

The Blumenthal Viewpoint

October 21, 2011

2011 Q3 Market Strategy and Performance Update – Understanding Tactical Strategies

In this Viewpoint I will provide a candid look at performance as well as my two cents on the Tactical Investment space. I will take a look at performance relative to our benchmark as well as discuss how I believe it is best to utilize our Tactical and other Alternative strategies within a Total Portfolio. I hope you find this information helpful.

Tactical Investment Strategies (Quantitative, Systematic Trading, Diversified):

I'm frequently asked about performance; more so when performance is disappointing and less so when performance is strong. Last week I spoke with two advisors. One expressed how happy he is with us and the other expressed how disappointed he is with us. One happy, the other upset, both calls on the same day. The difference was when they started doing business with us. It is a question of timing.

Often the performance comparisons are tallied against the S&P 500 Index. I don't believe that is the correct way to think about Tactical Investment Strategies or other Alternative strategies for that matter. Bonds are a different asset class than stocks and play a different diversifying role in a portfolio for a reason. Tactical Investment Strategies are a different asset class than both stocks and bonds. All are different and serve a purposeful role in your portfolio.

In the portfolio construction process, I believe that it is important to utilize a number of non-correlating strategies to manage risk over time. Within your personal portfolio, you have the ability to dial up or dial down your desired risk exposure depending on your long-term fundamental market view. The overall goal of including Tactical and other non-correlating diversified strategies is to enhance your return and lower your overall downside risk. Over the last ten years, the 60/40 stock/bond allocation failed to protect investors. Two recessions and two 50% equity market declines proved painful. It is important to think differently. Even more so within long-term secular bear cycles.

At one of our recent investment conferences, Dr. Christopher Geczy, a highly respected expert in portfolio construction and alternatives suggested that it wasn't Modern Portfolio Theory that failed, the failure occurred in the portfolio construction process. He believes investors need to rethink their overall approach and include as many non-correlating types of risk diversification as they can. The good news is that there is a better solution yet what is clear is that additional education is needed. Dr. Geczy is the head of the Wharton Wealth Initiative and an Adjunct Associate Professor of Finance at the Wharton School. He is Founder and CEO of Forefront Analytics, LLC where he consults with multi-billion dollar institutions and high net worth investors. Dr. Geczy is a highly sought after expert in the alternative investment space, advising some of the world's largest asset managers.

So just what is non-correlation? The following is a simple illustration (see Table 1) using the HFRI Macro Systematic Diversified Index as the benchmark for Tactical Investment Strategies, the S&P 500 Index as the benchmark for the equity market and Barclays Aggregate Bond Index as the benchmark for the bond market. Note the different return streams year by year in each of the three indices, especially in 2000, 2001, 2002 and 2008. I have also included our Moderate Blend for comparison purposes. The column on the right titled “R-Squared” (also known as the coefficient of determination) is a common measure of correlation. A reading near “1” reflects a high correlation and a reading near “0” reflects a low correlation. You can see the three different asset categories (S&P 500 Index, Barclays Aggregate Bond Index and HFRI Macro Systematic Diversified Index) are non-correlating with each other and thus when combined together in a portfolio, provide a diverse, non-correlating return stream.

Table 1.

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011 YTD Thru Sep	Annualized Return			R squared vs	
																1 Year	3 Year	5 Year	S&P	Agg Bond
HFRI Macro Systematic Diversified Index	13.57%	24.82%	26.17%	11.79%	4.09%	-3.25%	15.36%	6.42%	14.40%	16.84%	10.34%	18.06%	-1.68%	9.76%	0.87%	6.25%	6.17%	9.07%	0.17	0.00
S&P 500 Index	33.36%	28.58%	21.04%	-9.11%	-11.88%	-22.10%	28.68%	10.88%	4.91%	15.79%	5.49%	-37.00%	26.46%	15.06%	-8.68%	1.14%	1.23%	-1.18%	1.00	0.00
Barclays Aggregate Bond Index	9.68%	8.67%	-0.83%	11.63%	8.42%	10.27%	4.11%	4.34%	2.43%	4.33%	6.96%	5.24%	5.93%	6.56%	6.67%	5.29%	7.99%	6.53%	0.00	1.00
CMG Moderate Blend										9.99%	14.78%	14.09%	7.26%	1.11%	-2.64%	2.00%	0.56%	7.55%	0.03	0.03

*Information from PerTrac Financial Solutions, LLC, HFRI and CMG. Following is a link to CMG Moderate information and disclosure information:
http://www.cmgfunds.net/main11/managed_blends.asp

It is from this perspective that we view the importance of combining non-correlating investment strategies in the portfolio construction process. But what happens in real life?

1. Incorrect comparisons – return chasing:

Recently we received a call from a relatively new client named Walt. He said the market is up 100% in the last 2 ½ years and his account is flat. We didn’t press on his math but we do know the investment space pretty well. If one was so fortunate to buy at the crash low of 666 on March 9, 2009 and sell out at the bull market high of 1370 in early May 2011 then, yes, he was up over 100%. However, the S&P 500 gained 26.46% in 2009 and 15.06% in 2010 and is now down 8.68% year-to-date through September 2011. Let’s call the actual return 35%. Not too bad but certainly not 100%. Walt is comparing his tactical investment performance against the S&P and not against the proper benchmark and he believes he missed out on a 100% S&P move, not the actual gain of 35%.

2. When you start investing does matter:

If Walt’s investment into the S&P was just six months earlier on Sept 15, 2008, his stock market return would be down approximately 5.14% (then through 9/30/2011). Just six months earlier and a 40% difference in return (+35% to -5%). A start date of one year after the market crash, in April 2010, would have produced a negative 4% return. And what about the 3 year and 5 year returns for the S&P? Not so good. Since the S&P 500 Index high in March 2000, the returns are flat; as in 11 ½ years of flat (a rough ride). When you start and the time frame you give your investments is significant.

3. Investor Behavior is critically important:

The single biggest investor behavior flaw I have witnessed over my 27 years in the business is the chase mentality. Call it years of real life experience of watching investors buy at market tops and sell at market bottoms; investors buy and sell at the wrong time typically chasing yesterday’s best performers. To this end, Dalbar Research conducts an annual study on investor behavior and the 2011 report shows, for the 17th year in a row, significant investor underperformance (see [Dalbar results on page 3 of our Investor Behavior Report](#)). I have been sending investor sentiment statistical information in my Viewpoint letters for some time. Here, too, the data shows that investors would be better served doing the opposite of what their emotions direct them to do at points of major inflection.

Take another look at the three diverse categories in the above table (S&P 500 Index, Barclays Aggregate Bond and HFRI Macro Systematic Diversified), specifically the HFRI Macro Systematic Diversified Index performance since 1997. What is important is the lack of correlation, consistent returns and nominal losses in down years versus the other two categories. There were some very good years, some less than hoped for years, but more importantly, it was a strong demonstration of downside risk management. It was the best of the three categories. When building a long-term investment plan, it is essential to understand the benefits of compound interest. Here is the math: a hypothetical \$100,000 investment made in the HFRI Index in 1997 is currently worth \$468,635 (1/1/97 – 9/30/11). A hypothetical \$100,000 investment made in the S&P 500 Index in 1997 is currently worth \$198,264 (1/1/97 – 9/30/11). Two 50% equity market corrections put the S&P 500 way behind; requiring a 71% cumulative out performance just to catch up to the HFRI Index. The picture is statistically more challenging since the beginning of the secular bear market in 2000. A hypothetical \$100,000 investment in the HFRI Index in 2000 is currently worth \$262,000 (1/1/00 – 9/30/11) vs. a hypothetical \$100,000 investment in the S&P 500 Index in 2000 is currently worth \$95,521 (1/1/00 – 9/30/11).

It would be wonderful to switch to the best returning category each year but the likelihood of accomplishing this is an extremely difficult task. Managing your total portfolio from a risk perspective is different than looking to chase the hottest category. I believe a better plan is towards broader diversification. One third allocated to each of the three categories would have certainly been a better approach vs. 100% in equities or even 60/40. Thus, the beginning steps toward a more broadly diversified portfolio.

We humans tend to forget the long-term view and become narrowly focused. Without a formal game plan, discipline is easily lost. The last two years have not been great for the Tactical space. The HFRI Index is a broad based index of a number of Tactical managers. Some did better than others and that is why broad diversification to non-correlating asset categories is important. Would you sell your HFRI investment because equities have outperformed the Tactical index over the last few years? I wouldn't. There have been many underperforming periods and they tend to be followed by better periods.

With that said, I do understand Walt's current frustration and know you might be feeling the same (depending on when you started working with CMG) as our returns, relatively flat the last two years, have been below your expectations and below ours. Below I address the performance issue head on and share my thoughts, discuss what we are doing, and touch on what I believe the outlook ahead holds for our Tactical Strategies and the alternative space in general.

Below in Table 2, I compare our various strategies (with three years of history or more) looking at one year, three year and five year cumulative net performance vs. some of the best hedge fund and CTA managers in the business.

	Sep-11	YTD	1-Year	3-Year Cum.	5-Year Cum.	Strategy
CMG Strategies (data through September 2011)*:						
Scotia Growth S&P Plus	0.58%	9.04%	22.07%	5.34%	244.27%	Equity Long/Short
System Research Treasury Bond Program	11.44%	25.01%	35.81%	80.47%	n.a.	Long/Short US Treasury
Howard Capital Sector Rotation	1.94%	-19.21%	-9.30%	7.41%	13.25%	Sector Rotation
CMG Managed HY Bond	0.00%	0.31%	0.62%	24.89%	24.44%	High Yield Bonds
Traub Capital	11.02%	1.52%	6.01%	26.39%	80.76%	Foreign Exchange Currency Futures
Anchor Capital Long/Short HY	-1.35%	-1.25%	-1.73%	17.99%	30.76%	Long/Short High Yield
Heritage Capital Gold	-0.52%	1.33%	2.21%	10.55%	80.28%	Tactical Equity
CMG Moderate Blend	1.47%	-2.64%	2.00%	1.69%	43.90%	CMG Strategy Blend

* Net of all fees.

Popular Hedge Funds (data through September 2011):**

Bridgewater Pure Alpha Strategy 18% Vol	-0.31%	24.83%	37.76%	111.45%	129.53%	HF Global Macro
Bridgewater Pure Alpha Strategy 12% Vol	-0.22%	15.82%	23.61%	66.04%	81.04%	HF Systematic Futures
Tudor BVI Global Ltd	n.a.	0.55%	9.05%	n.a.	n.a.	HF Systematic Futures
Transtrend DTP Enhanced Risk	n.a.	-3.62%	8.96%	n.a.	n.a.	HF of Fund - Event
Millenium Int'l Ltd	-0.38%	4.84%	10.01%	36.48%	56.30%	HF Multistrategy
Canyon Value Realiztn Cayman Ltd	-3.89%	-6.60%	-3.02%	37.16%	34.12%	HF Systematic Futures
Winton Futures	0.16%	6.32%	10.81%	29.03%	77.26%	HF Macro/Systematic
Aspect Diversified Programme	0.27%	5.43%	11.41%	30.17%	62.36%	HF of Fund - Equity

** source: Barrons.

Alternative Indices (data through September 2011)*:**

S&P 500	-7.03%	-8.68%	1.14%	3.74%	-5.76%	Large Cap Equity Index
HFRI Macro Systematic Diversified Index	0.20%	0.87%	6.25%	19.68%	54.36%	Hedge Fund Strategy Index
Barclays Equity Long Short Index	-2.02%	-3.88%	1.37%	13.36%	16.27%	Long Short Equity Index
HFRI Emerging Markets Global	-4.42%	-6.17%	-2.41%	17.16%	27.93%	Hedge Fund EM Index
HFRI Fund of Funds Composite Index	-2.78%	-5.29%	-1.87%	0.36%	1.97%	Hedge Fund Index

*** source: S&P, HFRI and Barclays.

* All CMG returns are net of the management fees. The performance numbers for all of our strategies and managed blends are posted on our website net of fees. Hedge Fund data courtesy of Barrons.

Not too bad against some of the very best in the business and important to understand is that all of our strategies have daily liquidity. We are not a hedge fund. Hedge funds typically charge 2% and 20% of profits and offer quarterly or annual liquidity and are subject to gates, side-pockets, lock ups and more complicated K-1 tax filings. We have a flat management fee, full transparency and daily liquidity. Our strategies had a very good 2008 and cumulative performance that I am pleased with over the last three and five years. Since mid-2009 the performance of our strategy blends has been relatively disappointing as has performance for the HFRI Macro Systematic Diversified Index (our benchmark).

I'm often asked if I think there is something going on with high frequency trading, an aggressive Fed or has something somehow rendered Tactical trading strategies suddenly mute. I don't think so. I also believe that the post crash snapback period is behind us. It was a historically unique few years, similar to prior crash recoveries in 1974, 1938 and 1929. It was not a period that favored quantitative Tactical Investment approaches as measured by the HFRI Macro Systematic Diversified Index. Is the period behind us? Statistically I believe the answer is yes and I certainly hope so but there are no guarantees. I wish I could make that promise, but I can't. All investment approaches run into head winds. The key to me is the risk management along the way. I trust a better period is ahead for Tactical Strategies.

Please know that we are not sitting idle, we are working hard. We closely monitor every trade of every strategy every day. Are the quantitative and systematic trading processes being adhered to? Does edge remain? We have a great deal of data on long-term performance, win rates, and manager behavior in times of performance stress and we have what I believe are a number of great strategies. We are not perfect and we will have some misses. I can promise that we will do our very best to incorporate our years of experience to provide attractive Tactical solutions. I am confident we have a good line up of strategies.

Additionally, we review hundreds of potential strategies a year. We have a deep due diligence process tied to many years of experience in the alternative and tactical investment fund space. Our research team is always looking to add additional value to our platform. Frankly, most of the strategies we see don't meet our high standards. We look for non-correlation, we look for edge and we look for experienced managers that have the discipline to execute their strategy in the face of a great deal of daily market noise. Trading is a tough game that requires great skill. We continue to seek only the very best.

It is important to remain forward looking. There are serious global structural and fundamental problems. We remain in a deleveraging cycle and a long-term secular bear market. Call it a slow motion train wreck. My thought is we will see another recession by 2012 as I reflected in a recent [Blumenthal Viewpoint](#) . It is time to think differently about your portfolio. Focus on a portfolio construction game plan that meets your needs and one that you can commit to for the next five years and remember the lessons learned in the Dalbar study on Investor Behavior. I favor a balanced approach of 1/3 equities (hedged), 1/3 Fixed Income (short-term maturity focus and tactical bond management), and 1/3 Tactical-Quantitative-Alternatives.

Here is to a better period ahead. Your business is important to us. Please know I understand how you might be feeling and know that we are working very hard to always improve. Finally, please click on the link below for the CMG Q3 2011 Performance Summary.

[CMG Q3 2011 Performance Summary](#)

Wishing you the very best.

With kindest regards,

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