

CAPITAL MANAGEMENT GROUP, INC.

Alternative Investment Strategies

May 14, 2010 Market Update: Valuations and Sentiment - Trading Range 950-1250 and Tax Free Bonds

Post my [April 23, 2010 Market Update: Optimistic Extreme – Time to sell/get defensive](#), a client asked me what my longer term thinking is on the market. I talk about that below and thought I'd attach a recent investor sentiment chart if you are interested in reviewing. The market has had another mini crash; the S&P 500 Index hit a high of 1219.80 on April 26 and an intraday low of 1094.15 on May 7. The market is under additional pressure today (note on the attached the significant drop from the Extreme Optimism (Bearish) post the recent sharp correction).

I continue to believe the market remains in a long-term bear market environment – perhaps for the next seven years or so. Similar to all past secular bear markets there will be shorter-term bull market rallies, yet those too will become challenged by excess valuations and over optimism. I believe at best it is a long, choppy process similar to the 1966-1982 bear market; an environment that favors trading strategies and frustrates long-term directional investing. The structural problems are significant and with higher taxes on the way, higher interest rates, and the end of government stimulus, risk is high. Government's will ultimately be forced to address debt (there is a limit) and while individuals and corporations are prudently shoring up their balance sheets, valuations are simply too high by all reasonable measures (Price to Earnings, Price to Sales, etc). Risk will be reduced when valuations move below their historical mean and I believe PE ratios will move below 10 before a new long-term secular bull market is born. This is no different than past secular cycles. Until then I believe the market chops sideways with risk to the downside. Some good rallies, some painful declines, little net progress over the next five to seven years (similar to the last 10 years).

Technically, I see a trading range between 950 and 1250 on the S&P 500 Index (tied to some important technical levels). Of course, that trading range view could change depending on a number of fundamental and political issues but for now even 950 reflects a slightly over valued level (I'm estimating fair value to be around 900). I also believe we will see a period of greater volatility ahead which is historically a productive environment for active trading strategies. Our Scotia Partners S&P Plus Program gained approximately 8.50% this past Monday and is up approximately 6% net of fees for the year. My personal investment plan it to remain invested in our various Absolute Return Strategies as a number of those strategies have the flexibility to profit in both a rising and declining market. For my 401k, I plan to trade back into the market (currently in MM funds) when Sentiment moves to the Extreme Pessimism (Bullish) zone. See attached investor sentiment chart updated through yesterday, May 12, 2010. Sentiment is back in the neutral zone (better) but not at a level that I'm willing to tactically trade my 401k back into the market. For now, I remain patient and believe a number of trading opportunities will occur this year and next. I continue to believe that you should include a mix of Absolute Return Strategies into your diversified equity and fixed income portfolio. Trade the equity portion more tactically in long-term secular bear periods and more directionally in long-term secular bull periods. And be very careful on your fixed income allocation (see the idea below).

Tax Free Municipal Bond Investing:

Yesterday a 70 year old client called and wanted to speak to me directly. He wanted to know my opinion on what I would do with my money if I were in his shoes. I asked him a number of questions to find out what was important to him, what his needs are and what his risk tolerance level is. Noting the coming wave of higher taxes and the significant potential for higher interest rates coupled with his risk aversion, I shared with him the following idea: I told him if I were 70 years old and had \$1 million in liquid investments with similar needs and a similar risk profile, I would allocate at least 70% to individual high quality Tax Free bonds and I would allocate the remaining 30% to a blend of various non-correlating absolute return strategies. To combat this coming tax and rising interest rate risk, I would ladder \$700k of my \$1 million over several years in a high quality tax free bond portfolio. I'd invest \$100k in tax free municipal bonds that have a 2 year maturity, \$100k with a 3 year maturity, \$100k with a 4 year maturity, \$100k with a 5 year maturity, and so on in equal amounts up to year eight. The average maturity would be approximately 4.5 years and when the first \$100k matures I would invest that onto the back end by buying a new 7 year maturity so that I'm always extending the portfolio by one year. As rates move higher, the portfolio yield moves higher and takes zero interest rate risk if each position is held to maturity. Now if rates move higher quickly, when one of the bonds mature, consider tilting the portfolio a little longer-term to capture that high yield but for now think about taking the interest rate risk out of the portfolio in anticipation of much higher interest rates coming in the next few years. So, by rolling the maturing bonds out another 7 years as rates move up, the portfolio yield also goes up. Should rates move lower, the portfolio remains in pretty good shape. Though how much lower can interest rates go? My principals intact, I have high quality bonds and nominal interest rate risk. I feel safe and can sleep at night. With the remaining 30%, while I can't ever make any investment guarantees, I'm confident I can generate above average returns with relatively nominal downside risk exposure with a combination of CMG's HY Bond trading strategy and other risk managed trading strategies. The 30% allocation to absolutes would be designed with a goal to generate 8% to 10% per year. I'd look to a more defensive conservative to moderate risk allocation. I'd keep my living needs in check with the expected return allowing for some portfolio growth to protect against future inflation.

Your level of risk might suggest an 80% tax free and 20% absolute return portfolio mix, or perhaps a 60%, 30% and 10% other. That is something for you to decide. The key is to have a plan and to stick to that plan. I'm 49 years old, if I were to sell my business today and retire, I'd put approximately 50% in a laddered tax free portfolio and the balance in various absolute return strategies (CMG's managers, some CTA's and several liquid and transparent hedge funds). When the bear market ends, I would likely mix in a little longer-term directional equity market exposure into my portfolio. Just how much at that time would depend on my investment game plan, how much risk capital I'd be willing to invest, and the opportunities I might see ahead.

This long-term secular bear market will end - until then I believe it is important to be tactical with your investments (similar to the 1966-1982 period). Valuations matter – bull markets do not start at 22 times earnings. Continue to look to find trading strategies with an edge, a high probability win rate and a solid/disciplined investment process. To me it's about capital preservation, achieving above average returns, and combining non-correlating strategies for enhanced diversification.

If you are a tax free bond investor or interested in learning if you should invest in tax free bonds, we have a relationship with an outstanding tax free municipal bond money manager who has over 35 years of experience in this space. He has a unique approach to finding mispriced and misunderstood high quality municipal bonds. He deals in smaller pieces of \$100k to \$4 million and because of lack of knowledge and/or due diligence on the part of most dealers, he can purchase bonds for his clients at substantially higher yields. Email me at steve@cmgfunds.net if you would like an introduction.

One last thought shared with a bit of emotion: In late April, the cover of Newsweek magazine said “America’s BACK, The Remarkable Tale of Our Economic Turnaround”. So is now the time to invest? The perception to investors is full steam ahead, believing now is a safe time to get back into the market. Imagine the cover of the major magazines back in December 2008. The world was falling apart. Who wanted to invest then? Yet it was the exact time to invest as the market followed with its second best move in history (second only to 1932). The crash occurred as sellers were forced out (margin calls) or panicked out while would be buyers stepped aside. Balance was lost – there was no reasonable floor. It wasn’t about valuations or future earnings, it was about supply and demand and investor sentiment (fear and greed). As I reflected in December 2008, post crash reversion recovery bounces are attractive. Good news begins to slip in, sellers are now out of the way and the market moves higher with little resistance (often on very light volume). Market environments change and I believe the post crash recovery rally is behind us and we are entering a new phase. One that favors quantitative trading strategies in need of increased volatility and counter trends to perform. That period will come again just as it has in the past. Quant strategies had their worst year in 20 years in 2009. Is it time to shift out of them and invest in the market or is time to shift out of the market and invest in quant strategies? I believe that time is now here.

I’m running late for my daughter’s lacrosse game and the weekend is loaded with baseball for the little guys. Ugh, late again. Wishing you the very best.

With kind regards,
Steve

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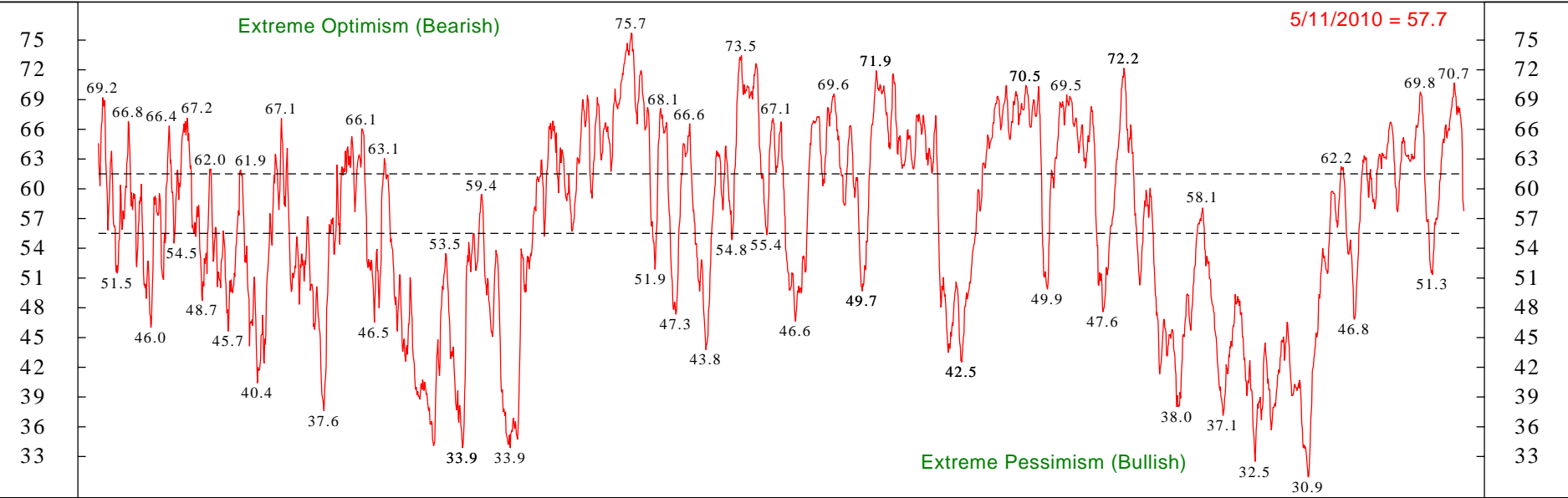
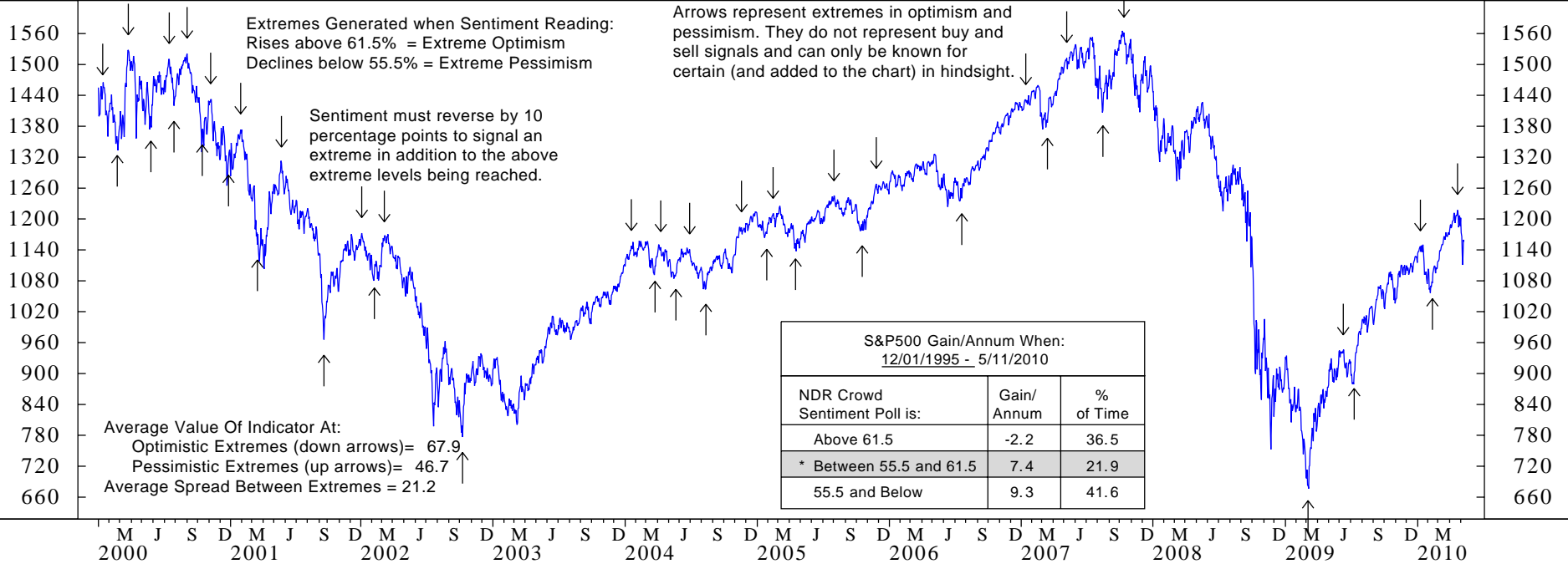
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S&P 500 Composite Index

Daily Data 1/03/2000 - 5/11/2010

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