



Passionate About Performance

April 2009

CAPITAL MARKET WATCH

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In this report, the following areas will be explored:

**KOALA OR GRIZZLY? How big is this Bear?
About Ken Stern & Associates**

Many of the financial decisions you make today will determine the lifestyle you enjoy tomorrow. Ken Stern & Associates is committed to partnering with individuals, striving to help them accumulate, maximize and preserve their wealth.

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Economic Outlook 2009

KOALA OR GRIZZLY? How big is this Bear?

I read a review for Michael Lewis' new book, *Panic*, last week that had one of the best quotes I've read in quite some time:

“How many times does the end of the world as we know it need to arrive before we realize that it's not the end of the world as we know it?”

Isn't that kind of wisdom apropos, given the year that we've seen in the market?

INTERESTING TIMES...

After a challenging first quarter, the question on everyone's mind, of course, is whether the bear market is over or not. Are happy days here again? What is KS&A's outlook and how are we positioning portfolios?

The volatility in the markets over last quarter was nothing short of epic. January brought a decline of 8.43% in the Standard & Poor's 500 Index, followed by a decline of 10.65% in February. March looked to be even worse, declining by almost 8% in the early part of the month, before abruptly turning around and racing higher on strong volume.

So, now what? I'm always concerned of bull market geniuses and bear market craziness. I feel confident that the recession that we're currently in will eventually end (signs of life are already beginning to emerge), but that, similar to an earthquake, it will take many years of adjustments and market corrections to wash out the terrible excesses, debts and abuses that contributed to the current situation. I am also keenly aware of the very real possibility that the “fixes” that bring the economy back to life may set the stage for more problems down the road. In fact, it seems apparent that the raging bull market in real estate (and resulting bubble) that followed our last recession were at least partially due to the monetary easing instituted to help pull the economy back up from the Tech Wreck at the beginning of the decade. Could the cure end up being worse than the disease?

A BRIEF HISTORY LESSON

From 1966 through 1982, U.S. equity markets were essentially “range-bound” – the Dow Jones Industrial Average only briefly rose through resistance at the 1,000 level and only briefly fell below support at 700. For over 17 years, the market was basically flat.

In 1982, a new bull market emerged. It is interesting to note that in 1982, as the market moved higher, unemployment was comparable to today's levels, pessimism was high and the general mood was bleak. Despite these factors, it ended up being one of the longest bull markets in his-

tory, with stocks (generally) trending upwards until the technology-led implosion of 2000. Since that time, despite short to intermediate-term moves upward, we have dropped back down to 1997 levels on the S&P 500 and 1998 levels on the Dow. After years in this trading range, is it possible that we will continue to be range-bound in the coming years? Our founder, Ken Stern, calls this trading range “The Great Nothingness.”

YOUR PRECONCEIVED NOTIONS OF THE MARKET MUST CHANGE

Investors are always being cautioned by professionals against believing that “it’s different this time.” But, what if it is? Is it possible that we could remain range-bound for many more years to come?

In bull markets, investors tend to be primarily interested in growth, often believing that it is possible to have growth without risk. In bear markets, fear drives a “herd” mentality, as investors sell without regard to longer-term “value.” But what happens when moods shift from bull to bear frequently, not giving the market any “true” direction for years? How should we invest for “The Great Nothingness?”

One solution may be, for portions of your portfolio, to seek out investments that are not as tied to “market” returns, taking an approach that is not as dependent upon which way the market is headed.

The single most popular methodology for allocating portfolios, industry-wide is known as Modern Portfolio Theory (MPT). MPT is based on the idea that, by combining various asset classes into a portfolio, each with differing characteristics and different levels of correlation to the other asset classes, it should be possible to reduce the volatility of a portfolio while maintaining similar expected returns. For instance, if you were to combine small cap, mid cap and large cap and international stocks, portions of the portfolio should “outperform” while other parts are “underperforming,” which theoretically leads to more stable average rates of return. Whether small cap outperforms large cap or vice versa, the portfolio is diversified across both asset classes. The recent downturn in the market, however, has illustrated to us some of the inherent limitations of MPT.

The primary limitation that has become apparent to us is, “How does this help if the markets are headed down and all of the asset classes, which have historically had differing levels of correlation to one another, suddenly start moving as one?” It really pointed out to us the necessity of including in our portfolio allocations, an “Uncorrelated” asset class – one that is not tied to the returns of the stock market.

Additionally, we believe that portfolios could benefit from “opportunistic” intermediate-term ideas, whether they are based upon our views of macro-economic events or upon market psychology. Although we still believe that MPT plays an important part in most portfolios, we feel

that, by adding “Tactical” and “Uncorrelated” portions to a “Core” portfolio, derived from the tenets of MPT, we have the opportunity to benefit client portfolios. We refer to this three-pronged approach as our “Alpha Wealth” system, based upon the term used in Finance to describe performance in excess of market returns.

THE ELUSIVE “UNCORRELATED”

Assuming that there is some rationale for adding an “Uncorrelated” component, are there any asset classes that are truly “uncorrelated,” though? The different classes of equities seem to move together and, although bonds have historically moved inversely with stocks, there has been a surprising degree of correlation recently. Even commodities, traditionally thought to be independent of stock returns, have been trounced, along with the greater market.

There is a class (or sub-class) that moves independently of the stock market, which is even more surprising because it actually invests in stocks! What I’m referring to is called “Equity Market Neutral” (“EMN”). Until recently, this was a strategy that was only available to sophisticated institutional investors, but now it’s breaking into the mainstream.

EMN’s strategy is both simple and complicated. In a traditional, “long-only” investment, the investor is not only making a bet on the individual stock that they purchase, but they are indirectly betting on the overall direction of the market. They say that a rising tide raises all ships, but, in a declining market, even a good stock picker has the odds turned against them. EMN seeks to “hedge” the market risk out of the investment, looking for “relatively” good stocks – i.e., stocks that don’t necessarily go up, but simply outperform whichever “hedge” is being used.

Let me give the example of a “pairs trade.” Let’s say that there are two hypothetical computer companies competing for business – Orange Computer and Dill Computer. Both are trading at a price of \$20 per share. Orange Computer made \$1 per share last year (for a price / earning multiple of 20) and their earnings are expected to grow at 5% annually for the next five years. Dill Computer made \$2 per share last year (for a P/E multiple of 10) and their earnings are expected to grow at 10% annually for the next 5 years. All other things being equal, it appears that Dill is a better deal than Orange as they’re trading at a lower P/E, even though they’re expected to grow at twice the rate. Again, this isn’t to say that Dill is a “good” investment, just that Dill appears to be relatively inexpensive when compared to Orange. What good is this information to an investor, though? It’s really somewhat of a moot discovery, until the investor has the ability to “short” one of the stocks.

This frequently maligned trading strategy actually has great applicability in a “pairs trade.” The investor actually borrows the stock from another investor, then sells it (without actually owning it), with the intention of repurchasing it at a lower price later on. There are many risks involved with this strategy and it’s certainly not for everyone, but I believe that it is a valuable tool for a pairs trade.

Going back to our example, let's assume that we buy 1,000 shares of Dill and sell short 1,000 shares of Orange. We are no longer trying to figure out whether Dill is going to go up; now we are speculating that Dill will simply outperform Orange. Here are some examples:

- I. Dill goes up 20% to \$24 and Orange goes up 10% to \$22. The long side (owning Dill) would have a gain of \$4,000 (1,000 shares of Dill X \$4 per share increase in stock price), while the short side (shorting Orange) has a loss of \$2,000, for a net gain of \$2,000.
- II. Dill goes down 10% to \$18 and Orange goes down 20% to \$16. The long side has a loss of \$2,000, while the short side has a gain of \$4,000, for a net gain of \$2,000.
- III. Dill goes up 10%, Orange goes up 20%. The long side has a gain of \$2,000, while the short side has a loss of \$4,000, for a net loss of \$2,000.
- IV. Dill goes down 20%, Orange goes down 10%. The long side has a loss of \$4,000, while the short side has a gain of \$2,000, for a net loss of \$2,000.

So, in pairs trades, the direction of movement is less important than the relative magnitude of movement. The position makes money as long as either the long position goes up MORE than the short position loses OR the long side loses LESS than the short side makes.

Equity Market Neutral funds typically run a large number of these “pairs” trades. In statistics, odds are calculated over a large number of occurrences. For example, if you were to flip a coin once, you could get either a head or a tail. If you were to flip a coin 100 times, odds would say that you're likely to get about 50 heads and about 50 tails. Assuming that the methodology used in selecting these pairs trades can add some small statistical advantage, having more pairs in the portfolio helps to decrease the chance that an individual position will cause a large variation in the return of the entire portfolio.

I have always enjoyed “math” problems – I still regularly use 9th grade algebra to solve for “x,” I was amazed the first time a professor explained the power of compounding and I used to make a living trading options that were mis-priced relative to the models I valued for them. In my mind, Equity Market Neutral is really a fun math exercise – looking for small advantages in calculating the “relative value” of a large number of positions, without the additional pressure of being dependent on the overall direction of the market. EMN is certainly not an end-all, cure-all for all portfolios, but, for investors looking to capitalize on relative mis-pricings, uncorrelated to market returns, it can be a useful tool. Although the description above makes this strategy sound relatively simple, it truly is a strategy best left to professionals; your KS&A advisor can help you decide whether EMN is appropriate for you and, if so, how best to implement it into your portfolio.

It is necessary to mention that there is no certainty that any investment will be profitable or successful in achieving your investment objectives.

SUMMARY

If I had polled investors a couple of years ago, in the midst of a bull market, if they would be happy with a relatively steady return, underperforming in rallies, but outperforming declines, I probably would have been told by many of them that they were more concerned with out-performance than protection. I've often said that investors tend to have an appetite for risk up until the point that they actually experience some. Bear markets make investors believers in conservative, stable strategies, though. Similar strategies can also be appropriate for range-bound markets, such as "The Great Nothingness." Embracing consistency is a change of mind-set for investors, but we believe that it can alleviate some of the fear associated with the switch from bull to bear and back again.

About Ken Stern & Associates

Ken Stern & Associates ("KS&A") is passionate regarding advanced wealth management. Every area of wealth management from investing to legacy planning requires a sound strategy. We pride ourselves on our discipline of investing. We execute our strategy effectively and with purpose. The desired outcome is to work toward the goal that the wealth management strategy created.

Chaotic markets, turbulent times, and booms and busts allow the skilled wealth manager to exercise this discipline and create long-term alpha on behalf of their clients. Our alpha objective is to help you make more money, reduce your risk, pay less taxes, and define your legacy.

Call KS&A today for a complimentary portfolio review, list of services & Alpha System Analysis for yourself, a family member, or a friend. (800)529-2884

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