CastleMoore News

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GOLD STOCKS VS GOLD BULLION: WHAT'S THE DIFFERENCE

By Robert 'Hap' Sneddon, FCSI, President

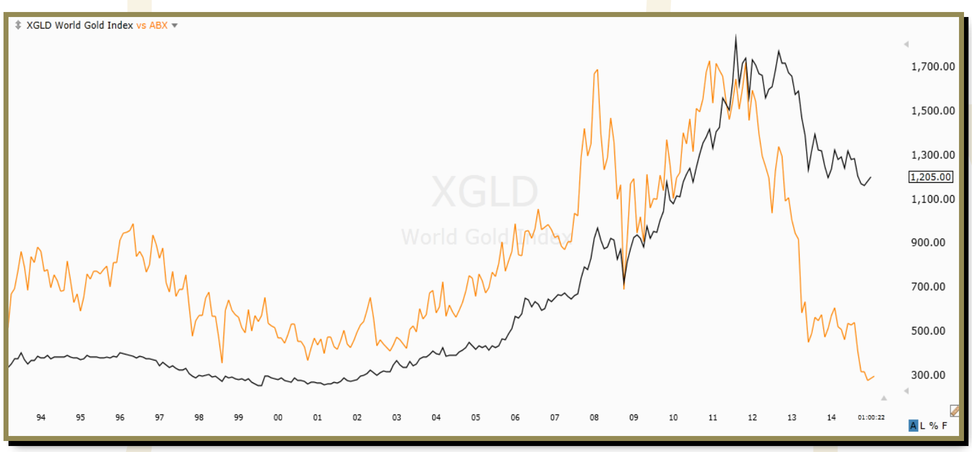
I first wrote on the topic of the difference between investing in gold bullion and gold stocks in 2006 (CastleMoore Investment News Apr-May 2006). With the high volatility – both up and down – and the attention all things gold is getting of late, and will get in the coming months, it's time to refresh things.

Without a doubt there are meaningful differences between physical gold and gold stocks, the most relevant being their intrinsic worth and price behaviour. The conventional thought is that they move in unison, that they are virtually the same thing. This is just not the case. Though they have a high degree of long term correlation they are not the same thing and the difference matters to investors.

Gold bullion is valued each day by world markets, much like oil, grains, unleaded gasoline, or one of my vices, cocoa. All are of course priced in US dollars. All of them are base or essential, and are pure physical items. Despite often being lumped in with the general commodity arena, as I just have, and as is commonplace, gold is not a commodity: it's a currency. Sure there are some industrial applications but by and large it is a store of value, one that is 6000 years old and still running. Unlike a gold stock, bullion is not surrounded by so many other particular or company-specific inputs. Its movements are more pure even if they are misunderstood or perplexing.

When you buy a gold stock today you are making an investment decision about the profitability of a company from between six to twelve months out into the future, just like any other equity. The "product" they sell just so happens to be gold. The price of the company stock will move like any other's will, but with an obvious correlation to the price of bullion. If a company mines gold but can't make a profit an investor may actually lose money against a positive or at least stable price backdrop in bullion. Some factors to consider when investing in gold stocks compared to investing in straight bullion are labour, environmental, country-risk concerns (political situation for example), and reserve assessments. Ever heard of Bre-X? I suppose they would fall into the "Do you have any reserves at all?" category.

Gold stocks also lead the price of bullion. They will run ahead of gold bullion moving up and begin falling sooner. This is part of the forward-looking aspect of the securities markets. Gold does trade on its future and some emotion, but it tends to revert to its mean, or its trend, rather efficiently. Put another way, gold bullion does not tend to become undervalued unless there is a significant disconnect hidden in the global macro landscape. With specific stocks you may be unfavourably surprised by events. You may also find a stock that is undervalued or finds a big gold deposit. Gold stocks have better stories to tell than does gold bullion and hence they are subject to a market of opinions.

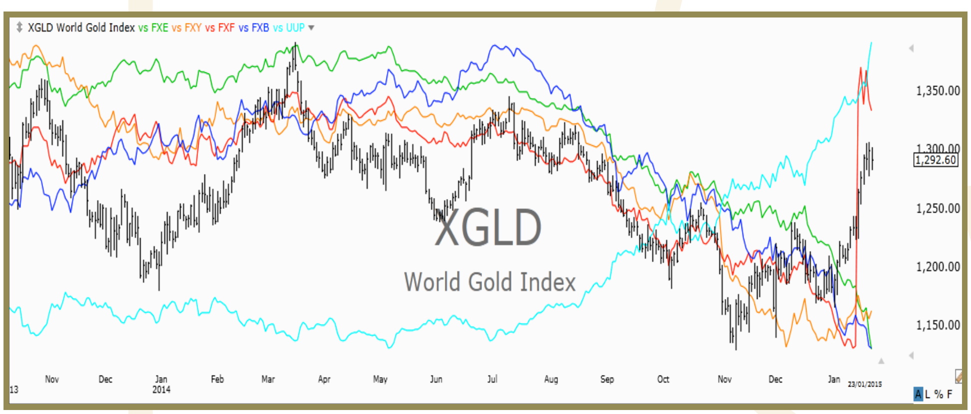


A quick look at this long term chart of gold bullion (black) and Barrick Gold (orange) shows that from the 1990's through to 2008 the stock outperformed gold itself; from 2008 to 2011 the two were highly correlated; then from 2011 to present, gold bullion outperformed.

Conversely, this short term recent chart of an ETF basket of gold producers (purple) compared to gold bullion (black) shows stocks now leading. While this shorter term chart still shows a high degree of correlation overall, particularly on the down move on the left hand side of the chart, the impulse now is for gold producers to run ahead and lead bullion. If we have made a meaningful bottom in gold bullion this impulse by gold producers to run ahead will continue.

Investing in gold bullion on the other hand is a decision about currency stability and not about inflation. The common belief is that gold is a hedge against inflation. Rather, currency volatility can eventually lead to inflation as a by-product, but gold bullion itself does not protect against inflation.

Like the above graphic from the front page of CNBC.com illustrates, you can have deflation and strong gold. With only so many primary currencies – US dollar, Yen, Euro, Pound, Swiss Franc – investors, especially very high net worth and institutions, must allocate their assets strategically and tactically based on expected future strength.



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

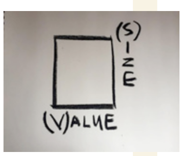
The continuing weakness in many of these currencies has moved investors into the US dollar, the Swiss Franc and gold bullion. In short, bullion represents a spreading of currency risk; gold producers, an investment in a commodity product.

STYLE BOX, BROKEN OR FIXED?

GUEST COLUMNIST

by Mukul Pal

Style box for the investor is a visual representation of investment characteristics for stocks, fixed income and mutual funds offered as a comparative tool to investors around the world for helping them determine asset allocations based on their risk preference.



Should an idea nearing 30 years of history need revisiting? Is the style box a good visual representation? Why should we bother with a mere visual? Maybe that's why no one asked the questions "Is there something wrong with the style box?" Is it still a good representation? Is questioning this representation essential for our broad comprehension of risk? Can we afford to be complacent about visual representations which determine our investment choices?

Industry standards are important for the investing community. When a standard talks about risk-return structure, its representation concerns me. Is it doing a good job for me as an investor? Is it dependable?

We know all the good about the style box: the mapping value it brought to the industry. Let's rethink the mapping. The industry's inability to look at the investing style grid from another angle is a limitation. The industry is designed to accept the status quo and not question it. It's harder to force it to actually think. What if the style box was wrong? What if markets and risk could be summarized by a better representation? This would mean that millions of investors are looking at the wrong map and the idea of an informed comparison might just be a flawed comparison.

A different visual map for different asset class. Fixed income is different so it has a different visual. The same for stocks and mutual funds. Is there a visual map that could generalize for all asset classes in a single map? Is risk and return not common across all asset classes?

Though the style visuals change for asset classes (there are none for commodities or currencies) but few of the factors overlap. The style box looks at value and growth as a commonality between fixed Income and stocks, but still represents them separately.

After all the debate around CAPM (Capital Asset Pricing Model or a model that the investment industry uses to analyse the relationship between risk and expected return and then price risky securities accordingly) with behavioural finance experts calling it CRAP (Completely Redundant Asset Pricing Model) while academic literature clearly says that the CAPM is not completely redundant, the style box assumption that small size adds riskiness to the portfolio is more of a visual generalization of a tendency.

There is a factor and a value factor. The industry is already toying with more factors. Academic literature talks about 15 factors. What about sentiment as a factor? What about volatility? The current style visual has a limitation to scale up for more factors.

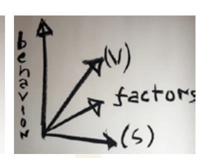
The style box comparison assumes geographical area. With the investing space increasing and investors looking at macro markets, how relevant is a constraint of geographical area? Why can't we have global value, global growth, and other factors in one representation? Is it a tough exercise to label value for a global portfolio? What earning constraints should we have for a global portfolio to be classified as value or growth? Does this exercise become a big data crunching problem which is beyond the scope of the 30 year old visual or that was not the initial mandate of the visual?

The changing times demand better solutions, visual or non visual. The move from active mutual funds to ETFs is already a big change, which suggests that a new style box should be able to classify ETFs. How should we classify ETF? What about tactical funds? How should we classify everything in one simple visual, a new framework?

The bigger limitation for style box and for the industry is to take a step back and differentiate factors from behaviour. Is momentum a factor or behaviour?

Investing Style is assumed because of what Graham and Dodd (Warren Buffet was an understudy) started discussing as value in 1920s. Then came Basu, Banz, Fama, Stattman, Klein and Bawa. The history of literature from the 1920's opens up more than a gap in our understanding of factors. There is duplication, proxy, redundancy, limitation in understanding of the factors. What if Investing style definition evolving sentimentally over the last 100 years was more of an investing style bias?

Does the style box scoring need a revamp? Do we need a new score to reclassify risk and style? Feeding the same information back to the industry which reflects it back in a loop is not the hallmark of a relevant industry standard. The industry needs a revamped representation.



Unlike the new, the old visual is about value and size. The new should consider value and size as a few of the many factors. While momentum (positive trend), reversion (change in trend) should be the common behavior (not be confused with psychological behavior) for every factor in nature. Everything in nature (including stock market prices) grows and decays. Growing trends can continue to grow or reverse and start to decay and vice versa. Winners can continue to win (momentum) or start to underperform, lose (reversion). The markets need one visual for every traded asset, which addresses every factor, including sentiment.

mukul@orpheus.asia, Orpheus Capitals
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BASED ON A TRUE STORY

By Jason Dubbeldam

For millennia, stories have underpinned the development of the human race. We love them. From the most sincere accounts, to the grandest of tales, stories have been the way we have communicated with each other and have attempted to understand the world. It is a trait that lives to this day. We still love to hunker down with a good book, or tuck into a bowl of popcorn for a great movie. Unfortunately the power and allure of a story also tends to pervade where it probably should not. Stories dominate the way investors share and consume ideas on world markets.

For many the power and attraction of a good story has become so compelling that it has become the starting point when trying to understand the markets and forming a methodology for navigating them. It's easy to understand why. For starters, a good story attracts attention. Whether it's a contrarian position that stands out from the crowd, a tale of impending doom, or the welcome calming salve of an everything-is-fine pat on the worrisome head, often it is a good story rather than a better methodology that grabs our attention. Humans use stories whether they are about inexplicable events in the world or in this case investing, to put things in some sort of order -- to have things make sense.

Once the story is in place, the storyteller must provide some sort of evidence to support that narrative, and give something to the listener to act upon. Often, however, evidence is force-fit into the pre-supposed story, rather than the story being shaped by an objective accounting of the evidence. Secondly, it provides a simpler form of conveying an opinion and how to invest based on that opinion. Most individual investors generally know how to act in the markets based on a certain outlook, and a well-built story will be much more easily digested and accepted because the average listener knows what to do with it when they next pick up the phone to their broker/advisor or sit in front of their computer. Lastly, a compelling story is very difficult to let go of. In behavioural finance this is referred to as belief perseverance, very closely related to the psychological concept of cognitive dissonance (the mental discomfort that occurs when new information conflicts with previously held beliefs), and there are a few different ways it can take shape. Conservatism bias occurs when investors inadequately incorporate new information into their views or forecasts. Confirmation bias happens when people only look for and/or notice information that confirms their existing story, and ignore or undervalue that which does not. Representativeness bias is when investors tend to classify new information based on a familiar past classification in a poor attempt to derive meaning from and guidance on the new information or experience. They rely on a "best fit" approximation to determine how to categorize, frame and respond to the new information when in reality the new information could be pointing to a completely different scenario. These inherent biases among market participants mean that a good storyteller may gain listeners that they otherwise wouldn't, or keeps listeners longer than warranted.

As managers here at CastleMoore, we are not immune to these biases, however we have built systems into our company that actively attempt to keep our investment methodology as objective as possible. We've often described ourselves as market mercenaries, going where the prices are rising, regardless of whether they fit into an economic narrative. That's not to say that we don't have and hold our own thesis on what is currently happening in global economics and where it might take us. We certainly do, and it is as much a starting point as our other tools. But our investment thesis does not solely determine the actions and positions that we are going to take in our portfolios. For that we rely on our various input models, which may or may not confirm what we think is going on in the big picture. For example, we have maintained that deflation is an undercurrent in global markets that has been masked by various events or parties. In the case of the US Federal Reserve the many versions of quantitative easing has caused distortions in asset prices that has maintained a story of pure, organic economic recovery. While some stories can hold investor attention for quite some time, eventually the stark reality of natural forces prevails. Are interest rates truly going to rise as CNBC or CBC economist consensus says they are? Our core models have held a large position in AAA government bonds and our models have been raising that level through the fall right to today.

As with any great story, when the data coming from those input models begins to paint a common picture it's a beautiful thing, and even better when that picture closely resembles our market thesis. Our thesis and model output should ultimately confirm each other with the model having the final say or being the arbiter of any conflict between them.

Our current portfolio holdings tell the story on their own. If you would like to know what we hold, what securities are strong please contact me.

jason@castlemoore.com
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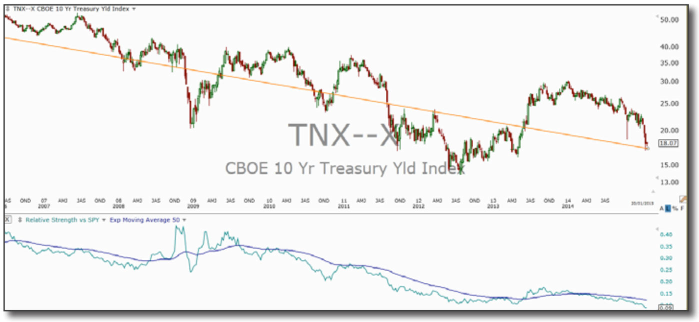
THE CHART PAGES

INTEREST RATES

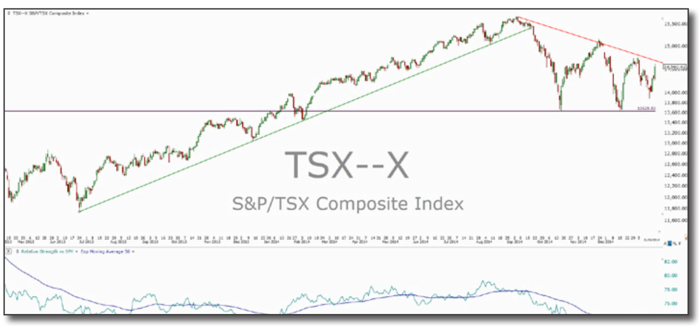


Interest rates continue to trend down. Based on this longer term chart showing the linear regression line, rates are just at the mean value now having been at an above trend level for most of 2013 and 2014. Current momentum, despite analyst consensus for rates to rise in 2015, is down. At present the CastleMoore Class and Focus portfolios contain 35% AAA Canadian and US government bonds.

GOLD BULLION

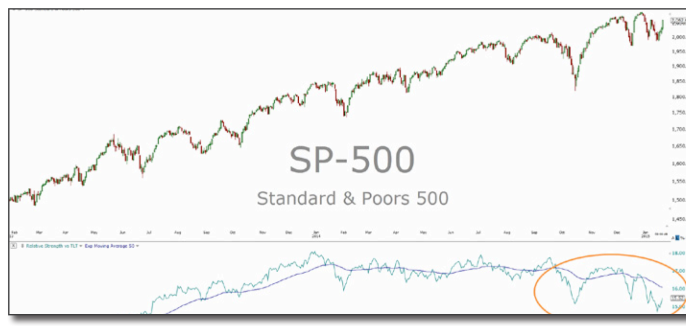
Gold bullion has been in a bear market since 2011 when we sold client holdings of the metal. Recently a downtrend break suggests higher prices ahead even in light of a strong US dollar. The lower panel shows a downtrend relative to the S&P attempting to be broken. Short term weakness is underway.

CANADIAN EQUITIES



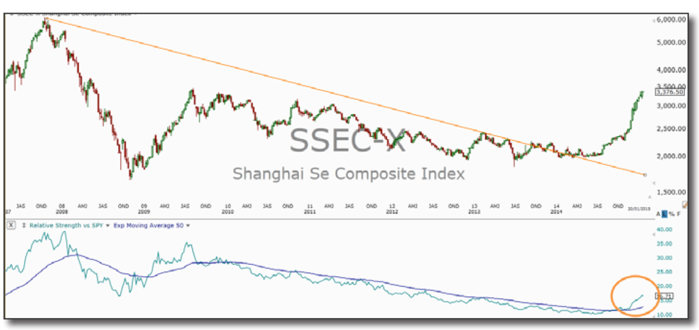
The TSX has lagged the S&P since 2008 due to weakness in energy and gold stocks which make up a significant portion of the index. With strength in gold now and a bottom trying to be forged in energy the TSX is pushing against resistance and underperformance vs. the S&P.

US EQUITIES



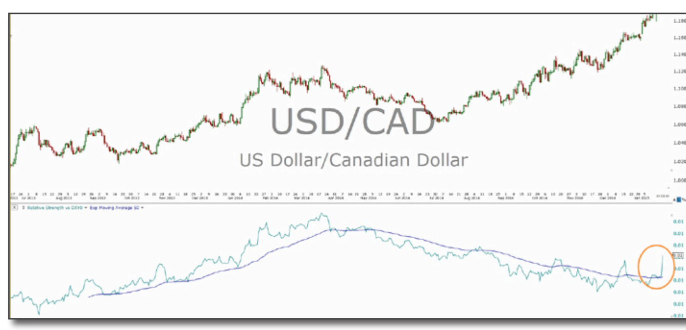
US stocks show an upward trajectory in price. The US sector page following breaks down just where the strength is today. The relationship between the S&P and bond prices was fairly even throughout 2014 (the horizontal move in the lower panel) though since late fall to today the market is underperforming bonds (oval highlight).

CHINESE EQUITIES



Breaking the downtrend line mid-2014, concurrent with the fall in oil and when CastleMoore sold all its energy stocks, the Chinese equity market is showing exceptional strength. Similarly, the market is breaking out against the S&P after 6 years of relative and absolute weakness.

US – CANADIAN DOLLAR EXCHANGE RATE



Current analysis suggests that there will be no reversal in the USD/CAD relationship. In fact, compared to the US dollar index in the lower panel the weakness looks to continue. To mitigate the negative impact of FX on investments CastleMoore monitors all stop loss management levels in C$'s and hedges where appropriate.

CASTLEMOORE IN THE MEDIA

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THE GLOBE AND MAIL

ON ENERGY STOCKS

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ON TOP STOCK PICKS

http://www.theglobeandmail.com/globe-investor/funds-and-etfs/etfs/three-top-picks-from-castlemoores-hap-sneddon/article22370601/

ON CONCORDIA PHARMACEUTICAL

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ON INVESTMENT EXPECTATION FOR 2015

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THE CLOSE – December 10, 2014

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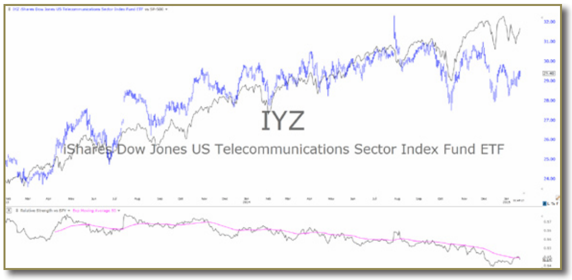
HEAD OFFICE
4275 Village Centre Court
Suite 201
Mississauga, ON L4Z 1V3

Phone 1.905.847.1400
Fax 1.416.352.0190

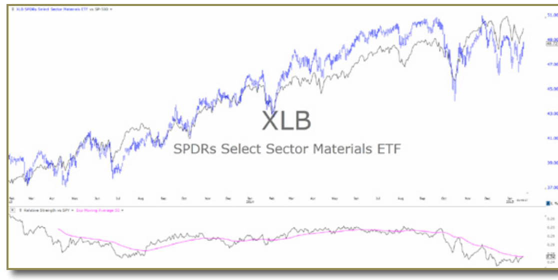
Toll Free 1.877.289.5673
Email info@castlemoore.com

www.castlemoore.com

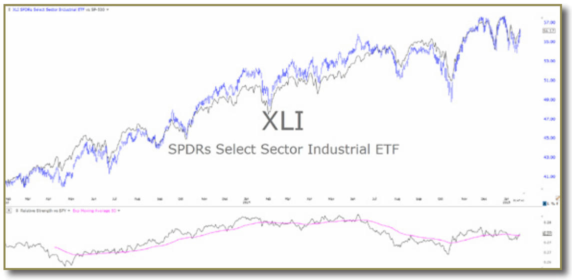
S & P 500 SECTOR PAGE



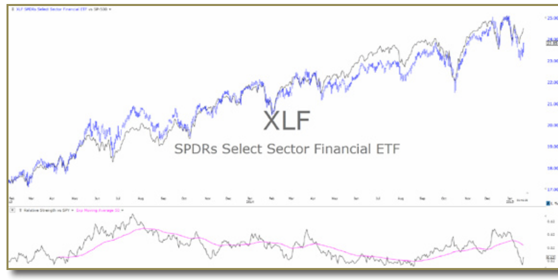
US Telecom underperforming the market



US Materials began dropping in September 2014

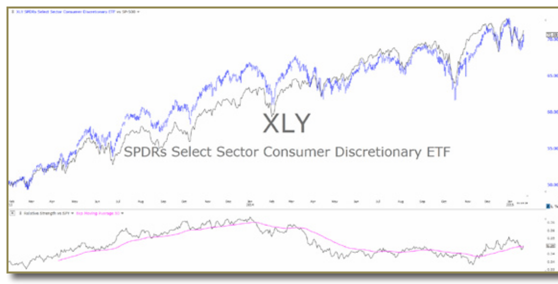


US Industrial tracks S&P well

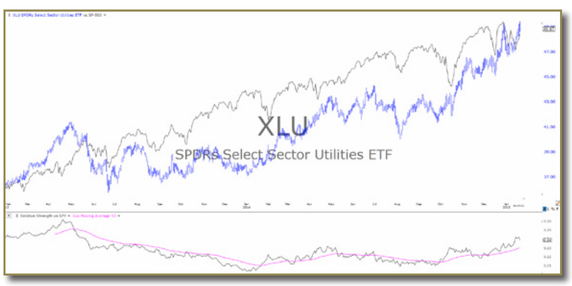


US Financials drop with 2015 foreward guidance

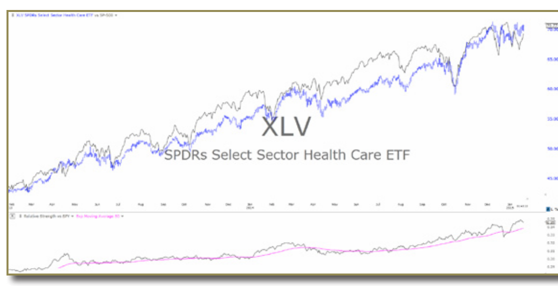
US Technology on pace but now stalling



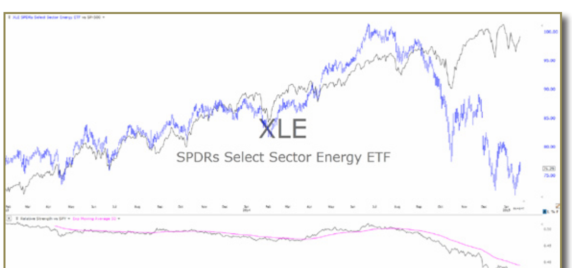
US Consumer Disc slightly underperforms in 2014



US Utility strength forecasts slower growth ahead



US Healthcare in secular bull market



US Energy underperformance began in June 2014

US Cons Staples strong, short term weakness ahead

GHOST IN THE MACHINE, PART I

GUEST COLUMNIST

By Ben Hunt

The way out is through the door. Why it is that no one will use this method?
– Confucius (551 – 479 BC)

Tanzan and Ekido were once traveling together down a muddy road. A heavy rain was still falling. Coming around a bend, they met a lovely girl in a silk kimono and sash, unable to cross the intersection.

"Come on, girl," said Tanzan at once. Lifting her in his arms, he carried her over the mud.

Ekido did not speak again until that night when they reached a lodging temple. Then he could no longer restrain himself. "We monks don't go near females," he told Tanzan, "especially not young and lovely ones. It is dangerous. Why did you do that?"

"I left the girl there," said Tanzan. "Are you still carrying her?"
– Nyogen Senzaki, "Zen Flesh, Zen Bones: A Collection of Zen and Pre-Zen Writings" (1957)

A student says, "Master, please hand me the knife," and he hands the student the knife, blade first. "Please give me the other end," the student says. And the master replies, "What would you do with the other end?"
– Alan W. Watts, "What Is Zen?" (2000)

Such in outline is the official theory. I shall often speak of it, with deliberate abusiveness, as "the dogma of the Ghost in the Machine." I hope to prove that it is entirely false, and false not in detail but in principle. It is not merely an assemblage of particular mistakes. It is one big mistake and a mistake of a special kind. It is, namely, a category mistake.
– Gilbert Ryle (1900 – 1976)

The trouble with Oakland is that when you get there, there isn't any there there.
– Gertrude Stein (1874 – 1946)

Dr. Malcolm: Yeah, yeah, but your scientists were so preoccupied with whether or not they could that they didn't stop to think if they should.
– "Jurassic Park" (1993)

It's a big enough umbrella

But it's always me that ends up getting wet.
– The Police, "Every Little Thing She Does is Magic" (1981)

Everyone who lost money on the Swiss National Bank's (SNB) decision to reverse course on their three and a half year policy to cap the exchange rate between the Swiss Franc (CHF) and the Euro made a category error. And by everyone I mean everyone from Mrs. Watanabe trading forex from her living room in Tokyo to a CTA portfolio manager sitting in front of 6 Bloomberg monitors to a financial advisor answering a call from an angry client. It will take me a bit of verbiage to explain what I mean by a category error and why it's such a powerful concept in logic and portfolio construction. But I think you'll find it useful, not just for understanding what happened, but also (and more importantly) to protect yourself from it happening again. Because this won't be the last time the markets will be buffeted by a forex storm here in the Golden Age of the Central Banker.

A year and a half ago, when I was just starting Epsilon Theory, I wrote a note called "The Tao of Portfolio Management." It's one of my less-downloaded notes, I think largely because its subject matter – problems of misunderstood logic and causality in portfolio construction – doesn't exactly have the sexiness of a rant against Central Bank Narrative dominance, but it's one of my personal favorites. That note was all about the ecological fallacy – a pervasive (but wrong-headed) human tendency to infer qualities about the individual from qualities of the group, and vice versa. Today I've got the chance to write once again about the logic of portfolio construction AND work in some of my favorite Zen quotes AND manage something of a Central Bank screed … a banner day!

I've titled this note The Ghost in the Machine because it starts with another pervasive (but wrong-headed) human tendency – the creation of a false dualism between mind and body. I know, I know … that sounds both really daunting and really boring, but bear with me. What I'm talking about is maybe the most important question of modern philosophy – is there a separate thing called "mind" or "consciousness" that humans possess, or is all of that just the artefact of a critical mass of neurons firing within our magnificent, but entirely physical, brains? I'm definitely in the "everything is explained by neurobiology" camp, which I'd say is probably the more widely accepted view (certainly the louder view) in academic philosophy today, but for most of the 19th and 20th centuries the dualist or Cartesian view was clearly dominant, and it was responsible for a vast edifice of thought, a beautiful cathedral of philosophical constructs that was … ultimately really disappointing and empty. It wasn't until philosophers like Gilbert Ryle and Van Quine started questioning what Ryle called "the ghost in the machine" – this totally non-empirical but totally accepted belief that humans possessed some ghostly quality of mind that couldn't be measured or observed but was responsible for driving the human machine – that the entire field of philosophy could be reconfigured and take a quantum leap forward by incorporating the insights of evolutionary biology, neurobiology, and linguistics.

Unfortunately, most economists and investors still believe in ghosts, and we are a long way from taking that same quantum leap. There is an edifice of mind that dominates modern economic practice … a beautiful cathedral where everything can be symbolized, where everything can be securitized, and where everything can be traded. We have come to treat these constructed symbols as the driver of the economic machine rather than as an incomplete reflection of the real world things and real world activities and real world humans that actually comprise the economy. We treat our investment symbols and thoughts as a reified end in themselves, and ultimately this beautiful edifice of symbols becomes a maze that traps us as investors, just as mid-20th century philosophers found themselves trapped within their gorgeous constructs of mind. We are like Ekido in the Zen koan of the muddy road, unable to stop carrying the pretty girl in our thoughts and trapped by that mental structure, long after the far more sensible monk Tanzan has carried the girl safely over the real world mud without consequence, symbolic or otherwise.

The answer to our overwrought edifice of mind is not complex. As Confucius wrote in The Analects, the door is right there in front of us. Exiting the maze and reducing uncompensated risk in our portfolios does not require an advanced degree in symbolic logic or some pretzel-like mathematical process. It requires only a ferocious commitment to call things by their proper names. That's often not an easy task, of course, as the Missionaries of the Common Knowledge Game – politicians, central bankers, famous investors, famous economists, and famous journalists – are dead-set on giving things false names, knowing full well that we are hard-wired as social animals to respond in ant-like fashion to these communication pheromones. We are both evolved and trained to think in terms of symbols that often serve the purposes of others more than ourselves, to think of the handle rather than the blade when we ask for a knife. The meaning of a knife is the blade. The handle is not "the other end" of a knife; it is a separate thing with its own name and usefulness. The human animal conflates separate things constantly … maybe not a big deal in the kitchen, but a huge deal in our portfolios. Replace the word "knife" with "diversification" and you'll get a sense of where I'm going with this.

Here's what I mean by calling things by their proper names. The stock ticker "AAPL" or the currency ticker "CHF" are obviously symbols. Less obviously but more importantly, so are the shares of Apple stock and the quantities of Swiss francs that AAPL and CHF represent. Stocks and bonds and commodity futures and currencies are symbols, not real things at all, and we should never forget that. The most common category error that investors make (and "category error" is just a $10 phrase for calling something by the wrong name) is confusing the symbol for what it represents, and as a result we forget the meaning of the real world thing that's been symbolized.

A share of stock in, say, Apple is a symbol. Of what? A limited liability fractional ownership position in the economic interests of Apple, particularly its free cash flows.

A futures contract in, say, copper is a symbol. Of what? A commitment to receive or deliver some amount of real-world copper at some price at some point in the future.

A bond issued by, say, Argentina is a symbol. Of what? A commitment by the Argentine government to repay some borrowed money over an agreed-upon period of time, plus interest.

A currency issued by, say, Switzerland is a symbol. Of what? Well, that's an interesting question. There's no real world commitment or ownership that a currency symbolizes, at least not in the same way that stocks, bonds, and commodity contracts symbolize an economic commitment or ownership stake. A currency symbolizes government permission. It is a license. It is an exclusive license (which makes it a requirement!) to use that currency as a medium for facilitating economic transactions within the borders of the issuing government, with terms that the government can impose or revoke at will for any reason at all. That's it. There's no economic claim or right inherent in a piece of money. As Gertrude Stein famously said of Oakland, there's no there there.

Why is this examination of underlying real world meaning so important? It's important because there is no positive long-term expected return from trading one country's economic license for another country's economic license. There is a positive long-term expected return from trading money for stock. There is a positive long-term expected return from trading money for bonds. There is a positive long-term expected return from trading money for commodities and other real assets. But there is no positive long-term expected return from trading money for money.

Unfortunately, we've been trained and encouraged – often under the linguistic rubric of "science" – to think of ANY new trading vehicle or security, particularly one that taps into as huge a market as foreign exchange, as a good thing for our portfolios. We are deluged with the usual narratives that alternatively seek to tempt us and embarrass us into participation. On an individual level we are told stories of savvy investors who look and act like we want to look and act, taking bold advantage of the technological wizardry (look! it's a heat map! that changes color while I'm watching it!) and insanely great trade financing now at our fingertips in this, the best of all possible worlds. On an institutional level we are told stories of liquidity and non-correlation (what? you don't understand what an efficient portfolio frontier is? and you call yourself a professional?), both good and necessary things, to be sure. But not sufficient things, at least not to cast the powerful magic that is diversification.

There are only a few sure things in investing. First, taxes and fees are bad. Second, compound growth is a beautiful thing. Third, portfolio diversification works. At Salient we spend a lot of time thinking about what makes diversification work more or less well for different types of investors, and if you're interested in questions like "what's the difference between de-risking and diversification?" I heartily recommend our latest white paper ("The Free Lunch Effect") to you. One thing we don't do at Salient is include currency trading within our systematic asset allocation or trend-following strategies. Why not? Because Rule #1 for tapping into the power of portfolio diversification is that you don't include things that lack a long-term positive expected return. Just because we can trade currency pairs easily and efficiently doesn't mean that we should trade currency pairs easily and efficiently, any more than cloning dinosaurs because they could was a good idea for the Jurassic Park guys. The point of adding things to your portfolio for diversification should be to create a more effective umbrella, not just a bigger umbrella. I like a big umbrella just as much as the next guy, but not if I'm going to get wet every time a forex storm whips up.

So if not for diversification, why do smart people engage in currency trading? There's a good answer and a not-as-good answer to that question.

The good answer is that you have an alpha-driven (i.e. private information-driven) divergent view on the terms of the government license embedded within any modern currency. This is why Stanley Druckenmiller is an investing god, and it's why anyone who put money with him before, during, and after he and George Soros "broke the Bank of England" in 1992 has been rewarded many times over.

The not-as-good answer is that you have identified a predictive pattern in the symbols themselves. I say that it's not as good of an answer, but I'm not denying that there is meaning in the pattern of market symbols. On the contrary, I think there is real information regarding internal market behaviors to be found in the inductive study of symbolic patterns. This information is alpha, maybe the only consistent source of alpha left in the world today, and acting on these patterns is what good traders DO. But because it's inductively derived, anyone else can find your special pattern, too. Or if they can't, it's because you've carved out a nice little parasitic niche for yourself that's unlikely to scale well. More corrosively, the natural human tendency is to ascribe meaning to these patterns beyond the internal workings of the market, something that makes no more sense than to say that goose entrails have meaning beyond the internal workings of the goose. The meaning of the Swiss franc didn't change just because you had a consistent pattern of market behavior around the EUR-CHF cross. Deviation in the expected value of the Swiss franc in Euro terms did not become normally distributed just because you can apply statistical methodology to the historical exchange rate data. I get so annoyed when I read things like "this wasn't just the greatest shock in the history of forex, it was the greatest shock in the history of traded securities! a 30 standard deviation event!" Please. Stop it. Just because you can impose a normal distribution on the EURCHF cross doesn't mean that you should. And if you're making investment decisions because you think that this normal distribution and the internal market stability it implies is somehow "real" or has somehow changed the fundamental nature of what a currency IS … well, eventually that category error will wipe you out. Sorry, but it will.

I don't mean to be snide about any of this (although sometimes I can't help myself). The truth is that an aggregation of highly probabilistic entities will always surprise you, whether you're building a baseball team or an investment portfolio. Portfolio construction – the aggregation of symbols and symbols of symbols, all of which are ultimately based on massive amounts of real world activities that may have vastly different meanings and underlying probabilistic natures – is a really difficult task under the best of circumstances for a social animal that evolved on the African savanna for an entirely different set of challenges. And these are not the best of circumstances. No, the rules always change as the Golden Age of the Central Banker begins to fade. The SNB decision was a wake-up call, whether or not you were directly impacted, to re-examine portfolios and investment behavior for category errors. We all have them. It's only human. The question, as always, is whether we're prepared to do anything about it.

W. Ben Hunt, Ph.D, Chief Risk Officer
SALIENT
4265 San Felipe, 8th Floor, Houston, TX 77027
Direct: 713.548.2627 | Fax: 713.993.4098
Twitter: @EpsilonTheory, bhunt@salientpartners.com

INCOME TAX FOLIOS – THREE CHEERS FOR THE CRA

By Ed Arbuckle

Income tax folios were first rolled out in March of 2013 and provide taxpayers with the CRA's interpretations of our tax laws as they apply to the important aspects of many tax issues that commonly confront taxpayers. They are not intended to be exhaustive nor do they explain how every part of the law will apply to potential situations. These words are taken almost verbatim from CRAs publication, Introducing Income Tax Folios so as not to stray too far from the precise wording of the CRA on the scope of the new folios.

Income tax folios are gradually replacing the older interpretation bulletins which date back to the 1970's and are being phased out. As new folios are issued which cover bulletins that deal with the same subject, the bulletins will be cancelled. As a matter of fact, many bulletins have already been cancelled because they were outdated and no longer reflected the CRA's current position.

Folios will be an excellent source of information to taxpayers on everyday tax topics. They are quite readable and do a good job in dealing with some of the complicated laws where taxpayers are looking for guidance. If a particular area concerns you, they are highly recommended reading and should help you understand the rules and CRA's current take on them. A folio should be the thing you reach for first when you are having trouble understanding a tax provision that affects you.

ORGANIZATION – SERIES, CHAPTERS AND FOLIOS

The folios have been divided into seven different series. This makes it easy to get started and avoids going through all of the folios to locate the one that you want. The seven series are as follows:

1. Individuals
2. Employers are Employees
3. Property, Investments and Savings Plans
4. Business
5. International and Residency
6. Trust
7. Charities and Non-profit Organizations

Individuals are most likely to be interested in series 1, 2, 3, and perhaps 4 and 6. That's not to say that others will not apply because in some cases they will.

Each series has a number of topic-specific chapters. Again, this organization will help you get where you want to be very quickly. Take for example in Series 1 dealing with Individuals. There are six chapters under the following headings:

1. Health and Medical
2. Students
3. Family Unit Issues
4. Personal Credits
5. Transfers of Income, Property, or Rights Third Parties
6. Deceased Individuals

You can see that the thoughtful organization of the new folios makes it easy to move around and find out if CRA has published a folio on something of interest to you. That is a great step forward. Even tax professionals look at these things to gain a better insight about CRA's thinking on a particular matter. The CRA will issue a conditional folio first and hold it for 30 days for public comments before it is declared final. That's fairer than fair.

You can find a list of current folios on the CRA's website by going to **http://www.cra-arc.gc.ca/tx/tchncl/ncmtx/fls/menu-eng.html.**

I prefer to Google folios and it gets me there just as fast without typing in a complicated address that more than likely I will get wrong.

KNOWING CRA's POSITION

If you have a tax issue that concerns you, folios are a great help. The flip side of this of course is that it may be an uphill battle to convince CRA to see your point of view if it comes up with a different interpretation – despite CRA's statement to the contrary. If you call the CRA hotline to get an answer to a tax question, chances are you may get a folio read back to you with no further comments from the CRA person – end of discussion. People on CRA's answer line are not as qualified as many others at the CRA so the value of their interpretation may be questionable. Before relying on their answer, you may want to get professional advice if you disagree.

COMPLYING WITH THE CRA

Sometimes there is more than one way to carry out a transaction. If you are in this situation and if there is a way for you to complete it to comply with CRA's position or to do it another way - what should you do? I think you know the answer – comply with the CRA of course.

CRA's new folios are a positive for taxpayers. They are very readable and generally fair. I suggest that you refer to this library of information before you carry out your transactions so hopefully you will comply with the CRA interpretation from the get go.

This Tax Alert first appeared in a newsletter for the Canadian Money Saver.

J. E. Arbuckle Financial Services Inc.
30 Dupont St. E., Suite 205, Waterloo, Ontario N2J 2G9
Phone: 519-884-7087 Fax: 519-884-7087
Email: jea@finplans.net