Jeffrey D. Saut, (727) 567-2644, Jeffrey.Saut@RaymondJames.com
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Investment Strategy

Lessons

Year-end letters are always hard to write because there is a tendency to talk about the year gone by, or worse, attempt to predict the year ahead. Therefore, we are titling this year's letter "Lessons" in an attempt to share some of the lessons that should have been learned over the past year. We begin with this quote from an Allstate commercial featuring Dennis Haysbert:

"Over the past year, we've learned a lot. We've learned that meatloaf and Jenga can actually be more fun than reservations and box seats. That who's around your TV is more important than how big it is. That the most memorable vacations can happen ten feet from your front door. That cars aren't for showing how far we've come, but for taking us where we want to go. We've learned that the best things in life don't cost much at all."

Charles Dickens' classic novel *A Tale of Two Cities* begins with the quote, "It was the best of times, it was the worst of times." That quote is certainly reflective of the stock market in the year gone by as 2009 should go down in the books with that moniker. To be sure, 1Q09 was ugly with the S&P 500 (SPX/1115.11) surrendering nearly 30%. From those March "lows," however, the SPX has gained some 69%. For those that targeted the "lows" it has been a great year. For those that didn't, it has truly been "the worst of times," for after losing ~58% in the SPX from the intra-day highs of October 2007 into the intra-day lows of March 2009, they have not come close to recouping the monies lost in that downdraft. The lesson that should have been gleaned is that if participants would have managed the risk (read: not allow positions to go too far against them before taking some kind of action; i.e., hedge, sell, etc.), they would have missed much of the SPX's 2008/2009 downside debacle and in turn done pretty well over the past two years. As often referenced in these missives, investors need to manage the risk, for as Benjamin Graham espoused in his book *The Intelligent Investor*, "The essence of investment management is the management of RISKS, not the management of RETURNS. Well-managed portfolios start with this precept."

Investors should keep that quote on their walls so they don't forget the major lesson of 2008/2009. Yet, there are other lessons to be remembered. To that point, Merrill Lynch lost two of its best and brightest in 2009 as Richard Bernstein and David Rosenberg left for less constrained environments. During their final weeks at Merrill they wrote about lessons they have learned. To wit:

Richard Bernstein's Lessons

1. Income is as important as are capital gains. Because most investors ignore income opportunities, income may be more important than are capital gains.
2. Most stock market indicators have never actually been tested. Most don't work.
3. Most investors' time horizons are much too short. Statistics indicate that day trading is largely based on luck.
4. Bull markets are made of risk aversion and undervalued assets. They are not made of cheering and a rush to buy.
5. Diversification doesn't depend on the number of asset classes in a portfolio. Rather, it depends on the correlations between the asset classes in a portfolio.
6. Balance sheets are generally more important than are income or cash flow statements.
7. Investors should focus strongly on GAAP accounting, and should pay little attention to "pro forma" or "unaudited" financial statements.
8. Investors should be providers of scarce capital. Return on capital is typically highest where capital is scarce.
9. Investors should research financial history as much as possible.
10. Leverage gives the illusion of wealth. Saving is wealth.

David Rosenberg's Lessons

1. In order for an economic forecast to be relevant, it must be combined with a market call.
2. Never be a slave to the data – they are no substitutes for astute observation of the big picture.
3. The consensus rarely gets it right and almost always errs on the side of optimism – except at the bottom.

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4. Fall in love with your partner, not your forecast.
5. No two cycles are ever the same.
6. Never hide behind your model.
7. Always seek out corroborating evidence
8. Have respect for what the markets are telling you.

There was another sage that left Merrill Lynch, but that was 18 years ago. At the time Bob Farrell was considered the best strategist on Wall Street, and while he still pens a stock market letter, his “lessons learned,” written back then, are as timeless today as they were in 1992.

1. Markets tend to return to the mean over time.
2. Excesses in one direction will lead to an opposite excess in the other direction.
3. There are no new eras – excesses are never permanent.
4. Exponential rising and falling markets usually go further than you think.
5. The public buys the most at the top and the least at the bottom.
6. Fear and greed are stronger than long-term resolve.
7. Markets are strongest when they are broad and weakest when they narrow to a handful of blue-chips.
8. Bear markets have three stages.
9. When all the experts and forecasts agree – something else is going to happen.
10. Bull markets are more fun than bear markets.

With these lessons in mind, we wish you good investing in the New Year.

The call for this week: Last Monday we wrote, “As we enter the New Year, we are once again turning cautious because the Treasury market is breaking down (higher rates) and the U.S. dollar is rallying. . . . Therefore, we think it prudent to ‘bank’ some trading profits and hedge some investment positions as we approach the new year.” Moreover, one of the lessons we have learned is that the beginning of a new year is often punctuated with head fakes, both on the upside as well as the downside. One of the greatest upside head fakes was in January 1973 when in the first two weeks of that year the DJIA rallied to a new all-time high of 1051.70 before sliding ~20%. While we are clearly not predicting that, what we have indeed experienced since the March “lows” is the second greatest percentage rally (69%), adjusted for time (nine months), since the 1933 rally. Following that 1933 explosion of 116% in just five months came a pretty decent downside correction. Since we tend to be “odds players,” prudence suggests some caution is again warranted.

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