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Investment Strategy
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The White Hurricane

"Unseasonably mild and clearing" was the weather forecast going into the *Ides of March* back in the year of 1888. And it was true, as temperatures hovered in the 40s and 50s along the East Coast. However, torrential rains began falling, and on March 12, the rain changed to heavy snow, temperatures plunged, and sustained winds of more than fifty miles per hour blew. The "Great White Hurricane" had begun! In the next 36 hours, some 50 inches of snow would blanket New York City, and the winds would whip that snow into 40- to 50-foot snowdrifts. Telegraph and telephone lines were snapped, fire stations were immobilized, New Yorkers could not get out of their homes, 200 ships were blown aground, and 400 people would die before the storm was over. The resulting transportation crisis led to the construction of New York's subway system.

I revisit The Great Blizzard of 1888 this morning not just because of last Monday's Manhattan blizzard but because there are pundits increasingly calling for an "unseasonably mild and clearing" outlook for the stock market. While I too think any correction will likely be for buying, I am becoming more cautious now that we are in January, worried about a repeat of January 2009. Recall what happened last year; I was cautious coming into the new year while the "crowd" was waxing bullishly. And just to make me look foolish, the S&P 500 (SPX/1257.64) rallied 3.2% from 2009's year end to a short-term peak on January 19th of 1150.23. Accordingly, the cry went out: "So goes the first week of the new year, so goes the month, and so goes the year." However, from that January peak, the SPX fell over 9% into its February 5th low of 1044.50. Subsequently, I wrote:

> "John Mauldin and I discussed the 'state of the state' as we cruised around the Gulf of Mexico in my boat yesterday while wearing our Minyanville.com hats. John is more worried about deflation while I remain worried about inflation. This morning, however, the equity markets don't seem to be worried about either as gold and crude oil are relatively flat and the pre-opening S&P 500 futures are better by some 4 points. I think the trading lows are 'in' and have tilted accounts accordingly."

We rode "the bull" from February 2010 until late March when most of my finger-to-wallet indicators counseled for caution. Once again, I looked foolish as the SPX rose another 4.2% into its April 26th intra-day high of 1220. From there, the SPX fell 17% into its July 1st low. As repeatedly stated in these missives, "All you had to do in 2010 to be a successful investor was to get two things right." First, you had to avoid losing much money in the first six months of the year, and then, you had to stay constructive on stocks the second six months of the year. The point of this diatribe is that in this business you have to play the odds. When they are tipped heavily in your favor, you should "play" pretty hard. When they are not, you have to pull in your horns or run the risk of losing real money. As Charles Knott, eponymous captain of Knott Capital, opines, "[*Investment*] opportunities come again and again; your clients' principal comes but once!"

Plainly, I agree with Charlie, and in the short-term, the odds are not tipped decidedly in investors' favor, at least not by the metrics I use. Indeed, the Volatility Index (VIX/17.75) is down to "complacency levels" last seen in April right before the 17% correction. Ditto, Investors Intelligence data shows advisory sentiment approaching the bullish extremes of October 2007. Meanwhile, stock market leadership is narrowing, internal momentum is waning, and every macro sector except Utilities is overbought. Additionally, correlations between various asset classes are decreasing, implying that investors are becoming increasingly selective. All of this suggests more caution is warranted as we enter the new year.

Speaking of the new year, this new year brings with it new rules. While taxpayers will continue to be required to report cost-basis information to the IRS, beginning January 1, 2011, under the Emergency Economic Stabilization Act of 2008, broker/dealers, banks, custodians, and transfer agents will also be required to report taxable cost-basis information to the IRS on securities covered under the new rules. The legislation will be phased in over the next three years beginning with equities acquired on, or after, January 1, 2011. You should know that if investors wish to specify a particular tax lot to be sold or transferred, beginning January 1, 2011, this must be indicated prior to settlement date. Moreover, as of this date, cost basis accounting method adjustments cannot be accepted after settlement date. The new regulations can have a significant impact on investors' tax situations as well as monetary penalties, and I encourage you to familiarize yourself with the new legislation by accessing http://www.irs.gov/, or by contacting your Financial Advisor.

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With these thoughts in mind, I leave you with the following quip titled "Resolved; An Investor's New Year's Resolutions" by John Magee. To wit, resolved, that in the coming year:

- "I will not alienate my friends and antagonize my family by reminding the world on every possible occasion how right I was about the upturn – or downturn – in steels, motors, airlines, or whatever.
- When I buy a stock I will not mobilize all the good news to make it look pretty. I will try to consider both the favorable and unfavorable angles as impartially as I know how.
- I will not close out a stock position that is doing well by me for no other reason than that I have a profit. I will not cut short my gains in a good situation.
- I will not hang on to a stock that is persistently going against me. I will limit my loss and close out any position that seems to have gone really bad before I am in danger of serious trouble.
- I will not be swayed or panicked by news flashes, rumors, tips, or well-meant advice.
- I will not put all my eggs in one basket nor will I be swept off my feet to plunge into some unknown or low-priced stock on a purely emotional basis.
- I will not attempt to tell the market what a stock ought to be worth. I will try to understand what the market has to tell me about what people are willing to pay for it.
- I will never forget that I am not in the market primarily to prove – to my broker, my friends, my wife, etc. – that I am smarter than everybody else, but to protect and, if possible, to augment my capital."

Those of you unfamiliar with John Magee should know that he was the author of *Technical Analysis of Stock Trends,* a book described as "the standard text for anyone interested in the construction and interpretation of charts; comprehensive, profusely illustrated, covering everything from alpha to omega; truly, a brilliant work!"

The call for this week: "History doesn't repeat itself, but it does rhyme," is a timeless quote from Mark Twain. Adhering to its meaning, I am worried that last January's stock market pattern may be repeated this year. While markets can certainly do anything (read: can continue to travel higher), the odds are not tipped in investors' favor in the short-term and I am cautious. As for fixed income, the recent "yield yelp" lifted the yield on the 10-year T'note from 2.37% to 3.57%; it currently resides at 3.31%. I expect interest rate spreads to compress in January, implying there could be some short-term opportunities in select fixed income vehicles. For that opportunity you might consider BlackRock Build America Bond Trust (BBN/$17.36), yielding 8.18%. Longer-term, however, I expect interest rates to rise, but rise for the right reasons (an improving economy). Therefore, I think it is very important to position fixed income portfolio allocations in specialized vehicles. The three I have been recommending are Putnam Diversified Income (PDINX/$8.10), Mainstay Floating Rate Fund (MXFAX/$9.47), and Pioneer Floating Rate Fund (FLARX/$6.91). As always, details should be vetted before purchase.

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