

Lowly Analyst Free Newsletter

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The Market

The economic news continues to be dismal but the market paid no attention to it; up 2% in a short term rally. All asset classes rallied, with Small Value increasing most and Large Value increasing least. Several small caps made strong moves, breaking out of their bases. The dollar fell against the Euro and Swiss Frank.

The spread between 10 year TIPS and standard Treasuries is 17 basis points, indicating expectation of a long depression. When the crises ends, treasuries will fall. I expect them to be the worst asset class in 2009.

The default rate of companies is still low. It is less than 4% on high risk bonds. Barclays Bank predicts that it will rise to over 14% by the second half of 2009.

It is certainly possible that the market will rally 10% in 2009.. Two of the best years in the stock market were 1933 and 1935 in the midst of the depression.

Asset Classes: For the past month: up Small Value 5 %, Small Growth 5%, Micro 4%, Mid Value 4%, Mid Growth 4%, Large Growth 2%, Large Value 2%.

Sector ETF's: For the past month: Real Estate up 15%, Swiss Frank 14%, Intrntl Communication, Steel 10%, Euro 10%, Silver 10%, Agribusiness 9%, RAFI Healthcare 9%, Gold 8%, Global Mtrls 8%, Agric Commodities 6%, RAFI Consmr Srv 6%, Software 6%, Metal Mining 4%, Intrntl Energy 5%, Technology 3%, Industrials 2%, Covered Calls 1%, Transportation 1%, Utilities -2%, Financial Services -3%, GSCI Commodities -11%.

Foreign Investing: For the past month: So Korea up 18%, Spain 15%, Germany 16%, Euro 50 12%, So Africa 12%, India 11%, Mexico 11%, Japan 11%, Pac-J 9%, France 11%, China 10%, Australia 10%, Italy 9%, Forgn Lrg Div 9%, Singapore 8%, World – US 7%, Emerging Markets 6%, Latin Am 6%, Taiwan 6%, Brazil 5%, Hong Kong 4%, Malaysia 6%, US -2%, Spain -3%, Emrg Mrkts -6%, Sweden -6%, United Kingdom -6%, Brazil -7%, Canada -11%, United Kingdon 1%, Russia -8%.

Bonds: Treasury Strips 21%, Emerging Mrkt Bnds 18%, High Yld Bonds 18%, Floating Rate Bonds 16%, Investment Grade Corporates 13%, :Long Term Bonds 12%, Euro Money Market 9%, Brazilian Money Market 9%, Intrntl Treas Bonds 9%. Power Shrs Preferred 8%.

Low Volatility Investing

1. Introduction

Low volatility portfolios try to achieve a return higher than treasury bills. They are particularly important today since 3-month treasury bills yield only 0.08%.

2. Importance of Returns

With a portfolio of \$ 1,000,000 and a return after inflation of 3%, one can withdraw \$51,000/yr., at 9% one can withdraw \$97,000/yr.

3. Volatility Hurts Returns

The table below shows that a constant 10% growth portfolio increases in two years 21%. A volatile portfolio that loses 20% one year and gains 40% the next, and an average return of also 10% grows only 12%. Volatility hurts.

	Portfolio 1	Return	Portfolio 2	Return
Start	\$ 100		\$ 100	
Year 1	\$ 110	10%	\$ 80	-20%
Year 2	\$ 121	10%	\$ 112	40%
Average		10%		10%

4. How to Handle Rising Volatility

One measure of volatility is Risk Grade. The average volatility of the global stock market 1995-1999 was set to 100. RiskGrade is scaled to range from 0-100.

Usually the US total market has a volatility of about 100. Currently the US total market has a risk grade of 278. Other risk measures show similar results.

In a previous newsletter, I showed that in order to have the largest sustainable cash flow from your portfolio your portfolio should have a RiskGrade of about 100. That means that today you have to hold many more low risk assets and fewer higher risk assets to maintain a reasonable risk.

5. Investment Return Risk

Generally higher returns have higher risks. If you are Bill Gates, you can leave your money in a money market fund. You need not take any risk with your investments. Most of us have to choose between eating well and sleeping well. We have to take some risk

6. Mitigation of Investment Risk

You can mitigate investment risk by holding a well diversified portfolio - a portfolio that is in asset classes that have a low long-term correlation with each other. That

means you want to hold assets that go up when some other assets go down. Long-term and short-term correlations differ. You should focus on long-term correlation. Unfortunately, bull and bear market correlations differ also. In a bear market all asset classes are correlated.

7. Low Volatility Strategies

A low volatility strategy is investing in 3 month Treasury Bills. Unfortunately Bills currently yield only 0.08%. Low volatility strategies try to achieve a return higher than Bills with low volatility.

The principal strategies to achieve low volatility are called stable value, market neutral, long/short, absolute returns, and mergers and acquisitions. Traditionally only Hedge Funds used these strategies. Since 1994 Mutual Funds also use them. There are no such ETFs yet.

In the past 5 Years these strategies had gains of up to 40% and losses of as much as 50%. Several lost money in last 5 yrs. Most lost money last year.

8. Example of a Low Volatility Portfolio

Below is an example of a low volatility portfolio

iShares Lehman 20+ Year Treasury Bond Fund	12%
iShares Lehman TIPS Bond Fund	5%
iShares Russell 1000 Growth Index Fund	4%
iShares Russell 2000 Growth Index Fund	9%
iShares Russell 2000 Value Index Fund	4%
ProShares UltraShort MSCI EAFE Fund	3%
ProShares UltraShort MSCI Emerging Markets Fund	3%
AIM Liquid Assets	15%
AIM STIT—ST Prime Portfolio Money Market	15%
AIM STIT—Treasury Portfolio	15%
Fidelity Institutional Money Market Portfolio—Select	15%
Total	100%

9. Examples of Low Volatility Mutual Funds

Total US Market, TMW

Max Drawdown

RiskGrade	1 Mo	3 Mo	6 Mo	1yr	15 Mo
277	2%	-27%	-30%	-37%	-39%

Highbridge Statistical Mkt Neutra. HSKAX

Max Drawdown

RiskGrade	1 Mo	3 Mo	6 Mo	1yr	15 Mo
24	1%	3%	1%	10%	10%

WS Disciplined Market Neutral, DDMIX

Max Drawdown

RiskGrade	1 Mo	3 Mo	6 Mo	1yr	15 Mo
39	1%	1%	-3%	3%	2%

Fusion Global Long/Short, FGLSX

Max Drawdown

RiskGrade	1 Mo	3 Mo	6 Mo	1yr	15 Mo
49	2%	1%	0%	3%	-1%

JPMorgan Market Neutral, JMNAX

Max Drawdown

RiskGrade	1 Mo	3 Mo	6 Mo	1yr	15 Mo
61	1%	3%	0%	-1%	-2%

Caldwell & Orkin Market Opportunity COAGX

Max Drawdown

RiskGrade	1 Mo	3 Mo	6 Mo	1yr	15 Mo
61	-7%	-4%	-10%	-10%	-2%

JPMorgan Multi-Cap Market Neutral, OGNAX

Max Drawdown

RiskGrade	1 Mo	3 Mo	6 Mo	1yr	15 Mo
28	2%	0%	-2%	0%	-3%

James Market Neutral, JAMNX

Max Drawdown

RiskGrade	1 Mo	3 Mo	6 Mo	1yr	15 Mo
61	-3%	0%	-4%	-5%	-3%

Laudus Rosenberg Long/Short Equity , BRMIX

Max Drawdown

RiskGrade	1 Mo	3 Mo	6 Mo	1yr	15 Mo
52	2%	-5%	-9%	-8%	-5%

Merger, MERFX

Max Drawdown

RiskGrade	1 Mo	3 Mo	6 Mo	1yr	15 Mo
74	-1%	-3%	-2%	-5%	-7%

Aberdeen Equity Long-Short , MLSAX

Max Drawdown

RiskGrade	1 Mo	3 Mo	6 Mo	1yr	15 Mo
70	0%	-5%	-13%	-14%	-10%

Vanguard Market Neutral, VMNIX

Max Drawdown

RiskGrade	1 Mo	3 Mo	6 Mo	1yr	15 Mo
33	-4%	-10%	-13%	-14%	-13%

10. Bottom Line

- A 6% higher return can double your cash flow.
- Volatility significantly decreases returns.
- Three month Treasury Bills have no volatility but currently yield only 0.08%.
- Mutual Funds that aim to achieve low volatility have substantially lower volatility than the market but also lower upside potential.