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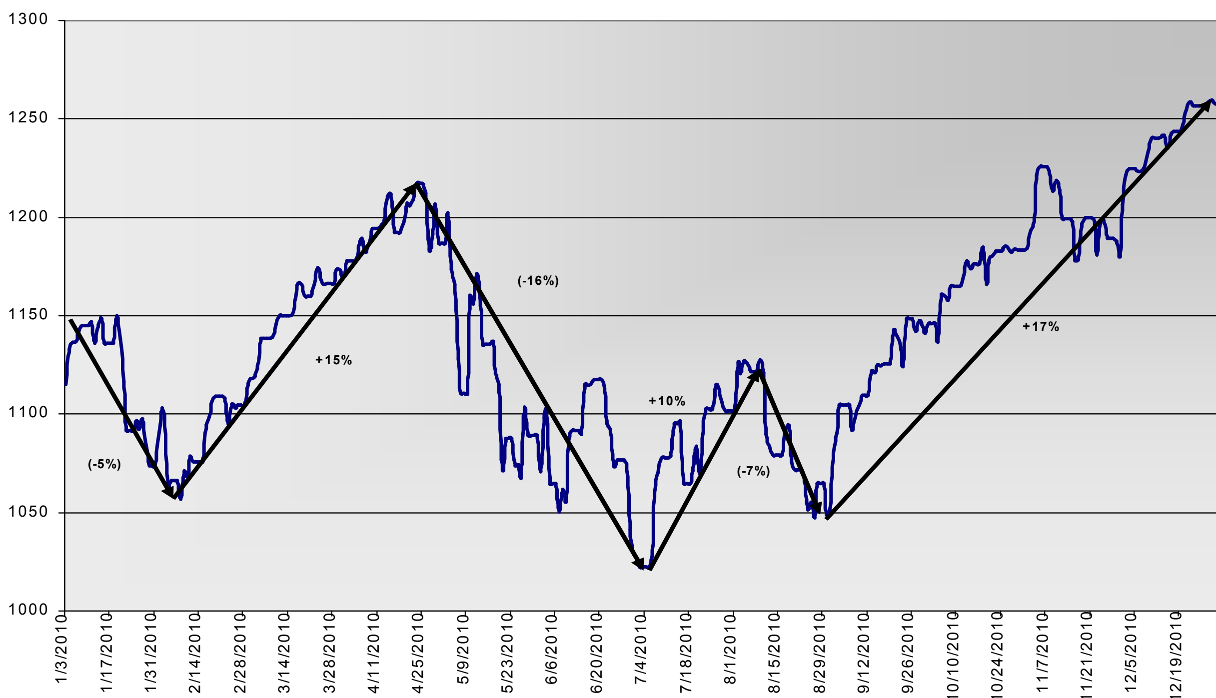
A Special Report

January 21st, 2011

2010 - A Year in Review

If one were looking for a single word to describe the calendar year 2010, "change" wouldn't be a bad choice. Following two years of the worst economic and market turmoil we've seen in (*literally*) seven decades, calendar-year 2010, by *every* account, brought a *lot* of change to our great nation. There were changes to the political landscape. There were changes to the economic conditions, and yes, there were changes to the markets' leadership. If one had spent the entire year 2010 in a coma, and woke to the Wall Street Journal on January 1st of this year, no doubt one would be very relieved to see that the threat of a "double dip" recession had been averted, and that by and large, the domestic equity markets had delivered more than respectable double-digit gains, year-over-year. (Depending upon your political leanings, the changes in the personnel in Washington D.C. would be viewed positively or negatively, but regardless, they might have represented the most *dramatic* of the changes you'd observe.)

As we're primarily focused on the investing environments in this missive, let's take a look at the year 2010 in domestic equities.



Source: Yahoo!Finance

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For the calendar year 2010, the S&P 500 Index appreciated by a "net" 12.78% (15.06%, inclusive of dividends paid). But the chart clearly shows that it was an extremely volatile year, with *five* distinct transitional (i.e. directional) changes taking place:

Dates	***S&P 500 Index Closing Value***	***% Change***
12/31/09 – 02/08/10	1056.74	- 5.23%
02/08/10 – 04/23/10	1217.28	+15.19%
04/23/10 – 07/02/10	1022.58	-16.00%
07/02/10 – 08/09/10	1127.79	+10.29%
08/09/10 – 08/27/10	1047.22	- 7.14%
08/27/10 – 12/31/10	1257.64	+16.73%

With the market's nadir arriving almost exactly at the year's mid-point (July 2nd), down over 8% for the calendar year-to-that-date, few at the time anticipated the momentum in the advance we'd experience in the final four months of the year, an advance that fully erased the first half's losses, and delivered the aforementioned 12.78% net gain for the year.

Not surprisingly, some investors in our model portfolios have noticed that their portfolios *didn't* appreciate by double-digit margins, and some have inquired as to "why"?

It's not an unexpected question, as I learned some years ago that investors tend to think of "*the market*" as being synonymous with domestic equities. But while they (domestic equities) are *a* market, they certainly aren't *the only* market that is relevant to our models' performance. In point of fact, they are only one of *many markets* into which we allocate client assets, and the table on the next page makes that point clearly.

Over those same years, I've also come to observe that generally speaking, clients tend to be "*relative-return*-oriented" in years in which equity markets *rise*, typically wondering why their portfolios didn't make as much as the markets did when they were rising. But as the market conditions in 2002 and 2008 clearly taught me, clients quickly become "*absolute-return*-oriented" when equity markets *fall*. In other words, investors who make "only" 10% when the markets rise by 15% are rarely happy, but the same investor will *not* be happy losing "only" 10%, when the markets lose 15%. Its human nature, but that's beside the point.

It's *certainly true* that we didn't see the strength of the September – December equity market rally in advance, and neither did many of the managers we've engaged, an admission that places us clearly and squarely in the midst of the *vast majority* of investors and money managers at last year's mid-point. In fact, few saw reason for hope in the heat of the last year's summer, as media headlines at the time loudly (and daily) bemoaned the many economic (and market) uncertainties the country faced then, many of which, candidly, remain today.

It is also true that when one compares the equity market results to our model portfolio returns for 2010, the equity markets out-performed our models in nominal terms. In my opinion, there were ***three basic reasons*** the model results were somewhat disappointing when compared directly to those benchmarks.

The first two reasons are pretty straightforward, while the third is a bit complex, but read on, as I think I can make it understandable.

1) In 2010, downside protection was our priority, and we simply didn't own a lot of equities throughout the year.

Do you remember how you felt about the economy, the markets, and your portfolio, this time last year? Let me refresh those memories if they've faded a bit. As you'll (*hopefully*) recall, at this point in time a year-ago we were all holding our collective breath every time an economic data point was being released. Unemployment claims, consumer sentiment indicators, housing data, trade imbalances, European sovereign debt defaults, and partisan political battles were at the very forefront of the American psyche. The term "double-dip recession" was cemented as a permanent part of the social lexicon, and debates over its possibilities and probabilities became the subject of water-cooler discussions, as well as the nightly news, all across the nation. Figuratively (and frankly) speaking, we were all still staring into the abyss of economic collapse just one short year ago. Because of that very real possibility, we made certain that our model allocation was constructed in such a way as to limit the impact of an equity market collapse by (1), *intentionally* spreading the investment dollars into as many asset classes ***other than equities*** as possible, thereby firmly limiting our potential exposure to a potential equity market collapse, and (2), where equity managers were employed, we only employed money managers who were *tactical* and *defensive*, with demonstrably strong "sell disciplines". This "forced" diversification away from equities, and our primary model's underlying asset allocation (by asset class) looked like this throughout the year 2010:

Change in Asset Allocation Over Time (2010)

	12/31/2009	1/31/2010	2/28/2010	3/31/2010	4/30/2010	5/31/2010	6/30/2010	7/31/2010	8/31/2010	9/30/2010	10/31/2010	11/30/2010	12/31/2010
Cash or Equivalents	10.76%	15.58%	21.73%	17.62%	13.75%	30.53%	28.48%	29.36%	28.36%	15.34%	19.34%	16.09%	18.02%
Commodities	4.36%	4.10%	3.92%	4.04%	3.93%	3.99%	3.99%	3.56%	3.55%	5.03%	5.31%	2.23%	2.56%
Domestic Bonds	38.18%	40.04%	37.07%	33.75%	34.57%	27.34%	29.68%	29.55%	26.77%	33.58%	31.07%	32.09%	30.43%
Foreign Bonds	0.28%	0.56%	0.94%	1.04%	1.05%	1.06%	1.07%	1.01%	1.03%	1.05%	1.05%	0.95%	0.96%
Domestic Stock	16.89%	14.58%	12.79%	14.56%	17.92%	10.86%	11.30%	10.30%	9.76%	12.98%	13.40%	22.58%	20.07%
Foreign Stock	9.17%	5.50%	2.80%	7.81%	8.22%	6.32%	5.53%	6.03%	6.37%	9.23%	7.53%	4.12%	5.00%
Hedge Fund	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.19%	0.19%	0.19%	0.19%	0.20%
Managed Futures	4.19%	3.89%	3.96%	4.42%	4.61%	4.21%	4.25%	4.39%	4.66%	7.39%	6.87%	8.71%	9.59%
Options	5.38%	5.46%	6.07%	5.61%	5.33%	5.00%	4.93%	5.08%	8.10%	3.36%	3.44%	0.00%	0.00%
Real Estate	10.80%	10.30%	10.72%	11.15%	10.62%	10.68%	10.76%	10.73%	11.20%	11.84%	11.78%	13.04%	13.18%
	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%

As you can see from the table, our portfolio's allocation migrated over the year as conditions changed, but the allocation "mix" remained extraordinarily diverse throughout the entire year. It included investments into equities (stocks), debt securities (bonds), real estate, managed futures, commodities, options, hedge instruments, and at various times as perceived needs dictated, a high percentage of *cash*. In point of fact, at its highest point, our equity allocation (domestic and foreign *combined*) never exceeded 26.70% of our total portfolio, although our allocations to "cash" rose as high as 30.53% at the end of May. So, the first, (and simplest) answer I offer to those who are wondering why their managed portfolio didn't deliver returns comparable to the S&P 500 Index in 2010 is because the equity markets' volatility (and risk) was unacceptably high through most of the year, and as a result, our portfolio (and our managers) largely avoided investing in stocks.

Parenthetically, we were not alone in espousing a much broader level of asset class diversification in our portfolio designs. Recently, it seems I've seen an avalanche of articles in the popular and industry press, extolling the virtues of adding "alternative", or "non-traditional" asset classes to portfolio construction, and the reduction of exposures to "traditional" (i.e. equity and debt market) asset classes. We were apparently ahead of our time, and our limited (25% - 30%) current exposure to equities is no longer considered unusual. Some have even gone so far as to question the risk-reward value proposition of stocks altogether. The enclosed article from the January 14th issue of the USA Today is a case in point.

Let me add further to this point by noting that we were *very pleased* by the downside protection our portfolios evidenced during the periods the equity markets were *in decline* last year. During the late-April to early-July decline in the S&P 500 Index, a market decline that reached (-15.19%) at its lowest point, our models barely budged, owing to the fact that the breadth of diversification in our asset class allocations was greater then than at any time in my professional career.

2) Three of our money managers did under-perform for the year.

We were disappointed in the performance of three money managers in our models, although most of our clients had exposure to only two of them.

Portfolio Strategies' ***Price History*** strategy, a "core" tactical money manager in our model design since early in 2009, and holding (on average) 20% of our clients' portfolios, really disappointed us in 2010. Their track record in prior periods had been stellar, especially during the "market crash" periods of 2002, and again in 2008. But while the market rebounded strongly in the final four months of 2010, the "Price History" strategy (apparently) never got the "buy signal" in equities, and as a result, they seriously lagged the equity markets' results. Following several conversations on the subject with the managers during the fall of 2010, we found ourselves increasingly dissatisfied with their explanations, so we replaced them with Flexible Plan Investment's "Combo" Manager strategy in early November.

At about the same point in time, we liquidated our holdings of the Direxion Commodity Trends Strategy Fund (DXCTX), replacing it with *two* mutual funds, the Altegris Managed Futures Strategy Fund (MFTIX), and the Princeton Managed Futures Fund (PFFNX). Direxion's fund was a small allocation (approximately 5% of our models), but it was down more than 20% for the year when we fired them.

Finally, the Tahoma Fund strategy, which fewer than a dozen of our clients owned, managed a smaller, 10% allocation to the portfolios of those clients who did, was down in mid-teens percentage terms when we terminated them. The Tahoma Fund's managers employed what was called an "option arbitrage" strategy, intended to be "market neutral" (i.e. equally weighted "long" and "short" the equity markets). Ironically, it wasn't the directional changes of the markets that hurt their performance, but the volatility of the markets itself did them in. The strategy's manager, Tim Biggam, is a well respected Options Trader, and he had delivered consistently positive results to his investors for over six years when we hired him. But as month after month passed in calendar year 2010, he consistently cited the market's volatility as the culprit for the strategy's sudden reversal

of fortune. Given that there was no assurance of an elimination of the markets' volatility, we had to move on.

All of our other money managers (JA Forlines' ***Global Macro*** strategy, Hanlon Investment Management's ***Balanced*** and ***Managed Income*** strategies, Genworth's ***Preservation*** strategy, all of our non-publicly traded ***REIT's***, the ***Superfund Managed Futures*** strategy, and the ***Permanent Portfolio Fund***) delivered excellent results for the year. All of these managers delivered results that were well within, or in excess of, our expected ranges for their intended returns. Where we needed to make changes, we did, and we are happy with the current line-up of managers. We will be making one additional recommendation for a strategy change, which I will discuss at the end of this Report.

3) 2010 was a tough year for trend-followers

What follows is a bit technical in nature, and to many readers it will be "dry", but try to follow along, as I think there are some important concepts that need understanding here.

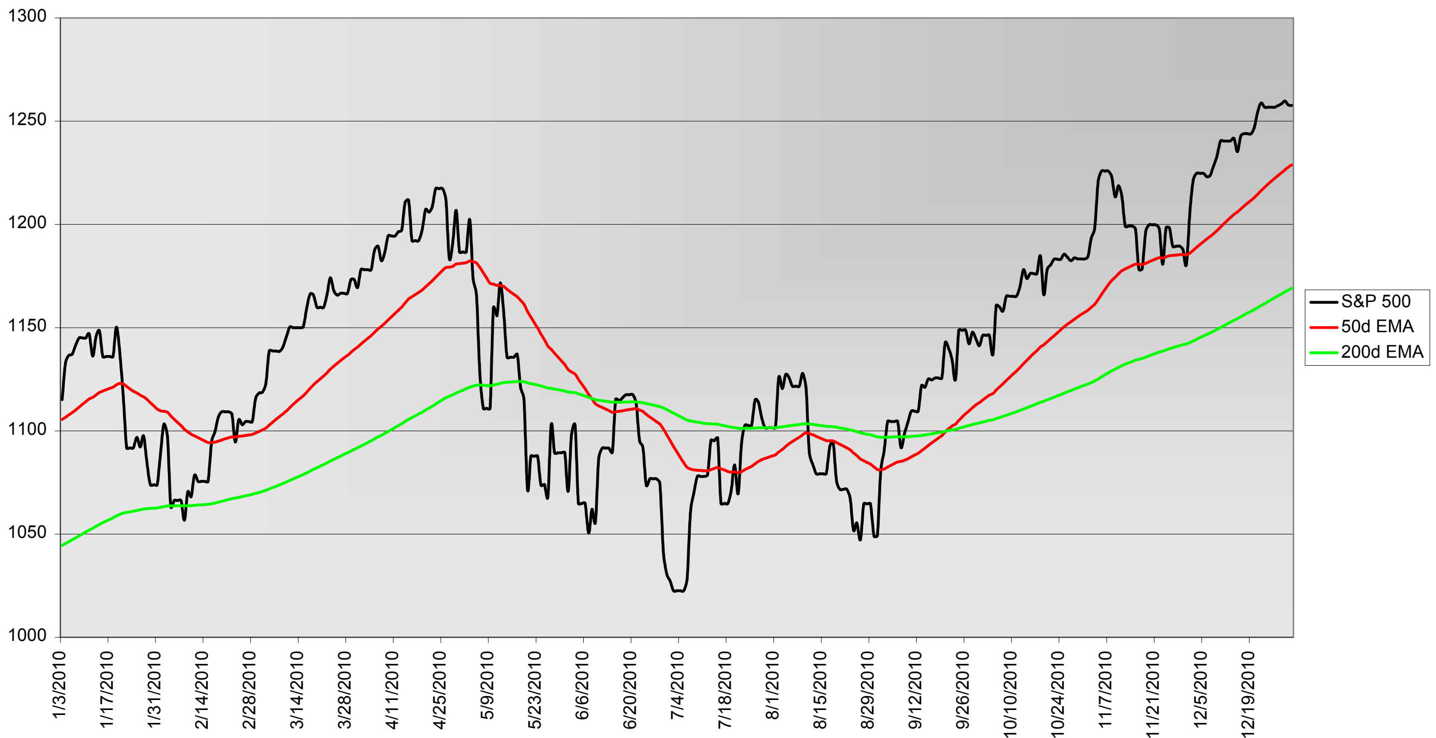
As you know, several of our current and recently past "core" money managers (i.e. Hanlon Investment Management, Portfolio Strategies, Inc., and more recently, Flexible Plan Investments), as well as a number of our "satellite" money managers (the Superfund, Direxion Commodity Trends Strategy Fund, the Altegris and Princeton Managed Futures Funds, etc.) use "trend-following" strategies to make their "buy" (entry) decisions, but more importantly, their "*sell*" (exit) decisions.

"Trend-Followers" use a lot of charts and technical indicators in making these decisions, but at their core, reversals in the trend lines' trailing historical prices, also referred to as their "moving averages", are the primary indicators that "signal" trend-followers that changes in trends, from "bullish" to "bearish", and vice versa, are occurring.

Let's say for instance, you are a "trend-following" money manager, looking at longer-term trend signals to help you determine the points at which to enter, and to subsequently exit the equity markets, at the most profitable points in time. (In this example, we'll use the S&P 500 Index as a "proxy" for the equity markets) You might use the trailing 50-day moving average, and the trailing 200-day moving average, as your trend-line indicators. Very simplistically, as the chart on the next page reflects, when the shorter-term (50-day) moving average (in red), and the longer-term (200 day) moving average (in green) are charted together, and the shorter-term red line rises *above* the longer-term green line, the trend-follower sees this as a *bullish* indicator, and believes investors should be "long" the market. Conversely, when the shorter-term moving average (red line) plunges *below* the longer-term moving average (green line), the trend is considered to be *bearish*, and investors should be "short" the market, or in cash. This strategy works well over most years, and almost always over time, but there are years, such as 2010, when the trends are too "shallow" or too short-lived to profitably exploit, with frequent reversals, which can result in investors being "whipsawed".

The chart on the following page illustrates the challenges trend-followers experienced in 2010.

S&P 500
(2010)



Source: Yahoo!Finance
(See Appendix A-1)

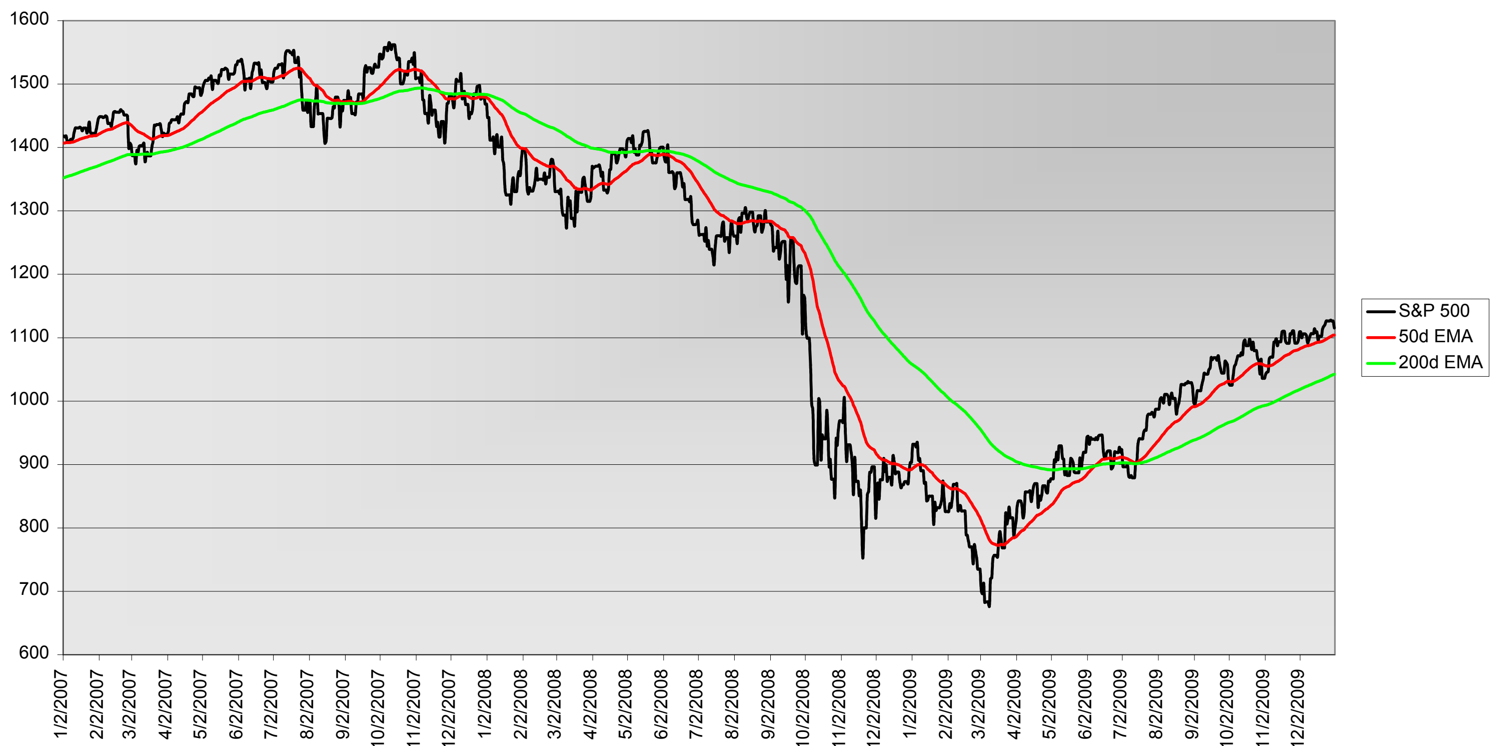
"Buy and Hold" Investor Return	*12.78 %*
Tactical "Trend Following" Return	*5.09 %*
Disadvantage of Trend Following	*-7.70 %*

A "buy and hold" investor might have nervously ridden through all the volatility during the year, nauseously tolerating the "ups" and "downs" the markets delivered, and in retrospect, they would have been amply rewarded for their worries and troubles with the aforementioned 12.78% for the year. The disciplined trend-follower, however, recalling the pain and angst of the immediately preceding years, would want to avoid large losses, and by using the simple 50-day, 200-day moving averages cross-over system I just described, would have sold in June at a point lower than their hypothetical purchase point at the beginning of the year, and would have waited until late September for the signal to buy back in, finishing with a relatively disappointing 5.09% return at year's end. In this one year's example, the volatility, and frequent reversals in the market's direction made for a tough environment in which to employ a trend-following discipline.

It (2010) was an *atypical year*, however. More typically, markets evidence far fewer directional changes during a single calendar year, and two recent periods *prior* to last year, while evidencing extreme volatility at times, illustrate this point on the pages that follow, as well as the benefits of such a trading discipline.

2007 – 2009: You may recall that as we entered calendar year 2007, the markets were generally rising, and there was little concern for the carnage we now know was to come later that year, and continue throughout the next. Over the three years that followed the start of 2007 (2007 – 2009, inclusive), a "buy and hold" investor in the Standard & Poor's 500 Index would have suffered a 21.38% *loss* for the entire three years, while the trend-follower, using the same indicators as just used in our previous example, would have enjoyed a *gain* of 18.61% over the same period.

S&P 500
(2007 - 2009)

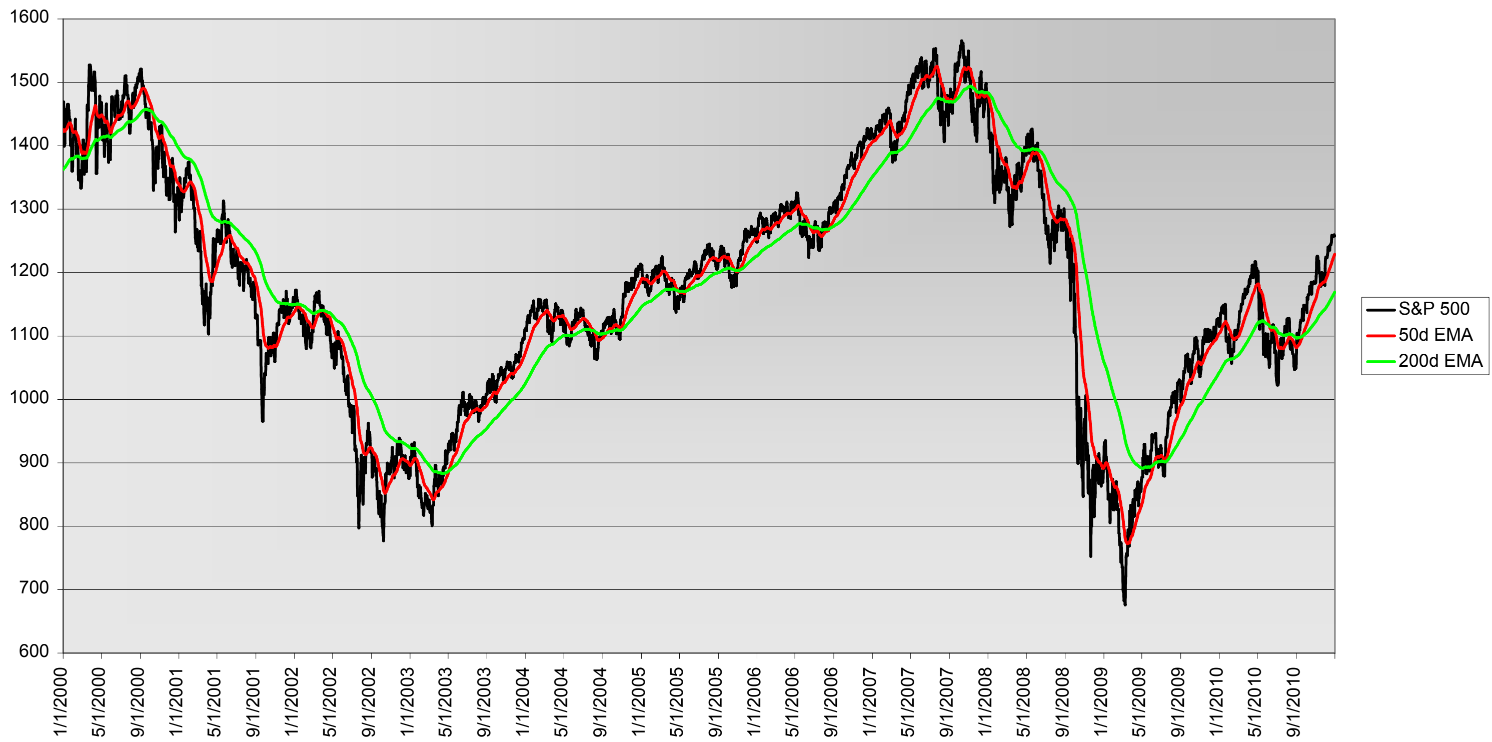


Source: Yahoo!Finance
(See Appendix A-2)

"Buy and Hold" Investor Return	*-21.38 %*
Tactical "Trend Following" Return	*18.61 %*
Advantage of Trend Following	*39.99 %*

2000 – 2010: The real benefit to trend-following, however, is its protection from *down* markets over more meaningful, longer periods, as the following, eleven-year chart reveals. Notwithstanding a year like 2010, ***over time***, and I *very intentionally emphasize* the words, "***over time***", trend following "wins", simply by preventing large losses.

S&P 500
(2000 - 2010)



Source: Yahoo!Finance
(See Appendix A-3)

"Buy and Hold" Investor Return -14.40 %
Tactical "Trend Following" Return 50.88 %
Advantage of Trend Following 65.28 %

The "delta", or total return difference between an eleven-year "buy and hold" approach, and a tactical, trend-following approach applied using this very simple discipline over the same period, would have been a whopping 65.28%, which equates to more than 5% of compound average added return per year for eleven years. With that "delta" of additional performance, the two hypothetical investors end up in very different "Zip Codes" in terms of portfolio value at the end. Without getting too technical, if one also takes into account the level of volatility reduction the trend-follower benefits from in addition to the much, much higher absolute return they would have received, the "value" of a tactical approach is even greater.

What About 2011?

As we look at the investment landscape for the coming year, we find ourselves becoming more comfortable with the prospect that the sky is less "likely" to fall than was the case a year ago, and as such, we are somewhat more comfortable today with equity risk than we were a year ago. Clearly corporate America is recovering nicely, although we'd all like to see them spend some of the cash they are hoarding to stimulate the economy a bit. The

unemployment problem, while still dire, has stabilized, and there are signs of private sector employment *slowly* increasing (emphasis intentional). Economic "green shoots" are starting to appear, and it appears that the fear of a European Debt collapse has been mitigated somewhat by austerity plans in the Euro-zone.

That said, we still have concerns that keep us awake at nights:

- What happens when the Fed stops printing dollars? Will a "QE 3" become necessary if the economy stalls without the steady inflow of monetary stimulus?
- Will the U.S. Government, currently spending $1.65 for every $1 it takes in, get its balance sheet in order before it's too late?
- Can the American consumer reduce the debt on their own balance sheets in an orderly fashion, without reducing discretionary spending to a level that hurts the economic recovery?
- Will the housing market stabilize anytime soon?
- When will the economy start producing sufficient private-sector jobs to reduce the unemployment rate?
- When will banks begin to extend credit again?
- What can we do about the dramatic rise in the prices of food and energy, which are strangely not in the calculation of the CPI, but affect every American consumer?
- What will the Chinese do about their currency? What will we do in response? Will they continue to buy our debt?
- Will geopolitical, and/or new military conflicts arise in Afghanistan? Iran? North Korea? The Sudan?

The list of questions and potential adverse outcomes is long, and a reversal or deterioration in the conditions surrounding almost any one of them could send the equity and debt markets into a tailspin.

The bottom line? While conditions are less dire today than a year ago, the concerns remain very real, and they aren't going anywhere soon. Consequently, we'll maintain a "defense-first" posture for the balance of this year. We will shortly be recommending a change to one of our managers' strategies that will gradually (and tactically) increase our equity exposure, but it won't involve a manager change. That recommendation will come under separate cover in the coming days.

In closing, let me "re-make" my points *briefly*.

- The S&P 500 Index is not now, nor is it likely anytime soon to become, a "relevant" benchmark for your portfolio's performance. We simply don't have an abundance of equities in the portfolio today, so comparing the portfolio's returns to the S&P 500 Index results fails to recognize the stark differences between the two investments, and the risk levels associated with each.
- When managers under-perform their (relevant) stated benchmark, as they inevitably will, we will continue to monitor said under-performance, and if necessary, replace them.

- Trend-following is an appropriate risk-mitigation, and return-enhancing strategy that works _over time_. At the end of the day, it's simply "math". And the math works!
- ***Try to recall how you felt a year ago, or two years ago, as the markets' uncertainties were more readily apparent. We simply don't ever want to go back there again.***

In closing, let me wish every reader a Happy New Year, and my further wish for you is that it be a safe, healthy, and prosperous one for all of us!

- JRP

This article is for informational purposes only. This information is not intended to be a substitute for specific individualized tax, legal or investment planning advice as individual situations will vary. For specific advice about your situation, please consult with a financial professional.

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APPENDIX A

1)

	Date	Index Value
Purchase	1/1/2010	1115.10
Sell	6/8/2010	1062.00
Purchase	9/21/2010	1139.78
Ending Market Value	12/31/2010	1257.64

2)

	Date	Index Value
Purchase	1/1/2007	1418.30
Sell	11/22/2007	1416.77
Purchase	6/8/2009	939.14
Ending Market Value	12/31/2009	1115.10

3)

	Date	Index Value
Purchase	1/1/2000	1469.25
Sell	10/10/2000	1387.02
Purchase	3/30/2002	1147.39
Sell	4/3/2002	1125.40
Purchase	5/4/2003	930.08
Sell	8/5/2004	1080.70
Purchase	9/13/2004	1125.82
Sell	4/28/2005	1143.22
Purchase	5/22/2005	1189.28
Sell	10/23/2005	1179.59
Purchase	11/5/2005	1220.14
Sell	6/16/2006	1251.54
Purchase	8/18/2006	1302.30
Sell	11/22/2007	1416.77
Purchase	6/8/2009	939.14
Sell	6/8/2010	1062.00
Purchase	9/21/2010	1139.78
Ending Market Value	12/31/2010	1257.64

Purchase and sell dates determined by the crossing of the 50-day and 200-day exponential moving averages based on the closing value of the S&P 500 Index.

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