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Investment Strategy
Published by Raymond James & Associates

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April 30, 2012

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Truth or Consequences?

> After 28 years at this post, and 22 years before this in money management, I can sum up whatever wisdom I have accumulated this way: The trick is not to be the hottest stock-picker, the winning forecaster, or the developer of the neatest model; such victories are transient. The trick is to survive. Performing that trick requires a strong stomach for being wrong, because we are all going to be wrong more often than we expect. The future is not ours to know. But it helps to know that being wrong is inevitable and normal, not some terrible tragedy, not some awful failing in reasoning, not even bad luck in most instances. Being wrong comes with the franchise of an activity whose outcome depends on an unknown future (maybe the real trick is persuading clients of that inexorable truth). Look around at the long-term survivors at this business and think of the much larger number of colorful characters who were once in the headlines, but who have since disappeared from the scene.

The aforementioned quote, from the brilliant Peter Bernstein (author, historian, economist, and investor), hangs on the wall of my office, for in this business one is often wrong. But, as Bernstein notes, "Being wrong comes with the franchise of an activity whose outcome depends on an unknown future." My redeeming feature is that when I am wrong, I tend to be wrong quickly. Or as stated by William O'Neil, "The majority of unskilled investors stubbornly hold onto their losses when the losses are small and reasonable. They could get out cheaply, but being emotionally involved and human, they keep waiting and hoping until their loss gets much bigger and [that] costs them dearly."

Indeed, we are always trying to manage the "risks" inherent with investing (or trading), for as Benjamin Graham wrote, "The essence of investment management is the management of risks, not the management of returns." And that, ladies and gentlemen, is why we often "wait" on an investment until its share price is at a point where if we are wrong, we will be wrong quickly, and hopefully the incidence of "loss" will be small and manageable. To be sure, we always consider the consequences of being wrong. This is when risk management lives up to its real meaning. Again as Peter Bernstein wrote in a New York Times article:

> The key word is 'consequences.' I learned this lesson many years ago from studying Blaise Pascal, a French mathematical genius in the 17th century who spelled out the laws of probability more clearly than anyone before him. This was a thunderclap of an insight that, for the first time, gave humanity a systematic way of thinking about the future. Pascal was both a gambler and a religious zealot. One day he asked himself how he would handle a bet on whether 'God is or God is not.' Reason could not answer. But, he said, we can choose between acting as though God is or acting as though God is not. Suppose we bet that God is, and we lead a life of virtue and abstinence, and then the day of reckoning comes and we discover that there is no God. Well, life was still tolerable even if less fun than we might have liked. Here, the consequences of being wrong would be acceptable to most people. Suppose, however, we bet that God is not, and lead a life of lust and sin, and then it turns out that God is. Now being wrong has put us into big trouble.
>
> RISK management, then, should be a process of dealing with the consequences of being wrong. Sometimes, these consequences are minimal — encountering rain after leaving home without an umbrella, for example. But betting the ranch on the assumption that home prices can only go up should tell you the consequences would be much more than minimal if home prices started to fall.

To this "truth or consequences" point, after being wildly bullish at the October 4, 2011 "undercut low" I turned cautious on the equity markets in late January when the "buying stampede" ended. Since then I have been waiting for a price decline that would produce another good risk-adjusted "buy point" like the ones identified on August 8th and 9th of last year, as well as the aforementioned "undercut low." That does not mean I have not been featuring certain investments when the risk/reward metrics were deemed as being tipped decidedly in our favor. Rather, I have opted for more conservative ideas and not aggressive ones. Case in point, in last week's verbal strategy comments 3.5%-yielding Rayonier (RYN/$45.51/Strong Buy) was again featured with these comments from our fundamental analyst:

> We are upgrading REIT Priority List member Rayonier to Strong Buy (from Outperform) as we believe RYN shares currently offer one of the most compelling risk/reward profiles in our REIT coverage universe. In our view, the

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> underperformance of RYN shares year-to date (RYN shares are down 1%, while the RMZ and S&P 500 are both up 10%) present an attractive entry-point for investors ahead of the company's highly accretive cellulose specialties expansion project, which is on track to come online in mid-2013.

Another name featured was 7%-yielding LINN Energy (LINE/$39.86/Strong Buy). As stated by our fundamental analyst:

> The partnership delivered another strong quarter beating our EBITDA and distribution coverage forecast, proving that not only does it know how to buy assets but it does a good job of operating them too. Speaking of operations, lightning has now struck twice in the Granite Wash with the partnership's horizontal Hogshooter play having the potential to be one of the highest rate of return oil plays in the country. Based on our continued bullish outlook for the acquisition market, our forecasted distribution growth (5%+), and its solid hedge book, we reiterate our Strong Buy rating.

Last week this conservative strategy looked somewhat foolish (again) with the D-J Industrials (INDU/13228.31) up 1.53% and the S&P SmallCap 600 Index (SML/462.02) better by 2.58%. The real weekly winner, however, was Natural Gas' 9.67% sprint. The best performing macro sectors were: Financials (+2.21%); Technology (+2.56%); Energy (+2.67%); and Consumer Discretionary (+2.76%). The Consumer Discretionary performance is interesting because last week's economic reports continue to soften as of the 15 reports released only six were above estimates. Also disappointing were earnings reports with 65.6% of reporting companies beating earnings estimates and 65.1% bettering revenue estimates. This was a pretty big drop from the previous week's ratio. Even more troubling is that forward earnings guidance turned negative, which was a decided negative swing week over week. The two sectors that have telegraphed the best forward earnings guidance are Healthcare and Industrials. Meanwhile, many of the indices I follow are breaking down from what a technical analyst would term a rising wedge chart pattern (read: negatively), the D-J Transportation Average (TRAN/5267.39) continues to struggle with its double-top often referenced in these comments (that would be negated by a move above ~5390), the NYSE McClellan Oscillator is back in overbought territory (see the chart on page 3), the Buying Power/ Selling Pressure Indicator suggests the rally from the April 10th low has been more about reduced selling pressure rather than increased demand, the Operating Company Only Advance/Decline has never confirmed the upside, and my weekly internal energy indicator still does not have enough energy to support a new leg to the upside. Regrettably, all of this continues to leave me in cautious mode.

The call for this week: In this business when you're wrong you say you're wrong; at least that's what the pros do. Clearly, I have been somewhat wrong by being conservative, but not wrong by much because the INDU is actually 70 points lower than where it was at the April 2, 2012 intraday high. Given the aforementioned litany of cautionary indicators, my sense remains the S&P 500 (SPX/1403.36) will spend some more time below 1425 while the short-term overbought condition is alleviated and the stock market's internal energy is rebuilt. Friday's market action only reinforced that belief with the indices gapping higher and then closing well below those highs on lower volume.

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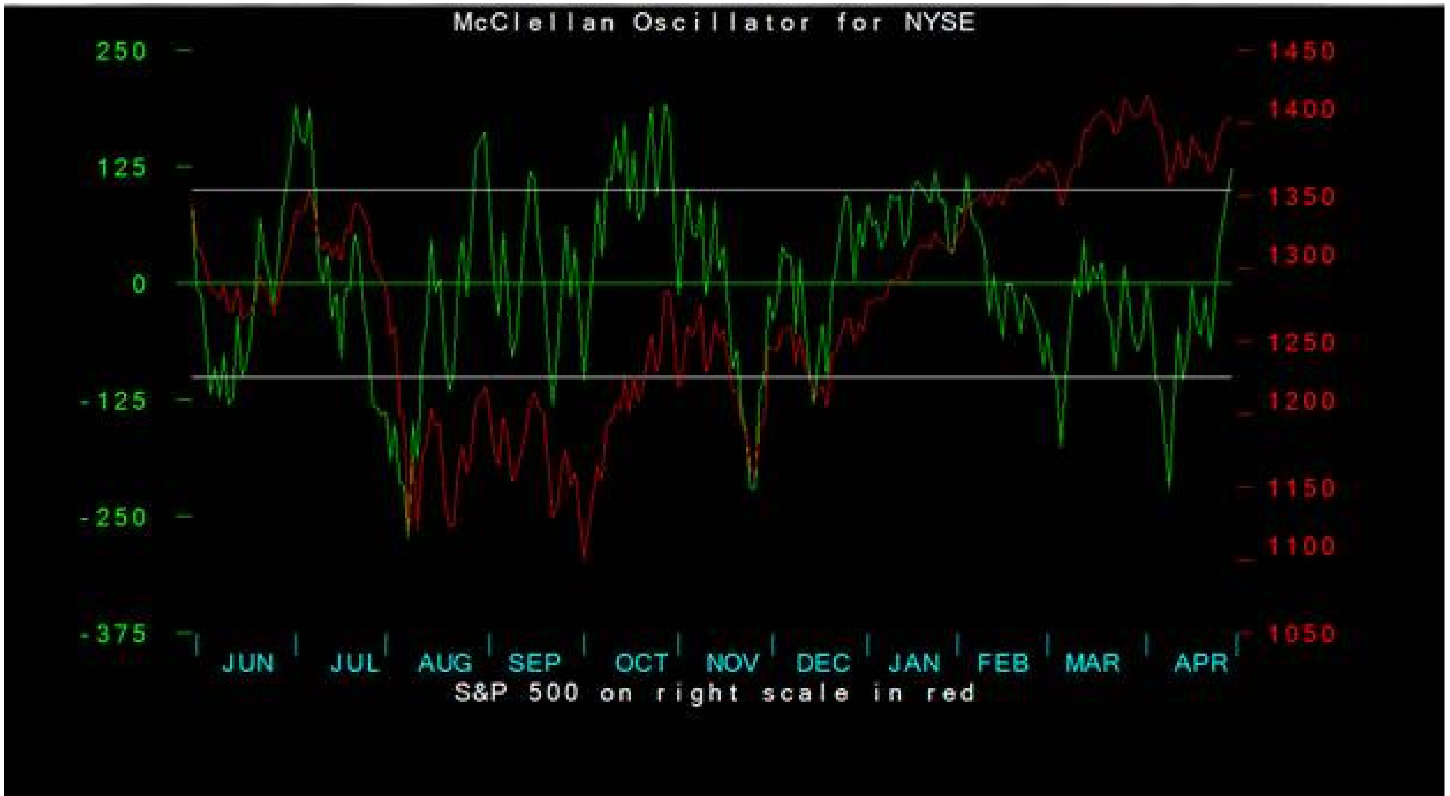

Source: Bloomberg.

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Market Perform (Hold)	37%	30%	57%	7%	27%	0%
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