CMG
CAPITAL MANAGEMENT GROUP, INC.
Tactical Investment Solutions

The Blumenthal Viewpoint

February 13, 2012

Sentiment Charts, Portfolio Construction and Future Inflation

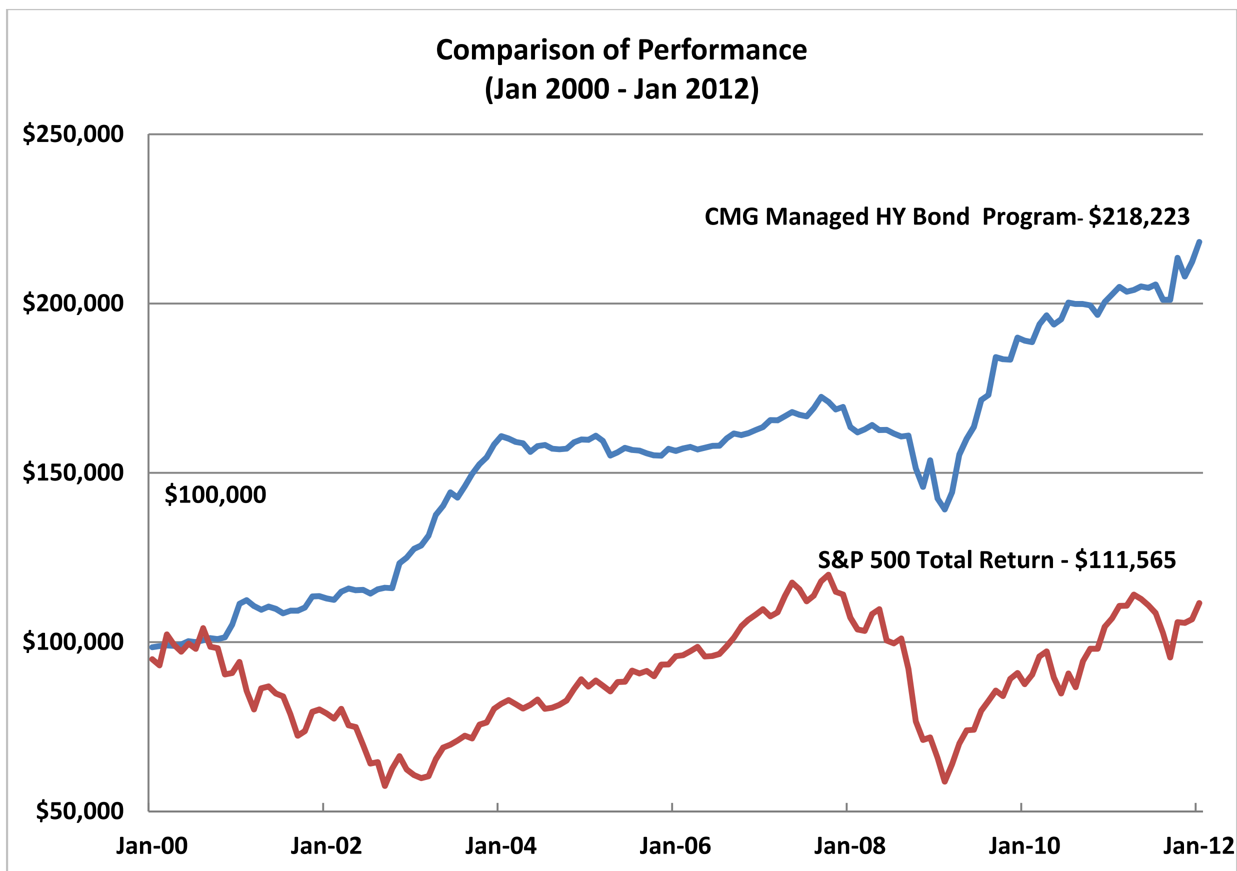
Sentiment Charts – Excessive Optimism (risk protect)
Cyclical Bull technical signals
More thoughts around portfolio construction and future inflation

The U.S. equity markets are off to an outstanding start in 2012 as is the performance of our various tactical strategies.

- Anchor Capital Long/Short HY Bond Program is up 3.01%.
- CMG Managed HY Bond Program is up 3.91%
- CMG Opportunistic All Asset Strategy is up 8.01% (Trust Company of America portfolio)
- CMG Opportunistic All Asset Strategy is up 6.95% (TD Ameritrade portfolio)
- Heritage Capital Gold Equity Strategy is up 2.35%
- Scotia Partners Dynamic Momentum Program is up 3.36%
- Scotia Partners Growth S&P Plus Program is up 8.24%
- System Research Treasury Bond Program is up -1.87% year-to-date and up 4.61% in February

**All performance is net of fees year-to-date through 2-9-12. Importantly, these are risk-managed strategies designed to profit in both up and down markets.*

Of course, there is no guarantee that ensuing months will see a repeat as risk remains ever present. As one can see in the S&P 500 Index and Investor Sentiment charts below, the markets are extremely volatile and marked by excessive bullish emotion. While it is relatively simple to risk protect, it is emotionally difficult to go against the crowd. Few do. Most humans are just not emotionally programed or trained that way.
I remember writing about the high valuations of stocks in 1998 and 1999 advising of a coming crisis. It was a “sell when everyone is buying” moment. The general sentiment was the market would continue to move higher. I remember in December 1999, a client, unhappy with a 30% gain in our HY trading strategy over the previous two years, advised me she was transferring her account to Merrill Lynch. She told me she was investing in “safe stocks”. I’ll never forget that meeting. She was nearing retirement. Those safe stocks turned out to be not so safe. I stuck to my risk management process and made money in the devastating period that followed. Here is the comparison.



Source CMG data, Pertrac Financial Solutions, LLC. See important disclosure information at the bottom of this letter. The above reflects CMG Managed HY Bond Program real returns net of a 2.50% management fee.

Was she able to hold firm in those "safe stocks" through two separate 50% stock market declines? Her $1 million declined to approximately $500,000 by the summer of 2002. Did she hold? Did she sell at the crash low in 2008? Was she able to stay firmly engaged in the game?

In 2007, I remember talking about sub-prime and CDOs. After deep research and discussions with some very smart hedge fund managers we were convinced an economic catastrophe awaited ahead. I wrote about Freddie and Fannie, 30:1 leveraged U.S. banks, the housing bubble, sub-prime mortgages and a ticking time bomb called derivatives. Investors were again fully pulled into the game. My views were not well received. I was accused of being too bearish. After all, retired Fed Chairman Alan Greenspan and many others said the U.S. housing market was "not prone to bubbles". What ensued were the stock market crash and "the great recession". The housing market crashed as well.

I have turned bullish and bearish many times over the last 20 years and I'll continue to share my views. I believe investors are getting antiquated advice when given a 60-40 portfolio allocation. You can do better and I'm amazed at the miss given the breadth of evidence before us.

Enhance the portfolio construction and find alternative risk diversifiers. They exist within mutual funds and managed accounts with daily liquidity. They can zig when your equity exposure zags. This enhanced construction is within reach for all investors (not just endowments and the super wealthy) and positions you in line with what I believe is the true intent of Markowitz's Modern Portfolio Theory construct.

Our tactical investment strategies and those that seek to replicate them will no doubt bounce around a bit, but I believe in tightly focused, daily investment discipline. The right mix of liquid alternative investments, coupled with well-reasoned and risk managed equity and bond allocations, will accrue to your benefit this year and the years that

follow.

In both long-term secular bull and bear periods, (the latter of which I feel we now inhabit), I support a strong allocation to a diverse selection of tactical investment strategies. In my "Uncommon Solutions" piece and others, I've advocated allocating a meaningful percentage of one's portfolio to alternatives in order to achieve the diversification needed to anchor portfolio performance against the volatile headwinds that exist today.
At this time, I believe allocating at least 40% to various alternatives designed to enhance portfolio return and mitigate risk is appropriate. For you it could be a higher allocation or a lower allocation based on your particular views. Today, advisors have just 5% allocated to gold and/or REITs. That won't do it. My long-term market view continues to support a secular bear theme, but that does not mean the market will always go down. My short-term view supports a cyclical bull move yet there remains great economic risk tied to too much debt and unsustainable spending in the U.S. and across the globe.

This time I believe the unintended consequences will be tied to the irresponsible pace of world wide money creation. Not an immediate problem but a future inflation problem of significant magnitude. We are all printing at the same time. We are all trying to paper over the same problem; unsustainable and unmanageable debt. If you do the deep research you will find that there is plenty of historical data to understand how this will play out.
To me it is a question of when, not if. I recently took my car into the shop. Something was knocking. The mechanic lifted the hood and spent some time studying the engine. He says that there is a big problem. Do I trust him? Do I fix it? If I decide to pass on the work and drive away and the car continues to get me where I'm going, was the mechanic wrong and I right? How far can I drive? In the back of my head rings the old commercial "… you pay me now or pay me later". What do I know or even care about car engines? Who do you trust to lift up the hood on the world's financial engine?

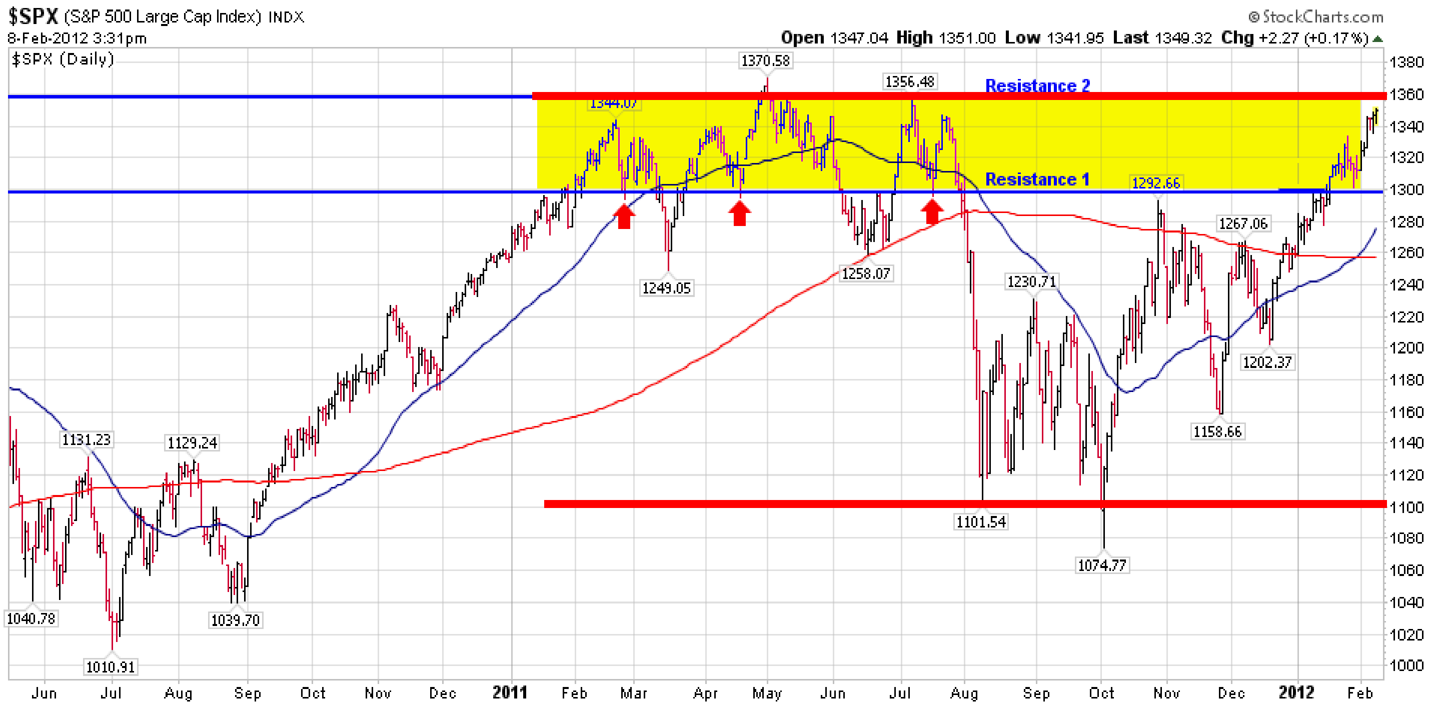
I spoke about sub-prime, the housing bubble and CDO mess in 2007, and before that I wrote in the late 1990's about the coming secular bear (42x PE ratios made no sense). Looking deep into the engine, the future problems were clear to me. Today I believe we have not yet fixed the engine. I trust my financial knowledge and instincts, yet frankly, I could be wrong this time. The point is that risk exists. The bigger point is that my view really doesn't matter if you get the portfolio construction correct.

Of course, the world could somehow pull out of this excessive debt mess and safely land on a narrow runway, late at night, in high winds, and trailing smoke. I hope so, but I wouldn't bet with a 60/40 investment hand. As I can't stress enough, I believe the key to investment success is a broadly diversified portfolio that includes multiple non-correlating risk diversifiers (strategies that can make money in up and down trending markets). This will better enable your clients to stay firmly engaged in the game without being lost in the emotional froth.

Can something in the magnitude of Lehman occur? I think the answer is yes, just multiply it by a few trillion. Will it play out that way? Don't know. Again, to me it doesn't matter if you risk manage the long equity exposure and get the portfolio construction right. If you are an individual investor, I believe a focused total portfolio solution will serve you well. If you are an independent investor advisor, in this period exists one of the greatest opportunities for you to separate yourself from the significant majority of your advisors stuck in the old 60/40 mindset, grow your business and help your clients.

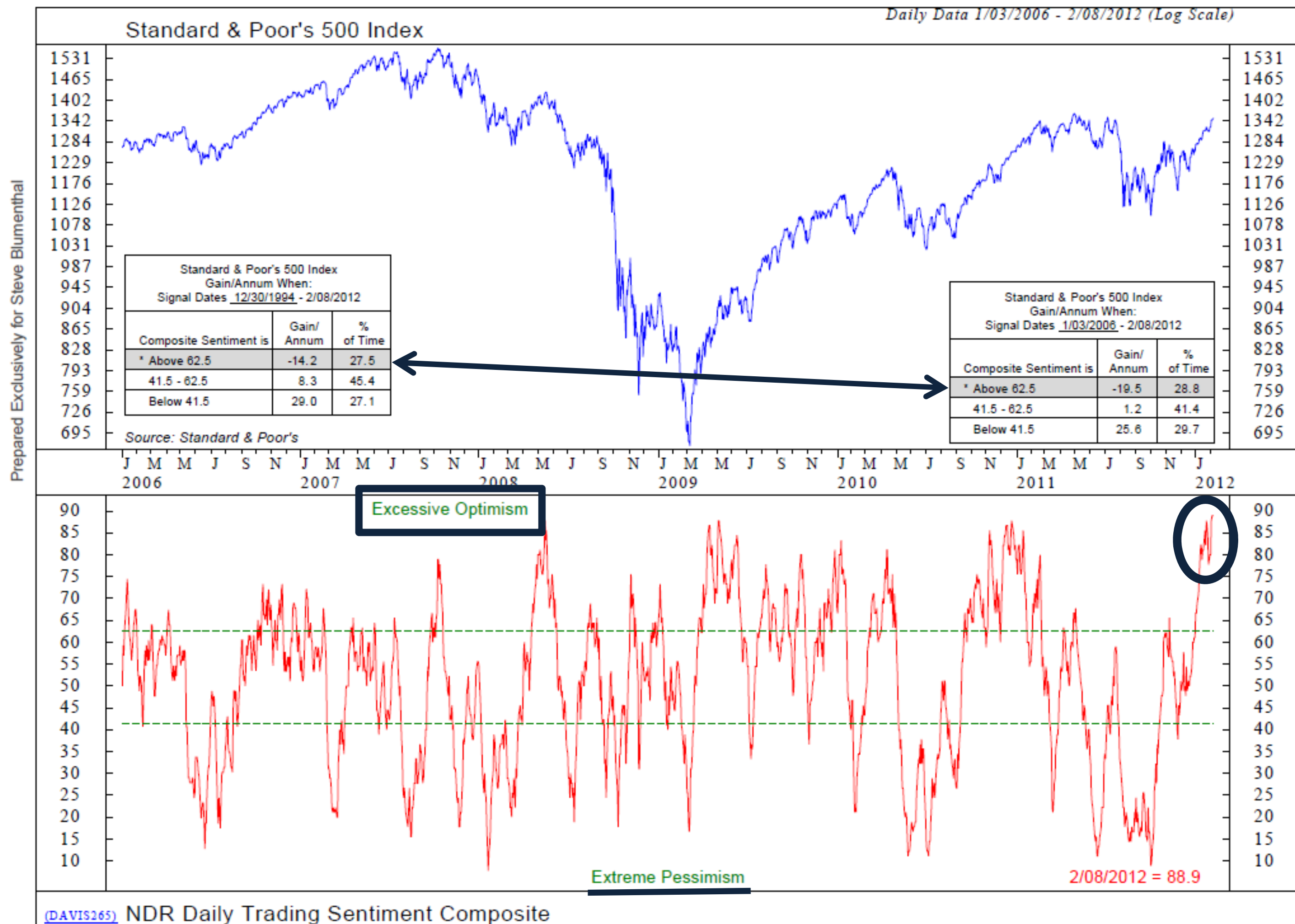
Charts and investor sentiment (for you quant geeks like me)

Ok – here are the charts along with my current thoughts. My best guess is that the market is range bound between 1100 and 1360. The S&P 500 Index chart below marks the significant overhead resistance at 1360 (top red line).



Given the immediate overhead technical chart resistance (marked in yellow) coupled with the Extreme Optimism as measured in the following two sentiment charts, I believe now is a good time to put hedges in place to risk protect the long-term equity exposure within your portfolios (major resistance tied to excessive optimism as is the case today).

SENTIMENT Chart #1 (dark blue highlights are mine)



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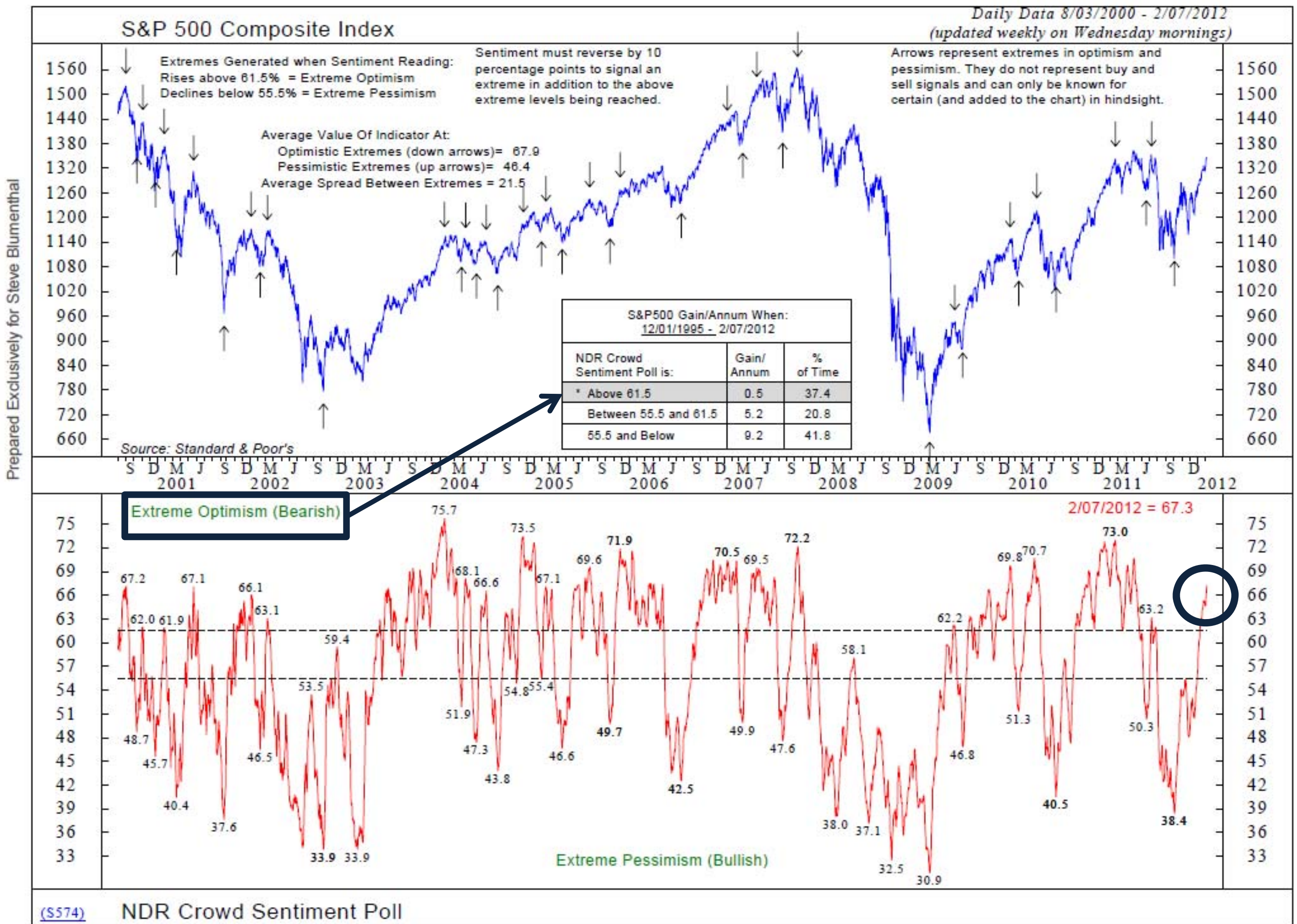
SENTIMENT Chart #2 (dark blue highlights are mine)



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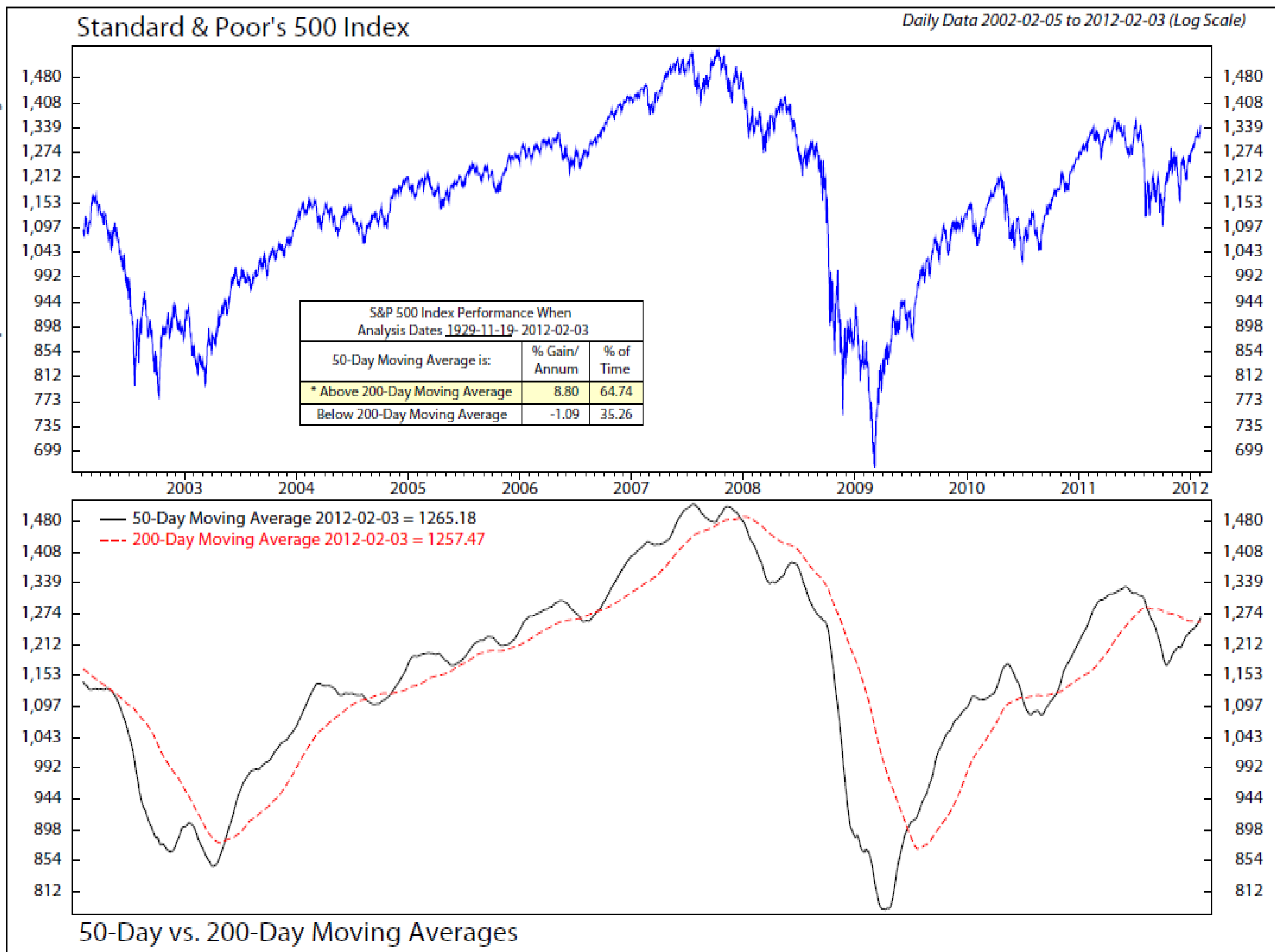
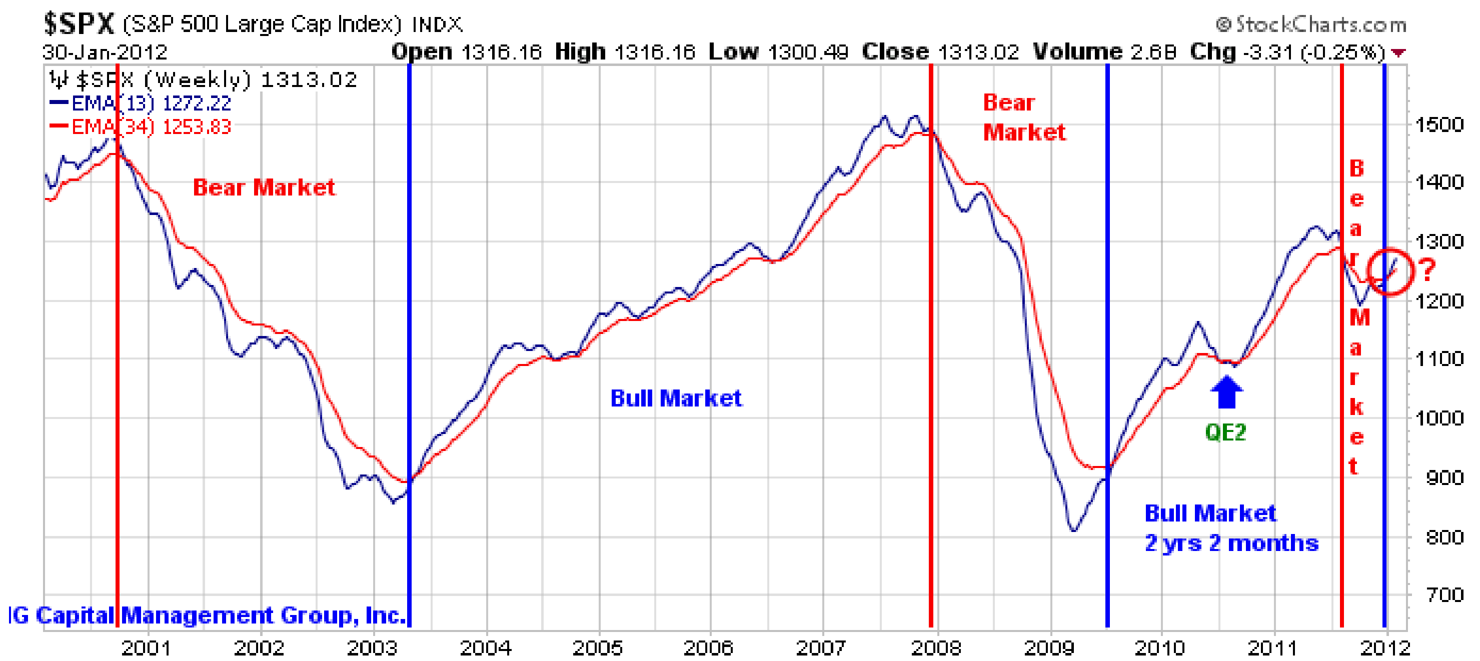
Cyclical Bull - The evidence supports a short-term bull period as there are several favorable technical indicators: First, the following chart reflects the performance of the S&P 500 Index from 2000 to present when the 50-day moving average line crosses above or below the 200-day moving average line. In this case, a cross above represents an intermediate term buy signal and below an intermediate term sell signal.



Second, I've shown the next chart in previous email updates. This chart looks at the 13-week exponential moving average "EMA" (blue line) compared to 34-week EMA (red line). The cross overs have done a pretty good job at picking up the last several cyclical bull and cyclical bear market periods. A new cyclical (short-term) bull move looks probable (red circle). A break above 1360 could see a further move this year to 1450 (probable). I see downside risk at 1000 (less probable).



Summary: Short term, I'd call myself a hedged bull; I continue to believe it is important to hedge at points of extreme investor optimism (as is the case today) and remove the hedges at points of extreme investor pessimism (that day will come again). Focus on the portfolio construction.

With a focus on best practices, I can share from my personal vantage point that the top advisory firms have in place a Total Portfolio investment solution: one that balances long equity exposure (risk managed with protective put options, volatility hedges and or inverse equity ETFs) and includes meaningful allocations to a number of alternative risk diversifiers. Fortunately, as I've mentioned, this type of approach is available to all investors today. I hope that this information proves helpful to you and your practice. If you are interested, we post weekly sentiment updates on our website. Here's the link to that page. How you might implement protecting your long exposure is up to you. Remember that no indicator is perfect. This is a probability game. It is a risk protection game plan that I feel is necessary given the challenges we face ahead. Figure out an annual risk budget. If you have 30% exposed to long-only equities, perhaps you budget just 1% or 2% of your total portfolio to protect that exposure. No large bets are required to be made, but some sort of portfolio insurance could prove invaluable given todays macro fundamental risks.

I will be in Kansas City on February 21'st speaking along with my partner John Mauldin at the Roth Companies Investor Conference and San Diego February 29 to March 2 at the Shareholder Services Group National Advisor Conference. Let me know if you're in the area. I'll have a little downtime and always open to a coffee or good IPA.

Wishing you continued success.

With kindest regards,

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