



Tactical Portfolio Risk Control Concepts

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Important Disclosures Pertaining To This Report

The use of the principles and indicators described in this report are not a guarantee of success and there is always risk when investing in common stocks, bonds, mutual funds and exchange traded funds. Investments in these securities fluctuate in value and investors can lose principal value, especially over short periods of time. Breiter Capital has developed proprietary modeling using inputs we believe provide an indication of the internal strength of the stock market, to form an opinion as to whether prices are more likely to advance or decline in the intermediate-term future (3 months to 1 year time frame). While the use of this model does not guarantee any level of success or profit, we believe these methods will enhance our clients' results and reduce volatility. Points identified on the charts displayed are not intended to represent specific buy and sell recommendations, but are shown for illustrative purposes to support the concept of measuring risk using data such as Advance - Decline Ratios, New 52 Week Highs and Lows, and price momentum measures. The charts are of past periods in market history and are general visual examples of what could have been seen at these times had the investor been monitoring the indicators discussed herein.

TACTICAL RISK CONTROL VS. PASSIVE ALLOCATION

Portfolio allocation techniques generally fall into one of two camps, Passive or Tactical. Passive allocation strategies generally target an allocation model which places portions of the portfolio in different asset classes with a goal of generating a particular rate of return with the least risk possible. Portfolios are rebalanced back to the target allocation periodically as market fluctuations create out of balance conditions. The truly passive investor uses diversification to reduce risk and makes no attempt to avoid overvalued asset classes, instead choosing to rebalance periodically.

Tactical asset allocation involves proactive manipulation of the portfolio based on inputs ranging from intuition to mathematical models, in an effort to over-weight or under-weight particular asset classes based on their likelihood of delivering desired results. For example, when stocks are believed to be over-valued, exposure may be reduced in favor of holding bonds or other securities which are anticipated to provide higher returns and lower risk. This portfolio shift will ultimately be reversed after market cycles cause stocks to be under-valued relative to bonds or other assets.

Passive allocation models became popular and successful during the decades of the 1980's, 1990's and into the new century. A long-term decline in interest rates during this period from record highs to multi-decade lows helped bonds, stocks and real estate achieve above average returns, up until the financial crisis of 2007 – 2009 unfolded. We do not argue that disciplined passive allocation modeling will not work. There is little doubt in that it will succeed and we believe it is a better alternative than an undisciplined “shoot from the hip” approach which is used by many, if not most, individual investors.

However, we believe the realistic investor looking into the future from our vantage point here in 2011 should acknowledge some simple concepts which will probably impact their investment portfolios.

1. Government bonds and other fixed income investments carrying guarantees are unlikely to provide above average returns, relative to historic results, over the next decade or two, as they have done since the early 1980's due to the very low level of interest rates today.
2. It is likely that the post credit bubble economy we face in the future may have characteristics more like the 1950's to 1970's than recently experienced. This may mean more frequent, but not necessarily severe, recessions and interest rates that are more likely to rise and fluctuate than fall.
3. Negative correlations, or the ability of one asset class like foreign equities to go up while U.S. equities fall in price, appear to be diminishing as the world's economies become more interdependent.

We believe the realistic passive investor must reset their expectations for the returns their portfolio might achieve, and be ready for more volatility than some of the models which use historical data from the last couple decades might indicate.

Of course, a successful tactical allocation cannot be accomplished by guessing. The investor ideally should have some sort of procedure or discipline they follow to make a decision as to which asset classes should be emphasized and which should be reduced in the portfolio.

CAN TACTICAL ALLOCATION WORK?

Those who promote passive allocation strategies often claim that you cannot risk missing out on the stock market's best days of gains because your results will be dramatically reduced. We won't argue with their math, but we do take issue with the presentation of a study showing the negative impact of missing the best days without also showing the positive impact of missing the worst days. Talk about a lopsided viewpoint! Certainly someone employing a strategy to tactically adjust their allocation may miss some of the large up days, but they will likely also miss some of the worst days. Many tacticians believe it is easier to avoid the worst days because they tend to be grouped together during significant market declines, while the best days tend to be more random.

The study referenced at the top of the next page shows the results of missing the 10, 20, and 40 best or worst days, as well as missing both the best and worst. Note that missing the worst days has a larger magnitude of positive impact than the negative impact of missing the best compared to a buy and hold average return. We believe the most important observation is that missing both the best and worst days offer consistent above average results which would have come with lower volatility and risk were someone able to accomplish it.

S&P 500 – 25 Years Ending Dec. 31, 2008
– Average Annual Return 7.06%

	Miss the Best	Miss the Worst	Miss Both
10 days	4.10%	11.23%	8.15%
20 days	2.15%	13.80%	8.58%
40 days	(-.93%)	17.59%	8.82%

Source: Hepburn Capital Management, LLC. The returns provided above are historical and shown for purely illustrative purposes. The S&P 500 is an unmanaged index and individuals cannot invest directly in the index. No consideration is made of costs that would have been incurred to an actively managed portfolio of S&P 500 stocks.

We don't have an expectation of being able to avoid all the worst and be in for all the best. But the table above effectively disputes the theory that tactical asset allocation cannot succeed. A consistently applied process using disciplined rules can, we believe, increase returns and reduce the risk level of an investment portfolio. ***There is no perfect market timing method. Perfect timing is impossible.*** However, perfection is not necessary for a successful investment program. Capturing a portion of the market's gains and avoiding a portion of the losses may yield attractive results with lower risk.

THE KEY IS IN THE DETAILS

Our experience and analysis has led us to acknowledge there is no one perfect indicator to employ in tactical decision making. We believe a combination of indicators which provide confirmation of potential market turning points based on history may be helpful in reducing risk by signaling times when it may be productive to increase or decrease exposure to asset classes offering higher potential returns, but which may decline more in value during market corrections. Breiter Capital's Risk Control Model uses a select series of indicators to adjust the portfolio allocation in a tactical response with the objective being reduced risk and increased return.

In our opinion, there are two important components to the issuance of useful signals from the Risk Control Model:

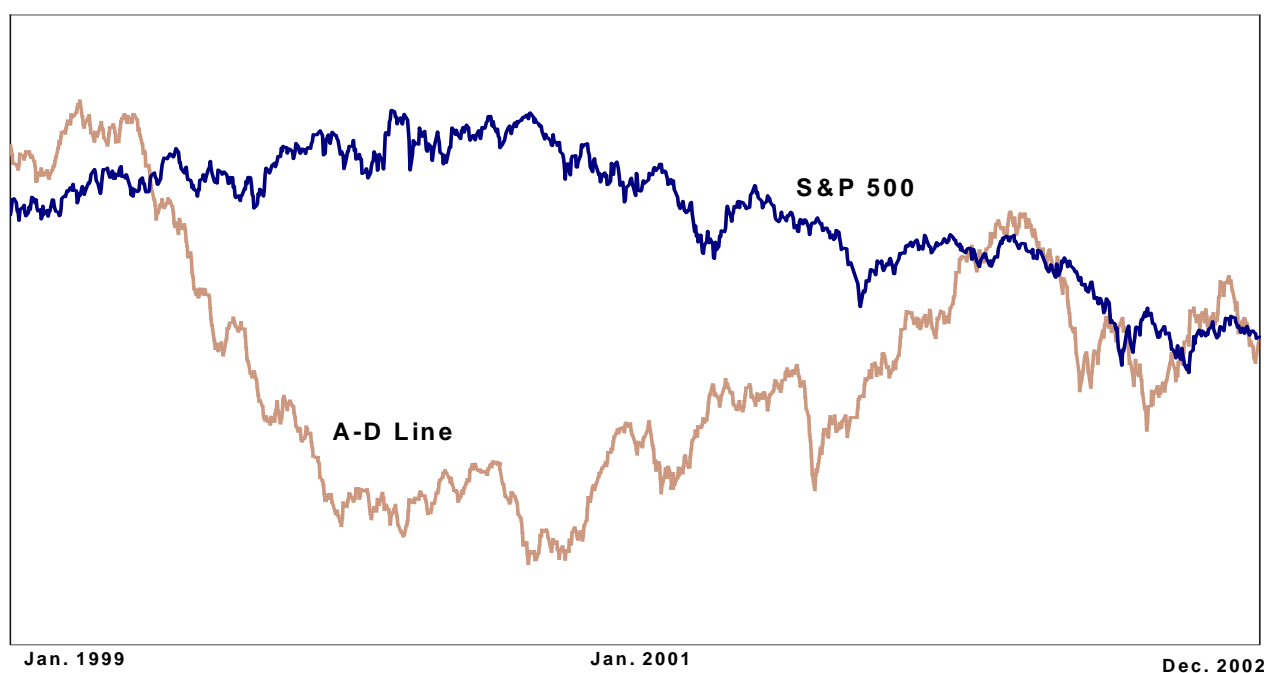
1. Measurement of the "Health" of the financial markets – are conditions such that an advancing trend can be sustained, or that a downtrend is likely to continue.
2. Measurement of the strength of the primary trend of prices – assume price momentum will continue until there is evidence of a change.

MARKET HEALTH INDICATORS

It is our historical observation that prior to peaks (tops) for the widely followed market indexes like the Dow Jones Industrial Average, S&P 500 Index and the NASDAQ Composite Index, there is almost always an identifiable deterioration in market breadth. Breadth refers to the number of companies rising or falling in price. A divergence in this pattern from the price action in the headline indexes, both up and down, is a potential sign that an up-trend, or down-trend may be living on borrowed time.

We use two indicators to monitor this “early warning” signal. Advance – Decline ratios and New 52 Weeks Highs & Lows help us assess the amount of participation or “health” existing in the market at that moment. A majority of stocks advancing in price versus the number declining has historically meant that the advance may go on for a while longer, or vice versa if decliners are out-numbering advancing issues. Reversals in these trends can be important early warning or confirming indicators at significant market tops and bottoms.

Below is a chart of the New York Stock Exchange Advance –Decline Line (A-D Line) from January 1999 to December 2002. Note the peak of the A-D Line in early 1999. While the headline indexes, the NASDAQ in particular, rose mightily into early 2000, the subsequent collapse is now infamous as the beginning of the major bear market of 2000 to 2003.



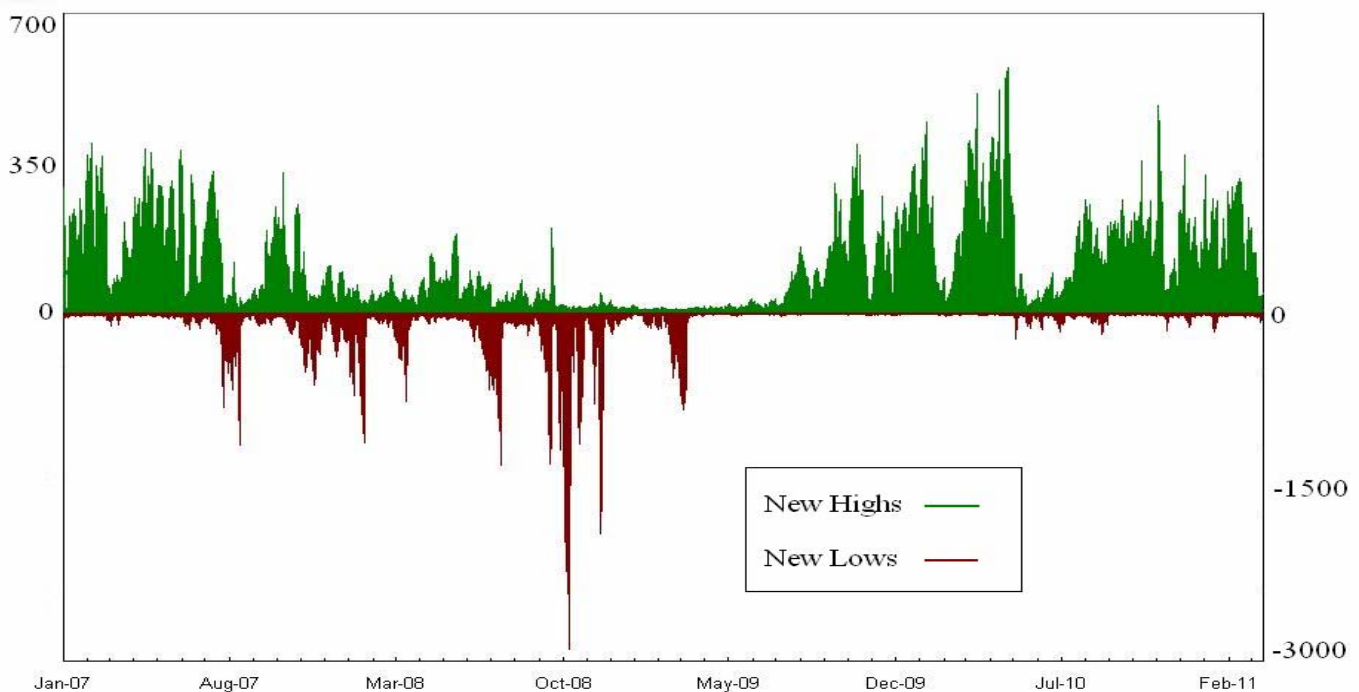
The S&P 500 Index lost about 48% of its value from peak to trough during this decline, and the NASDAQ Composite Index declined about 80%. The A-D Line certainly telegraphed the coming trouble for equities pretty effectively in this example.

Conversely, there have been cases where the major indices like the Dow and the S&P 500 were declining, causing investors to assume more declines to come. But, a review of the Advance-

Decline statistics reveals the A-D Line moving sideways and even starting to rise, signaling a transition from an unhealthy market to a healthy one in the near future.

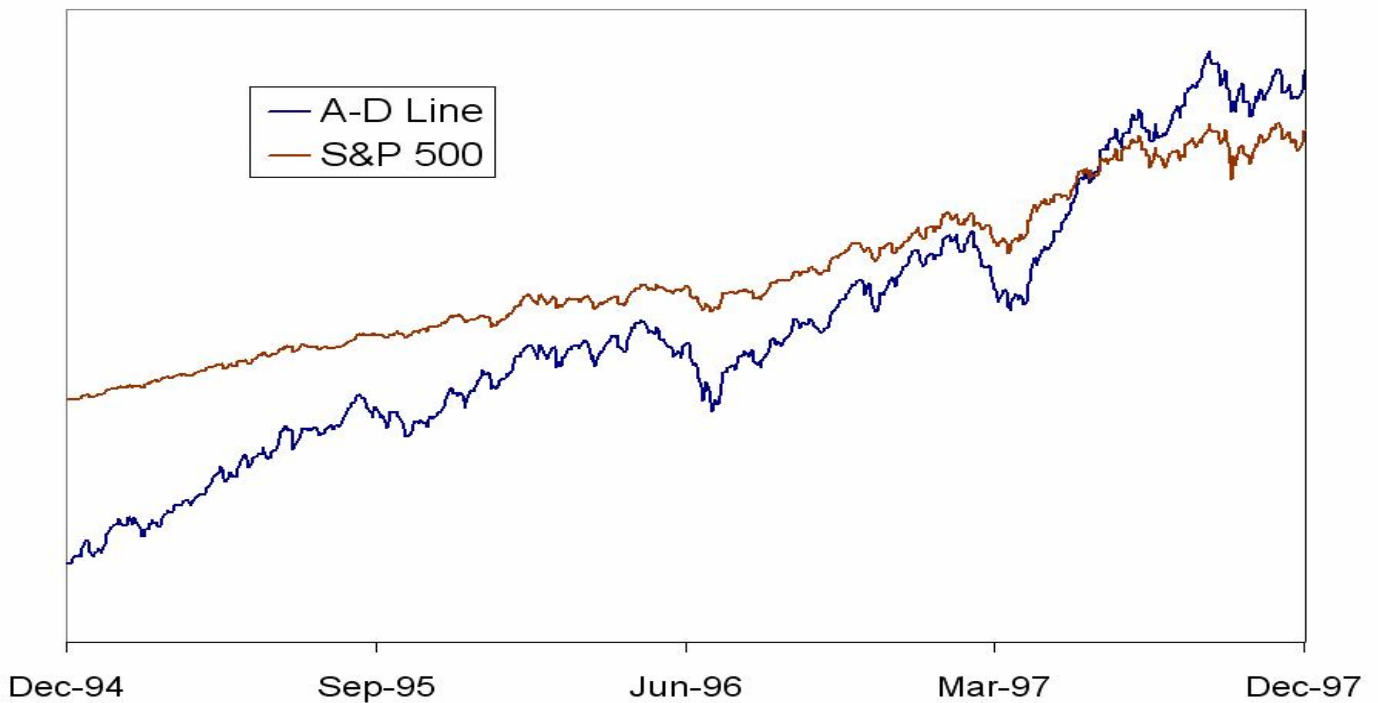
Monitoring the number of stocks making new 52 week high and low prices is a similar concept to the advance decline ratio. As market rallies grow old and momentum begins to wane for a majority of stocks, more stocks start to set lower prices than they experienced over the last year, and fewer make new high prices. As the percentage of stocks making new lows expands or contracts, it can be a useful indicator to identify potential turning points for trends in stock prices.

The chart below shows the number of issues traded on the New York Stock Exchange which made new 52 week lows as the bull market of 2003 – 2007 was getting ready to end. Note the expansion of the number of new lows starting in mid-2007 even though the indexes did not peak until late in the year. Also note the shrinking number of new lows late in 2008 and into 2009 as the market decline was nearing its end, and a significant rally started in March of 2009.



Sometimes, stock prices will continue higher even after breadth has started to break down, or move lower even when breadth has started to improve near the end of a decline. Breiter Capital monitors the primary trend in prices using “Rate of Change Oscillators” as well as Moving Average Crossover analysis to assess the momentum of prices, in an attempt to capture as much upside as possible during up-trends and avoid as much downside as possible during downtrends.

Statistical “noise” from Advance-Decline ratios and New Highs – New Lows analysis might also create signals to enter and exit the stock market which are subsequently, and quickly, reversed, creating what amounts to unnecessary and unproductive transactions. Using primary trend indicators may help filter some of these “whipsaw” signals and avoid unproductive allocation adjustments.



The chart above references the period from 1995 to 1997. In mid-1996 and the spring of 1997 there were sharp, but brief corrections, both telegraphed by the A-D Line (shown above) and expansion in new 52 week lows. Investors relying solely on these market health indicators may have reduced their equity exposure, only to find they were buying back in at higher prices a short time later as the rally resumed. Use of a primary trend indicator may have helped keep them in their equity positions, or helped them re-enter the market quickly after the correction to participate in subsequent gains.

There are many potential primary trend indicators. We favor two:

1. **Moving Average Crossover** – using moving averages smoothes the daily fluctuation of the various stock indexes. Monitoring when a shorter-term moving average crosses an intermediate moving average may be helpful as a supporting indicator to confirm action in the breadth indicators we use as early warning signals.
2. **Rate of Change Oscillators** - oscillators measure the rate of increase or decrease in a stock index or individual security. In other words, measuring the speed and power of the move in prices. As the oscillator changes from negative to positive and vice versa, it can be an important timing tool, working in conjunction with market breadth indicators to identify turning points in the market cycle.

Under Breiter Capital’s Risk Control Model, confirmation of indicators from both market breadth and primary trend are needed to take action and adjust the portfolio allocation. Confirmation reduces the chance of statistical noise in one indicator causing adjustment in the portfolio which may end up quickly reversed after the “noise” subsides.

SUMMARY

We use the Risk Control Model to identify periods of time when we believe equities and higher yielding bonds will tend to rise or fall in price. During periods when we believe prices will rise, we maintain full exposure to equities and high yield bonds within the limitations of the asset allocation for the particular investment program.

When the Model identifies that equities and higher yielding bonds may be susceptible to decline, we reduce exposure to these assets, and increase exposure to government bonds, higher quality corporate bonds, and cash equivalents. These latter asset classes have historically provided positive returns, or at least declined less than equities during market corrections.

The objective of our Risk Control Model is to capture the majority of intermediate and long-term stock market up-trends, and avoid the majority of downtrends. The process is unlikely to pick exact market bottoms and tops as entry and exit points, and we have no expectation of ever doing so, with the possible exception of being lucky. As indicated previously, perfection is not necessary for success, with success being defined as generating reasonable returns with acceptable risk. Security selection models are used to identify the individual securities which are used to implement the portfolio allocation.

Questions concerning implementation of the Risk Control Model in investment portfolios should be directed to:

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Important Disclosure:

Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will either be suitable or profitable for a client's investment portfolio. All investment strategies have the potential for profit or loss. Changes in investment strategies, contributions or withdrawals may materially alter the performance, strategy and results of your portfolio. The use of charts, formulas or models does not guarantee a particular success rate or prevent potential losses.

The performance of various indexes and asset classes being referred to in this information does not reflect the performance of Breiter Capital Management's clients. It is not possible to invest directly in an index. Historical performance results for investment indexes and/or categories generally do not reflect the deduction of transaction and/or custodial charges or the deduction of an investment-management fee, the incurrence of which would have the effect of decreasing historical performance results. Economic factors, market conditions, and investment strategies will affect the performance of any portfolio and there are no assurances that it will match or outperform any particular benchmark.