Continuum Global Asset Management, LLC

Are we going to get a Santa Clause Rally???

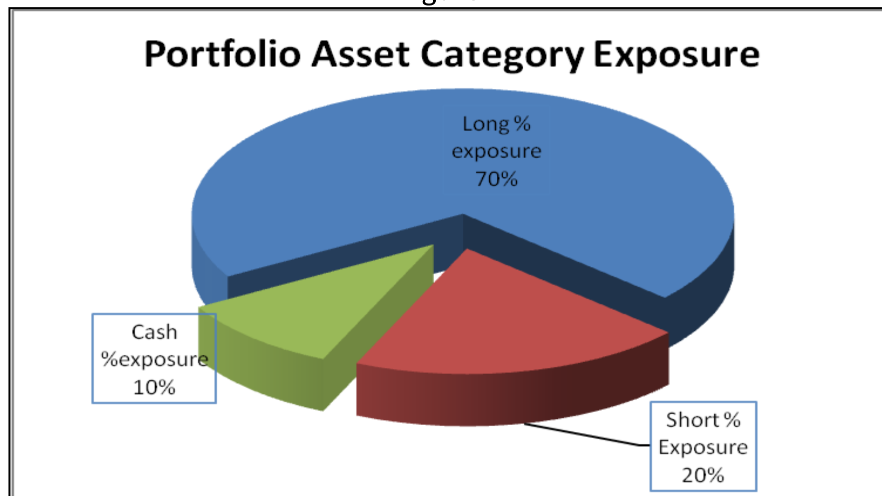
If we believe in the market cliches like the "January effect…", "Sell in May and go away…", and "October is generally a great month for a rally…", then we are all obviously waiting for a Santa Clause rally. Our October write-up had projected the broad based index (S&P 500) to gain approximately 11.5% for the next 12 months. The markets gained about 4% since.

Our market projection model based on a regression analysis of historical values of certain critical fundamental and technical variables is illustrated below in Table 1. We have made minor changes to the assumptions used for the market projection as illustrated below. A notable change was the increase of Price earnings ratio from 14 to 15, which is a result of our expectation of improving market sentiment. We have also reduced the expectation of the unemployment rate from 9% to 8.5%. The rest of the variables remain the same. We believe that once the European debt problems are resolved, markets will then focus on US economic fundamentals. Based on the positive developments in the US economy, we believe that the markets can grow by another 8-9% over the next 12 months as shown below.

Table 1

ASSUMPTIONS		**Market Projections**	
S&P 500 Earnings	$ 100.00	**S&P 500 (Projection) =**	**1,364.25**
S&P 500 PE Ratio	15	**S&P 500 (Current) =**	**1,225.19**
Treasury Bond Rate (%)	2.5	**S&P 500 (Gain/Loss) =**	**8.69%**
Inflation Rate (%)	3.2		
Volatility (VIX) Index	25		
Unemployment (%)	8.5		

Figure 1



With the European debt issues at the fore front, markets are experiencing a higher level of volatility due to the higher correlation between main streets in the world. In other words we are all progressively dependent on each other and the world continues to be threaded closer by the invisible hands of cross border trade and commerce.

Retail investors have limited time, temperament and talent to be consistently successful

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in investing. Studies have shown that that a long / short (Long: when an investor buys a security with an expectation of growth to the upside. Short: An investor benefits from the stock price decline) portfolio performs much better than long only portfolios. Most investors are invested in long only portfolios. The concept of long only portfolios is based on the premise that markets go up in the long term. Also, the truth of the matter is that it is very difficult to select companies that an investor can short.

In addition, a rising tide lifts all boats. Market's movement in either direction has a major impact on the movement of majority of the companies. We have therefore, developed an allocation that would use a certain portion of the portfolio allocated to the short side of the market. In other words, a natural hedge to the portfolio in case of major turbulence or markets corrections. This is how it works:

We have classified our market conviction based on three classes; Low, Medium and High Conviction. Based on a regression model, we have allocated percentage exposure to both the long and short portions of the portfolio. For example, with a growth potential of 8-10% for the market, we believe that a 70:20 long short exposure would be prudent. Similarly, if the model projects a declining market, we would then increase the short exposure and obviously reduce the long exposure.

A hedged portfolio is not always foolproof. There are a number of intricate nuances that an investor should consider before investing in this methodologyrr. Following are major points of consideration:

1. Protect the downside but cap the upside: A hedged portfolio is expected to protect an investor to the downside but remember, during a rally, this portfolio will not fully participate in the upside and may underperform the major broad based indexes.
2. A long short portfolio can be a double edged sword: The portfolio is constructed of long and short positions. These positions are stocks which are selected based on certain quantitative and qualitative variables. Stocks selection is a major part as poorly selected stocks can hurt the portfolio on both the long and short side. In other words, long stocks could underperform the market and short stocks could gain in value hurting the portfolio further.
3. Unlimited Loss: Theoretically, the short position can result in infinite loss as the price of a stock can theoretically go to infinite. Realistically, I have never experienced a stock to go to infinite in my lifetime.

Despite some of these major aspects of a portfolio, we at CGAM, believe that this is a prudent strategy for cautious investors who want to protect the downside at the cost of giving up some upside. Also, security selection is a major part of this strategy and risk mitigation techniques like stop losses or put protection can and should be used on the security level.

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