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## A Special Report April 23<sup>rd</sup>, 2009 *The Way Forward*

Over the past eighteen months, Americans and investors around the world have found themselves living through some of the most horrific market conditions seen in a generation. Not since The Great Depression has so much market dysfunction and outright capital destruction taken place in our society, and the recent market improvements notwithstanding, that dysfunction may be far from over.

This recession is now officially the longest on record since World War II, and while recessions inevitably lead to recoveries, economists' opinions differ today as to the length of time that may remain before expansion returns. The more optimistic among those who practice the dismal science believe that we may see recovery beginning in the third or fourth quarters of this year, while others are more cautious in their predictions, projecting the recession to persist throughout this year and in some cases, well into next. Regardless who's right, the damage to the confidence of consumers, investors, and businesses alike assures that the recovery process itself will *not* be a swift one, and in my humble opinion, probably prevents the capital markets from returning to their "pre-crash" levels anytime soon. Simply stated, market recovery is going to be a tough slog.

Given the responses I received following my last missive to you (A Special Report – *What's Next?* - February 24, 2009), I know that some of you are surprised to hear such a gloomy perspective from yours truly. Over the years, I've been a rather vocal (and consistently optimistic) proponent of a "strategic", or relatively static, portfolio asset allocation approach, and one that emphasizes equities (stocks, real assets) over debt (bonds, cash) at that.

I was not alone. Like 95% or more of my colleagues, especially those with more than a decade's experience managing clients' assets, these core beliefs were forged by several decades of daily personal and professional market participation and observation. Although the past year and a half's massive market decline obscures it, the fact of the matter is that over the entirety of my career as a portfolio manager, we've enjoyed generally rising stock *and* bond markets. These markets consistently delivered positive returns over the period, and "buy and hold" investors were correspondingly well rewarded.

By way of illustrating this point, I did a little research, and gathered the following data for the period coincidental with my working career (1983 – present). Generally speaking, this twenty-six year period also encompasses the vast majority of my clients’ investing experience.

<u>Asset Class</u>	<u>2008 Return %</u>	<u>26 Year Annual Average Return %</u>	<u># of Negative Return Years</u>
Large Cap Domestic Stocks	(-37.00%)	10.23%	5
Small Cap Domestic Stocks	(-36.72%)	10.71%	8
Long-Term Govt. Bonds	25.87%	10.58%	3
Long-Term Corp. Bonds	8.78%	9.75%	3
Interm-Term Govt. Bonds	13.11%	8.24%	2
U.S. Treasury Bills	1.60%	4.96%	0
Inflation (C.P.I.)	0.09%	2.99%	0

Source: Ibbotson SBBI 2009 Yearbook

Can you see why investment professionals have been utilizing strategic allocations to stocks, bonds, and cash over the past quarter century? In 80% or more of the years in which you could have invested in these markets, you were rewarded with positive returns, returns averaging 8% - 10% per year over the entire period! A key benefit associated with the approach has been that the discipline of rebalancing one’s portfolio to its strategic allocations forced investors to “buy low and sell high”, and generally prevented investors from making emotional decisions during occasionally volatile markets. The bottom line? Over my working lifespan, and generally speaking, over my clients’ investing lifespan, strategic asset allocation worked, and it worked extremely well.

Until now...

Indoctrinated in Nobel Prize Award winning Modern Portfolio Theory, advisors following the efficient market thesis relied heavily on fundamental analysis, and on traditional valuation methodologies in our portfolio designs and management. When markets exhibited dysfunction and pricing irrationality, we were trained to believe that such markets presented patient and prescient investors opportunities to profit, not to panic. When, from a fundamental valuation perspective, stocks became “cheap”, we were taught that those were opportunities to buy, not to sell. Conversely, when valuations became “frothy”, paring back stock holdings, or rebalancing one’s portfolio was indeed appropriate. The icons of this philosophy are men like Warren Buffet, Peter Lynch, Jeremy Siegel, and Benjamin Graham. Their guiding principles have proven tried and true for the entirety of my career. For the long-term investor, owning, and holding stocks made perfect sense, not to mention handsome profits, for the past twenty-five-plus years. That never changed.

Until now...

I guess it would be an understatement to say that the past year and a half’s disastrous results has forced investors and advisors alike to begin to question everything we’ve learned over these many years about the market mechanisms, and about the efficiencies of capital markets themselves. We’ve been forced to cast aside personal biases, and to “re-think” our portfolio

diversification techniques. Academics and asset managers like Robert Arnott are even presenting research challenging the long-held beliefs that stocks will *always* outperform bonds, and bonds will *always* outperform cash, *over time*. These foundational beliefs about the capital markets' hierarchies of return have been stood on their ear by the "perfect storm" we find ourselves traversing, and candidly, we are scrutinizing data and theorems from perspectives we never thought possible. Before I get into conclusions and potential market solutions, and *I promise I will*, indulge me while I expand upon my observations during my search for answers in the "new world" in which we find ourselves investing.

### **Confronting The Brutal Facts**

Jim Collins, in his excellent book, *Good to Great*, details a multi-year research study seeking to find the common threads among the very few *good* businesses who, not settling for simple goodness, decided instead to become *great* businesses. You may have heard the expression, "*Good is the enemy of great.*" That's Jim's, and it speaks to the tendency of businesses, and I might suggest, the tendency of individuals and professionals as well, once having achieved profitability and a measure of established success, to ignore innovation and change in their environments, because, as the saying goes, "*If it ain't broke...*"

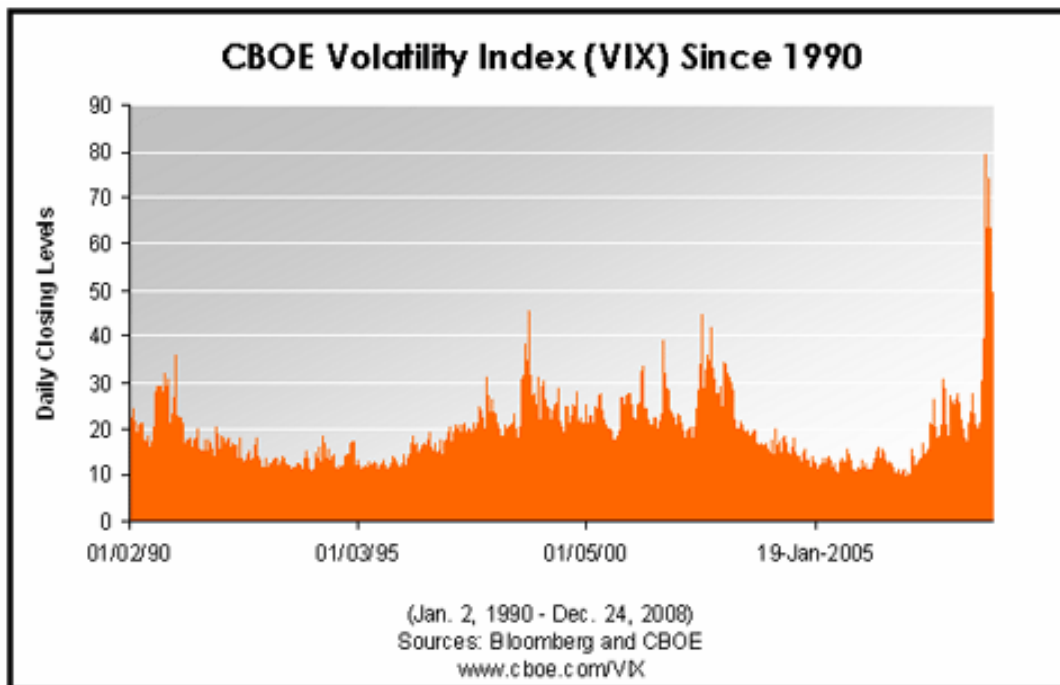
One of the study's most important conclusions about those who had in fact, achieved greatness was that they were universally able to: **Confront the Brutal Facts (Yet Never Lose Faith)**. These great businesses, and the heroic individuals he uses illustratively were able to see the incredibly difficult challenges before them, accept their realities, regardless how brutal, and adjust their tactics, all the while never, ever, accepting or even entertaining the possibility of defeat.

I believe that investors and investment professionals alike are faced with a metaphorically similar challenge today, namely, **confronting the brutal facts that the capital markets have fundamentally changed, and from all appearances, for the foreseeable future.**

*Brutal Fact # 1:* We must recognize the fact that markets are no longer behaving rationally, or at the very least, far less so today than during those aforementioned decades. Despite the huge increase in financial media the past few years, or perhaps *because* of it, the equity and debt markets have evidenced levels of sheer irrationality previously unseen in my professional career. And investors are once again finding that the old saw that, "*Markets can remain irrational far longer than you can remain solvent.*" is still very true.

Today the speed with which an adverse news item or a disappointing economic data release can be dissected and translated into a multiple-hundred point drop in the Dow Industrials is nothing short of breathtaking. On more than a few occasions, I have sat in my office and watched in horror, while President Obama would speak at a news conference, or as Treasury's Geithner would testify before a Congressional Sub-Committee, causing the markets to fall in *real-time*. People cite the "efficiency" of information flow, and while it's true there is seemingly no delay in its dissemination, market participants are so shell-shocked today that they immediately extrapolate bad news to *financial extinction*, even to those companies who remain profitable.

The markets' volatility (as measured by The "VIX Index") is at unprecedented levels. The brutal fact is that these incredible levels of market volatility are unlikely to dissipate in the near term.



***Brutal Fact # 2:*** We are in a severe, global recession, one born of financial engineering and excessive leverage. I won't spend too much time on this here, as we've all been inundated with the causes of the mess, with plenty of finger-pointing going on in Washington, on Wall Street, and on Main Street as well. The bottom line is that we are all leveraged to the hilt. "Cheap" money fueled irresponsible growth, and if we are honest with ourselves, many of us on Main Street *personally* adopted the behaviors we saw modeled by Wall Street, and by Washington. Expansion as far as the eye could see blinded us to the realities that a day of reckoning was inevitable, and unfortunately, that day has arrived with a vengeance. The painful, national de-leveraging of our personal and corporate balance sheets began last year, and continues apace today.

***Brutal Fact # 3:*** The final, and perhaps for me, the most significant "brutal fact" is that our political leaders, never known for their courage and foresight, are doing what they do best, that is, "fixing" the problem *today*, while simultaneously planting the seeds of an even bigger problem to be faced *tomorrow*.

According to the Congressional Budget Office (CBO), between the T.A.R.P. (Troubled Asset Relief Plan), the T.A.L.F. (Term Asset-Backed Securities Loan Facility), the F.S.P. (Financial Stabilization Plan), the P.P.I.P. (Public-Private Investment Plan), and all the other alphabet-soup acronyms assigned to the plans our government is in the process of delivering to us, this year's federal fiscal deficit will exceed \$1.7 Trillion. That incredible number will be close to three times the largest annual fiscal deficit in U.S. history.

The spending numbers are so staggering that it's difficult to put them into proper context, but we must try. From George Washington's administration through George Bush's, the unpaid debt the U.S. government has accumulated totals just over \$11 Trillion, about \$6.7 Trillion of which is publicly held. (The \$4.3 Trillion non-publicly-held balance is "owed" to *ourselves* in entitlement programs such as Social Security, Medicare, etc.) When you divide that total debt over today's U.S. population, it works out to approximately \$36,300 for every man, woman, and child in America. That "per capita debt" number is an important one for American investors to keep in mind, because, at the end of the day, *we are the government*, and collectively, *we must service that debt* through our tax payments. Ultimately, there is no other source for satisfaction and service of that debt.

While the thought of that burgeoning debt being placed on our backs, and on the backs of our children and grandchildren is sobering to say the least, we are about to *dramatically increase* that burden, and we're going to do so over a (relatively) brief ten year period! CBO projects that President Obama's initiatives in the areas of Health Care, Education, and in the development of "Clean Energy" alternatives, if enacted, would **add \$9.3 Trillion to the cumulative federal deficit projected over fiscal years 2010 – 2019, inclusive.**

And to add insult to injury, CBO also projects that changes to the tax policy proposed by the President and by Democratic leaders in Congress (i.e. *tax increases* on the wealthiest Americans) will actually *reduce total tax revenues* to the government by **an additional \$2.1 Trillion over that same ten year period.** As apparently only those of us who live outside "the Beltway" seem to know, increasing marginal tax rates on income and capital gains almost always reduces revenues to the government. (This phenomenon is often referred to as "*The Tax Paradox*". Raise tax rates, and you'll see reduced revenues. Parenthetically, I find it fascinating that when directly asked about this phenomenon, politicians proposing these tax increases don't dispute the behavioral adjustments that are historically made by taxpayers to reduce their effective tax. They simply cite "fairness" as their overriding concern.)

If the President and his supporters get everything on their wish list, and CBO is correct, **we would have cumulative federal debt outstanding exceeding \$22 Trillion by 2019.** The U.S. Census Bureau projects a U.S. population in 2019 of 338,190,000 Americans. If you do the math, a \$22 Trillion deficit spread over that number of Americans would result in a "per capita debt" in 2019 of \$65,000. That means that the typical family of four would be carrying \$260,000 of government debt... *in addition to their own!* Making matters worse, we know that only 56% of Americans actually pay income taxes today, increasing the burden on those who do, but even if we were spreading the burden over the *entire* population, the projected debt burden is simply too great to bear.

A little publicized factoid is that CBO estimates that by that final year of their projections (again, fiscal year 2019), fully 61% of the government's budget will be allocated to paying just the interest on our Treasury's debt, with the remaining 39% to cover little things like national defense, entitlement programs, government agencies, infrastructure, and the like. As much as I'd like to see all Americans with "free" health care, better schools and lower carbon emissions, the simple fact is that the revenue pie isn't big enough, and won't be, to do all we'd like to do.

### **What Does This Mean For The Economy And The Markets?**

Given that *nobody*, including the Administration or the Congress projects the government's revenues will approach its spending levels *at any point in the foreseeable future*, the question we should be asking ourselves (and our elected leaders) is: How on earth will we pay for our current spending levels, let alone for the President's bold new agenda? The truth is there are only three ways I am aware of. We can (1), dramatically raise taxes on *all* productive Americans, something the President says he won't do to 95% of Americans, (2), sell U.S. Treasury Bonds into the global capital markets to finance our needs, and/or (3), have the Federal Reserve simply "print" the money we need. Try as I might to find other ways to raise the money, there simply are no other ways to fill the gap between all the things we supposedly "need", and what we currently squeeze out of taxpayers. As investors, it is important to accept this brutal fact, as its implications for the economy and for the capital markets it reflects are severe.

How so, you ask?

One can choose to take the President at his word when he says he's not going to dramatically raise the taxes of 95% of Americans. (And if you believe that, I have some land west of Phoenix...way west...to sell you.) Ahem... That takes us to selling Treasuries at auction. As you know, much of our Treasury debt is sold overseas, and problematically to that purpose, we've recently seen and heard resistance to the Administration's agenda by foreign countries that have historically been eager to buy our Treasury's debt (i.e. China). Ironically, some of this vocal criticism has been coming from our European allies (i.e. France, and the Czech Republic among them), countries, candidly, not traditionally known for their fiscal restraint. (Certain pundits have proffered that when the French call your policies "irresponsible", and "socialistic", you might need to ask yourself if you've gone too far!)

The practical consequence to this foreign resistance is that regardless the Administration's desires for all of these spending programs, we're seeing a clear dampening of investor appetite for government debt all around the world. The German government has been experiencing "failures" at their Bund auctions for some time (failure being defined as not selling all their available supply to willing buyers). Great Britain recently experienced their first Gilt auction failure since 2002, and the U.S. has recently received tepid, if not outright *weak* responses to their auctions of longer-term Treasury bonds, despite a steepening yield curve that would normally make them more attractive. The reality is that it's difficult to accurately determine how much of this projected deficit spending could actually be foisted onto investors as buyers of Treasuries, but I suspect a large portion, perhaps as much as half of it would simply have to be printed by the Federal Reserve.

**The point I'm laboring to make is that the projected massive increase in the amount of our government's deficit spending will likely require the outright "printing" of trillions and trillions of U.S. Dollars by the Federal Reserve. Unfortunately, this leads inevitably to a substantial devaluation of the dollar, and consequently to extremely high levels of inflation, perhaps to inflation levels previously experienced in the late '70's, or worse.**

Wishing to spare you any further divergence down the “rabbit trail” of where foolish tax policy and fiscal irresponsibility from Washington leads, I think it needs acknowledgement by investors of all political persuasions that massive continuing deficits, devaluing the currency, and persistently high inflation are all “anti-capital” policies. You can vote any way you like, but tripling the federal deficit in ten years while simultaneously raising taxes is not “pro-capital”, no matter how you spin it.

### Secular Bear Market?

Investors are now facing the possibility that we may be mired in the middle of what is known within investing circles as a “secular bear market”. A secular bear market is defined as a fairly long period of time (historically 13 – 16 years) when stock prices effectively go nowhere. These secular bears are inevitably followed by secular bull markets, which are followed by secular bears, and so on. Unfortunately, these sea changes in sentiment are difficult to identify until you are well into them. The chart below shows us when these long-term trends have historically changed from bull to bear, and back to bull again.

**Dow Jones Industrial Average-January 1928 to November 2008**

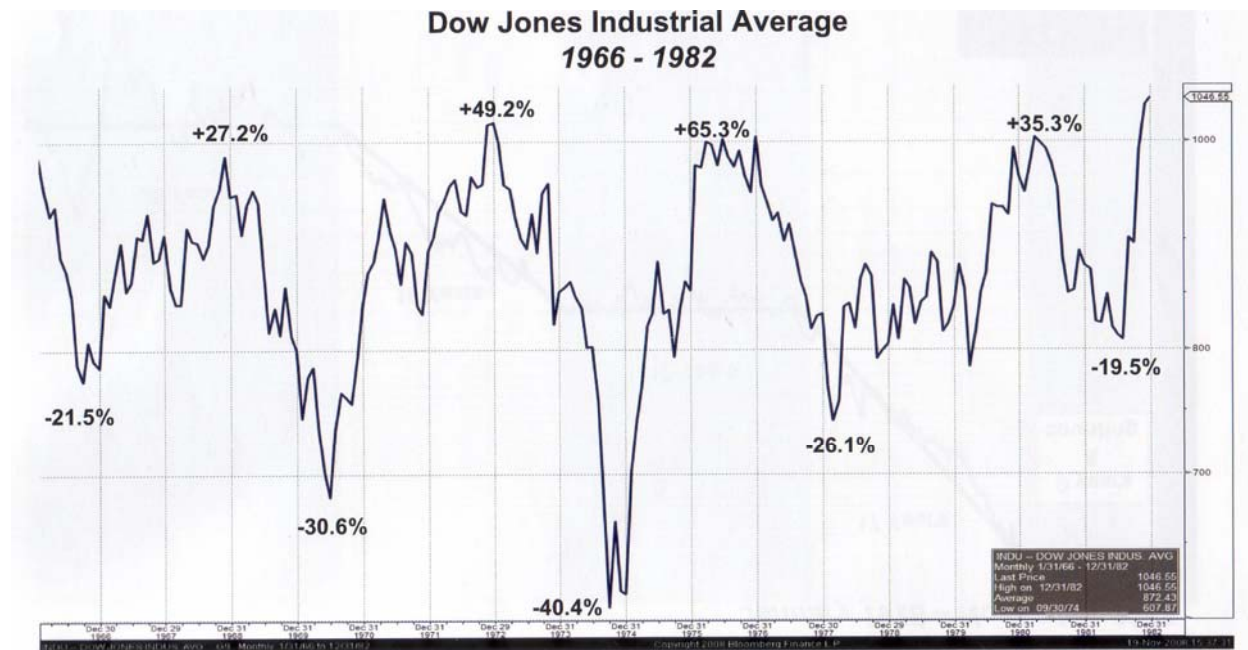


Source: Bloomberg

Early in the current decade, some wondered if we might be entering a new secular bear market. We’d just experienced the greatest secular bull market in our lifetimes, an eighteen year bull run that began in 1982, and ended in early 2000. There were only two calendar years (1990 and 1994) in the entire period when the domestic equity markets declined, and then only modestly.

But as we all painfully recall, the S&P 500 subsequently fell 49% from peak to trough (March 2000 – October 2002) in support of the premise that the bull was exhausted. However, that “secular bear” speculation gave way to a five year (“cyclical”) bull run (October 2002 – October 2007) that took the S&P 500 and other equity indices to new, all-time market highs, effectively quelling those secular bear claims. In retrospect, it turns out that that the five years of up-trending markets we enjoyed during those years was nothing more than a head fake. Despite the run up to new highs in 2007, as I write this, the S&P 500 is once again 45% below where it “peaked” way back in March 2000, and it seems clear that we are now eight years into a secular bear market. As the chart reveals, the average length of the past three secular bear market has been fourteen or fifteen years, so, if past is prologue, this secular bear could last another six years or longer.

Before you decide to jump out of a window, or to sell every stock you own, I need to let you know that there are ways to make money in stocks during a secular bear, and to make lots of it in fact.



Source: Bloomberg

As the chart above shows, secular bears don't just move sideways without gains or losses, even though that is often the sum total of the entire period's results. Actually, there are always “tradable” cyclical rallies *within* secular markets. As we see in this chart of the last secular bear (1966 – 1982), there were four “cyclical” bull markets imbedded within it. During this sixteen year period, the Dow Jones Industrial Average traded narrowly between 600 – 1000 the entire time, and each cyclical rally within it delivered gains of 27% to 65%, gains averaging 44%. The problem occurred when the subsequent declines effectively wiped out the gains each time. Sound familiar? It should, since that is exactly what we've seen during the past eight-plus years.

For example, we are currently approximately 25% above the “low” we recently experienced on March 9<sup>th</sup> (Dow Industrials: 6440; S&P 500: 672), and as we communicated to you in the aforementioned February 24<sup>th</sup> Special Report, this “bounce” off the bottom was not completely unexpected. In fact, I wouldn’t be surprised to see this rally continue to Dow 9,000, and possibly, even higher. However, for all the reasons (a.k.a. the “brutal facts”) I’ve already beaten to death, especially those having to do with the massive increase in government debt, the dollar devaluation and accompanying increase in inflation, I am now convinced that the equity market declines we’ve seen over the past eighteen months will likely recur again, bouncing up and down within a fairly narrow range, and perhaps for years to come.

### **Tactical Solutions**

Given my experience, and the rather bullish period during which I’ve been an investor, I didn’t come to this “bearish” conclusion easily, but I’m nothing if not pragmatic. In this type of economic and market environment, sitting on one’s hands, or actually placing one’s money in the mattress, is not an effective strategy. We need tactical, market-based solutions that will grow our assets in “real” (net of inflation) terms. Holding cash for the remainder of this bear market isn’t a solution, especially if inflation rises dramatically. Bonds, while perhaps better than stocks in a recession, still don’t hold up well in an inflationary periods, especially when coupled with massive dollar devaluation. Real estate, traditionally an inflation hedge, is illiquid, and as we’ve seen, the landscape is littered with investors who speculated in real estate and got crushed when financing dried up and buyers disappeared. Gold, another great inflation hedge, trades today about 20% above where it traded in 1980. Commodities are extremely volatile (See: Oil Prices from 2008 – 2009), and private equity and hedge funds are opaque and not available to the average investor.

### **“Sailing” Markets Vs. “Rowing” Markets**

During secular bull markets, a monkey throwing darts at the Wall Street Journal can make money. Everything rises and everyone wins. A friend of mine calls this a “sailing” market, a time when pulling the oars out of the water, lifting the sails, and letting the wind (i.e. the rising tide of the markets in general) do the work makes most sense. You want to be “all in” during a secular bull market, and as previously explained, in these sailing markets a strategic equity allocation works well.

But during secular bear markets *we need a more tactical approach*. Sticking with my friend’s metaphor, secular bear markets are “rowing” markets, markets where there is no wind, and we need to put the oars back into the market and row like hell. In a rowing market, we need to be more opportunistic in our allocation strategies. We need more frequent reallocations and rebalancing transactions. And we need to employ more “absolute return” strategies within our overall portfolio strategy. We need to more broadly diversify our portfolio allocations, using non-correlated strategies to a greater extent, much the way large endowment managers do.

The large university endowments (i.e. Harvard, Yale, and Stanford) have historically taken the concept of portfolio diversification to a level above that seen within the typical retail investor's portfolio, and while many of these endowments, like everyone else, experienced their worst performance year in decades in 2008, few endowments experienced percentage declines anywhere near those the average retail investor experienced. An endowment strategy is designed to make money in every market environment, or at the very least, not to lose much money.

**The Core/Satellite Model**

We can employ this endowment strategy in a “Core/Satellite” design, illustrated below:



The “Core” portfolio within this strategy will receive the largest allocation, holding 40% - 60% of every client's portfolio. Like our strategic money managers today, it will invest primarily within the “traditional” capital markets (i.e. stocks, bonds, cash), and to a lesser degree, into certain “alternative” investment markets, such as natural resources, commodities, and currencies. These allocations will be *tactically managed*, with broad latitude given the managers to move in and out of each asset class as they see fit. While all of these managers will actively manage their allocations, each tactical manager will employ unique proprietary methodologies to decide which asset classes and/or sectors they will invest in, and which they will avoid. But if one had to describe in the simplest of terms possible the *difference* between the strategic managers we use today, and the tactical managers we will use going forward, it would be to say that while all managers (tactical and strategic) will have a disciplined *buy* strategy, the tactical managers will also utilize a disciplined *sell* strategy.

If they determine that cash is the best place to be, they will hold cash. If they are very bullish on stocks, they can hold concentrated positions of them. If shorting the markets is appropriate, they can do that as well.

Tactical money managers generally fall into one of two camps, and I will try to describe each approach here.

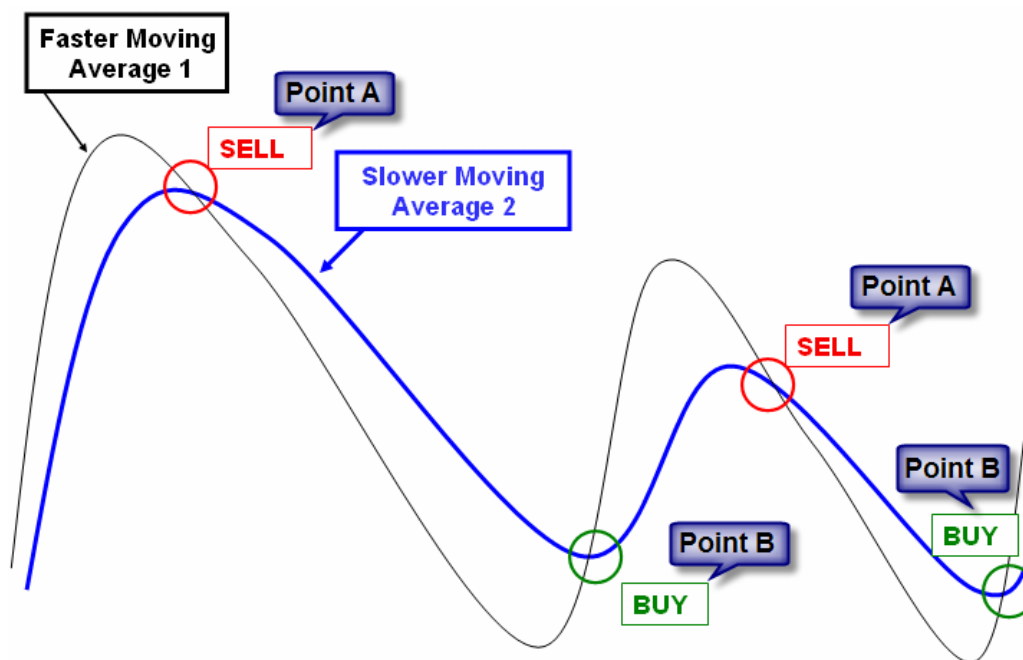
### Global Macro Managers

Global Macro (tactical) Managers take a “top down” approach to investing. Typically, this means evaluating all sectors of stocks and bonds from around the globe, and essentially ranking each in terms of their near-term potential for appreciation. These managers will invest in their highest ranked sectors and, if they are right, their allocations to a more concentrated (less diversified) portfolio, and their ability to hold cash when they feel the need, will, over time, typically allow them to generate greater portfolio returns than a “strategic”, broadly diversified portfolio that seeks to replicate broader market exposures. As the term “global macro” implies, these are “go anywhere” managers, and those who have demonstrated success use proprietary formulae for determining which sectors are poised for near-term growth.

What we look for in these managers is a track record that reflects out-performance in both rising *and* falling markets. We have identified several of them, and will be using them for a third to a half of our “core” portfolio. What are the risks associated with these managers? The primary risk is that they might be invested in areas that decline, or that they might not be invested in areas that are rising. Those who have a great track record seem to add as much, if not more return to their portfolios by avoiding large losses with the aforementioned sell strategy that gets them *out* of market sectors in decline *as early as possible*. These managers show us that avoiding large losses, such as those seen in 2000 – 2002, and again in 2008, can be very effective in improving relative portfolio performance versus a “buy and hold” strategy, especially over complete market cycles.

### “Trend-Following” or Price History Managers

Trend-Following managers, like their global macro counterparts attempt to deliver the same relative outperformance over full market cycles using moving (trailing) averages (i.e. the “price history”) of various indices and issues. Typically, managers using a price history approach chart longer-term moving averages (i.e. 200 – day) against shorter-term (i.e. 60 – day) moving averages. When the shorter term moving average(s) break through the longer term moving average(s), it signals a change in “trend”. Very simply stated, if the shorter term average drops below, or breaches the longer term average (Point A in the graph below), that is perceived to be a bearish signal, and if it should subsequently break above the longer term average (Point B), it is considered a bullish indicator.



Often these managers add a number of market data points and economic factors to this simple formula into their decision making, so for the best among them, it is not just a “blind” following of moving averages. Several of the managers we spoke with during our research claim their models add as many as 60 – 80 proprietary factors to their price history charts. When markets are broadly moving higher, these managers should participate in those gains, since their shorter-term trend lines will be above their longer-term trend lines. When markets reverse, and a declining trend becomes apparent, managers typically exit the markets, hopefully avoiding participation in those losses.

The risks associated with trend-following lie primarily in two areas.

The first potentially problematic “environment” for practitioners of a trend-following discipline is that of a “Black Monday” Event. On the day known as “Black Monday” (October 19<sup>th</sup>, 1987), the Dow Jones Industrial Average declined 508 points, which was a single-day (percentile) record decline of 22.61%. Trend followers will not likely anticipate this type of single-day decline, and like strategically allocated investors, if the trend indicators hadn’t changed previously, providing the manager a “sell” signal, a trend follower can lose the same 22.61% on that same day.

More likely than these once in a decade/generation/lifetime single-day declines, there is also the potential for a manager to get “whipsawed”. If markets are unusually choppy, particularly when evidencing very short, very sharp reversals up and down in direction, a manager may get a “buy” signal after a positive change in trend is signaled, committing capital to a market, only to see a reversal virtually (or practically) immediately thereafter, exposing the manager (and his/her capital) to the downside (a.k.a. “getting whipsawed”). This hasn’t been a problem for trend-followers of late, as recent market declines, such as those seen during the past two bear markets, were relatively prolonged in duration and pronounced in decent, and those conditions allow for

early indication and confirmation of a change in trend. These longer lasting trends, up or down, provide the *best* conditions for these managers, because regardless the trend, *the longer it lasts in time*, and the higher it grows (or deeper it falls), the trend-follower ensures his/her relative out-performance of a strategic allocation over a complete market cycle. Essentially, if you can get the majority of a rising trend, and in the same cycle, avoid the majority of a decline, it goes to reason that the full market cycle return experience will be superior. In late 2007, or early 2008, the trend-followers tended as a group to get out relatively “early” in the equity market decline, and as such, have been *dramatically* outperforming strategic allocations since the fall of 2007. When you look back five years and even longer, avoiding this massive loss, and potentially some of the 2000 – 2002 declines as well would put a hypothetical trend-following investor in much better stead today than a strategically allocated investor. Did I mention we’re in a secular bear market?

Several of the trend followers we looked at are still completely “out” (in cash) today, having missed the recent equity and debt market “upticks” we’ve experienced since the March 9<sup>th</sup> lows. (Of course, if you can avoid the 50% decline, accurately timing the re-entry point is less problematic! These managers can well afford to be patient, and some would tell you that despite the percentage recovery, the indicators they follow are still suggesting caution.)

### Other “Satellite” Strategies

Around, or surrounding these tactical “Core” managers, we will be employ four “satellite” strategies. While these satellite managers will be expected to deliver portfolio returns over time that are comparable to the “Core” managers, they will be applying their strategies in capital markets having little or no correlation to the stock or bond markets the “Core” managers labor in. This lack of correlation amongst managers will reduce overall portfolio volatility, and further help to avoid large losses in a given year.

### Non-Publicly-Traded Real Estate Investment Trusts (REIT’s)

These programs raise capital for investment into commercial office, industrial, retail and multi-family residential properties. The primary investment return is delivered in the form of their dividend, which will typically average 6% - 7% per year. Capital appreciation may be added to that dividend should the real estate purchased appreciate over time. Although the investors’ exit strategies differ by syndicator, we like several of these programs offered today, as we feel they have the potential to opportunistically buy real estate, and in some cases, the debt secured by the real estate, at extremely attractive prices. Cash buyers in real estate, which REITs are, are finding very motivated sellers in these markets, and investors with a time horizon of five years or more, typically the holding period these programs offer investors, hope to see recovery in the real estate market when its time to sell the underlying properties.

Because these programs are not publicly traded, their share prices are adjusted only when/if appraisals of the underlying real estate portfolio are made, typically annually. Historically, these markets have little correlation to the stock and bond market cycles, so they add a level of diversification to the investor’s portfolio without taking away from returns over time.

Commodity Trading Advisors/Managed Futures Funds

CTAs (Commodity Trading Advisors) also known in some cases as Managed Futures Funds, generally manage their clients' assets using a proprietary computer-based trading system, or a discretionary method, that may involve going long or short in futures contracts in areas such as metals (gold, silver), grains (soybeans, corn, wheat), equity indexes (S&P futures, Dow futures, NASDAQ 100 futures), soft commodities (cotton, cocoa, coffee, sugar), as well as foreign currency and U.S government bond futures. In the past several years, money invested in managed futures has more than doubled and is estimated to continue to grow in the coming years if hedge fund returns flatten and stocks continue to under-perform. Historically, managed futures funds have done well in years when the stock market is doing poorly, boosting an investor's returns in those years. Over time, many of these managers have delivered equity-like returns to investors, but with little to no correlation to the traditional markets.

These managers typically utilize "pattern-recognition" software that helps them identify a directional trend in whatever commodity or futures market in which they trade. Like the trend-followers we described earlier, they work best when trends are prolonged, regardless the direction.

Absolute Return Managers

As their name implies, Absolute Return strategists aim to produce a positive absolute return every year, regardless the direction of financial markets. Their strategies are myriad, but their primary mandate is to not lose money, and they typically achieve this by defensively positioning the portfolio's assets in cash or other low volatility investments when markets appear to be choppy. When appropriate, they may take hedged (long and/or short) positions in securities that are expected to have modest exposures to market declines. Their philosophy is to "win by not losing". Giving up on the opportunity to make large gains when the stock and bond markets are rising, they maintain a defensive stance. Some glean returns through arbitrage opportunities in options markets, and others limit their loss potential by placing trailing stops on market positions they hold. The resulting portfolio should have low correlation with financial market performance. Of course, whether such portfolio actually delivers a positive absolute return depends on the skill of the portfolio manager in selecting profitable long and short positions. We will typically position *two* of these managers in client portfolios.

"Pros" and "Cons" of our New Strategy

As we all know, no investment strategy is perfect, offering nothing but market gains with no downside. Even defensively sitting in cash, as many investors are today, exposes the investor to the risks of inflation, and the loss of buying power over time. Being aggressively (and strategically) invested in equities offers higher returns than cash over time, but as we all realize, the potential for very large portfolio losses. Our new strategy is designed to offer our clients the best of both worlds by (1), effectively reducing our strategic (i.e. permanent) exposure to the stock and bond markets to zero, tactically participating in those markets only when and where the macro outlook or the trend is favorable, and (2), much more broadly diversifying our portfolio allocation as endowments do, such that we are not "over-exposed" to the more volatile

markets. We believe this strategy has the potential to deliver equity-like returns over time, but at much lower levels of overall portfolio volatility or risk.

The negatives associated with implementing this strategy are relatively few and in my opinion, relatively inconsequential when viewed in the context of its advantages. The primary “negative”, is the potential that we’re wrong in our fundamental conclusion relative to our being mired in a secular bear market today. If we are incorrect in that most basic assumption, and we are now about to enter a secular bull market, a strategic allocation would more fully participate in rising stock and bond prices. As I’ve mentioned earlier, tactical managers are not always fully invested, and frequently are in cash as a defensive maneuver. The possibility exists of course, that a long-term bull run could be missed in part is a real one, but for all the “brutal facts” we’ve covered earlier, I think that the “risk” of a major, multiple thousand point rally to new market heights over the next few years is a small one. Extremely small, unfortunately.

The secondary “negative” is more cosmetic in nature, and that is the necessity that we “unbundle” our consolidated accounts, primarily held at SEI Private Trust today, and open separate accounts for each of these “Core” managers and our satellites. This will mean more paperwork (i.e. statements) delivered to your home. We hope to minimize the inconvenience clients will experience by aggregating these accounts in our new aggregation system (Albridge), which we will set up for each client. Clients will be able to go online every day, and see an Albridge aggregation of all their holdings in one place, priced daily. They will also receive an aggregated Albridge performance report from us on an automated basis, custom designed to their formatting preferences and desired frequency.

Other than these relatively minor risks, we believe this new strategy will much better protect our clients’ assets, and because of the increased protection against large losses, deliver higher returns over time than our strategic allocations could.

### **Implementation**

Over the coming days and weeks, my staff and I will be contacting each of our clients to begin the process of moving to this new strategy with their portfolio. Everyone’s transition process will be different, as every client has differing portfolio sizes, registrations, tax considerations, income needs, and time horizons. My staff and I are diligently putting together the “mapping” of assets from their current custodians to our new custodians and managers. We will provide each client with a detailed, side-by-side analysis of the new portfolio versus the current. We will also be delivering the paperwork necessary to accomplish this transition for each client in a timely manner, focusing on accuracy, and retention of data for tax purposes. We’d ask that you contact our offices directly if you have questions, and that you turn the documents we send you around as soon as is humanly possible, in order to minimize the market risks we currently have exposure to.

We have hired licensed temporary staff to assist us with preparation of the paperwork necessary to effectuate this monumental task. Our goal is to have every client’s portfolio transferred to the new managers and strategy within four weeks of beginning the process, a process which should begin the first week of May.

### **Conclusion**

As we all know, change is difficult to embrace, especially change that challenges long-held beliefs and paradigms. This is such a change, and we recognize that investors may need to ask questions and will seek reassurances that we've done our homework and that our logic and the reasoning behind this recommendation is sound. Let me say in response that *we have*, and *it is*. As those of you who have known and worked with me for a time, in some cases, for decades, know that this is change at its most fundamental level, and should realize that I didn't come to these conclusions quickly or easily. However, I am completely convinced that this strategy is the best way forward for the times in which we live. I hope you agree, and together, we will prevail.

-JRP

The views are those of Jay R. Penney, CFA, CFP, and should not be construed as investment advice. This is not a solicitation to buy or sell any security. All information is believed to be from reliable sources; however, we make no representation as to its completeness or accuracy. All economic and performance information is historical and is not indicative of future results. Investors cannot directly invest in an index. Additional risks are associated with international investing such as, currency fluctuation, differences in accounting standards, and political and economic stability.

Alternative investments such as Managed Futures, Market Neutral Investments, Inflation Benefiting Investments, Private Equity and Trend Following, involve specific risks that may be greater than those associated with traditional investments and may have specific suitability requirements. You should consider the special risks with alternative investments including limited liquidity, tax considerations, potentially speculative investments strategies and different regulatory and reporting requirements before investing.