LETTER FROM THE EDITOR

This year’s Annual Symposium will focus on the fusion of technical analysis with fundamental valuation, behavioral finance, macroeconomics and quantitative methods. The work of three of the scheduled speakers is included in this month’s newsletter.

Steven Leuthold explains his investment strategy for the next year and readers can ask him for an update in April at the Symposium. Steve is the only individual who has received the Charles H. Dow Award from the MTA and the Graham and Dodd Scroll Award from the CFA Institute. Dr. Ben Hunt relies on game theory to understand the markets and the economy. Dr. Tucker Balch, a featured speaker, presents the results of research into buying and selling by company insiders that he completed with Scott Strong. Insider trading information is a form of sentiment analysis that technical analysts have used for many years.

We also have several other articles this month including Tom McClellan’s look at VIX ETNs and John Bougearel’s review of the current state of the market. Tom presents facts to demonstrate why long-term investors should avoid an ETN that is designed specifically for short-term traders. John presents some interesting chart patterns and provides a forecast based on technicals and fundamentals. He includes an overview of the macroeconomic environment that exists now and at several key turning points in the market. Please send any feedback or work you’d like to share through the newsletter to editor@mta.org.

Michael Carr
2014 OUTLOOK
BY STEVEN C. LEUTHOLD

Editor’s note: This is a reprint of a letter to clients which discusses successes and missteps along with an investment strategy for the future and is reprinted here with permission.

For most individual and professional investors, the biggest unexpected surprise of 2013 was the huge surge in the U.S. stock market. Those full year gains of 26% for the DJIA, 30% for the S&P 500 and 37% for the Russell 2000 (Small Caps) seemed impossible 12 months ago. But the median gain for hedge funds in 2013 was a mediocre 6.7% (HFRX Hedge Fund Index). Some investors did anticipate a market rally in early 2013 while few, if any, dreamed it would continue all year!

In the last half of 2013 the S&P 500 advanced an additional 15% with the Russell up 19%. Institutional investors scrambled to play catch up. Speculators climbed aboard and even individual investors finally began joining the party. Nevertheless, the smart money crowd (Hedge Funds?) typically posted a meager gain of 3.44% in the second half of 2013, according to the HFRX Hedge Fund Index.

Six-Month Leuthold Strategies Performance

As previously noted, June 30th, 2013 was the official birth date of Leuthold Strategies Investment Partnership (over this same period, three new babies were also produced by our staff). Since the launch, the partnership’s 15.2% gain kept pace with the S&P 500 six-month gain (15.07%) and exceeded the Dow Jones Industrials (11.2%). It should be noted that during this six month period the portfolio’s net equity exposure, after equity hedges, was about 50% of total assets while the Dow and S&P index performance represent 100% equity exposure.

I should add that clients with us before the introduction of Leuthold Strategies Partnership have lagged the S&P 500 for the full year because our first quarter 2013 performance was, as noted in earlier letters, “terrible.”

…..Yes, I was way too cautious towards the U.S stock market during the first stage of 2013 upside explosion. I don’t view Leuthold Strategies as a hedge fund although there are some similarities. To reiterate: the hedge fund index was up a lagging 6.7% for the year and only 3.4% for the last six months. How many more hedge funds are now experiencing net redemptions from disappointed investors?

Performance Critique

In years past, when I was the Major Domo at The Leuthold Group, I insisted on an annual critical review by our entire investment team because “self-examination is good for the soul if not the ego.” At the end of each year we published “A Look In The Rearview Mirror,” reviewing what was good, bad and ugly about our strategies in the preceding year. The goal was to learn from our mistakes. Here is a current abbreviated version:
• The portfolio was out of synch in the first half of 2013, particularly in the first quarter. I paid too little attention to momentum factors and wrongly underestimated the market impact of QE.

• Sector and equity theme strategies, while overall ineffective early in the year, kicked in, in the second half. When 70% outperformed their comparators, equity sectors (excluding hedges) about doubled the performance of the S&P in the second half.

• On both an annual and a six-month basis the portfolio’s total return more than doubled the performance of the typical hedge fund and most income funds.

• Overall, I’d say the portfolio’s performance was OK even though equity exposure proved to be overly cautious for most of the year.

**MAJOR PORTFOLIO EQUITY THEMES**

**24% ASIA:** About 75% of our Asian holdings are in China with investment emphasis on water stocks (part of our “Fresh Water Depletion” sector). Why the China emphasis? The China stock market is cheap, at 7.5 times forward earnings (2014) compared to 17 times earnings for the U.S. market. In addition, China’s real GDP growth is 7%, more than three times the real GDP growth rate here in the U.S. In the last six months, our China holdings were up 17%, lead by a 66% gain in Beijing Water, a “fresh water depletion” component.

China’s stock market languished in the first half of 2013 but now appears to have bottomed out, although most foreign investors remain gun shy and skeptical. I expect China to be a performance leader for us in 2014. But, the 6% of assets in Asian emerging markets continues to lag. Our holdings in this category were up a disappointing 5.5% over the last six months.

**23% CLEAN ENERGY:** This theme combines 10% in Natural Gas and 13% in the controversial Uranium/Nuclear area. More detail about this sector in our last report (copies available). Natural Gas stocks were up 34% in the second half of 2013, mostly in Q3.

Performance from the Uranium/Nuclear sector was, in reality, stronger than anticipated, particularly in Q4 of 2013 (up 18%). Our “star,” with a six-month gain of 68% is Areva, a large integrated French company, playing a major role in nuclear plant design and construction around the world. Revenues for Areva now come from South Korea, China, India, and other Asian countries. The company is now involved in a new large Nuclear project in Great Britain. In these nations the perceived risk of radiation (radiation and nuclear phobia) is minimal compared to the current health risk and death count from choking air pollution.

**19% INFLATION RESURGENCE FEARS:** Lenin was certainly right about one thing: there is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. As my friend Art Cashin observes, “Throughout history, nations have faced the burden of onerous debt in one of three ways: they pay it off (very, very rare), they default, or they inflate it away.”

In theory, a government with debt denominated in its own currency (like the U.S.) need never default. We now print money to buy our own debt and
government, with manipulation, keeps the cost of carry (interest rates) close to zero. Even now the Fed already owns 50% of all Treasuries with maturities between 10 and 15 years. Why not 75%? 100%? We could print enough new dollars to buy the national debt down to respectable levels....the new magic, printing press magic. But there is no printing press for our nation’s credibility. Recall that our forefathers once protested “not worth a continental”?

At year-end 2013 the portfolio included two forms of longer-term inflation hedge. 10% of assets were held in a physical gold ETF (GLD), a holding backed by actual gold, not derivatives. For the full year of 2013, this holding was a 28% loser, but in the last half of the year the price of gold declined only 1.8%. While it may be wishful thinking it appears gold may be stabilizing. I expect a positive return from gold in 2014 based on rising inflation fears and/or increased global political instability (Middle East? Africa?).

Until recently, 9% of portfolio assets were invested in companies holding large amounts of raw land (inflation hedge?). In the last six months the return from land stocks was +28%, about the same as the S&P 500. In the third quarter, as noted in our previous letter, we sold St. Joe because the company was planning to sell a large part of its undeveloped land. We have not been able to find adequate land rich replacements and are looking elsewhere for inflation hedge stocks. An initial 4% commitment has been made in industrial metals stocks.

.....Later in this issue readers will find some additional commentary regarding the risks associated with monetary debasement inflation. See last quarter’s letter for additional comments (copies available upon request).

**17% FRESH WATER DEPLETION:** As detailed in the previous quarterly letter, this was introduced as a new major investment theme in July. In the last half of 2013 these stocks recorded a 22% gain led by Beijing Enterprises Water (five month gain of 66%). Much of the world is, or will soon be, facing a water crisis, potentially now a far more serious crisis than the energy crisis. For example, the Middle East has lost 117 trillion acre-feet of fresh water in seven years, enough to fill the Dead Sea. 60% of this loss was pumped up and out of the region’s aquifers with farming being the biggest drain.

The companies we own in “Fresh Water Depletion” are of two types. First are the five companies that provide services and products that clean and recycle contaminated water and wastewater. This includes water from industrial operations such as fracking and electronic manufacturing, as well as wastewater from urban areas.

Second are the three portfolio companies importantly involved in desalination, typically in coastal cities like San Diego, Perth, Australia, and in the water-starved Middle East.

Interesting that China is now the world volume leader in desalination. Technology has reduced the costs of converting saltwater to freshwater by over 75%. 16,000 desalination plants are in operation today with capacity expanding at more than a 15% annual rate. This is just the beginning.
10% AIRLINES: This holding dates back more than two years. After cutting back some, we again increased in Q3 2013 (Delta and American). Thanks primarily to a huge gain in American (bought before completion of the American/U.S. Air merger), the airline position posted a 56% gain in Q4 with American gaining an estimated 168%, and an additional 14% in early January 2014. The portfolio will be receiving additional shares of the merged American/U.S. Air in the next few months.

We currently hold only three airlines (American, Delta and Copa). The technical and fundamental factors remain strongly bullish at this time. As I noted back in October, “It ain’t over, ‘til it’s over” (Yogi). How high is high? When upside momentum fades, the portfolio will be harvesting some big long-term capital gains.

6% INTEREST RATE HEDGE: In early fall of 2013 this short position in U.S. Treasuries took some profits, cutting back from 10% to 6% as 10-year treasury bond yields moved up to 3% before retreating. We realized some gains, but may move this hedge back up to 10% or so if 10-year bond yields again fall below 2.50%. Ultimately I expect to see 5% yields, but it may take two years or longer. (Note: When yields rise bonds fall and short positions profit.)

4% EMERGING EASTERN EUROPE: Recently we trimmed the holding in Russia slightly and added Poland and Turkey. Poland is acting well but Turkey looks like a turkey, down 15% from our Q4 purchase. Russia continues to be (by the metrics) the cheapest major stock market in the world. Will Putin and his advisors come to recognize that Mother Russia must work to get along in order to diversify the country’s now narrow (energy) economic base and expand industrial manufacturing and trade? Maybe so. Are Syria and Iran indications of this changing attitude?

3% HOLDING TANK: Previously the portfolio had maintained a relatively small holding in a theme tagged as “Healthy Tigers.” Emerging Asian countries are spending 4.5% of GDP or less on health care compared to 18% for the U.S. This appeared to be creating a growth opportunity for investment.

But over the past year most stocks included here turned sour, losing momentum. Thus we, at least for now, have deactivated the sector. But two stocks performed well and have been moved to “the Holding Tank” (explanation follows).

.....What is “The Holding Tank”?

This is a portfolio discipline I initiated many years ago at The Leuthold Group. Even if we eliminate a group or theme from a portfolio, component stocks that remain superior performers are at least temporarily moved down to the “Holding Tank,” staying in the portfolio for as long as they continue to outperform the market from month to month (a few of these exceptions have remained in our portfolios for as long as a year). Sometimes the gains ultimately realized have been very impressive. Current Holding
Tank survivors include Sihuan Pharmaceutical and also Sino Biopharmaceutical.

COMMENTS ON CURRENT PORTFOLIO

- I am comfortable with the Uranium/Nuclear commitment, as indications of a major low are building and investor sponsorship for this long-term theme (three years?) seems to be building.
- The other “Clean Energy” holding, Natural Gas, lagged some in November/December. But, with some help from my friend Charlie Maxwell (Wall Street’s Dean of Energy Analysts) we may be changing a few of our current names.
- Our long-term Airlines holding has been a great holding and recently a homerun thanks to the huge gain in American Airlines. We are now focusing on when to take more profits, rather than adding.
- The Asia holdings have not yet proved to be productive but China seems to have stabilized and was up 17% in Q4. China could be one of our big winners in 2014. The commitment in Asian emerging countries is less encouraging at this point.
- Inflation Resurgence? The gold holding appears to be stabilizing, down only 1.2% in Q4. Even though gold is down about 30% from its highs, it continues to be the most effective historical hedge against currency debasement. Consideration is being given to adding 1-2% to existing holdings.
- We also had been using investments in companies rich in raw land as part of inflation resurgence. St. Joe (a former holding) planned to sell most of its raw land so we sold the stock. We have failed to uncover an adequate land rich replacement stock. We are currently researching other industries that should provide an inflation hedge.
- A new theme introduced in July 2013 is Fresh Water Depletion and is working out. We might add another 1-2% here but no other changes are contemplated.
- No changes are contemplated in the Interest Rate Hedge unless there is a significant (100 basis points) rise or fall in the yield of the 10-year Treasury.
- The small 4% holding in Emerging Eastern Europe has plans to liquidate our turkey in Turkey on a bounce, adding a new position in Hungary or adding 1% to Russia.

“Put Insurance” Detail

2% of the portfolio’s cash has been used to buy defensive puts linked to the S&P 500 Index. The strike prices are 1700, 1725 and 1750 and expire on January 15, 2015, about a year from now. The average of the strike prices is about 6% below the current level of the S&P 500.

80% of the current portfolio is invested in common stocks, but 45% of this equity exposure is hedged with our current portfolio put options limiting the theoretical loss on this 45% portion of equity assets to 6% plus the cost of the puts. We assume that the 45% of portfolio equities will perform about in line with the S&P 500 (but this may not be the case).
Currently 35% of the portfolio’s common stocks are not covered by the loss reducing put position. That is, they are “unhedged.” While the current put contracts expire a year from now they can be exercised, sold or otherwise modified at any time before January 15, 2015. This portfolio put position can be increased or decreased at any time depending on market conditions.

**MY CURRENT MARKET VIEWS**

…..As always, subject to change.

**U.S. Stock Market**

Per historical intrinsic value benchmarks, the U.S. stock market is overvalued in the high 15-20% of valuations over the last 60 years. However, the market momentum measures remain quite positive and the U.S. economy continues to edge higher (2-3% GDP growth?). I would not be surprised to see the S&P 500 and DJIA up another 10% to peak levels sometime in 2014. A very strong majority of investors, professional and individual, now expect at least another 10% market gain in 2014. Being a contrarian, this consensus in itself makes me uncomfortable.

Market history tells us that very rarely does the market accommodate such a strong consensus of opinion.

**Steep Correction Sometime In 2014**

Still I think it is possible that the S&P 500 could challenge 2000 sometime in 2014 with the DJIA reaching 18,000. But I remain convinced 2014 will finally bring a major correction of at least 15%, probably in the second half of the year. Currently a 15% decline would approximate median valuation levels per our benchmarks. If this correction should morph into a major cyclical bear market a 30% decline might be a target (but is not currently projected).

**Here Are Some Events That Could Trigger A Major Correction:**

- Major revolution crisis in South Africa
- Surprise major uptick in U.S. inflation
- Significant deterioration in U.S. economic outlook
- Japan/Russia conflict significantly accelerates
- U.S. profit margins shrink and earnings disappoint
- Social unrest and riots in U.S. income inequality
- WTI Crudes soars above $125
- Israel/Iran conflict explodes
- Major cyber sabotage disruption

These are not predictions, only possibilities. Keep in mind that the triggers for historical declines have sometimes come out of left field, events nobody anticipates.

**THE GRAND EXPERIMENT: THE EURO**

As at least some of you are aware, I have remained skeptical of the long-term endurance of the Euro as a surviving multinational common currency. I
have previously cited, among other factors, the widely diverging cultures, languages, ethnic groups, and vast differences in fiscal responsibility attitudes. In addition is the range of political systems and factors such as nationalistic pride and prejudice, leadership rivalries, jealousy and divergence in levels of economic success and prosperity. My skepticism may have been early but longer term it may still prove to be justified.

Historically, past examples of cross-border common currencies were the result of military and/or economic dominance. One exception might be the short-lived Scandinavian experience with a multi-national currency over 100 years ago.

Frankly, I have been surprised that the Euro survived so far in spite of the crisis conditions in Greece, Portugal and Cyprus, etc., and the failure of member nations to abide by “rules” regarding deficits and austerity.

But now the European sovereign debt crisis has rekindled a new round of anti-Euro, antisystem and anti-EU political parties in Europe. In 2014, 13 Euro area popular elections will be held from the Netherlands in March to Slovenia in November.

Elections to the European Parliament take place in May and UBS believes there is a strong possibility that a higher proportion of anti-Euro element will be elected this time around.

In recent years a growing number of Euro-skeptic parties have been established, but their platforms are hardly uniform. Still, public opinion polls show that support for the EMU and the Euro has now fallen to 51% from 61% back in 2009. According to the semi-annual Eurobarometer poll, those declaring against the EMU and the Euro has risen to 42% from 32% since 2009 (7% undecided).

The financial clout of Germany has held the Euro together through some very troublesome times, but public support now seems to be fading even as the Eurozone economy led by Germany seems to be on the mend. Will continued economic improvement in the Eurozone now improve public support for the EU and the Euro?…..Or will an improving economy build the confidence and courage of European countries that want to go it alone? In 2014 the results of 13 Euro area popular elections should provide some clues.

…..My personal view is the Euro has now survived a major storm. Braving war, a severe recession or financial panic, the Euro should survive the decade.

…..WORTH NOTING

The Importance of Credibility

Back in November, John Hussman noted that the Fed then held $3.84 trillion in assets against its capital of $54.86 billion. This put the Fed’s leverage ratio at 70 to 1 against its capital.

Hussman estimates that, considering the relatively long average maturity of the Fed’s asset holdings, even a 20 basis point rise in interest rates would
(marked to the market) theoretically wipe out the Fed’s capital. Bear Stearns and Lehman were leveraged at 30 to 1 when they collapsed, but of course they did not have their own printing press.

Historically, panic runs and subsequent collapses of financial institutions and governments were related to leverage. But more important was credibility. And as Art Cashin notes, “there is no printing press for that.”

…..The Federal Reserve, not investors, now owns 50% of all treasuries with maturities between 10 and 15 years.

…..I keep a bank note issued by the Reserve Bank of Zimbabwe with a face value of One Hundred Billion Dollars issued in July 2008 but only good for six months, after which the Zim dollar was again revalued. In U.S. dollars back in 2008 this bill was worth $12.50. That was then. I wonder how much a trillion dollar bill is worth today (I have not been back to Zimbabwe).

Steve Leuthold has been an investment strategist, manager, and researcher for over 45 years. He is Founder of The Leuthold Group, LLC, an institutional investment research firm established in 1981.

In 1987, Steve initiated a small investment management operation that is driven almost exclusively by The Leuthold Group’s own internal research. Steve served as Chief Investment Officer of the registered investment advisor, was senior executive of the investment portfolio management team, and was a member of Leuthold Funds’ Board of Directors through 2012. Steve is the author of many books and articles, including The Myths of Inflation and Investing and Index Funds, the Risks and Pitfalls. He has been a frequent contributor to leading trade journals, including The Wall Street Journal, Barron’s, the Journal of Portfolio Management, the Financial Analysts Journal, Newsweek, and Business Week.

In 1999, Steve and former Leuthold team member Eric Bjorgen co-authored a special study, Corporate Insiders’ Big Block Transaction, for which they won the Charles H. Dow Award. In addition, Steve’s Financial Analyst Journal article, “Inflation, Deflation and Interest Rates,” was awarded the 1982 Graham and Dodd Scroll Award by the Financial Analysts Federation.

Most recently Steve has been spending his time between his Family Office (Leuthold Strategies, LLC) in Minneapolis and continued efforts in obtaining forestland in the U.S. to devote to Wilderness Forests via his Family Foundation. He has spent many hours with the Nature Conservancy of Maine, New York, and New Hampshire to find available land to purchase with the purpose of preserving natural land and wilderness for generations to come. His Family Office is a small investment firm that manages family assets and the Leuthold Family Foundation, as well as private clients.

After graduating from Albert Lea High School (Minnesota) in 1956, Steve pursued a higher education at the University of Wisconsin and graduated from the University of Minnesota.
IT WAS BARZINI ALL ALONG
BY W. BEN HUNT, PH.D.

Editor’s note: This was originally published in a newsletter by Ben Hunt and is reprinted here with permission.

“Tattaglia is a pimp. He never could have outfought Santino. But I didn’t know until this day that it was Barzini all along.” – Don Vito Corleone

Like many in the investments business, I am a big fan of the Godfather movies, or at least those that don’t have Sofia Coppola in a supporting role. The strategic crux of the first movie is the realization by Don Corleone at a peace-making meeting of the Five Families that the garden variety gangland war he thought he was fighting with the Tattaglia Family was actually part of an existential war being waged by the nominal head of the Families, Don Barzini. Vito warns his son Michael, who becomes the new head of the Corleone Family, and the two of them plot a strategy of revenge and survival to be put into motion after Vito’s death. The movie concludes with Michael successfully murdering Barzini and his various supporters, a plot arc that depends entirely on Vito’s earlier recognition of the underlying cause of the Tattaglia conflict. Once Vito understood WHY Philip Tattaglia was coming after him, that he was just a stooge for Emilio Barzini, everything changed for the Corleone Family’s strategy.

Now imagine that Don Corleone wasn’t a gangster at all, but was a macro fund portfolio manager or, really, any investor or allocator who views the label of “Emerging Market” as a useful differentiation ... maybe not as a separate asset class per se, but as a meaningful way of thinking about one broad set of securities versus another. With the expansion of investment options and liquid securities that reflect this differentiation – from Emerging Market ETF’s to Emerging Market mutual funds – anyone can be a macro investor today, and most of us are to some extent.

You might think that the ease with which anyone can be an Emerging Markets investor today would make the investment behavior around these securities more complex from a game theory perspective as more and more players enter the game, but actually just the opposite is true. The old Emerging Markets investment game had very high informational and institutional barriers to entry, which meant that the players relied heavily on their private information and relatively little on public signals and Common Knowledge. There may be far more players in the new Emerging Markets investment game, but they are essentially one type of player with a very heavy reliance on Common Knowledge and public Narratives. Also, these new players are not (necessarily) retail investors, but are (mostly) institutional investors that see Emerging Markets or sub-classifications of
Emerging Markets as an asset class with certain attractive characteristics as part of a broad portfolio. Because these institutional investors have so much money that must be put to work and because their portfolio preference functions are so uniform, there is a very powerful and very predictable game dynamic in play here.

Since the 2008 Crisis the Corleone Family has had a pretty good run with their Emerging Markets investments, and even more importantly Vito believes that he understands WHY those investments have worked. In the words of Olivier Blanchard, Chief Economist for the IMF:

In emerging market countries by contrast, the crisis has not left lasting wounds. Their fiscal and financial positions were typically stronger to start, and adverse effects of the crisis have been more muted. High underlying growth and low interest rates are making fiscal adjustment much easier. Exports have largely recovered, and whatever shortfall in external demand they experienced has typically been made up through an increase in domestic demand. Capital outflows have turned into capital inflows, due to both better growth prospects and higher interest rates than in advanced countries. ... The challenge for most emerging countries is quite different from that of advanced countries, namely how to avoid overheating in the face of closing output gaps and higher capital flows. – April 11, 2011

As late as January 23rd of this year, Blanchard wrote that “we forecast that both emerging market and developing economies will sustain strong growth.”

Now we all know what actually happened in 2013. Growth has been disappointing around the world, particularly in Emerging Markets, and most of these local stock and bond markets have been hit really hard. But if you’re Vito Corleone, macro investor extraordinaire, that’s not necessarily a terrible thing. Sure, you don’t like to see any of your investments go down, but Emerging Markets are notably volatile and maybe this is a great buying opportunity across the board. In fact, so long as the core growth STORY is intact, it almost certainly is a buying opportunity.

But then you wake up on July 9th to read in the WSJ that Olivier Blanchard has changed his tune. He now says “It’s clear that these countries [China, Russia, India, Brazil, South Africa] are not going to grow at the same rate as they did before the crisis.” Huh? Or rather, WTF? How did the Chief Economist of the IMF go from predicting “strong growth” to declaring that the party is over and the story has fundamentally changed in six months?

It’s important to point out that Blanchard is not some inconsequential opinion leader, but is one of the most influential economists in the world today. His position at the IMF is a temporary gig from his permanent position as the Robert M. Solow Professor of Economics at MIT, where he has taught since 1983. He also received his Ph.D. in economics from MIT (1977), where his fellow graduate students were Ben Bernanke (1979),
Mario Draghi (1976), and Paul Krugman (1977), among other modern-day luminaries; Stanley Fischer, current Governor of the Bank of Israel, was the dissertation advisor for both Blanchard and Bernanke; Mervyn King and Larry Summers (and many, many more) were Blanchard’s contemporaries or colleagues at MIT at one point or another.

The centrality of MIT to the core orthodoxy of modern economic theory in general and monetary policy in particular has been well documented by Jon Hilsenrath and others, and it’s not a stretch to say that MIT provided a personal bond and a formative intellectual experience for a group of people that by and large rule the world today. Suffice it to say that Blanchard is smack in the middle of that orthodoxy and that group. I’m not saying that anything Blanchard says is amazingly influential in and of itself, certainly not to the degree of a Bernanke or a Draghi (or even a Krugman), but I believe it is highly representative of the shared beliefs and opinions that exist among these enormously influential policy makers and policy advisors. Two years ago the global economic intelligentsia believed that Emerging Markets had emerged from the 2008 crisis essentially unscathed, but today they believe that EM growth rates are permanently diminished from pre-crisis levels. That’s a big deal, and anyone who invests or allocates to “Emerging Markets” as a differentiated group of securities had better take notice.

Here’s what I think happened.

First, an error pattern has emerged over the past few years from global growth data and IMF prediction models that forced a re-evaluation of those models and the prevailing Narrative of “unscathed” Emerging Markets. Below is a chart showing actual Emerging Market growth rates for each year listed, as well as the IMF prediction at the mid-year mark within that year and the mid-year mark within the prior year (generating an 18-month forward estimate).

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<td>Actual</td>
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<td>Mid-yr est.</td>
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<td>18-mo. est.</td>
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Pre-crisis the IMF systematically under-estimated growth in Emerging Markets. Post-crisis the IMF has systematically over-estimated growth in Emerging Markets. Now to be sure, this IMF over-estimation of growth exists for Developed Markets, too, but between the EuroZone sovereign debt crisis and the US fiscal cliff drama there’s a “reason” for the unexpected weakness in Developed Markets. There’s no obvious reason for the persistent Emerging Market weakness given the party line that “whatever shortfall in external demand they experienced has typically been made up through an increase in domestic demand.” Trust me, IMF economists know full well that their models under-estimated EM growth pre-crisis and have now flipped their bias to over-estimate growth today. Nothing freaks out a statistician more than this sort of flipped sign. It means that a set of historical correlations has “gone perverse” by remaining predictive, but in the opposite manner that it used to be predictive. This should never happen if your underlying theory of how the world works is correct. So now the IMF (and every other mainstream macroeconomic
a big problem. They know that their models are perversely over-estimating growth, which given the current projections means that we’re probably looking at three straight years of sub-5% growth in Emerging Markets (!!) more than three years after the 2008 crisis ended, and – worse – they have no plausible explanation for what’s going on.

Fortunately for all concerned, a Narrative of Central Bank Omnipotence has emerged over the past nine months, where it has become Common Knowledge that US monetary policy is responsible for everything that happens in global markets, for good and for ill (see “How Gold Lost Its Luster”). This Narrative is incredibly useful to the Olivier Blanchard’s of the world, as it provides a STORY for why their prediction models have collapsed. And maybe it really does rescue their models. I have no idea. All I’m saying is that whether the Narrative is “true” or not, it will be adopted and proselytized by those whose interests – bureaucratic, economic, political, etc. – are served by that Narrative. That’s not evil, it’s just human nature.

Nor is the usefulness of the Narrative of Central Bank Omnipotence limited to IMF economists. To listen to Emerging Market central bankers at Jackson Hole two weeks ago or to Emerging Market politicians at the G-20 meeting last week you would think that a great revelation had been delivered from on high. Agustin Carstens, Mexico’s equivalent to Ben Bernanke, gave a speech on the “massive carry trade strategies” caused by ZIRP and pleaded for more Fed sensitivity to their capital flow risks. Interesting how the Fed is to blame now that the cash is flowing out, but it was Mexico’s wonderful growth profile to credit when the cash was flowing in. South Africa’s finance

 minister, Pravin Gordhan, gave an interview to the FT from Jackson Hole where he bemoaned the “inability to find coherent and cohesive responses across the globe to ensure that we reduce the volatility in currencies in particular, but also in sentiment” now that the Fed is talking about a Taper. Christine Lagarde got into the act, of course, calling on the world to build “further lines of defense” even as she noted that the IMF would (gulp) have to stand in the breach as the Fed left the field. To paraphrase Job: the Fed gave, and the Fed hath taken away; blessed be the name of the Fed.

The problem, though, is that once you embrace the Narrative of Central Bank Omnipotence to “explain” recent events, you can’t compartmentalize it there. If the pattern of post-crisis Emerging Market growth rates is largely explained by US monetary accommodation or lack thereof ... well, the same must be true for pre-crisis Emerging Market growth rates. The inexorable conclusion is that Emerging Market growth rates are a function of Developed Market central bank liquidity measures and monetary policy, and that all Emerging Markets are, to one degree or another, Greece-like in their creation of unsustainable growth rates on the back of 20 years of The Great Moderation (as Bernanke referred to the decline in macroeconomic volatility from accommodative monetary policy) and the last 4 years of ZIRP. It was Barzini all along!

This shift in the Narrative around Emerging Markets – that the Fed is the “true” engine of global growth – is a new thing. As evidence of its novelty, I would point you to another bastion of modern economic orthodoxy, the National Bureau of Economic Research (NBER), in particular their repository of working papers. Pretty much every US economist of note in the past 40
years has published an NBER working paper, and I only say “pretty much every” because I want to be careful; my real estimate is that there are zero mainstream US economists who don’t have a working paper here.

If you search the NBER working paper database for “emerging market crises”, you see 16 papers. Again, the author list reads like a who’s who of famous economists: Martin Feldstein, Jeffrey Sachs, Rudi Dornbusch, Fredric Mishkin, Barry Eichengreen, Nouriel Roubini, etc. Of these 16 papers, only 2 – Frankel and Roubini (2001) and Arellano and Mendoza (2002) – even mention the words “Federal Reserve” in the context of an analysis of these crises, and in both cases the primary point is that some Emerging Market crises, like the 1998 Russian default, force the Fed to cut interest rates. They see a causal relationship here, but in the opposite direction of today’s Narrative! Now to be fair, several of the papers point to rising Developed Market interest rates as a “shock” or contributing factor to Emerging Market crises, and Eichengreen and Rose (1998) make this their central claim. But even here the argument is that “a one percent increase in Northern interest rates is associated with an increase in the probability of Southern banking crises of around three percent” … not exactly an earth-shattering causal relationship. More fundamentally, none of these authors ever raise the possibility that low Developed Market interest rates are the core engine of Emerging Market growth rates. It’s just not even contemplated as an explanation.

Today, though, this new Narrative is everywhere. It pervades both the popular media and the academic “media”, such as the prominent Jackson Hole paper by Helene Rey of the London Business School, where the nutshell argument is that global financial cycles are creatures of Fed policy … period, end of story. Not only is every other country just along for the ride, but Emerging Markets are kidding themselves if they think that their plight matters one whit to the US and the Fed.

Market participants today see Barzini/Bernanke everywhere, behind every news announcement and every market tick. They may be right. They may be reading the situation as smartly as Vito Corleone did. I doubt it, but it really doesn’t matter. Whether or not I privately believe that Barzini/Bernanke is behind everything that happens in the world, I am constantly told that this is WHY market events happen the way they do. And because I know that
everyone else is seeing the same media explanations of WHY that I am seeing … because I know that everyone else is going through the same tortured decision process that I’m going through … because I know that everyone else is thinking about me in the same way that I am thinking about them … because I know that if everyone else acts as if he or she believes the Narrative then I should act as if I believe the Narrative … then the only rational conclusion is that I should act as if I believe it. That’s the Common Knowledge game in action. This is what people mean when they say that a market behavior of any sort “takes on a life of its own.”

For the short term, at least, the smart play is probably just to go along with the Barzini/Bernanke Narrative, just like the Corleone family went along with the idea that Barzini was running them out of New York (and yes, I understand that at this point I’m probably taking this Godfather analogy too far). By going along I mean thinking of the current market dynamic in terms of risk management, understanding that the overall information structure of this market is remarkably unstable. Risk-On / Risk-Off behavior is likely to increase significantly in the months ahead, and there’s really no predicting when Bernanke will open his mouth or what he’ll say, or who will be appointed to take his place, or what he or she will say. It’s hard to justify any large exposure to public securities in this environment, long or short, because all public securities will be dominated by this Narrative so long as everyone thinks that everyone thinks they will be dominated. This sort of game can go on for a long time, particularly when the Narrative serves the interests of incredibly powerful institutions around the world.

But what ultimately saved the Corleone family wasn’t just the observation of Barzini’s underlying causal influence, it was the strategy that adjusted to the new reality of WHY. What’s necessary here is not just a gnashing of teeth or tsk-tsk’ing about how awful it is that monetary policy has achieved such behavioral dominance over markets, but a recognition that it IS, that there are investment opportunities created by its existence, and that the greatest danger is to continue on as if nothing has changed.

I believe that there are two important investment implications that stem from this sea change in the Narrative around Emerging Markets, which I’ll introduce today and develop at length in subsequent notes.

First, I think it’s necessary for active investors to recalibrate their analysis towards individual securities that happen to be found in Emerging Markets, not aggregations of securities with an “Emerging Markets” label. I say this because in the aggregate, Emerging Market securities (ETF’s, broad-based funds, etc.) are now the equivalent of a growth stock with a broken story, and that’s a very difficult row to hoe. Take note, though, the language you will have to speak in this analytic recalibration of Emerging Market securities is Value, not Growth, and the critical attribute of a successful investment will have little to do with the security’s inherent qualities (particularly growth qualities) but a great deal to do with whether a critical mass of Value-speaking investors take an interest in the security.

Second, there’s a Big Trade here related to the predictable behaviors and preference functions of the giant institutional investors or advisors that – by size and by strategy – are locked into a perception of Emerging Market


meaning that can only be expressed through aggregations of securities or related fungible asset classes (foreign exchange and commodities). These mega-allocators do not “see” Emerging Markets as an opportunity set of individual securities, but as an asset class with useful diversification qualities within an overall portfolio. So long as market behaviors around Emerging Markets in the aggregate are driven by the Barzini/Bernanke Narrative, that diversification quality will decline, as the same Fed-speak engine is driving behaviors in both Emerging Markets and Developed Markets.

Mega-allocators care more about diversification and correlations than they do about price, which means that the selling pressure will continue/increase so long as the old models aren’t working and the Barzini/Bernanke Narrative diminishes what made Emerging Markets as an asset class useful to these institutions in the first place. But when that selling pressure dissipates – either because the Barzini/Bernanke Narrative wanes or the mega-portfolios are balanced for the new correlation models that take the Barzini/Bernanke market effect into account – that’s when Emerging Market securities in the aggregate will work again.

You will never identify that turningpoint in Emerging Market security prices by staring at a price chart. To use a poker analogy you must play the player – in this case the mega-allocators who care a lot about correlation and little about price – not the cards in order to know when to place a big bet.

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VIX ETN NOT RIGHT FOR INVESTORS
BY TOM MCCLELLAN

Editor’s note: This was originally published as a Chart in Focus by McClellan Financial Publications on January 02, 2014 and is reprinted here with permission.

In the Dec. 16, 2013 issue of Forbes magazine, the editors offer their list of "365 Ways To Get Rich" with their 2014 Investment Guide. #100 on the list is this suggestion: "Profit from stock market volatility: Buy into a VIX futures fund and use wild, seemingly irrational swings as buying opportunities."

The most commonly known VIX futures fund is VXX, the iPath S&P 500 VIX Short-Term Futures ETN. And while it might be a useful trading vehicle for someone looking to trade extremely short term moves, it is a horrible idea for "investors".

The share price history of VXX has a terribly negative bias, and it has ever since it debuted back in 2009. VXX ended 2013 at a price of 42.55 (unlike SPY or GLD, VXX's numerical price is not directly related to the numerical value of the VIX). That is down huge from its March 2, 2009 high of 7449, when we adjust for 3 separate 1 for 4 reverse splits.

This persistent negative bias has to do with the nature of the VIX futures contracts that VXX invests in. Most of the time, those futures contracts have a contango to their pricing, meaning that the price is higher the farther out into the future you go for a contract's expiration.

The table below shows the closing prices for VIX futures as of Dec. 31, 2013, extending out through the September 2014 contract (the furthest one currently open). You can see that all of the contracts are priced higher than the spot VIX Index, and the further out you go, the greater that premium is.
As of this writing, VXX currently has its holdings divided between the January (F4) and February (G4) 2014 VIX futures contracts. As the January contract nears expiration, the folks at iPath will have to replace it with the March contract (H4), and presumably at a higher price. That price premium will then decay back down toward where the spot VIX is as the contract nears expiration. So VXX shareholders are continuously being victimized by the "roll" to later expiration month contracts, with that ETN buying higher and then selling lower, and repeating. That explains why the VXX's long term "performance" has been so awful.

That does not mean VXX cannot be used for very short trading periods, when a rising VIX pushes up the prices of its futures contracts, and when the effect of the roll to the later contracts is not an important factor. But for investors with a longer time horizon, owning VXX can be a hedge against a portfolio ever making any money.

Interestingly, just as the roll to later contract months can hurt investors in VXX, that same factor can help others. XIV is an ETN sponsored by VelocityShares which is designed to move inversely to the VIX. So if the stock market were to be making a short term price bottom, with the spot VIX up at a high level, then a trader could own shares of XIV to play the possibility of the VIX coming back down. In other words, with a long position in XIV, a trader can be short the VIX.

And unlike VXX, which gets hurt by the roll to later contract months, XIV gets the benefit of that roll by shorting VIX futures at a higher price, and then harvesting the benefit of the decay as each contract's price moves back closer to the level of the spot VIX Index. It is for that reason that XIV has a positive bias relative to what the actual VIX does.

You can see that XIV does move inversely to the VIX in the short run, and the magnitude of those movements can be quite violent. But the longer term trend is decidedly upward, owing to the profit factor from harvesting the contango by shorting VIX futures contracts at higher prices further into the future.

Because the VIX has a reliably inverse relationship to the S&P 500, and because the XIV moves inversely to the VIX, many traders have figured out that they can use XIV as a leveraged proxy for the S&P 500. Since January 2011, the daily percentage changes in the S&P 500 and XIV have a correlation coefficient of +0.82, and a "beta" (leverage factor) of 3.19. In other words, if the S&P 500 were to move up or down by 1%, then the
expectation would be that XIV would move by 3.19% in that same direction. It does not always work out perfectly that way every day, but on average that is their relationship.

And in addition, XIV gets a performance enhancement by harvesting the contango as mentioned above. Here is a chart comparing the S&P 500 to XIV for the past 3 years:

![Chart comparing S&P 500 to XIV for past 3 years](chart.png)

Since January 2011, the S&P 500 has grown 45%, but XIV has grown 178%, adding up to 33 percentage points of alpha over that 3-year period. It has not been a very smooth advance though, as some significant drawdowns have occurred over that period. Most notably, the big drop in 2011 took XIV down 74% from its high that year to its low. There were not enough months of harvesting contango to make up for the negative effects on XIV from that big rise in the VIX. So investors and traders really can get hurt.

But in a period of a rising stock market, traders who can enter and exit efficiently and who can stomach the higher beta may find the XIV a useful trading vehicle, turning the problem of the roll to higher price futures contracts to their advantage. Please note: I am not advocating that anyone adopt such a trading scheme, and I never recommend the use of any individual securities or trading plans. My purpose here is to help educate readers about how these products work.

Tom McClellan has done extensive analytical spreadsheet development for the stock and commodities markets, including the synthesizing of the four-year Presidential Cycle Pattern. He has fine-tuned the rules for interrelationships between financial markets to provide leading indications for important market and economic data.

Tom is a graduate of the U.S. Military Academy at West Point where he studied aerospace engineering, and he served as an Army helicopter pilot for 11 years. He began his own study of market technical analysis while still in the Army, and discovered ways to expand the use of his parents' indicators to forecast future market turning points.

Tom views the movements of prices in the financial market through the eyes of an engineer, which allows him to focus on what the data really say rather than interpreting events according to the same "conventional wisdom" used by other analysts. In 1993, he left the Army to join his father in pursuing a new career doing this type of analysis. Tom and Sherman
spent the next 2 years refining their analysis techniques and laying groundwork. In April 1995 they launched their newsletter, *The McClellan Market Report*, an 8 page report covering the stock, bond, and gold markets, which is published twice a month. They utilize the unique indicators they have developed to present their view of the market's structure as well as their forecasts for future trend direction and the timing of turning points.

A *Daily Edition* was added in February 1998 to give subscribers daily updates on their indicators and also provide market position indications for stocks, bonds and gold. Their subscribers range from individual investors to professional fund managers. Tom serves as editor of both publications, and runs the newsletter business from its location in Lakewood, WA. He can be reached through the *McClellan Financial Publications* web site.
Investment Courses For Professionals
A sample of a growing list of fundamental and technical courses is shown below. The courses are associated with global destinations and dates, both for open and private client formats. They are produced by various knowledge vendors throughout the world. Details can be provided by contacting NYIF.COM, or John Palicka (palicka@pipeline.com).

Taught by John Palicka CFA CMT

FUSION ANALYSIS-
This is a professional approach that blends fundamental, technical, behavioral and quant strategies.

EQUITY PORTFOLIO MANAGER-
Serious managers will utilize this course to analyze leading Wall Street valuation models and investment strategies for equities using fundamental, behavioral/technical and quant approaches, and then study how these are modified by the best performing equity portfolio managers to produce risk-adjusted excess returns.

INVESTMENT FUND SELECTION-
This is a must attend course for all professionals involved in the selection and management of third-party investment managers.

TECHNICAL ANALYSIS CMT 1-
A must attend course for investment professionals wishing to gain the CMT Level I professional qualification in Technical Analysis from the Market Technicians Association (MTA).

INTRODUCTION TO STEALTH TRADING USING FUSION, ALGORITHMS, AND DERIVATIVES FOR PROFESSIONALS-

Today, portfolio managers increasingly must use stealth trading in order to disguise their intentions and thus benefit from best execution.

ADVANCED CAPITAL MARKETS ANALYSIS
Spot, forwards, futures, swaps, options, and statistical issues are discussed in dynamic capital market strategies.

STRATEGIC GOLD INVESTING
Gold has been one of the very few assets to have created wealth in the past several years. Gold offers investment opportunities for investors, traders, and financial engineers.

GLOBAL SMALL CAP INVESTING
Global small cap stocks offer investors the ability to participate in the world’s future big winners.

PORTABLE WEALTH INVESTING
Portable Wealth (PW) management offers investment opportunities for wealthy investors and their advisors. PW can generate attractive risk-adjusted excess returns to traditional and alternative investments.

Instructor John Palicka CFA CMT is a top-ranked portfolio manager of Global Emerging Growth Capital (WWW.GLGEGC.COM) with over 30 years experience of managing $ billions. He has doubled client money, on average, every 4 1/2 years since 1980*. His high course ratings from major investment firms reflect clear interpretations and practical applications of complex topics; knowledge applied to examples and cases found in the current worldwide and GCC marketplace; his experience with specific situations actually encountered in his career and consulting contracts that parallel the learning topics. John has an MBA from Columbia University and also teaches these courses for leading training institutions, including The New York Institute of Finance (WWW.NYIF.COM).

* Past performance is no guarantee of future results.
ASSESSMENT OF INSIDER TRADING INFORMATION FOR INVESTMENT STRATEGIES
BY SCOTT STRONG AND TUCKER BALCH, PH.D.

Editor’s note: This was previously published at The Augmented Trader and is reprinted here with permission. Dr. Balch will be a presenter at the MTA Annual Symposium in April. This paper demonstrates how he applies insider transaction trader and offers a detailed look at his thought process.

Overview

Lucena Research has evaluated the InsiderInsights Company Ratings database as an information source for an event-based study. In this white paper we provide a brief background concerning insider trading information, implement an event study with the data and conclude with back tests to assess the effectiveness of the information in trading.

Overall, our analysis shows that the data provided by InsiderInsights has persistent and meaningful value.

Background on insider trading information

(The information in this section is excerpted from the book “Profit from Legal Insider Trading”)

It should come as no surprise to anyone that insider trading occurs every day in the stock market. What might surprise investors is that most of it is done with the full knowledge and sanction of the U.S. Securities and Exchange Commission (SEC).

This isn’t the sort of insider trading that has made Ivan Boesky infamous. He profited from trading on material, non-public information provided to him by a network of informants. The activity we refer to is the trading by directors and executives in their own companies’ shares. This “insider trading” is not only legal, it is reported by executives to the SEC via a document called a “Form 4”.

This legal insider data, and that provided by other SEC documents, is a great source of investment ideas no matter what style you prefer. It’s also invaluable for following stocks you already own. After all, who’s in a better position to know a company’s prospects than its own management? Corporate insiders obviously have access to the same material, non-public information that sent Mr. Boesky and his friends to jail–only they can act on it in many cases!

Obvious abuses by corporate insiders, such as purchasing large amounts of shares just before their company is acquired at a premium, still aren’t allowed, of course. Most publicly traded companies now also have internal guidelines that only allow their executives to trade during certain “windows” of time. But an executive can hardly forget what he or she saw in the last sales report or heard in the last strategy meeting when on the phone to a broker. There is undoubtedly plenty of important, non-public information influencing insiders’ investment decisions regarding their own firms’ shares.
By analyzing the Form 4s filed at the SEC, you may not know what these insiders know, but you can certainly know what they do. And this information is arguably just as good.

Academic studies have proven that this SEC data is useful for garnering “excess returns” in stocks. A more important testimony comes from institutional investors, many of whom have successfully used the SEC’s insider data to help make their investment decisions for years.

**Background and Related Work**

The key hypothesis of this work is that legal insider trading activity, whether buying or selling, reveals information that can be used to predict the future performance of the associated company. If true, this supports a conclusion that, given recent insider trading activity information, a profitable trading strategy can be created.

In this article we show how the insider information extracted from the InsiderInsights Company Rating database can be utilized to create a successful trading strategy. Specifically, we:

- Introduce the concept of event-based analysis applied to finance and apply it to the InsiderInsights Company Rating data.
- Determine a suitable purchasing trigger and holding period based on event analysis results.
- Develop an event-based trading strategy using the determined trigger and holding period and simulate (back test) it using realistic models for transaction costs

This research builds on the concepts presented in work by J. H. Lorie and V. Niederhoffer of the University of Chicago (1968) and many others suggesting “that proper and prompt analysis of data on insider trading can be profitable”. In their study, it is asserted that insider trading activity, particularly an accumulation of insider buying, has a persistent and positive impact on the stock price up to six months into the future. In addition, Lorie et al. call for the SEC to “provide faster and more complete dissemination of insider trading data” to allow for a more actionable data source.

In our research we confirm that, with a prompt and accurate data feed provided by InsiderInsights, we can indeed create a profitable strategy using insider trading information.

**Data**

The InsiderInsights data that is used for this research is an aggregation of many different data points into a single company rating on a particular date in which significant insider trading activities took place.
To begin, an insider is defined as an officer or director of a public company, or an individual or entity owning 10% or more of any class of a company’s shares (SEC Act of 1934). Provided this definition, the company rating is borne out of information obtained by InsiderInsights from SEC filings and other data sources including the following factors:

- Size of insider transactions (dollar value and percentage of insider’s holding)
- How many insiders are acting in the same way
- Track records of insider’s trading
- Whether and how an insider of one company is trading at another company in which he/she is an insider
- Overall acceleration/deceleration of insider activity
- Price action of the stock the insiders are trading

All of these factors are then mapped to a rating scale from -3 (Extremely Bearish) to 3 (Extremely Bullish) as shown below in Figure 1.

Additionally, we use stock price/volume data from a separate data provider which supplies daily close information adjusted for splits and dividends. Overall, this study includes data spanning 10 years, from 2003 to 2013, using nearly 4,600 symbols and over 13,000 individual ratings.

**Methodology: Event Studies**

The basic drive of this research is to determine if information exists in the ratings that were created from the InsiderInsights raw data. To accomplish this, we use a technique introduced to finance by A. C. MacKinlay (1997) called event studies or event-based analysis. An example of this technique is depicted in Figure 2. It can be seen that after the day of the event (Day 0), firms having positive news events do better on average in future return when compared to firms that have no news (the opposite is also true).
Figure 2: Example event study based on news relating to stocks. Positive news has a positive effect on future prices.

An extension of this concept can be made to analyze any type of event-based data source, including insider trading information. An analyst can then observe how equities behave on average after the occurrence of an event. We examine these signals using QuantDesk’s Event Analyzer software. Figure 3 shows this technique applied to the InsiderInsights Company Rating Data, where Bins 0 and 1 represent bearish sentiment (0 – More Bearish, 1 – Less Bearish) and Bins 2 and 3 represent bullish sentiment (2 – Less Bullish, 3 – More Bullish).

Note that both of the bullish events show positive return, on average, after the event.

As can be observed from Figure 3, the data seems to contain information on average. In addition, positive ratings are generally more profitable when compared to negative ratings. We will focus on positive ratings for the remainder of this paper and implement a long position only strategy to test the profitability of the positive indicator. The threshold from the above figure shows that any rating at or above 0.5 will, on average, result in a positive return. In addition to this, a holding period of approximately 15 days was determined to be an optimal mix between risk and return (denoted by the diamond markers for each bin).

**Methodology: Back Tests**
An event-based trading strategy was implemented using a full transaction-based simulation, including realistic modeling of transaction costs, using the threshold and holding period defined by the above event study.

![Figure 4](image)

Figure 4: Back test of the event driven strategy discussed in the text. Performance of the strategy is illustrated in green. The purple line represents the performance of the S&P 500.

The strategy simply purchases shares of companies that have had a new rating that is at or above 0.5 and exits the position 15 days later. In addition to this, a stop-loss and stop-gain of +/-5% was added to eliminate extremes on both the up and down side for each individual position. Each time an event is triggered 50% of the portfolio value is allocated (if less is available, the remaining amount will be allocated). If more than one event occurs on a single day, the total allocation for that day (50%) will be split evenly among all of the events that day (limit 10 events per day).

Transaction costs are modeled with commissions of $0.0035 per share or $5.00 minimum, and slippage estimated at 5 basis points (bps) for each transaction (indicating that the price will move against the trader by 0.05% when entering and exiting a position).

We present the performance of this strategy using the S&P 500 as a benchmark in the figure below.

This back test shows very promising results, demonstrating that even with the presence of transaction costs, this strategy has alpha over the market with an average annual return of approximately 14%.

![Figure 5](image)

Figure 5: Randomized control back test.

As a control, a series of ten random tests were run to determine if any bias exists within the data. Each test uses the exact same distribution of rating data as the above test, but the data points are randomly scrambled within
the database. A sample performance of the control experiment is provided below.

Over the ten control tests, the average total return was 16.35% compared to the strategy’s 85.7% and the average Sharpe Ratio was 0.18 compared to 0.96 for the strategy. The performance of the control portfolios clearly show the alpha that is present in the data being used and the strategy implemented.

More detailed back test reports, including specific transactions are available from Lucena Research upon request.

**Discussion**

We show that the use of insider trading information, provided in a prompt and accurate manner can inform a profitable trading strategy. By using the InsiderInsights Company Rating data combined with event analysis, we defined a suitable event-based strategy to test this hypothesis. The data and strategy together were evaluated through three tests in total:

1. An event study to show initial value in the data.
2. A back test simulation using the defined threshold and holding period with transaction costs.
3. A set of 10 random control simulations with transaction costs

It was shown that the defined strategy significantly outperforms the random control experiments. This suggests that there is information that can be successfully extracted and utilized in the InsiderInsights Company Ratings data.

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He teaches courses in Artificial Intelligence and Finance. Balch has published over 120 research publications related to Robotics and Machine Learning. His work has been covered by CNN and by New York Times. His graduated students work at Goldman Sachs, Morgan Stanley, Citadel, AQR, and Yahoo! Finance. He can be reached at tucker@lucenaresearch.com
INTERVIEW WITH BRUCE KAMICH, CMT
BY AMBER HESTLA-BARNHART

How would you describe your job?

My job and current passion is teaching technical analysis (TA). I am an adjunct professor of finance at Baruch College in New York City. Every semester I work hard to teach a lifetime skill (TA) to eighty, 20-30 year old students from various backgrounds and experiences.

For the past fifteen years I have been combining old school and new school approaches. On the first night of classes students select a stock to follow and chart by hand from the IBD top 50 list. The CANSLIM methodology is covered later in the semester. Students must enter a real time trading contest. The contest could be FX or stocks or commodities. There is homework to convert the classroom theory into practice. But teaching has gone beyond chalk and talk - today you need to have access to videos, online discussion boards and extra readings without making a trip to the library. We spend three nights in the state of the art trading room at Baruch and have a number of guest lectures from other teachers and professionals.

In addition to covering a lot of new material with the students I encourage them to join the MTA and attend the New York meetings when possible. Outside of the classroom I mentor students, write references and consult with the student run investment fund.

What led you to look at the particular markets you specialize in?

It was chance or luck. When I got out of university it was one of the worst bear markets on Wall Street - 1973. I couldn’t break into the equity markets with firms closing left and right. I remember having an interview with the manager of the big Grand Central office of the firm of Dupont Glore Forgan. This was a Monday. I called back on Friday to follow up for a second interview and phone rang and rang. They were closed. New York and Hartford (the insurance industry) was closed to someone with no experience and people with experience were out of work. The first job opportunity for me came in the commodity markets. For three years I worked as a commodity researcher in a small consulting firm. This is where I met Steve Nison. For the past forty years I have followed the commodity markets. In those three years I saw more bull and bear markets that most people do not see in their entire careers.

When commodities peaked in 1980 I was lucky to get a job in the fixed income market. For the next eighteen years I rode the bond bull learning hedging and trading and creating a few bond market indicators along the way.

Do you look at any fundamental of economic inputs to develop your opinions?

Sure - you have to have an idea if we are looking at an expansion or a contraction in the economy. You need to look at the dollar and the direction of interest rates, both of which I consider fundamental inputs.

What advice would you have for someone starting in the business today?
My best advice for someone starting out and this is what I would tell my students:

- Learn about all the markets.
- Develop good/great presentation skills.
- Keep up with technology.
- Be prepared for or think about hyphenated job descriptions. A sales-trader the traditional sell side technical analyst job is gone but someone with a technical background can add color to recommendations or sell research...or market technical products

What is the most interesting piece of work you've seen in technical analysis recently?

Clouds.

What research area do you think offers the greatest potential in technical analysis at this time?

I would have to say cycles. This approach is not widely followed, but if you believe that history tends to repeat itself then you have to add cycles to your "tool box."

Bruce Kamich, CMT, brings to the table 40 years of Wall Street experience. Starting out as a commodity researcher he soon found how important technical analysis and timing was to be successful in the markets. Over the years he has learned about the fixed income markets, equities and ETFs at top firms like Merrill Lynch and Smith Barney. Bruce is both a past president of the MTA and the MTA Educational Foundation. He is the author of “How Technical Analysis Works” – one of Barron’s top picks for 2004 and “Chart Patterns” in 2009. He enjoys passing on his wisdom and technical skills to the next generation as an adjunct professor of finance at Baruch College in New York City. You can follow him on Twitter @BruceKamich
NY FED MODELS FORECASTING EXCESS RETURNS THROUGH 2018 ENCOUNTER THE YEAR OF THE HORSE, VALUATION MEAN REVERSIONS, & GEORGE LINDSAY’S THREE PEAKS AND A DOMED HOUSE

BY JOHN BOUGEAREL, CMT

The NY Federal Reserve has an equity research department. Their research department determined in 2013 that “stocks are cheap” and investors should enjoy “excess high returns” in an abnormally low or negative real interest rate environment for the next five years through 2018. Before reviewing potential mean reversions, implications from the Year of the Horse, & George Lindsay’s bearish Three Peaks and Domed House model, let’s attempt to quantify the NY Fed models and determine how high the Dow Jones might climb if it is to enjoy “excess high returns” through 2018.

Goldman Sachs research team, based on their earnings growth models, forecasts the S & P 500 to rally a modest 19% to 2200 by 2016 from the 2013 close. That amounts to roughly 6% annualized returns for the next three years in US equities, an amount that hardly qualifies as “excess high returns.”

The two behavioral models shown below suggest the Dow can rally another 30 - 50% by 2016. The first model correlates the March 2009 negative real rate environment to the June 1949 negative real rate environment low. This model targets 21,000 by 2016. The second model correlates the March 2009 negative real rate environment low to the March 1980 disinflationary low. That model targets 24,000 by August 2016, about 50% higher than today. It seems a disinflationary environment may be better for equities than a negative real rate environment.

2014 is the Year of the Horse and the 4th year in a Decennial pattern. In the next chart, vertical lines are placed on the Year of the Horse dating back to 1906. With the exception of 1954, the Year of the Horse finds the Dow Jones down at least –11% from the previous year’s close at some point during the year before rebounding.

The 4th year in the Decennial pattern dating back to 1974 has produced mixed results for investors. In 2004 and 1994, the Dow ended up just 3%
and 2%. In 1984, the Dow ended the year down (–2%). In 1974, the Dow was down 28%.

The Year of the Horse and the 4th Year in a Decennial Pattern

Decennial and “duodecennial” (year of the horse) observations are not stand-alone rationales for making investment considerations. Duodecennial observations should be supported by other considerations, such as mean reversion tendencies, valuations and long-term pattern recognition. We will turn our attention to those topics now.

The Fed decision to reduce asset purchases beginning in January 2014 represents a shift in a policy that it has pursued for the past five years. As such it is an attempt at mean reversion. QE policies have indirectly been supporting US equity prices for the past five years. The positive correlation between QE and stock prices has been running at 0.9 or higher. For instance, when QE1 was removed in mid-2010, the stock market corrected. Deflating equity prices that summer may have been a precipitating factor to Bernanke’s QE2 telegraph from Jackson Hole, WY in late-August 2010. (Which came first the chicken or the egg? We don’t know). The partial removal of QE3 and QE4 may be a precipitating factor to a potential valuation mean reversion in US equity prices. Likewise, the onset of “QE5” in response to deflating equity prices (or deflation more generally) would likely spark yet another stock market rally.

Regardless of the partial removal of Federal Reserve asset purchases, historical evidence shows that financial markets themselves tend to revert after trending strongly for three to five years. The historical examples below show mean reversions after a five-year run into 1937, 1987 and 2007, along with one four-year mean reversion in June 1946. This most recent bull campaign fell just one quarter shy of 5 years. Four- to five-year mean reversions in the Dow Jones exhibit a tendency to lose 25% or more of the index value.
Mean Reversion Tendencies

Based on current valuation metrics, the Goldman Sachs global research team downgraded the S&P 500 in January 2014 to underweight based on the risk of a 10% drawdown. (Goldman is probably underestimating downside risks by a wide margin—and I will address that shortly). From David Kostin: “S&P 500 valuation is lofty by almost any measure, both for the aggregate market (15.9x) as well as the median stock (16.8x). We believe S&P 500 trades close to fair value and the forward path will depend on profit growth rather than further expansion of the forward P/E from the current 15.9x... further P/E expansion will be difficult to achieve. ...The forward P/E ratio for the S&P 500 during the past 5-year, 10-year, and 35-year periods has averaged 13.2x, 14.1x, and 13.0x, respectively. At 15.9x, the current aggregate forward P/E multiple is high by historical standards.”

The Goldman Sachs research team believes that from this point forward it will be earnings growth rather than multiple expansion that will have to drive the stock market higher between now and 2016. Based on their earnings growth models, they believe the S&P 500 can reach 2200 by 2016. If forward earnings grow 10% each year between now and 2016, the 2016 forward earnings forecast will be roughly $145 and the S&P 500 will have to trade at a 15.3x forward earnings multiple (the Jan 2014 forward earnings multiple) to reach 2200 by 2016.

The chart below pencils in a potential 21% decline, bringing the S&P 500 to the 12x forward earnings multiple at 1450 in 2014, before heading towards 2200 in 2016. The 15.3x forward multiple at the end of 2013 was more than two multiples greater than the average 13x forward multiple. The baseline scenario suggests a mean reversion of one or two multiples below the average 13x forward multiple. The actual correction may be greater or less than a mean reversion to the 12x forward earnings multiple. Also penciled in our chart are rebounds to Goldman Sach’s 2200 price target for 2016 from the 13x forward multiple, the 12x multiple, and the 11x multiple.
Mean Reversions to a Lower Forward PE Multiple and Goldman’s SP500 Earnings Growth Model Price Target of 2200 by 2016

The George Lindsay Three Peaks and a Domed House model that I will illustrate in the pages that follow theoretically implies a round trip to the October 2011 low. As important as the Domed House model is for identifying tops and bottoms, I do not believe the theoretical model at this juncture will allow the market to bottom that low (partial explanation to follow).

While above 1800, Goldman’s Kostin noted that 1) the current forward P/E multiple is high by any historical standard and 2) that further multiple expansion is unlikely.

Under these conditions, Goldman sees risk of a 10% stock market correction, the kind of correction that is dismissed by most investors. But as we saw on the previous chart, a mean reversion to the average annual P/E multiple of 13x forward earnings, means the S&P 500 needs to correct 15%, not 10%. By using Goldman’s forward multiple valuation metric, we see Goldman understates what the size of any looming correction should entail for traders and investors.

Also, historical evidence suggests that mean reversions following five-year bulls have a tendency to lose 25% or more. For higher beta stocks, the risks would be far greater.

Mean reversions greater than 20% following five-year bull campaigns are consistent with the multi-year topping pattern described by George Lindsay known as Three Peaks and Domed House.
There are two floors to the Domed House, followed by a dome itself, before the stock market reaches its peak. Both the first floor and the second floor hammer out some sort of triple top or “three peaks” pattern, then the stock market flushes before heading higher. The Dow tops out on what Lindsay calls point 23, after which a bear market ensues that returns the stock market to its point 10 low before bottoming.

This is the theoretical model. Now let’s look at some actual models, beginning with the present day Three Peak and a Domed House and then look back to the Three Peaks and Domed Houses from 1929, 1973, and 2000.

Between the two sets of “three peaks” that hammered out the first and second floor is a new count that represents a shift in Lindsay’s theoretical count. It is no longer just 23 points to the Dome. The new count features 25 points to reach the Dome. An extra two points (15 & 16) were added to this count when the fiscal cliff crisis came up in the second half of 2012 and was resolved in November 2012.

*If you are looking for the count to end on point 23, you might get lost on the pattern.* The key attribute to look for is the dome to form via a zig-zag pattern after the second set of “three peaks” - hence the name, three peaks and a domed house. That is the pattern “tell” informing investors and traders that the “end is nigh.”

The theoretical implication of the Lindsay theory is that a bear market will ensue and retrace to the point 10 low set in October 2011. But I hypothesize that is too low a target. You will see I traced out a theoretical bear market correction that takes the Dow only back to the November 2012 QE3 low at 12,471. The November 2012 low is roughly 11x 2014 forward earnings estimate, two multiples below the average 13x forward earnings (just as the recent high peaked 2x above the 13x average forward multiple).

Again, while there are many other contributing factors, a primary reason I ended the tracing near point 16 in the 12,500 to 13,000 price zone rather than the point 10 low is because of the low probability that our centrally
planned markets would allow the Dow to fall much below the November 2012 QE3 low before the Federal Reserve announces some sort of “QE5” program to put a floor under the stock market. What I am hypothesizing is that the correction ends at a much higher level than the traditional application of Lindsay’s theoretical model posits. Nevertheless, 25% will still be a big hurt and is in line with other historical 25% mean reversions after a five-year bull market.

Adding two points to Lindsay theoretical count of 23 to reach the Domed House is a novel twist. Hypothesizing a higher floor than the point 10 low is also new. This new Lindsay count may be partially attributed to the artificial distortions introduced by our policymakers.

The December 31, 2013 high at 16,588 appears to be the final high of the Domed House. From George Lindsay’s Three Peaks and a Domed House perspective, the Dow tops in 1973, 2000 and 2013 all feature a triple top pattern that began the prior spring and resolved to the upside with a final thrust off an October low. Always, the catalyst for the final thrust off the October low was some form of massive stimulus, either monetary stimulus from the Fed or fiscal stimulus from the US government.

A price reset to the November 2012 low equates to a mean reversion of approximately 25%. My working hypothesis is that the stock market can “reset” at or above the November 2012 low near 12,500 and then we will see another incredible stock market rally transpire in 2015-2016. A powerful stock market rally in 2015 would also be consistent with decennial tendency for strong bull markets in the 5th year of a decade and be consistent with Kostin’s idea of profit growth expanding in the years ahead.

Dow Commonalities

Note the triple tops that began in the spring of 1972 and 2013. The final thrust that began in October 1972 was related to the Fed’s massive increase in the money supply according to Edson Gould’s Findings and Forecasts in January 1973. I believe the final thrust in October 2013 was the result of the US government lifting the debt ceiling.

1973 and 2013 Domed Houses

As was the case with the 1973 and 2013 tops, the 2000 Three Peaks and Domed House features a triple top that began in the spring of 1999 followed by a final thrust off an October low. The final thrust off the October 1999 low was massive Y2K monetary stimulus. When Y2K never showed up to the
party, the Fed removed the liquidity they provided.

If you stayed with me this far, below you will find a bonus chart: the analog of the December 31, 2013 top to the September 3, 1929 high. The 2013 correlation to 1929 is not as strong as the 1973 and 2000 tops but the three peaks and a domed house pattern is present.

2014 BOARD NOMINATIONS

For the fiscal year commencing July 1, 2014, all four (4) Officer positions are up for consideration for a 2-year term (President, Vice-President, Secretary and Treasurer), and two (2) At-large Board positions are up for consideration for a 3-year term.

Members, Honorary Members and Emeritus Members in good standing are invited to submit recommendations for consideration to nominations@mta.org. Individuals may nominate themselves or others. For complete details on the Nominating Process, please visit the appropriate sections of the MTA Constitution and MTA By-Laws.

AUTHOR GUIDELINES

The Market Technicians Association serves a global community and the organization’s publications strive for articles that can be easily understood by readers around the world. To meet that objective, all submissions to Technically Speaking should be in English and minimize the use of vernacular phrases and references. This is necessary to improve the readability for international members who may not understand phrases commonly used in one region but unknown in most of the world.

In Technically Speaking, we want to publish articles that use simple language whenever possible. Specific terms associated with financial analysis in general and technical analysis specifically should be defined unless they are found in the MTA’s Body of Knowledge. The editors may have to make changes to any work that is published for clarity and consistency.

Submissions should not use text boxes or advanced text formatting, as they make it more difficult for our staff to implement into our newsletter layout.

Please send any material you would to have considered for publication before the 20th of the month. We will work to include anything received by that date in the next issue.