



March 2010

Dear Investor,

In February, stocks recovered from their decline in January, and in early March some sectors have moved to a new rally high, while others have not. Similarly, a few markets outside the US have moved to new highs, while most have not. Overall, stocks remain in a slightly upward-sloping range, while market internals continue to be weak.

Yields in the bond market also remained range-bound over the past 4 months, with the yield on the 10-year Treasury note fluctuating between 3.5% and 3.9%. The 10-year yield remains below critical resistance near 4%. A rise above this area would mean bond yields could rise substantially. However, unless we see such a rise, the trend we've seen since last summer toward lower yields remains intact.

The dollar has continued to strengthen, and the US Dollar Index is now more than 8% off its low in November of last year. However, the dollar rally has not dampened gold, which has been impressively trading water in dollars and moving to new highs in euros. With stocks sluggish, the dollar and gold rising, and Treasury yields trending slightly down (despite record issuance), it's clear that the demand for safe assets remains strong.

Part of the continued trend toward safe assets is undoubtedly due to the rising awareness of the risk of sovereign default, notably Greece. Although a temporary solution to Greece's deficit problems will likely be found, the larger problem of burgeoning government debt in many countries, including the US, appears to be grabbing a larger share of the spotlight.

In simple terms, governments cannot borrow as much as they want for as long as they want. Greece found that out over the past few months, and other governments will likely discover that as well in the coming years. The sovereign debt problem will likely be a major issue, and we will be talking more about it in the coming months.

This month, we will look at some of the theoretical underpinnings of mainstream investment advice, and why that advice tends to get investors into trouble. We also look at what lessons the Japan's Nikkei offers investors hoping to avoid losses in a long-term bear market, and how those lessons are incorporated into our overall approach to the markets today.

<u>Stock Indexes</u>	<u>February</u>	<u>2010</u>	<u>Market Indexes</u>	<u>February</u>	<u>2010</u>
S&P 500 Index	+3.1%	-0.6%	HFRX Global Hedge Fund Index	+0.3%	+0.2%
MSCI World (ex USA) Index	-0.3%	-5.0%	US Dollar Index	+1.1%	+3.1%
Amex Oil Index	+0.4%	-4.4%	CRB Commodities Index	+3.5%	-3.0%
Gold and Silver Index	+9.1%	-4.1%	Gold (Continuous Contract)	+3.3%	+1.9%

If you have been investing for a while, you have probably come across many of the main tenets of “successful long-term investing” that are promoted by the mainstream financial services industry. Most of these mainstream investment doctrines are focused on strategies that are effective in very long-term time horizons, managing risk with diversification, and, above all else – remaining invested in the markets at all times.

Interestingly, this foundation of modern investment advice stems not from finance or economics, but from observations of pollen grains by a Scottish botanist and a lone student in Paris more than 100 years ago.

In 1827, Scottish botanist Robert Brown was studying pollen grains under a microscope. With close observation, he noticed that the pollen grains jiggled continuously on their own. When he looked at small samples of other things—living and not living—he noticed the same incessant jiggling, in seemingly random patterns. He couldn’t figure out what caused the continuous motion, and he concluded that it was the result of some mysterious, random force. (It was not until 1905 that Albert Einstein was able to explain this random motion, which was by then called *Brownian Motion*.)

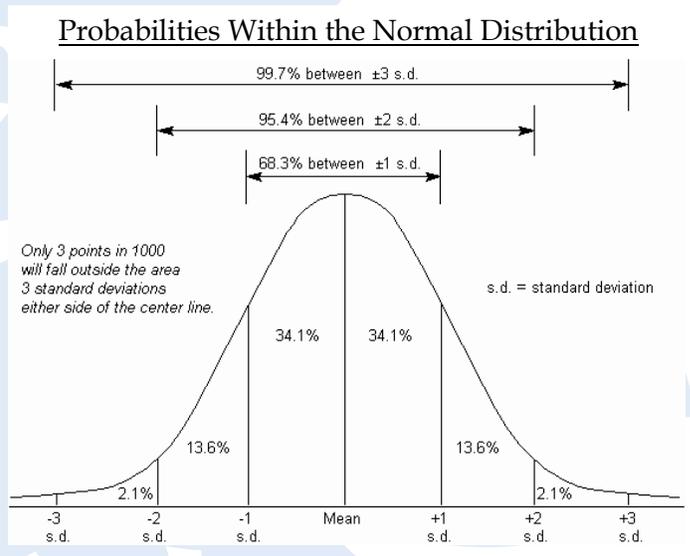
Later, in 1900, a student at the University of Paris named Louis Bachelier published a dissertation on the markets. In his analysis he observed that bond prices on the exchange in Paris moved in a pattern that was mathematically identical to the motion that Robert Brown had described for pollen grains. He concluded that price changes of stocks and bonds traded in the markets were essentially random; like the jiggling of pollen grains, there was no way to predict whether market prices were about to go up or down.

Through his paper, Louis Bachelier transformed the movement of market prices into a statistically random process. This transformation eventually led to the Efficient Market Hypothesis (EMH) and Modern Portfolio Theory (MPT). Both of these concepts rely on the assumption that markets are systems of completely random movements, which can then be accurately modeled using statistics. The management solution provided by MPT is for investors to spread their assets into a diversified basket of different asset classes, so that the random movements of each will tend to cancel out some of the volatility and risk.

The bell-shaped curve, or the *normal* distribution, is the statistical distribution that is most often used to model financial market data. It basically posits that most market movements, being completely random, will fall randomly around a certain average, and larger market movements will be relatively rare.

Whether or not these themes are presented directly, they underpin the advice that most investment advisors give their clients. At its core, the message is usually something similar to this: “The markets are random and unpredictable, so the best way to invest is to properly diversify and wait for the averages to play out.”

It’s no coincidence that this advice dovetails perfectly with the business model of Wall Street, which places the highest priority on keeping investors’ money in the markets at all times. This is how the most management fees are generated, and how demand is kept high for new issuance of stocks, bonds and other investments. Keeping Main Street’s savings in the markets is how Wall Street makes the most money.



However, what most investors seem to be unaware of is that this whole theory of random movement of market prices was proven *false* over 50 years ago by one of the most influential mathematicians of the 20th century, Benoit Mandelbrot. The random motion of market prices was a very nice theory, but it just doesn't match what actually happens in the real world.

In a completely random world, a large movement in prices would be a relatively rare event. But we know from market history that large movements in prices happen far more frequently than they should if prices moved completely randomly. In fact, if we look at annual market returns, there are 50% more extreme events than there should be if prices were truly random. It's clear that there are other forces influencing the markets that aren't taken into account by the statistics of purely random movements—and they have to do with human behavior.

Since the movement of market prices is not random, most investment advice given today that is based on Modern Portfolio Theory is simply wrong. Particularly, the assumption that market risk can be reduced by diversification has led to frequent catastrophic results throughout market history—most recently in 2008.

\* \* \*

Ten years ago this month, the Technology bubble reached its frenzied peak, marking the end of one of the largest stock market bubbles in history. One year ago this month the market hit a fresh low, amid fears of bank nationalization and economic depression.

Although the theory of random market movements was proven false more than 50 years ago for those fluent in mathematics, with multiple bubbles and busts in the last decade it has become painfully obvious to everyone that there is more to market movements besides a Brownian-like random motion. Markets are subject to the rational and irrational decisions made by millions of people, and as such they are prone to cycles of extremes in sentiment and valuation—booms and busts.

One of the most damaging types of investment advice you may hear is that the best way to achieve long-term growth of your assets is to stay 100% invested in a diversified portfolio, all the time. The basis for that advice is that the markets are purely random, and therefore can't be predicted with any certainty. Unfortunately, there are long periods when that advice has not worked out very well. One example is the 1970s, when both stocks and bonds lost most of their value. Another example is Japan, shown below, in which the Nikkei lost 80% of its value over the course of 2 decades.

### Trading vs. Investing in Japan's Nikkei Over the Past 20 Years



While market gyrations certainly carry an element of randomness, there is also a lot that is very predictable—in a loose sense of the word. The bust in the housing market was predictable in many ways, because it carried so many classic signs of a market bubble. While there was no way to know beforehand exactly when the bubble would end or precisely how the bust would impact the markets, for those familiar with market history it was clear there was trouble brewing as early as 2004.

The only way to effectively manage the risk of a significant loss, like what happened in the 1970s and in 2008 following the housing bust, is to incorporate the human element into one’s thinking and adopt an investing strategy that fits the market environment. The way we do that is by studying market history and performing technical analysis.

Market history provides us with examples of how people and the markets have reacted when confronted with similar circumstances. We also learn about long-term cycles, such as valuation cycles, which would not exist if the market were purely random. Given that crowds of people are prone to periodic bouts of euphoria and hopelessness, understanding cycles between high valuations and low valuations makes perfect sense when viewed in human terms.

The chart of the Nikkei on the previous page is an example of a “modern” deflationary bear market; i.e., a deflationary bear market which is influenced on the way down by episodes of central bank monetary printing. The Nikkei did not go straight down like the US market did during the Great Depression, but the end result was the same. The main difference is that it took 20 years to do it, instead of just 4 years.

In order to achieve positive gains in Japan’s market during that long deflationary bear market, it was necessary to *trade* into the market when the odds were favorable for gains, and then trade out of the market when the odds were unfavorable. It took discipline to not try and wring every point out of an advance, because often the market took back late gains much quicker than they were made, as it did in Japan in 1993, 1996 and 2000.

This trade-focused approach has also been the winning approach here in the US over the past 10 years, and it will likely continue to be the winning approach until the end of this long-term valuation contraction.

Technical analysis gives us an in-depth view of what is actually moving the markets, and how.

We can then compare the current market environment with what we have seen in the past, and estimate our own odds of what is likely to happen next—because we know the odds are not always an even 50:50.

The market is currently telling us that although it made a new high in January, and is currently revisiting that high again here in March, it is doing so with fewer stocks participating.

The NYSE Composite with a Breadth Indicator



In other words, the indexes have made new highs, but they have done so on the backs of fewer and fewer stocks. When we have seen this type of technical divergence between price and breadth in the past, it has often signaled that the main trend is about to change. This was the case at the 2003 bear market bottom, the 2007 bull market top, and the low 1 year ago.

These technical divergences have also occurred at times that did not lead to a trend change, at least not right away. However, if we sum up the past occurrences we get close to 70:30 odds in favor of a change in the primary trend. This is one of the reasons our portfolios were positioned conservatively in mid-2007, and also one of the reasons we are positioned conservatively today.

This is the type of information that allows us to make a rational judgment about the market's prospects. The red arrows on the Nikkei chart back on page 3 show times when that market was flashing technical warning signs similar to what we are seeing in our market today. You'll notice that the Nikkei often continued to rally for a while before ultimately turning down, but that each time the gains made during those late rallies were given back – sometimes very quickly.

The main lesson of the Nikkei over the past 20 years is that the way to prosper during a deflationary bear market is to remain exposed to the market only when the odds are stacked strongly in favor of gains, and to be out of the market at all other times. This is because in a long-term bear market, the overall trend is down and surprises tend to happen on the downside.

As noted at the top of the chart on the previous page, most stock indexes are currently right under the area that marked the beginning of the crash in 2008. Whether the market can break through the resistance from the crash will say a lot about what we can look forward to.

Up to this point, market action has suggested this has been a large bear market rally. However, if the market successfully rises above the area that marked the start of its 2008 crash, it will be a strong message that stocks are moving beyond the issues that were at the core of the bear market. If that were to happen, it's likely we would see more stable and healthy growth trends emerge that we could take advantage of.

However, if the market fails to rise above this resistance, the rebound from the 2009 low will look like a standard technical rebound from the 2008 crash. That would strongly suggest the primary trend is still down, and the gains made over the past year could eventually be given back.

\* \* \*

Our main goal is to get to the end of this long-term bear market in the best shape we can, so that we can then take advantage of the next bull market from a higher base of capital. While every investment strategy will go through periods of outperformance and underperformance, all of our portfolios are structured with this long-term goal in mind.

To achieve this goal, we have to recognize that market prices aren't random – they are subject to a whole host of influences that drive long-term valuation cycles. The current valuation contraction is being influenced by the bursting of two major asset bubbles and a credit bubble, along with the undertow of a large demographic shift. These issues will not influence the markets forever, but we are still in the middle stages of working through them.

During this process, our investment approach needs to match the market environment, and we are constantly evaluating our stance in light of current market conditions. Currently, it appears stocks are in the later stages of the rally from the 2009 low, at a point similar to the areas indicated by red arrows on the Nikkei chart on page 3. The odds suggest there is very little potential return here, but a lot of risk.

In Absolute Return, we remain hedged with regard to stocks. We have recently added to our positions in Treasury bonds, largely because the technical “lines in the sand” are very clear and the risk/reward ratio is favorable. Bond yields could be preparing to move higher or lower from here, and if yields move higher above resistance we will move this portion of the portfolio to cash. We remain invested in gold, though we have continued to trim our exposure to other commodities. As we are currently positioned, we stand to benefit from an outperformance of gold relative to oil and other commodities.

Hedged Growth has continued to have a difficult time in the past few months. Although the market has remained in a 12% range over the past 6 months, the outperformance of poor quality stocks has continued, and this has been a negative for Hedged Growth.

We continue to hold the Growth portion of the portfolio in cash, because the performance of these stocks has not been strong—which is a symptom of the poor quality of this rally. If the market decides to move higher than the start of the 2008 crash (highlighted in the chart on page 4), the main driver behind such a rally would likely be an improving economy. This would be a positive for Hedged Growth, because we’d likely see strong growth trends emerge that would benefit the portfolio.

However, due to the deterioration of the internals of the market over the past 5 months, it appears more likely that stocks are either about to consolidate sideways or decline. Our current market-neutral stance is best suited for those outcomes, but we will adjust if the odds change in favor of a more positive market environment.

In Dividend Growth we remain fully hedged as well. As with Hedged Growth, at this point there is more value in keeping market exposure at a minimum than in investing for the low-probability outcome—that the market breaks higher from here. There will likely be opportunity for gains once the market either declines or builds a more solid base from which another sustainable rally could emerge.

In Commodities Focus I we remain invested in gold and gold mining stocks, but have trimmed exposure to silver, energy and other commodities over the past few months. There appears to be a rather acute risk that oil and silver could retrace a sizable portion of their rise over the past year, and in fact many silver mining stocks have already fallen 20%-40% from their highs last fall. We are watching these sectors closely, but for now remain on the sidelines.

We’ll continue our discussion next month. If you have any questions about your account or issues raised in this letter, just send us an email or give us a call. We would enjoy hearing from you.

Sincerely,  
Brian McAuley

Brian McAuley  
Chief Investment Officer  
Sitka Pacific Capital Management, LLC  
[investing@sitkapacific.com](mailto:investing@sitkapacific.com)

*The content of this letter is provided as general information only and is not intended to provide investment or other advice. This material is not to be construed as a recommendation or solicitation to buy or sell any security, financial product, instrument or to participate in any particular trading strategy. Sitka Pacific Capital Management provides investment advice solely through the management of its client accounts.*