CAPITAL MANAGEMENT GROUP, INC.
CMG
Tactical Investment Solutions

The Blumenthal Viewpoint

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Uncommon Solutions

What if, in the best case scenario, the next ten years looks like the last ten years?

I spoke with an advisor this week and we debated on the future market outlook. He's a good friend (working with CMG for many years), super smart and has a portion of his client portfolios invested in several of our tactical strategies ("uncommon solutions"). The balance of his portfolio is allocated more traditionally to various stocks, ETFs, mutual funds and bonds.

The future remains challenging. Excessive debt, political dysfunction, a stretched consumer, unemployment, underfunded pensions, tax revenue shortfalls, higher tax rate pressure in the U.S., austerity across the globe, low dividend yields, escalating currency wars and a systemic ticking time-bomb tied to 60:1 leveraged European banks. Depressing…I know. What if inside this picture lays tremendous opportunity? I told my friend that I believe there is great reason to be excited…remember, your competition is largely idled in the old way of thinking!

Below we will take a look at an outstanding chart that over the last 14 decades (140 years) has accurately predicted the forward ten year return. Hint: It is just 4.4% and there is solid math behind the projections as you will see. This serves as the starting point to answer every investor's number one most pressing question to their advisor: How are you going to make me money?

I believe it is in this answer that there exists great opportunity. In this Viewpoint, I will review expected returns and enhanced portfolio construction. Let's call it an "enhanced Modern Portfolio Theory" discussion. We'll take a look at how traditional investments gain and lose together and how you can, by expanding the risk diversifiers in your portfolios, increase return and reduce your total portfolio risk.

Ultimately the goal is to shape your portfolio to include strategies and/or alternative mutual funds that can provide unique return not singularly dependent on a bullish stock market. I can tell you from experience that most advisors and investors have very little experience with alternative funds, which is to them, a brand new space.

Let's first take a deep dive into expected returns over the next ten years as a starting point to answer the question: How are you going to make me money?

The following chart, courtesy of Research Affiliates, looks at the last 14 ten-year periods. There are three factors that have accurately predicted future ten-year returns for the equity and bond markets. By adding together the following statistics - *Beginning Dividend Yield*, *Real Long-Term Earnings-Per-Share Growth* and *Implied Inflation*, you get the *Expected Equity Return* for the next ten years. The Bond calculation assumes you invest in a 10-year treasury bond and hold it for ten years. If the yield is 2%, then your *Expected Bond Return* is

2%. Following is the chart and I explain the math below.

Expected Return Model for a 60% Equity / 40% Bond Portfolio

Decades	Beginning Dividend Yield	Real Long-Term EPS Growth	Implied Inflation	Expected Equity Return	Beginning Bond Yield	Expected 60/40 Return	*Realized 60/40 Return*	*Expected Minus Realized*
1871 - 1880	5.9%	1.7%	2.4%	10.3%	5.3%	8.3%	*8.3%*	*0.0%*
1881 - 1890	4.5%	1.7%	0.8%	7.1%	3.7%	5.7%	*3.1%*	*2.6%*
1891 - 1900	4.8%	1.7%	0.5%	7.1%	3.4%	5.6%	*6.9%*	*-1.3%*
1901 - 1910	4.4%	1.7%	0.0%	6.1%	2.9%	4.8%	*5.7%*	*-0.9%*
1911 - 1920	5.2%	1.7%	0.4%	7.5%	3.3%	5.8%	*2.9%*	*2.9%*
1921 - 1930	7.5%	1.7%	2.8%	12.4%	5.7%	9.7%	*11.6%*	*-1.9%*
1931 - 1940	6.3%	1.7%	0.1%	8.2%	3.0%	6.1%	*3.9%*	*2.2%*
1941 - 1950	6.4%	1.7%	-1.3%	6.7%	1.6%	4.7%	*8.6%*	*-3.9%*
1951 - 1960	7.4%	1.7%	-0.7%	8.5%	2.2%	6.0%	*10.6%*	*-4.6%*
1961 - 1970	3.4%	1.7%	0.9%	6.2%	3.8%	5.3%	*6.3%*	*-1.0%*
1971 - 1980	3.5%	1.7%	3.5%	8.9%	6.4%	7.9%	*6.9%*	*1.1%*
1981 - 1990	4.6%	1.7%	9.9%	17.0%	12.8%	15.3%	*14.3%*	*1.0%*
1991 - 2000	3.7%	1.7%	5.2%	10.9%	8.1%	9.8%	*14.4%*	*-4.6%*
2001 - 2010	1.2%	1.7%	2.3%	5.4%	5.2%	5.3%	*3.8%*	*1.6%*
Average	**4.9%**	**1.7%**	**1.9%**	**8.7%**	**4.8%**	**7.2%**	***7.6%***	***-0.5%***
Std Deviation							***3.9%***	***2.6%***
Current*	**2.3%**	**1.7%**	**2.0%**	**6.0%**	**2.0%**	**4.4%**		

Sources: Robert Shiller, Federal Reserve, BEA, Research Affiliates

*Data as of August 29, 2011.

Source: Research Affiliates, LLC., based on data from Morningstar Encorr and Bloomberg.

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Research Affiliates – X-Factor 2011

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Source: Research Affiliates, LLC

Take today's *Beginning Dividend Yield* of 2.3%, add *Real Long-Term EPS Growth* of 1.7% and add *Implied Inflation* of 2% gives an *Expected Equity Return* of 6%. Then take 60% of the *Expected Equity Return* of 6% and 40% of the *Beginning Bond Yield* of 2% and you get an *Expected 60/40 Return* of 4.4%.

Take a look at each of the last five decades. I have circled the *Expected 60/40 Return* as well as the *Realized 60/40 Return* (yellow circle):

1961-1970: *Expected Equity Return* was 6.2% and the *Beginning Bond Yield* was 3.8%. Taking 60% of 6.2% and 40% of 3.8%, the *Expected 60/40 Return* was 5.3% and the actual was 6.3%.

1971-1980: *Expected Equity Return* was 8.9% and the *Beginning Bond Yield* was 6.4%. Taking 60% of 8.9% and 40% of 6.4% the *Expected 60/40 Return* was 7.9% and the actual was 6.9%.

1981-1990: *Expected Equity Return* was 17% and the *Beginning Bond Yield* was 12.8%. Taking 60% of 17% and 40% of 12.8% the *Expected 60/40 Return* was 15.3% and the actual was 14.3%.

If you look at all of the years combined, the *Expected 60/40 Return* was 7.2% and the actual was 7.6%. What about the next ten years? The *Expected 60/40 Return* is expected to produce just 4.4%.

4.4% is the lowest forward expected annualized return in the last 14 decades (140 years). I wonder what those underfunded pension plans are going to do, needing 7.5% returns in a period that will likely produce just 4.4%? Harvard and Yale reallocated their endowment portfolios over ten years ago to significantly boost the allocations to alternatives. Did the smart guys see this math back then?

Investors are expecting 7-10% and they are going to get 4.4% before your investment advisory fee. A lot of money is going to be in motion and will move to advisors that **think differently**.

The forward outlook for traditional 60/40 is not pretty. If the backdrop were a long-term secular bull market then one could simply buy and hold. However, that is not the case today. Fortunately, you now have access to tools that can help you build a better portfolio for the period that remains ahead. Alternatives are not just REITs,

Gold and MLPs (Master Limited Partnerships). They include specific strategies like Long/Short Equity, Tactical Trading Strategies – Systematic Diversified, CTA-Managed Futures, Convertible Bond Arbitrage, Global Macro and more. In fact, in this past year alone, Morningstar created several new categories on Alternatives. A positive step forward.

It was 1985 and I was sitting in a large dinning room at the Union League in Philadelphia. The featured speaker was an industry legend, Sir John Templeton. I thought I was going to listen to a pitch from a mutual fund wholesaler. It turned out to be one of those "wow" moments in my life. Sir John said, "I am going to give you the single greatest piece of advice about investing that I have learned over many years". I sat up in my seat. He continued, "The secret to my success is that I buy when everyone else is selling and I sell when everyone else is buying." While that sounds easy to do on paper, it is not so easy to apply in real life. It is for this reason that I am such a big fan of investor sentiment. It has made me a much better trader and I believe it can help you as well.

I recently presented at a large wealth conference in Las Vegas and shared the following chart. It takes a look at valuations over 111 years and arrives at a simple and logical conclusion: bull markets begin with low PEs (Price to Earnings Ratio) and end at high PEs. They start with high inflation and end with low inflation. Bear market cycles are just the opposite. Investing is often reverse logic. Like Sir John said, you want to buy when everyone else is selling and sell when everyone else is buying (both are very hard to do). You want to buy when dividend yields are high and you want to buy when inflation is high. Yet in order to do so, you'll need the courage to go against the crowd and fight your strong emotions. It simply doesn't feel like value when inflation is high, interest rates are high and the markets are falling apart.

For the data junkies, note the four arrows on the left in the chart below. The point I make here is that the evidence I see continues to say that the markets remain in a secular bear market cycle. One might blindly cling to the traditional 60/40 way; however, this chart too says to **think differently**.

Valuations Determine Secular Bull and Secular Bear Cycles

WEIGHTED AVERAGE BEAR (excluding 2000)	42%	58%	2.1	2.7	21%	-18%	-14%
WEIGHTED AVERAGE BULL	83%	17%	5.8	0.9	19%	-5%	810%

Notes: The index and returns reflect the Dow Jones Industrial Average at year-end from Dow Jones & Company. The P/E ratio is based upon the S&P 500 as developed and presented by Robert Shiller (Yale; Irrational Exuberance). Bull & Bear Market classifications are based upon Crestmont's assessment of cycles using peak and trough P/E ratios, inflation trends, and other analysis. The presentation does not include dividends, taxes, inflation adjustments, or transaction costs.

RETURN PATTERN (Red = down year; Green = up year; #% = annual change in the index; starting and ending DJIA index is presented on the ends of the rows)

Period	Start	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	End
1901–1920: BEAR	71	-9%	0%	-24%	42%	38%	-2%	-38%	47%	15%	-18%	0%	8%	-10%	-31%	82%	-4%	-22%	11%	30%	-33%					72
P/E Ratio		23	22	18	16	19	19	13	13	15	14	14	14	12	11	12	12	9	6	7	5					
CPI: Inflation		-2%	6%	1%	0%	1%	3%	6%	-4%	8%	4%	-8%	7%	3%	1%	1%	8%	17%	18%	15%	16%					
1921–1928: BULL	72	13%	22%	-3%	26%	30%	0%	29%	48%																	300
P/E Ratio		5	8	8	8	10	12	16	22																	
CPI: Inflation		-11%	-6%	2%	0%	2%	1%	-2%	-2%																	
1929–1932: BEAR	300	-17%	-34%	-53%	-23%																					60
P/E Ratio		28	22	15	8																					
CPI: Inflation		0%	-2%	-9%	-10%																					
1933–1936: BULL	60	67%	4%	39%	25%																					180
P/E Ratio		11	12	13	19																					
CPI: Inflation		-5%	3%	2%	1%																					
1937–1941: BEAR	180	-33%	28%	-3%	-13%	-15%																				111
P/E Ratio		19	14	16	15	12																				
CPI: Inflation		4%	-2%	-1%	1%	5%																				
1942–1965: BULL	111	8%	14%	12%	27%	-8%	2%	-2%	13%	18%	14%	8%	-4%	44%	21%	2%	-13%	34%	16%	-9%	19%	-11%	17%	15%	11%	969
P/E Ratio		9	11	11	13	14	11	11	10	11	12	13	12	14	18	18	16	15	18	17	21	19	20	23	23	
CPI: Inflation		11%	6%	2%	2%	8%	14%	8%	-1%	1%	8%	2%	1%	1%	0%	1%	3%	3%	1%	2%	1%	1%	1%	1%	2%	
1966–1981: BEAR	969	-19%	15%	4%	-15%	5%	6%	15%	-17%	-28%	38%	18%	-17%	-3%	4%	15%	-9%									875
P/E Ratio		21	22	22	19	15	17	18	16	11	10	12	10	9	9	9	9									
CPI: Inflation		3%	3%	4%	5%	6%	4%	3%	6%	11%	9%	6%	7%	8%	11%	13%	10%									
1982–1999: BULL	875	20%	20%	-4%	28%	23%	2%	12%	27%	-4%	20%	4%	14%	2%	33%	26%	23%	16%	25%							11497
P/E Ratio		7	10	9	11	13	16	14	17	17	18	20	21	21	23	26	31	36	42							
CPI: Inflation		6%	3%	4%	4%	2%	4%	4%	5%	5%	4%	3%	3%	3%	3%	3%	2%	2%	2%							
2000–????: BEAR	11497	-6%	-7%	-17%	25%	3%	-1%	16%	6%	-34%	19%															
P/E Ratio		42	32	26	24	26	26	26	27	21	17															
CPI: Inflation		3%	3%	2%	2%	3%	3%	3%	3%	4%	0%															

Note:
Bull markets: low PE's to high PE's
high Inflation to low inflation
Bear markets: high PE's to low PE's
low Inflation to high inflation

CRESTMONT RESEARCH

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Source: Crestmont Research

The four arrows on the left point to the last two secular bear market and secular bull market beginnings. Note the PE Ratio and the CPI: Inflation levels. Currently inflation remains low, and as we'll see in the next few charts, PE levels remain relatively high. The next secular bull cycle will begin when inflation is high and PEs are low.

Following is data on ninety-two 20-year rolling periods from 1919-2010. The message in this chart is simple; when you buy at low valuations you get higher returns. Conversely, when you buy at high valuations, you get low forward returns.

20 Year Periods Ending 1919 - 2010 (92 periods)

DECILE	NET TOTAL RETURNS BY DECILE RANGE FROM	TO	S&P500 DECILE AVG	AVG BEGIN P/E	AVG END P/E
1	1.2%	4.5%	3.2%	19	9
2	4.5%	5.2%	4.9%	18	9
3	5.2%	5.4%	5.3%	12	12
4	5.4%	6.0%	5.6%	14	12
5	6.2%	7.9%	6.9%	16	16
6	8.0%	9.0%	8.6%	16	19
7	9.0%	9.6%	9.3%	15	19
8	9.7%	11.0%	10.4%	11	20
9	11.5%	11.9%	11.7%	12	22
10	12.1%	15.0%	13.4%	10	29

Note: P/E ratio based upon average 10-year real EPS (P/E10)

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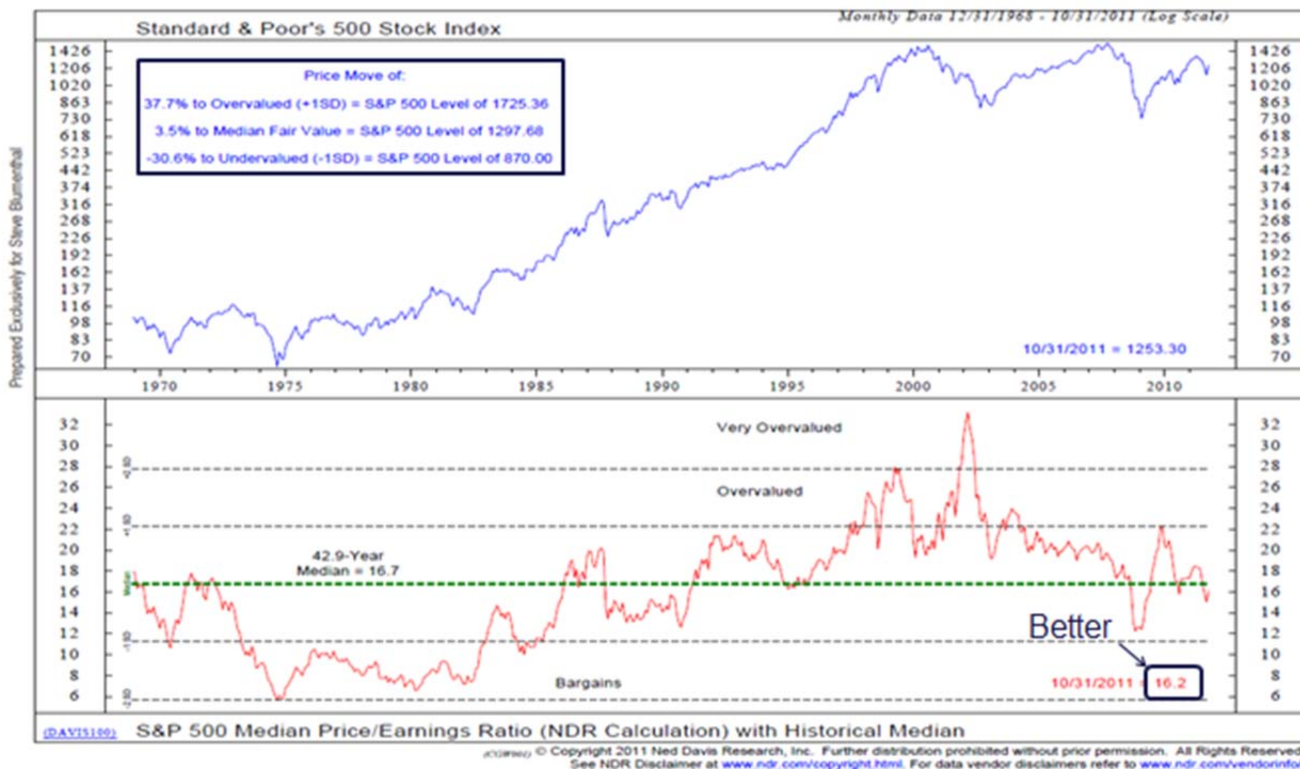
Source: Crestmont Research using Shiller PE methodology

If your starting point is a PE above 19 then your probable Equity market return over the next 20 years is 3.2% (top arrows), representing the lowest decile of the 92 periods. Conversely, if your starting point is a PE of 10, your expected 20-year return is 13.4% (bottom arrows), representing the highest decile of returns.

The current Shiller PE is **21.35** as of 1-3-2012. http://www.multpl.com/

When inflation is high, so are dividend yields and dividend yields are more than half the equity investment return you will receive. When inflation is high, so are bond yields and investors tend to like those high bond yields so they sell stocks and buy bonds. The selling pressure drives prices lower relative to earnings and you get a lower PE ratio. Sir John would see this as a time to buy when everyone else is selling. It is really pretty simple if you think about it but it requires patience and discipline.

While Shiller's PE is currently above 20, following is a recent NDR Median Price/Earnings Ratio chart showing their measure of PE at 16.2. While both are based on actual reported earnings, the difference is how they smooth the data. Shiller takes a slower look at PE change.

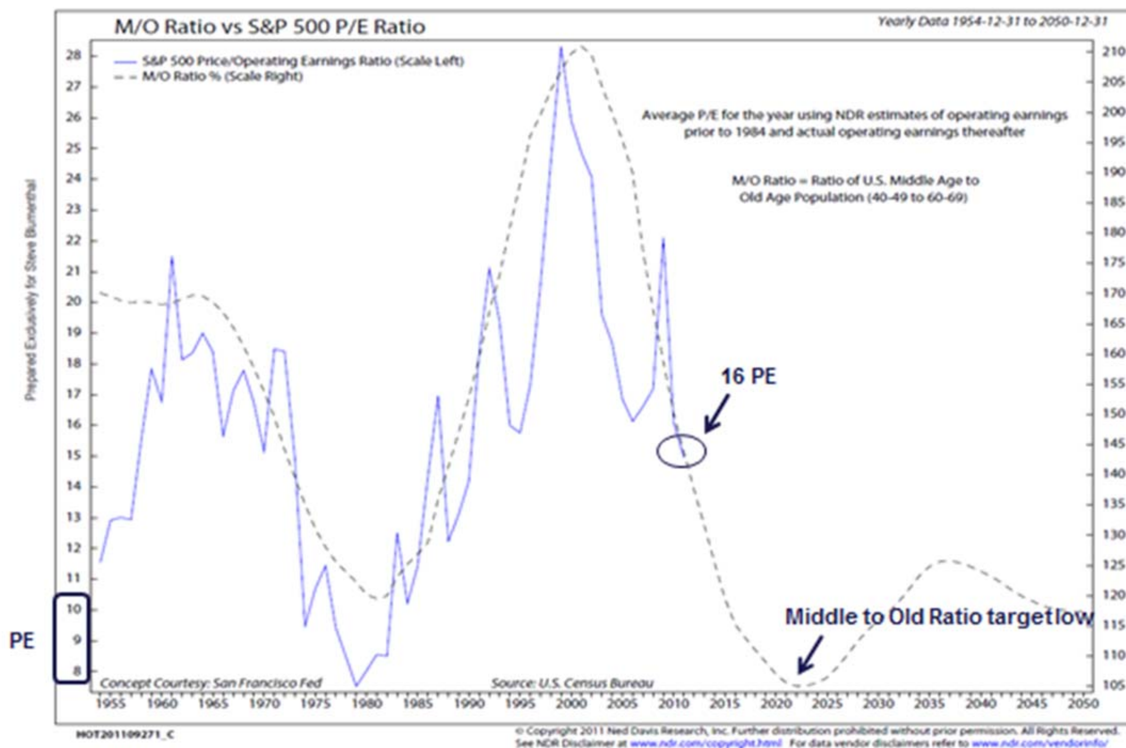


Source: Ned Davis Research

My simple two cents is to wait until PEs are at ten (I like medium PE) or below before re-establishing your overweight position to long-term buy and hold equity positions.

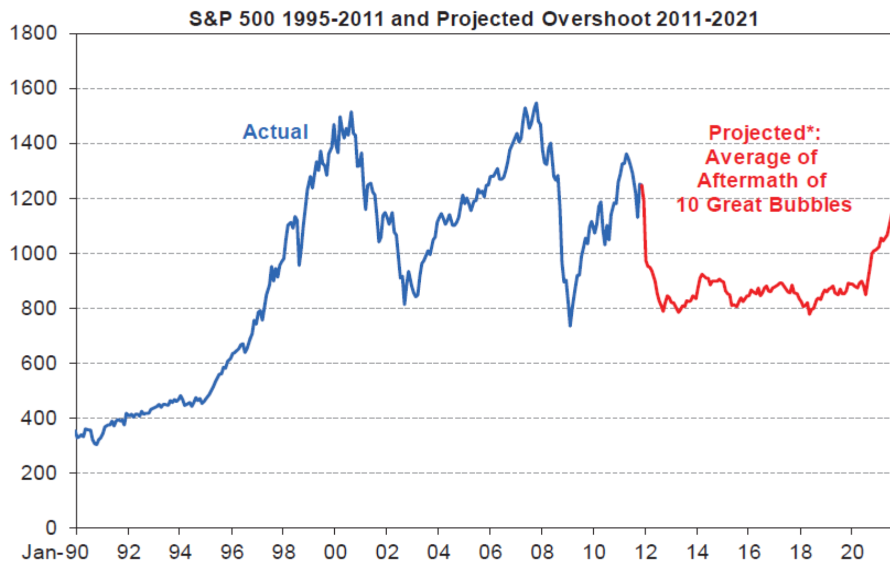
Inflation is low (but the risk is for rising inflation) and interest rates are low; PEs are relatively high and improving but no where near ten. To hammer the PE discussion just a little more, I find it hard to ignore the next chart from NDR which looks at the Ratio of U.S. Middle Age to Old Age Population (40-49 to 60-69).

One last major return headwind – the aging U.S. population. We baby boomers are getting up there. Somehow at age 50 I was left off the chart and it really seems to me that 60-69 is not Old Age… yet I'm after the data and found this chart quite interesting. Notice how the PE ratio tends to follow the dotted demographics line. If you step back and ask yourself if an aging investor population causes an investment behavioral shift from the need for growth to a need for income, this chart clearly says yes.



Source: Ned Davis Research

What if the next eight years look like the red line in the following chart from Jeremy Grantham's December 2011 Quarterly research letter?



Source: Global Financial Data, GMO

The data to me remains convincing. I continue to believe we are in the grips of a long-term secular bear correction. At best I believe we are in the fifth inning of a nine inning game. It is an environment that offers return for those who **think differently** and one of great challenges for those stuck in the old way of thinking.

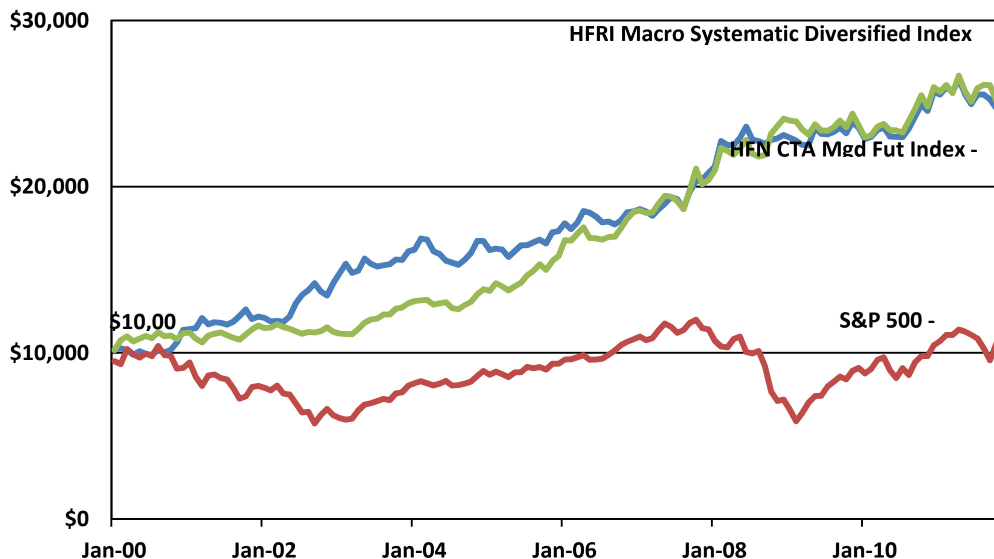
Based on the historical data, I believe that if your portfolio is passively positioned 60% Equities and 40% Bonds, your return over the next ten years will be 4.4% gross of advisory fees. The forward outlook for traditional allocation is the worst it has been in more than 140 years. A starting point of low dividends, low inflation, low interest rates and aging demographics are the biggest obstacles. Don't forget the overwhelming fundamental global debt crisis that remains in the way.

Here is where I believe the great opportunity begins. Can 4.4% be improved upon? The answer is yes but it requires you to consider uncommon solutions. I have been suggesting for some time that within the period I see ahead, (low traditional returns and continued secular bear market pressures) a more balanced portfolio approach includes an equal mix to equities, bonds and tactical/alternatives.

We know from industry research that most advisors still use the standard 60/40 portfolio allocation mix. They are dipping a small toe into alternatives with a 5% allocation. According to Cerulli Associates, 5% of advisor assets are invested in REITs and/or gold and they plan to increase that to 10% in 2012. Frankly, 5% is not an allocation weighting that will have any material impact on a portfolio. A 10% portfolio allocation won't cut it either. Harvard and Yale have over 80% allocated to various alternatives. I believe, given the forward outlook for traditional returns, at a minimum it should look more like 30% to 40%. Importantly, there are a number of liquid solutions and I believe we can help you in this regard. .

While we have spent over 20 years in the alternative investment space, our focus at CMG zeros in on one particular alternative category, Tactical Investment Solutions. Out of the many other alternative categories, we use the HFRI Macro Systematic Diversified Index as one of our benchmarks. Of course, there are other alternative categories like CTA-Managed Futures, Equity Long/Short, Distressed Debt, Global Macro, Hedge Fund of Funds and more.

Here is a chart of two of my favorite alternative categories vs. the S&P 500 Index. The point is simple, if you **think differently;** you can find ways to grow your money.



Source: Information from PerTrac Financial Solutions, LLC, HFRI and HedgeFund.net.

Today, information is readily available to all investors. Many investors are reading Jeremy Grantham, Bill Gross, Mohamed El-Erian, John Hussman and John Mauldin, they are concerned about the forward outlook and they are seeking a more comprehensive solution. I have statistically presented what I believe is a highly probable outcome. For investors, the traditional return opportunity remains challenging. There is a better plan and I believe it requires the inclusion of multiple portfolio risk diversifiers to enhance your portfolios return and reduce its risk.

Because of the significant advancement in technology, alternative strategies that were previously out of reach are now easily accessible via mutual funds and managed accounts. What is critical in building a balanced portfolio is finding a number of diversified strategies whose return streams have very little correlation (one investment might zig when another zags) with each other.

We can help you better understand the liquid alternative space. As investors, we all need to embrace risk. It is the only choice as there is risk in everything we humans do in life. Risk in your bank deposits, risk in CDs, bonds, stocks – there is risk in putting money under your mattress. It is through what I believe is an enhanced view of Modern Portfolio Theory that you can broadly diversify your risks, weave together non-correlating strategies, and most importantly, structure your portfolio allocation in such a way as to not only grow your money but risk protect what you have.

I realize that my Viewpoint may paint a negative picture. Please know I am anything but negative as I see great opportunity; but, it requires you to **think differently**. There is no guarantee I will be correct in my outlook; however, the forward probabilities are challenging for traditional buy and hold 60/40 investors. If I am correct in my thinking, stock and bond returns will be low. If I am incorrect, stocks and bonds will produce a higher return. Either way, the tactical strategies I favor are built to perform in up and down market periods. To be clear, on one last point, alternatives are not bear market strategies (unless you invest in short funds, which I do not favor), they are "all-the-time" strategies. Do your research, set your plan and stay committed to executing that plan.

There are solutions for the period ahead. Give us a call, we can help. As a sidebar, we are pleased to report that our CMG Absolute Return Strategies mutual fund finished 2011 near the top of its peer group in the Morningstar multi-alternative mutual fund category. For more information on the fund, please visit us at www.cmgarsfunds.net. For more information on our tactical investment solutions please visit us at www.cmgfunds.net or call your CMG Investment Representative at 610-989-9090.

Wishing you the very best in 2012!

With kindest regards,

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Mutual Funds involve risk including possible loss of principal. An investor should consider the Fund's investment objective, risks, charges, and expenses carefully before investing. This and other information about the CMG Absolute Return Strategy Fund is contained in the fund's prospectus, which can be obtained by calling 1-866-CMG-9456. Please read the prospectus carefully before investing. The CMG Absolute Return Strategy Fund is distributed by Northern Lights Distributors, LLC, Member FINRA/SIPC. NOT FDIC INSURED. MAY LOSE VALUE. NO BANK GUARANTEE.