The CJ Investment Newsletter
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Bear Market Tactics, Tracking Error and the SEC

Purpose

The *CJ* Investment Newsletter deals with the entire spectrum of securities investing, including cash (money market funds), bonds, equities and options. It will evaluate the overall investing environment and then discuss the relative allocations of these asset types, as well as strategies to implement within them. Essentially, it reflects what I'm actually doing with my clients.

These letters are not sent "cold." Either I know you or someone you know gave me your name. Yes, this letter *is* a sales tool. It communicates how I apply my investment strategies, so that you can decide, without any sales pressure, if my thinking is compatible with how you want your money invested. If you're not already a client, I would like to discuss your *becoming* a client. Please call me for more information.

However, that's not its only purpose. Even if you never become a client, if you want this information, I want you to have it – for a while, anyway. My hope is that providing this information and teaching you what I think is important when investing may help you. Please contact me if you have any questions or comments. I'd love to hear your reaction to my letter.

The CJ Growth Strategy (back page) has been an ongoing aggressive growth model portfolio since 1/98. Its results continue to be tracked herein.

Quick Look

Market	Next Expected Move

- Investment risk in a bear market.
- Bear market investment tactics and governmental restrictions.
- Tracking error and bear market ETF's, including new SEC disclosures.

Investment Risk in a Bear Market

I believe risk is one of the most misunderstood concepts in investing. It must be, because I'm writing about it for the second time this year, the first being in the 1/10 issue of the *CJ Newsletter*. That was a somewhat comprehensive and "scholarly" article. I'm hoping that this article will be a good companion for that one with perhaps a little more practical information.

While I quoted a good definition of risk in my original article, let's be a little more down-to-earth here. "Risk" could be considered the likelihood of an investment not turning out as planned when entered into and the likely loss incurred when the hoped-upon result was not realized.

Let's be clear; *there is no such thing as a "no-risk" position in investing*. Risk is present in all investment positions, even

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"cash." Risk is clearly and obviously understood to be present in investments in things like real estate, private businesses, stocks, derivatives and many other tangible and intangible investments. What about bonds? Cash?

Yes. Bonds, especially in bond mutual funds and ETF's have risk as market interest rates change in the economic environment. Bonds in the marketplace are continuously "discounted to maturity" at the then current market interest rate. If market rates increase, the principal values of bonds decrease as they are discounted to realize the market interest rate. Conversely, if market rates decrease, bonds can experience an increase in value (premium) from the same mechanism. Additionally, bonds from specific issuers (even governments at times) can become riskier if the issuer's solvency and ability to pay become weaker or compromised. Adverse credit risk changes can impair the cash value of bonds issued from impaired issuers. Such changes are recognized currently in both mutual funds and ETF's.

Yes, even cash. As I've said many times in the *CJ Newsletter*, most people think of a US$ as an unchanging measure of value, when it's clearly not one. Inflation is not an increase in prices; it is a decrease in the value of the currency, causing sellers to charge more for their goods and services in that currency in order to receive the same economic value as they were able to previously receive when the currency was more valuable. The ramifications of this could be discussed for hours, but that's not my purpose here.

What is my purpose is to explain why putting your cash in a coffee can in the back yard or in your mattress is still not risk free. In an inflationary period, which we have had, with the exception of the Great Depression, continuously since the formation of the Federal Reserve Bank in 1913, your cash will become less valuable over time. If you dig it up 10 years later, you will have incurred a loss on your money as you will be unable to buy as much with it as you could have 10 years earlier. This also means that, when holding bonds until maturity, the principal returned at maturity will likely be worth less than it was when you purchased the bond. Effectively, this means you earned less than the interest you received over the life of the bond, especially net of taxes.

Are we clear? There is no such thing as risk-free. The best we can hope for is to attempt to *manage* risk as best we can through understanding of the economy, government fiscal, tax and monetary policies, investment vehicles and market forces. Simple, huh?

Bear Market Tactics

Not to belabor the obvious, but a bear market is where the primary trend of the market is down – that is, securities become cheaper over time, generally as a result of the contraction of the P/E (price/earnings) ratio. Psychologically, this can be explained as the tendency of investors to be willing to pay progressively less for each dollar of earnings than they did in the past, thus contracting the P/E ratio. The exact opposite phenomenon occurs in a bull market.

In a bear market, there are basically three tactics that could be used:

- Purchase *specific* long investments and HOPE that those specific investments will be able to fight the bear market trend. This does happen and likely gave rise to the old saw "There's always a bull market somewhere."
- Move to a large or complete cash (or STMM) position. See the discussion of cash above. At the current <0.25% per annum overnight interest rate, your cash truly earns virtually nothing.
- Invest in accordance with the primary trend – make bear market investments such as shorts, bear market funds and ETF's, option plays, etc. This is a method that has a good chance of succeeding in a bear market, maybe the only "sound" method.

The important thing to remember about bear markets is that investments decline in price over time. Sadly, this is one place where our governments' adherence to Markowitz's Modern Portfolio Theory does not serve us (the citizen investors) well. Its primary weapon against loss is diversification. If the entire market is declining, how will diversification help? If the primary trend is down, virtually all long-security investing will lose money. Still, the government considers short positions and options to be too risky and doesn't allow them for many types of accounts such as qualified money (IRA's, Roth IRA's, 401(k)'s, and other tax-deferred or tax-free investment vehicles) and custodial accounts (UTMA's, UGMA's, *etc*.).

Modern Portfolio Theory also discusses diversification between asset "classes," especially using asset classes that are negatively correlated. The problem here is, as the world has become a more integrated, 24-hour, real time marketplace, assets that were once negatively correlated are now positively correlated. Yet government policy hasn't changed.

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Asset Allocation Percentages
CJ Current Suggested Ranges

Dow Theory Market Phase: **BEAR**
Appropriate Current Allocation: **DEFENSIVE**

Asset Class	**Conser-vative**	**Aggres-sive**
Money Market Funds	70-10%	55- 5%
Long Positions:		
Bonds & Bond Funds	30-60%	40-60%
RD Stocks	0-10%	0-10%
Growth Stocks	0%	0%
Gold Equities/Funds	0-20%	10-30%
Bear Market Funds	0- 10%	5-20%
Aggressive Positions:		
Shorts and/or Options	0%	0- 5%

Notes:
Income generating portfolios may not conform to the above guidelines. If income is the primary purpose of a portfolio, income needs are met *first*, then other allocations are made.

Up to 50% of bond/bond fund positions should be in international (non-US) bonds. I expect such bonds will provide higher interest paid on the face due to the additional *perceived* risk of foreign bonds, as well as providing hedging gains if the dollar declines against foreign currencies due to Fed monetary policies.

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These are the kinds of things that happen when lawyers pass legislation on things they don't understand. Except, we are the ones who pay the price for their misunderstandings.

Tracking Error and Bear Market ETF's

Recently, I got a call from friend/client for whom I had beefed up a position in TWM (the Proshares Ultra Short Russell 2000 ETF) in one of her accounts. As required, she received some documentation about TWM in the mail and there were some newly required SEC disclosures regarding TWM (and all ETF's of this type) that said the investment should be treated as a "daily" investment, not one that should be held for any length of time. She called me and I explained to her what I'm now going to discuss here.

The SEC's "beef" with TWM and its brethren is that the security, as I've explained to all my clients prior to creating Trend Capital, moves, on a daily basis, *twice* as far *on a percentage basis* (because it's an "ultra" short ETF) in the opposite direction as the Russell 2000 index.

This creates a phenomenon called "tracking error." Tracking error, which I discovered on my own months prior to the hubbub at the SEC (remember, most of my clients bought their original position in late 2007), happens because of the use of percentage and the daily settlements. So, for example, assume the RUT (Russell 2000) was at 700 when TWM was purchased at $100/share. A couple of months go by and the RUT moves up and down some, finally landing back on 700 again. TWM will, most likely, NOT be priced at the $100/share price. It will be above or below the $100 mark because of the way percentages move. THIS is "tracking error." Try a simple example yourself. Assume some moves in the RUT and apply double the percentage in the opposite direction to your starting price on TWM, being sure to return the RUT to your starting point. It doesn't take many days to see tracking error occur.

Is this a problem? Perhaps. It's certainly a problem to the SEC, because they now require some scary disclosures in the literature describing these types of investments. When I became aware of the problem in early 2008, I decided to think the issue through instead of simply dumping the investment because of the unexpected tracking error issue. By thinking it through, I learned that the important part to making money in this type of investment is the "streak." If the RUT goes up, you would expect to lose money on this type of investment. If the RUT "thrashes around" in a trading range, TWM appears to be more likely to lose money than gain because of the way the percentages work, although it doesn't always work that way. However, if you have a streak of several to many consecutive days of the RUT moving down, the investment can make a lot of money very quickly.

Finally, I thought of why I wanted this type of investment in the first place:

- It's one of the very few direct bear market investments allowed in qualified and custodial accounts.
- I wanted to "buffer" client portfolios from downward moves in the market with a direct bear-market investment. I feel we still need such protection.

Obviously, because of the above. I elected to continue using TWM and its brethren despite the tracking error problem. If you feel differently about your account(s), please call me and we can discuss what to do about it.

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