



Market Commentary

By Bryce James

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This research report includes analysis from Smart Portfolios, but its main purpose is to give the reader an overview of financial markets using multiple market valuation methodologies. These observations are the views of Bryce James and not Smart Portfolios.

In December of 1999 my color-coded quantitative models turned pure red, which was the worst color in the ranking system. It was enough information for me to move my clients' assets to cash accounts, recommend commodities, and resign from RBC Dain as a Senior V.P./Portfolio Manager. Three months later, on March 24th of 2000, the "Market" (S&P 500) hit an all-time high. Then, a year and a half later, by October 10th 2002, the market had fallen 50.50%. In hindsight, the reasons for a market top appeared obvious; but at that time, many investment professionals thought it crazy to be selling into such a strong market rally.

Ironically, a cartoonist named Jeff MacNelly in Chicago had written an insightful sketch in May of 1999. It was a side-by-side picture of two young men. The first pane depicted the now classic story of the shoeshine boy giving stock advice to Joe Kennedy just a week prior to the great crash of 1929. Because of that tip, Mr. Kennedy sold out of the market just in time. The cartoon's header read "1929" with the caption stating, "My broker says." In the second pane was a college-age kid sitting at his computer with his cap on backwards; the cartoon header read "1929.com." This quote reads "I am my broker!" MacNelly might have been a year early on his market call, but currently the market index (S&P 500) remains around the same level today, 11 ½ years later.

MacNelly would have missed participating in the bull run of 1999. That year, the market went nearly straight up, especially the technology stocks. The S&P 500 was up 19.53% and the NASDAQ returned 85.59%. If MacNelly was a broker, then most likely his clients would have wanted to fire him for missing the big opportunity; this would have been right at the top of the market. A decade later, the same client would have sung his praise because the S&P 500 was down -16.87% from its 2000 high. So as they say, "timing is everything."

The Big Picture

Currently, the financial markets are starting to exhibit behavior similar to that of 1999; specifically in the way markets are rising unchecked. This report is an attempt to bring rational investing to light and use history as our guide. As most of you know, I'm a big fan of long-term cycles. Since the start of the millennium I've been touting that we are in a debt-destruction cycle; what cycle theorists call the "winter cycle." The last winter cycle started in 1929 and did not end until 1949. However, the market didn't hit its previous 1929 high until 1959. I'm not saying we have another 20 years of this boom &



bust market movement, but I suspect we are far from over. That is just my opinion and not the output from our scientific asset allocation model.

Nobody is Perfect

People love to cite Warren Buffett as one of the world's best fund managers. No doubt he is genuinely smart, thorough in his research, and an honorable guy. However, investors in his Berkshire Hathaway Fund (BKA.A) were down nearly half their investment (-48.57%) at the start of the 2000 crash (from its high one year prior). Compared to MacNeely's under-performance in 1999, Buffet's fund was a catastrophe. This was not Buffett's only major draw-down of the decade; during the 2008 crash Buffet's fund dropped more than 50% in just six months. If you can stomach this type of volatility, then it's nice to know his fund has returned to its 1998 high with a total return of 48.33%. That is an annualized return of 3.18% over 12.6 years. Something tells me that a decade of 50% drops and an annualize return of 3.18% won't help me reach my financial goals.

I believe Wall Street could be setting up for a market environment similar to 1999 because of the way equities are behaving, specifically as it relates to equity **volatility** and **valuations**.

Don't Chase Short-Term Performance

The financial industry tends to judge performance on short-term results. When comparing the portfolio performance of money managers for the past 18 months, it is easy to find a group of top-performing managers with double-digit returns. However, if this analysis is widened from 18 to 29 months to include the pre-crash high of October 2007, it is evident just a few money managers have delivered positive returns. In fact, the S&P 500 remains down –more than 18% during the past 29 months. My concern is that market rallies, like 1999 and now, can be very inviting and cause portfolio managers and their clients to forget the most basic fundamentals of investing.

Market Risk

The industry's risk models used in professional investing are one of the biggest problems on Wall Street. For a decade I've been arguing the point that the traditional risk models (Standard deviation, Semi-Variance, and Value-at-Risk) are flawed in their ability to measure risk. These traditional methods measure risk based on the "volatility" as it relates to the "mean" return of a security or index. This concept holds several flaws. First, standard metrics ignore the tails (big loss and gain days) of a security's price distribution because of poor mathematics. Second, this same methodology assumes that volatility is correctly measured using the average variance of the selected time series (which is typically decades of data), a method known as mean-variance; this ignores current market volatility. Third, the volatility metric ignores the operational risk of a company (such as: negative cash-flow, liability coverage, fraud, etc.) and ignores market valuations (such as: P/E, P/BV, and P/CF). Lastly, these traditional methods are unable to differentiate good volatility from bad volatility. In other



words, how dangerous is a security that only moves upward, since that upward movement is considered good volatility?

How dangerous is a run-away market? The answer to that question is what makes this market look and feel like 1999. Normally I would argue in favor of good volatility. Typically, a chart of a security with “good volatility” would illustrate a security moving upward to the right without many down days. This would be analogous to measuring the safety of a pilot. It would be hard to crash if the plane kept a steady, gradual, increase in altitude (until the point where the oxygen gets too thin). The pilot and passengers could even track their safety with the help of an instrument called an altimeter. The altimeter is to flying what a risk metric (like Standard Deviation or VaR) is to portfolio management; they both measure the volatility around the slope (rise/run).

The problem is that an airplane can’t go up forever, nor can the price of a security. This is my concern with all risk models; a problem I’ve never heard discussed. This occurs towards the peak of markets when the market rallies with low volatility because everything is moving upwards. Investors fear missing the market and therefore invest; so the market “climbs the wall of worry”, which is what I call the “spike effect.” The market fundamentals reach historic levels, but investors ignore the risk (see Table 1).

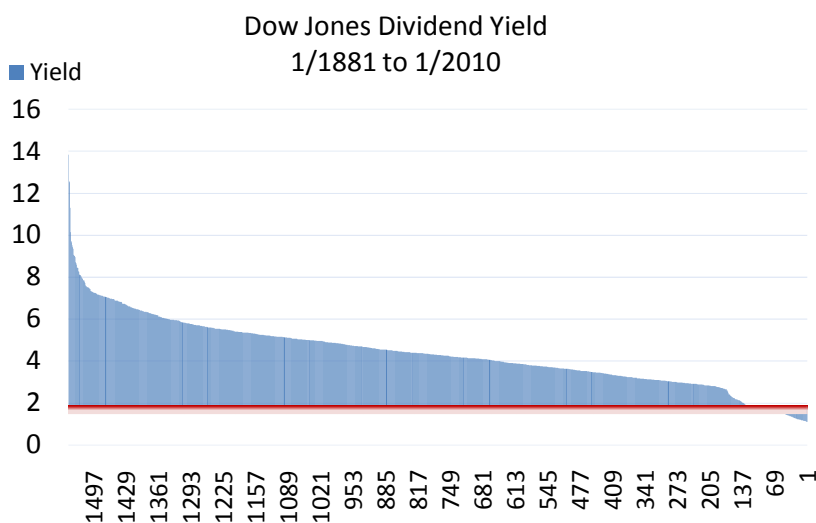
The current risk models used by most of the industry become worthless during these times when markets rise to new highs with low volatility. The most recent occurrences were in late 1987 and early 2000. A chart of a security in 2000 would display a ski jump pattern as securities move sharply upward without many down days. In other words, a security moving in an upward direction with few downward corrections will have low volatility (risk) even though the underlying valuations are in the nose-bleed section.

To demonstrate, look at the upward spike in the S&P 500. It moved up for nearly 100 days without once closing below its 50-day moving average, a scenario which has only been matched 17 other times since 1928. Furthermore, it did not close below its 10-day moving average once in the previous 30 days; a feat that has never occurred in markets 82 year history. This inability to see the risk of low volatility during market spikes as markets climb the Wall of Worry, is the problem with all risk models. This is where the next big hit will blindside professional investors who only look at volatility as a measure of risk.

Fundamental Valuations

Measuring risk using volatility totally ignores the fundamental risks of a company, such as: profitability, excessive liabilities, industry decline, and risk for fraud? My concern today is even more basic, I want to know the current Price/Earnings Ratio, Price/Cash Flow Ratio, and the Price-to-Dividend Ratio, A quick survey of these basic fundamentals currently indicates the industry is at the high end of the range looking at historical valuations. Please see the Charts in Table 1 for Fundamental Valuations.

The error many individuals make in analyzing fundamental data, such as financial ratios, is not realizing bigger historical spikes mask the relevance of market valuations. For example, in the following chart, look at the Price-to-Dividend Ratio scaled from highest to lowest. Can the yield go lower? Yes. Is the probability high?



Market may go higher, increasing its richness, but will you become rich if markets regress to their historical averages (or move lower?)

Forward-looking analysis, such as Estimated Earnings, can be dangerous. A 25 year study of earnings estimates found that analysts' forecasts were off by nearly 100%. Tell me this doesn't contribute to market volatility when expected earnings come in at half the earlier projections.

Earnings forecasts can be misleading when companies are reducing expenses to increase earnings. Cost cutting can only occur so long before the reductions impact a company's long-term growth. The real key is sales growth. The market has been rising as earnings have surpassed Wall Street estimates for seven continuous quarters. However, sales growth has trailed analyst forecasts since 2008. Only this past quarter did sales growth materialize (2%); this is the first positive sign I see for the industry's recovery.

Economic Research

As I mentioned earlier, I have been contending we are in an economic down cycle; known as 'winter' - the debt destruction phase. This equity market will have a difficult time recovering until we reduce more debt, either through paying it down or debt repudiation. To me, we simply continue extending the inevitable which will only delay the economic recovery.

United States unemployment remains around 9%, with a total loss of 8.75 million jobs during the worst recession in seven decades. Interestingly, the S&P 500 has rebounded 94% from its March 2009 low,



the biggest gain since 1936, as the revenue for the S&P 500 companies are estimated to increase sales 7.5% this year. Compare that to 2009 sales which decreased 13% during the worst drop since 1930. So, the net result is that the industry is still behind in sales growth. According to Bank of America Chief U.S. Equity Strategist David Bianco, the cost cutting has led to operating margins of 19.8%. While that appears impressive, my concern is there is likely little room for further cost reductions and future earnings will have to come from increased sales.

I'm not an economist, but it's hard to believe the run up in the market is real when the fed prints money like never before and regulators waive the debt of companies deemed 'too large to fail.' Even the industry's leading figureheads, Ben Bernanke and Warren Buffet state these financial times are "uncharted waters." Since the 2007-2008 financial crisis, investors have witnessed unprecedented actions not only by the U.S. Federal Reserve and the U.S. Federal Government, but virtually every central bank on the planet engaged in aggressive monetary stimulus to combat perceived risks, as well as never before seen fiscal actions.

Investor Sentiment (Bullish/Bearish Indicator)

In addition to fundamentals, one of the best indicators of future market direction comes from tracking investor sentiment. When investors are highly optimistic the sentiment index is low, which suggests the market is set for a reversal of the bullish trend, and vice versa. One of the most predictable sentiment indicators measures sentiment on a scale of 0 to 100, with 100 being the extreme low sentiment (very bullish). Currently, this market indicator is at eight, which is extreme bearish. This is its lowest score since its inception in 2001. The previous record low was nine on 12/23/04.

Technical Analysis

A short-term trader can argue that the market technical's are extremely bullish. Others see the major stochastic as being very high and at risk. The longest of technical indicators might suggest the market has room to run (see chart on next page). This is about the only case, in my opinion, which looks promising from a technical point of view. Most technicals are biased because they depend entirely on the time series selected to perform the analysis. I believe that understanding the time-series analysis is the most important factor in modeling. In the chart below, the red lines are periods where the relative strength (lower chart lines) is above 80 and declined below 70. The green lines are periods of low relative strength (below 20) and on the rise.



These are traditionally good times to be entering or exiting the market, depending on the signal. The chart indicates the industry is just above the 60 Relative Strength and still rising. This indicates I might be early in my fear regarding the current market condition, although the shorter-term RS signal is above 80 and ostensibly at risk. Although I think most of the industry's technical indicators are wrought with errors, I do enjoy some of the more esoteric (what I deem to be more intellectually designed) signals like those by Tom DeMark.

Summary

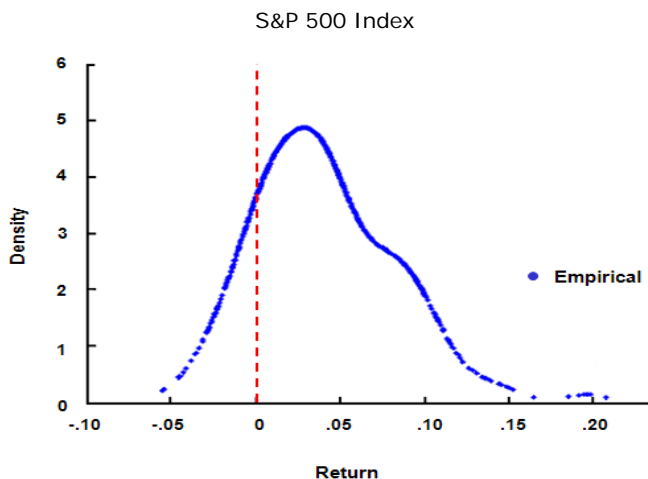
Prices go up the most and in the shortest period of time when markets are nearing their peaks; what is known in the industry as "climbing the wall of worry." This occurs when investors panic or become euphoric; they can feel left out or upset due to under-performance, or get short squeezed, become greedy, or simply feel safe again with all the good news. This is historically a terrible time to invest. With the sentiment indicators currently hitting historical lows (very bearish) the probability of large near-term loss is very high. With the exception of the past few days, investors are dancing on the roof tops. It appears that the sky is the limit, but hitting the ground is more probable.

The fact is that the underlying market valuations, in my opinion, are very high. Earnings forecasts from analysts, proven to be notoriously wrong, disregard the source of the earnings. An earnings increase attributed to improving revenue is good, whereas earnings increases derived from cost cutting can only last so long and is not so good. I think much of the increase in earnings has come from cost cutting, not sustained revenue growth.

So what is risk? Volatility? Nay. I believe it is the combination of all information which can impact security prices. Measuring risk using the popular risk models is akin to taking a knife to a gunfight.

I have focused on the fundamentals, sentiment, technicals, earnings, economic, and risk models, because these factors are what influence security prices. If the market is down today it is due to one of those factors. More specifically, it is because one of investor's expectations regarding those factors has changed (please see Table 2: Smart Portfolios Investment Theory). It is fundamentals, sentiment, technicals, earnings, economic, and risk models, which changes the price of a security. Changes in price impact the shape of its price distribution. In "Bull" markets, the shape becomes highly skewed to the right. In "Bear" markets it skews to the left.

Currently, the shape of the market is skewed to the right. The market has completed a prolonged move upward, causing the underlying fundamentals to shift near the high range of their historical averages. Likewise, sentiment index, along with the other influencing factors of price, are also high.



The chart on the left depicts the frequency of daily returns during 2010. Note the large number of positive days (area to the right of the red dotted line). Typically, 55% of the days are positive. Definitely not the case this past year.

One could argue the market is finally back to its level of 10 years ago, but I believe the fundamentals are driven by cost-cutting and that debt remains too high.

I predict our models will be turning more conservative because of the the drivers of a pricing model like ours: fundametals, volatility, economic, technical, and sentiment. It is the expectation of these factors which create the change in price, which lead to the change in the distributions' shape, which result in the change in our expected risk and return. Smart's job, is to deliver the optimal mix of risk-adjusted return.

I've been told good things come in small packages, but when I get going I find I just want to report it all. Thank you for taking the time to make it to the end of this letter. Should you have any question please feel free to contact me.

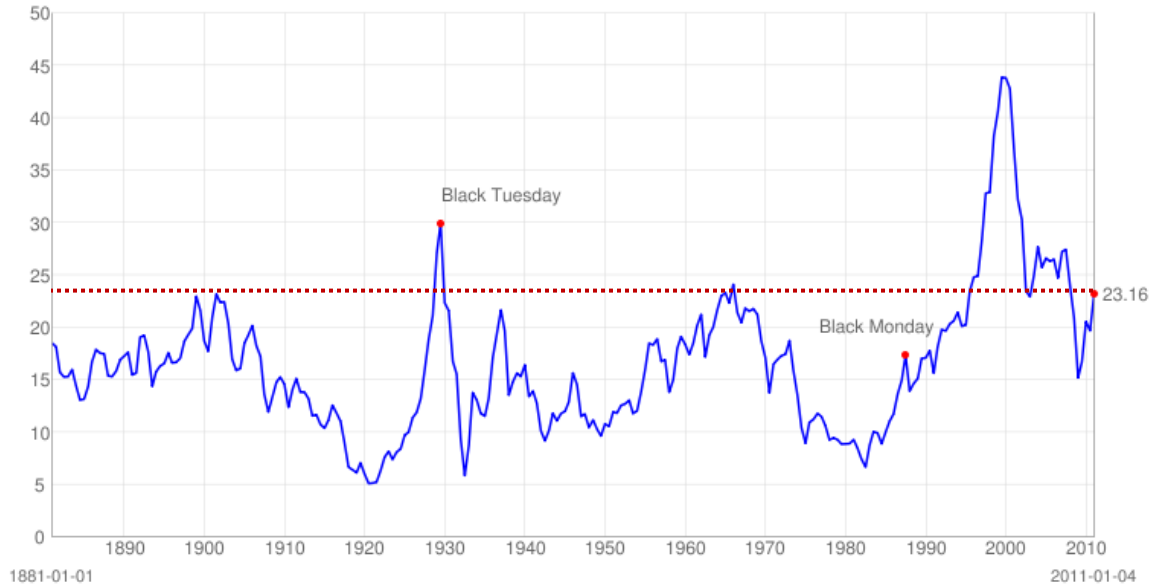
Peace & prosperity,

Bryce James
President

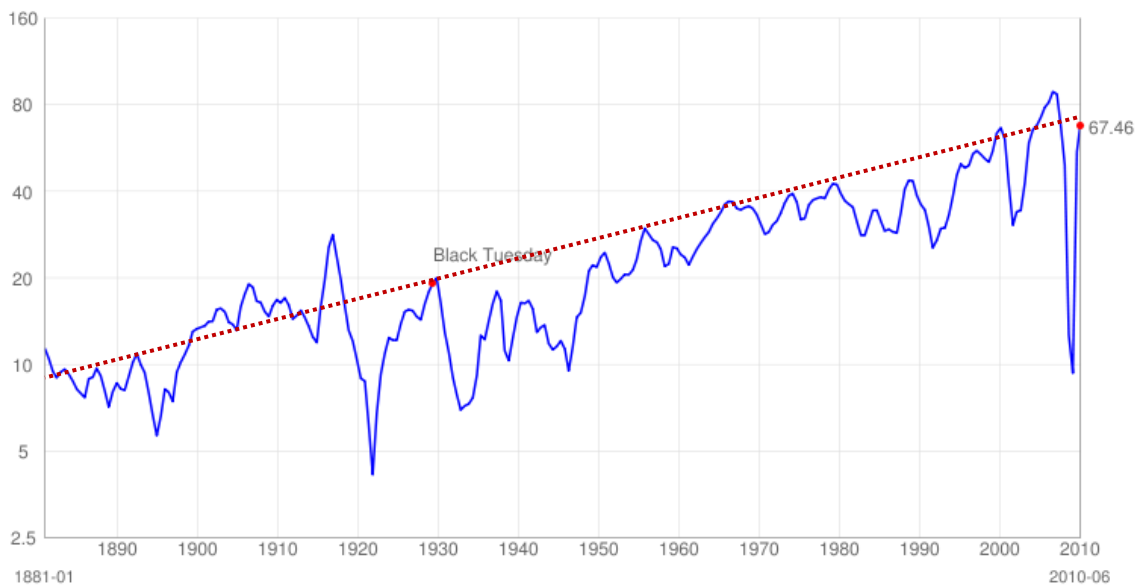
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Table 1: Fundamental Valuations

S&P 500 PE Ratio



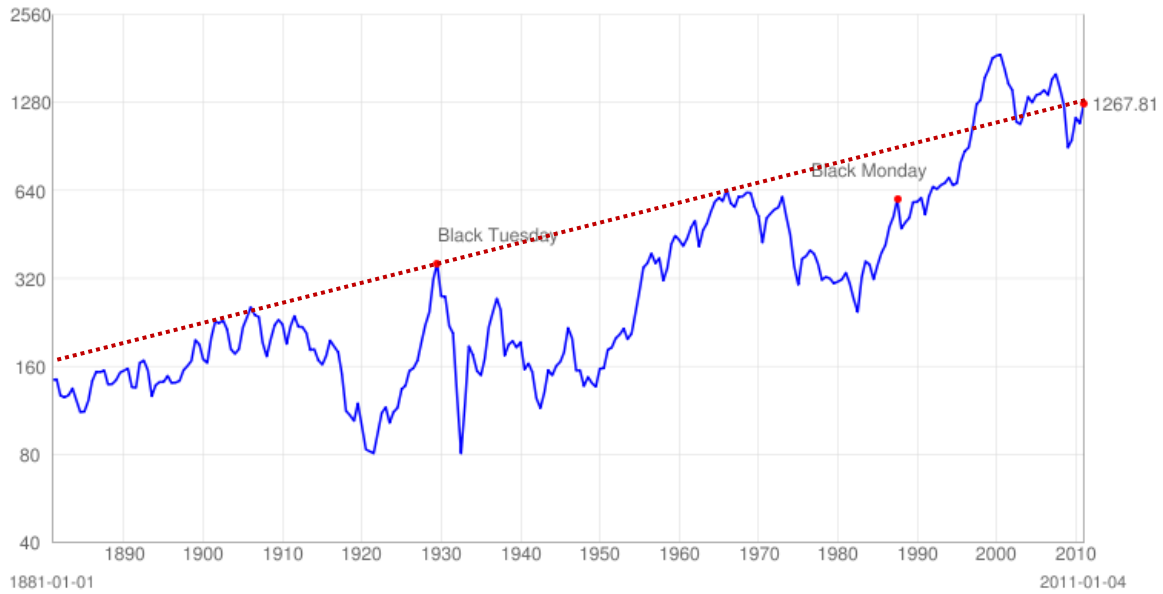
S&P 500 Earnings



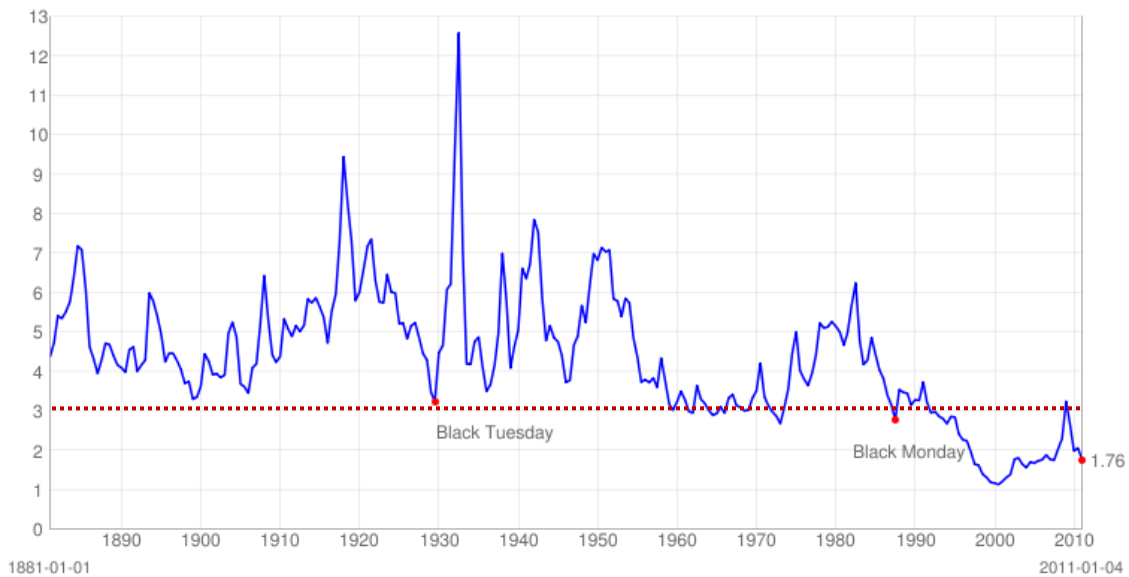
Source: www.multpl.com



S&P 500 Price, Inflation Adjusted



S&P 500 Dividend Yield



Source: www.multpl.com

10 Year Treasury Yield Chart



Source: www.multpl.com

Table 2: Smart Portfolio's Investment Theory

1. Investors (collectively) make the market
2. Markets are driven by investor expectations (fundamentals, economics, technicals, etc.)
3. Changes in expectations impact security prices (earnings estimates, interest rates, technical breakouts, etc.)
4. Large errors in expectations cause rapid and pronounced price changes (dot-com bubble, real estate boom, flash crash, Greek currency, Russian Bond default, etc.)
5. Managing the changes in price and velocity of change, optimizes your performance



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