalty holding stocks. I was a personal client of Strategic Analysis Corp for over a decade, and over the last year CastleMoore has forged a corporate relationship with them in the in-house construction and management of the TSX Value, DOW Value and Growth Structural Portfolios. Here is a graphic showing a "structural" breakdown of the S&P/TSX 60 large cap index in August and the confirmation in September to leave the game early. This methodology would have gotten you out at a 4% loss for the year (less if you would have switched to bonds). Of course, for the observant traders in the group, you would have had the technical signals to exit earlier and then would have used the structural breakdown in the index to hedge your holdings or even look for short opportunities.



For those of you who don't just buy the market here is a stock specific example. Our TSX Value portfolio sold RIM in April 2011 when it broke a key structural line. It could be a buy soon?

Methodologies aside, investors of all shapes and sizes have found that the markets are indeed different. **What is really happening is that investors are getting their emotional risk tolerances tested.** Having your investments "on track" is not just about the dollars or percentages…you can always adjust your spending habits and plans…it is more and more about sleeping at night and feeling confident about how your capital is being managed. Prudent, careful money management requires methodologies – methodologies that work, methodologies that adapt to the changing investment landscape.



Your portfolio returns for 2012 can be quite satisfactory by simply avoiding and evading downtrending asset classes and stocks. Your portfolio returns for 2012 can be even better by investing in uptrending asset classes and stocks.

Give me a call sooner than later to discuss your investment goals for 2012 and how we would allocate your precious financial assets, accumulated over a lifetime, in a way that lowers the risks for your returns. Right now, compared to our clients, most investors have way too much of something and not enough of another. Again, dynamic asset allocation is not hard to do. And beyond the regular Know Your Client's financial risks we consider your emotional risk tolerance in the construction of your portfolio…right down to knowing the risk to your holdings on a dollar amount daily. During our talk you will come to realize that our approach to your life savings is not just a second opinion, but a better, thought out plan.

thomas@castlemoore.com 1.905.847.2713
or toll free: 1.877.289.5673 www.castlemoore.com

A REPRIEVE FROM PENALTIES FOR US NON-FILERS

By Ed Arbuckle, CA, FCA, TEP

There is probably little doubt that there are readers of this newsletter who are US citizens living in Canada and should be filing US personal tax returns – Form 1040 to be exact. They also should be filing a financial accounts report called an FBAR (Foreign Bank Account Report). But they are not.

The United States Internal Revenue Service (IRS) has gone through several amnesty programs recently calling for US citizens to get their tax filing up to date. In December 2011, the IRS had a major epiphany and announced that draconian penalties for late filing would be withdrawn if non-resident Americans file six years of tax returns and FBAR returns. To my knowledge, this is the first time that the six year period has been formally acknowledged as being acceptable to catch everything up and get a do not go to jail card.

Many Americans living in Canada have not been filing US tax returns because either they do not realize that they are American citizens or because they are already filing here in Canada and think a US return is not required.

The definition of an American citizen is broader than most people understand and includes anyone born in the United States, people with two US citizen parents (no matter where they were born) and even some individuals with only one US citizen parent. US tax law, unlike the laws of most countries, requires its citizens to file tax returns no matter where they live in the world. The US taxes you both on the basis of US citizenship or US residence.

In order to comply with recent IRS pronouncements, our practice is to prepare six years of unfiled returns for our clients and attach a letter to each return indicating the following:

1040 Income Tax Returns

- Explanation for not meeting your filing obligation
- Indication that your Canadian filing compliance has always been met
- Indication that you filed as soon as you were aware of your obligation
- Never been penalized by the IRS
- Recent changes to UStax law or forms that you were not reasonably aware of
- US tax complexity is beyond your grasp
- Unaware of the filing law requirements but made a reasonable and good faith effort to do so when found out
- Could not be reasonably expected to know of filing obligations

FBAR Returnss

- •All of the income from accounts was reported on US tax returns
- The taxpayer was unaware of the requirement to file the FBAR
- The taxpayer promptly filed the return when they became aware of their obligation
- The taxpayer relied on US tax advice from a 1040 tax preparer and no such advice was provided
- All of the financial accounts exist for legitimate purposes
- No intended efforts were made to subvert the reporting of income or assets
- The income tax has been fully reported and paid for all prior years
- The taxpayer never intentionally did not disclose the existence of financial accounts to the 1040 tax preparer

I suggest those of you who are US citizens and read this newsletter that you proceed to comply with all due haste. If the IRS finds you before you file, your life will be completely miserable and it will crunch your pocket book. Chances of that happening increase in 2013 when Canadian financial institutions must report investment income to the IRS for its US citizen customers. Only tax preparers such as ourselves who are registered with the IRS can prepare US tax returns. Our website contains a detailed US tax preparation checklist to help you assemble your six years of information.

Ed Arbuckle CA, FCA, TEP, Personal Wealth Strategies - Fee based family wealth planners, 205 – 30 Dupont St. E., Waterloo, Ontario Phone: 519-884-7087 www.finplans.net

ARBUCKLE
Personal Wealth Strategies

VOLATILITY IS HERE TO STAY

By Jason Dubbeldam

Volatility today is an ever-present challenge to successful investing, increasing risk and limiting returns. The last 11 years have born witness to some of the most extreme price swings in securities and portfolio values for investors in their investment experience. That said, such volatility is far from unheard of. Largely trendless stock markets, like the ones the world is currently wrestling with, or large corrective actions have occurred before, most recently during the 70's, but of course the reasons are always different.

So what are the causes of much of the volatility seen recently in our equity markets? Although there are several to be sure, three have had significant impact. The first, and largely the catalyst for the other two, is the drastic reduction in trading costs provided both by increased market and investment management competition and the efficiency of electronic trading systems. Cheaper trading costs allowed for the proliferation of Exchange Traded Funds (ETFs) and the rise of high frequency algorithm trading.

Until recently, both in North American and around the world, trading on equity markets were a costly endeavour. The labour intensity involved in running and maintaining an equity exchange has been drastically reduced through the help of computers and the networks they run on. These new and efficient means of trading allowed for increased competition both among market providers and management firms alike. So much progress has been made that individuals can now manage their own investments online through a multitude of providers. As with any product or service, the cheaper it is the more we consume it, and with higher volume comes higher volatility to both sides of the ledger. When it costs as little as it does to trade, investors also react to smaller and smaller news items and events in an attempt to earn higher returns.

It's not just individuals who have taken advantage of the lower costs of trading. Firms have taken the opportunity to innovate. This has led to the introduction of ETFs. By their nature ETFs can only intensify moves made in the markets they track. When price action in the underlying stocks causes index weightings to change, hundreds of ETFs worldwide must follow suit. This higher level of turnover made possible by the reduction in trading costs already discussed and the cost savings of passive management. If the power that these forces can have in the underlying market is at all in doubt, one must only look at the example of gold. ETFs allowed the average investor to trade and hold physical gold for the first time. Managers and individuals clamoured for this new means of portfolio diversification and the precious metal took off.

But the innovation doesn't stop there. Both the introduction of electronic trading and reduction in trading costs has allowed an entirely new form of portfolio management to emerge: high frequency algorithm trading. The moniker alone doesn't even attempt to hide its high level of buying and selling. Managers build mathematical rules into a trading program and the computer does the rest, buying and selling based on a multitude of market observations and calculations. This has had not only the effect of increasing volume, but volatility as well as the trading programs are built to be cold calculators, not always agreeing with the broad market sentimentality or conclusions on any particular day, week, month or year, and sometimes in direct contradiction to the popular trade of the time in attempts to take advantage of sentiment change or simply a reversion to the mean.

Of course there are other reasons for why we see market volatility in varying degrees at any time. Currently, the culprits happen to be ongoing sovereign debt problems and slow and slowing economies. But these are temporary issues, however long it seems for them to be dealt with. What should be of greater concern to long term investing is dealing with these underlying shifts in the market and investment management landscape grown and encouraged by low-cost and electronic trading opportunities and platforms. It is key to not "fight fire with fire" by increasing your own trading volumes in an attempt to stay ahead of this increasing volatility as that is more likely to simply increase your own portfolio's volatility and eat away at profit. What's needed is a methodology that steps outside of the emotion and drama of the impact of these developments to calmly and consistently find markets and assets that are profitable. By expanding the investment scope beyond just the equity market, we find there are opportunities to participate in solid long-term uptrends elsewhere while we selectively manage equity positions with attention to risk management levels and an unbiased sell discipline.

jason@castlemoore.com
1.905.582.7350 or toll free: 1.877.289.5673 www.castlemoore.com