

Risk Assets

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

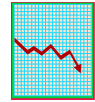
Market



- The most effective way to deceive.
- What are "Risk Assets?" Why do investors keep buying them? What does it mean to you?

Next

Expected Move



How to Deceive

A very good friend and I were having a conversation recently that set me upon thinking about deception in today's overly political world. I sent him an email. Here is the relevant section. I doubt I could word this idea any better than I did to him:

"...upon reading the articles you sent me, I was reminded of what I consider a very important idea. The absolute best way to deceive (even yourself) is not to lie, but to speak only *part* of the truth. It gives the deception the appearance of truth, but without the perspective to understand what the truth actually is. Politicians are masters at this. Take notice whenever you're given a presentation of disjointed facts and statistics. If something doesn't seem to follow, it's because someone is trying to convince you of something that isn't true by reciting a disjointed litany of items which may be individually true, but don't prove anything individually or collectively about the matter at hand. Upon reflection, you may find the amount of dishonest

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presentation of this type in our society shockingly ubiquitous.

“But, you don’t have to believe me. Recall Mark Twain’s exhortation: ‘Lies, damn lies and statistics...’”

Those of us who pretend to be sophisticated in politics and those who wish we were (sophisticated) should constantly work on developing our “untruth antennae,” especially with regard to people using statistics, instead of sound, factual *causality*, to persuade us.

Perhaps the first myth that should be exploded is the notion that statistical evidence equals scientific proof. Not true. Never will be true. Anyone who suggests it likely doesn’t understand himself or herself what constitutes *proof* in the natural sciences. Or, they are insulting you mightily by assuming you don’t know enough to call them on their deliberate lie.

Scientific *proof* means that someone *observes* a phenomenon, then proposes a *hypothesis that explains* the phenomenon. Then, (if the hypothesis is correct) defines the conditions under which the hypothesis, when applied under those conditions, will predict with 100% certainty the results. If the correct hypothesis is sufficiently far-reaching, it will be dubbed a theory. If the results are **not 100% predictable**, it has not been scientifically proven and the knowledge of science has not been expanded.

Clearly, this can become problematic in the science of biology, where isolation and control of conditions becomes difficult, if not impossible. Still, biologists hold to the strict standards of scientific proof, difficult as that might be.

Statistics, then, almost by definition do not deal in the world of scientific proof. They may use some scientific instruments and techniques, but *the essential nature of statistics does not involve the discovery and proof of 100% causal relationships*. Be wary of anyone – and I mean **anyone** – who would try to tell you otherwise.

Risk Assets Defined

If you watch a lot of CNBC or other investing programming on TV, you will likely have heard the term “risk assets” mentioned and discussed. According to www.BusinessDictionary.com, a “risk asset” is defined as:

1. Bank asset affected by changes in credit quality, interest rates, repricing opportunities, etc.
2. Equity capital and other assets of a troubled firm that may become subordinated to the debtors’ claims.

From context, most pundits discussing these are using a more inclusive form of the second definition, which would be:

Risk assets include equity capital and other assets with associated risks well up the risk curve; that is, assets with much higher than average risk among the entire universe of assets. This includes not only intrinsic risks of loss in the assets involved; it also includes market risks of the pricing of those assets.

For the purposes of the rest of our discussion here, we will use this last definition above when referring to the term “risk assets.”

Why the Move to Risk Assets?

So, why the discussion about risk assets? It has to do with investor behavior in the current environment. It appears that investors (as a group) have adopted the behavior of buying positions (or too large of positions) in these risk assets. In other words, *investors are taking greater risks than their risk tolerances would normally allow*. Put another way, if the market crashes again, *these overexposed investors will lose more than they are either psychologically or fiscally capable of bearing*.

The obvious next question is why? Why are they taking risks they aren’t really able to bear? The answer is both multifaceted and involved. It also involves a new phenomenon I’ve dubbed “Super K” derived from Marshallian K theory. Let’s start with the high points:

- Market interest (yield) is virtually zero on debt instruments. Net of inflation, return on US treasuries of less than 10-year duration is negative. You may heartily thank the Fed (along with most other world central banks) for this; it is entirely their fault and under their control.
- Market yield is not sufficient for older or retired investors to live on without significantly eating into their principal, and therefore, their future earnings. This tempts even the least risk tolerant investors to move up the risk curve into the “greener pastures” they think they see there – the risk assets.

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- Further tempting the risk averse investor into securities that appear too risky for them is the continuing enormous money injections by the Fed in order to “stabilize” the system. The Fed is currently injecting \$85 Billion *per month* to create this illusion of stability. It must be working. Investor behavior *has* become more aggressive.

Marshallian K Review/ “Super K” is Born

As discussed many times in past *CJ Newsletters*, Marshallian K theory was originally stated by English economist Alfred Marshall in Appendix K of his *Principles of Economics*, (1890). While I don’t agree with many of Marshall’s principles, his K theory appears to me to be a true representation of human economic behavior.

Simply stated, Marshallian K theory states that if more money exists in the money supply of an economy than that economy needs to operate (perform its necessary transactions), the excess money will move into the financial markets, thereby inflating them. The process works in both directions.

Flash to the fall of 2008. The Fed begins to, for the first time ever, triple the money supply (as measured by M0) in order to “stabilize” the financial system and investment markets from the crash caused by similar Fed policies in prior years that caused the housing boom and eventual crash. Easy credit, low rates of interest – you know the drill. You must; it’s the only drill the Fed has known since Alan Greenspan became chairman in 1987.

Following Marshallian K, the excess money floods into the financial markets. The primary components of the financial markets would be the debt (bond) and equity (stock) markets. I’ve never actually checked their relative size, but writers I trust have always asserted that the bond markets were roughly *10 times* the size of the equity markets, making equities only 9% of the total investment securities markets. Even as much money as the Fed was creating could likely be absorbed by the combined markets with some individual distortions, but without massive distortions of values.

Except for this time. Beginning interest rates were so low that the massive money injections by the Fed (even though they were not completely absorbed) dropped the overnight Fed funds rate to around 0.125% per year! 10-year treasuries dropped to around 2% per year. Now you have a situation where

the yields available in the bond markets ranged from too low to nonexistent.

Once bond market rates became so low that money invested provided less yield than a great number of investors required, investors began moving further up the yield curve into the equity markets and other risk assets in order to achieve some sort of meaningful return.

Thus was born “**Super K.**” As investors bypassed the now meaningless return from the bond markets, the *risk assets markets, particularly equities, received proportionately much more than their expected 9% of the money supply excess.* Such extreme amounts of money inflows into risk assets could only have one effect – inflate the equities markets much beyond what would have happened had the bond markets been able to provide a significant return. The Marshallian K effect was now “supercharged” – **Super K.**

Remember, these processes work in both directions. The obvious questions are: What happens when the Fed slows or stops providing excess liquidity from the money supply? What happens if they don’t?

Assuming all other factors remain equal, the answer to the first question is that interest rates will rise, stock and equity prices will fall, tax rates will rise and the economy will contract, probably in the form of a crash. I say this because, in spite of historic monetary stimulus from the Fed and unprecedented amounts of federal government spending over a period of years, the economy has clearly not shown that it can expand on its own. The government obviously doesn’t believe the economy is self-sustaining. Otherwise, why would they continue the massive deficit spending and monetary stimulus? Especially at levels that threaten a crash of unprecedented proportions?

Perhaps the most onerous part of continuing existing policies is that they become self-extinguishing to potential self-sustaining economic expansion. This is because inflation has only been dampened by the massive decline of the money multiplier factors. One defining characteristics of a true economic expansion is money multiplier expansion. Therefore, should an economic expansion start, either massive inflation would ensue from the expansion of the money multipliers or the Fed would have to withdraw money from the money supplies to prevent this. If the Fed withdraws money from the money supplies, interest rates will rise. Both significant inflation and increased interest rates would snuff out

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any nascent economic expansion prior to it becoming self-sustaining. Yes, sadly, the Fed has most definitely painted us into a corner.

Market Risk Perspectives

It's early afternoon on 2/1/2013 and the DJI has crossed over the 14000 level. So, the stock markets continue to rise in spite of the underlying conditions, which should have investors hunkering down, rather than taking more risk. Perhaps you are one of those risk averse investors who is feeling "antsy" about needing to get into risk assets. Maybe a longer view of our main stock market indices would remind you of the actual risk that exists in those markets.

Following are simple charts of the S&P 500, DJI and NASDAQ COMP from 2000 through 2013. These charts are *not* adjusted for inflation. Despite the cheerleading from the government, the Fed and market bulls, do these charts show significant investment returns over the last **13 years**? Or, do they show that, despite the machinations of the government and the Fed, there is significant undeniable risk in investing in these markets? Decide for yourself.

S&P 500 2000 - 2013



DJI 2000 - 2013



NASDAQ 2000 - 2013



Clients and Risk Asset Investing

In the late summer and early fall, I invested a lot of time and research on adjusting my *CJC Indicator*. My indicator, while not perfect (no tool or person I've ever seen is), gave me many signals which led to profitable transactions, although not all of the transactions were. It was also instrumental in my understanding of the timing of the 2007 – 2009 market crash.

The distortions created from the massive Fed money manipulations lessened the effectiveness of many technical indicators, including my *CJC Indicator*. Since then, I invested using fundamental tools and other TA techniques that still seemed to work, but I wasn't quite as comfortable with my investment decisions as I was when my *CJC* was working completely.

After more than 200 hours of work, I believe I have found a way to restore most, if not all, of its accuracy through factoring out those distortions. It should allow me to work on a shorter investment time frame. I'm hoping to use the adjusted *CJC* to become able to reach into the equity markets for profits while still limiting the risk of loss. Some such opportunities may happen in the next month or two; it simply depends upon analyzing index instruments and individual securities until solid opportunities are found.

If you're a client, I have already tested and documented your risk tolerance. Ethically, I can't automatically start using strategies and tactics at a level that would be inappropriate to your risk tolerance as I understand it. If, as client, you are interested in investing using this newer strategy, please call me and let's discuss the level of risk you are willing to bear while implementing this strategy.