Continuum Global Asset Mgt., LLC
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Newsletter

Statistics show that 2008 was one of the most tumultous years for domestic and global markets since the great depression in the 1930s. Readers need not be reminded of the doom and gloom of 2008, but I would like to share my observations regarding the unprecedented market events and inferences that would be useful for 2009.

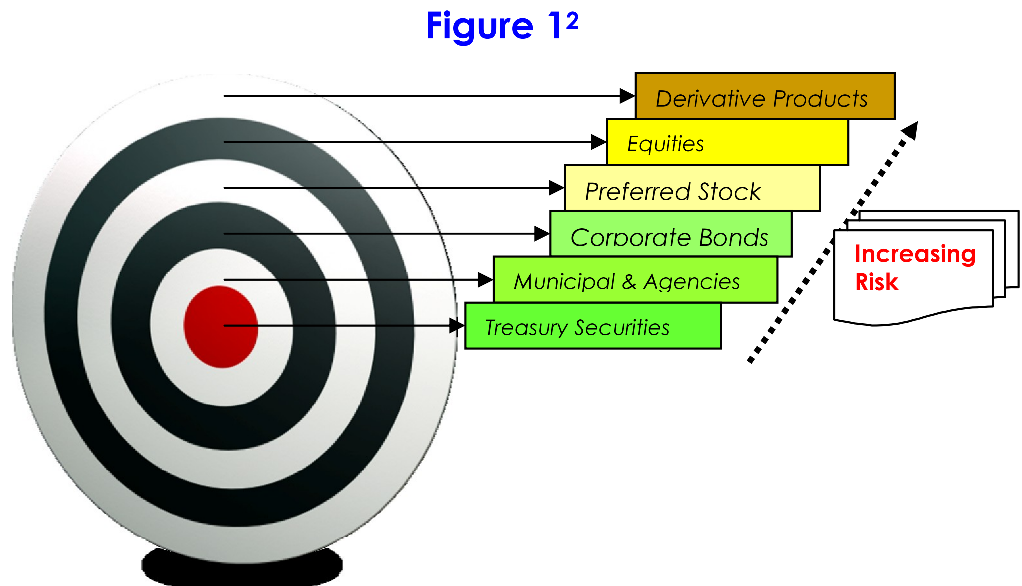
Under normal circumstances, investors view the risk associated with different asset classes as illustrated in Figure 1 below; US Treasury securities being the safest and derivatives being the riskiest[1]. In other words, as investors desire higher returns, they start gravitating towards the outer rings of the target shown below, with an acceptance of higher risk for the desired returns. This is known as the risk premium, built into respective securities. Its important to consider and understand how this phenomenon catalyzed the movement of the markets in 2008.

2008 brought the dire housing crises and the problems associated with mortgage related products, fueling the fear level in the capital markets to unprecedented levels.

As large number of domestic and global institutions (including hedge funds, mutual funds and even insurance companies) had already invested heavily in these securities, fresh buying activity virtually came to a halt.

Major financial institutions started to liquidate their holdings in these products creating a downwards spiral in valuations within the industry.

Figure 1[2]



This obviously created a buy/sell imbalance resulting in liquidations at fire sale prices. As liquidations of most of these products were done at significant losses, it put immense pressure on balance sheets of many institutions. US and international accounting guidelines expect institutions to report their financial positions to investors as marked to market. In other words, the securities held on their financial statements are to be reported at current market values. This means that even if an institution holds a security till maturity with an expectation to recoup some or all of its investment, it has to report the diminished value currently commanded by the market.

The most important point to illustrate is that as major financial institutions report substantial losses, investors started to panic and loose faith in the viability of these institutions, comprising of the US banking system. Both institutional and retail investors started to gravitate towards the middle of the target shown above; investing in US Treasury securities as they liquidated riskier investments. This phenomenon got so exxagerated that during the fourth quarter of 2008, investors couldn't decipher between the safety of Municipal bonds or the risk of equities. Liquidations were experienced amongst all major asset classes, as investors raised cash and took shelter under the US treasury umbrella. The panic and the irrationality of investors reached a point of significant deviation from a historical perspective, as municipal bonds were yielding 10-12% higher than treasuries during Q4, 2008. Similarly, corporate bonds and preferred stocks also experienced one of the worst declines in Q4, 2008 since the 1930s.

[1] *These securities do not include investments in private equity and limited partnerships*
[2] *Source: Continuum Global Asset Management LLC*

17991 Lost Canyon Rd., Suite 138
Canyon Country, CA 91387
Manu Walia
Email: manuwalia@cgamadvisor.com
www.cgamadvisor.com
Office: 661-299-1920
Mobile: 661-312-2070

The aggregate investor sentiment determines the short and intermediate movements in various asset classes. During times of euphoria and similarly panic, market participants over react and valuations overshoot in respective directions. The intensified fear and panic selling resulting in the recent carnage, has created certain inefficiencies that in my view can be taken advantage of:

Shorting the Treasury: What!!!

Chart 1

I believe that there has been undue demand for the US treasury bonds as most investors have raised a significant amount of cash during 2008. In addition, the US government has issued a large amount of debt in the form of treasury securities that domestic and global investors have gobbled up. Following are major reasons for a bearish stance on the US treasury:

1. As capital markets stabilize, investors in my opinion will gradually start to invest their cash, (current Money Market accounts are at approximately $3.7 trillion) into riskier securities. This will put pressure on the treasuries due to money market liquidations invested in short/intermediate treasuries.
2. Most emerging countries have huge surpluses which have been invested primarily in Treasury securities. Due to the diminishing confidence in the US economy and therefore the need to diversify their surplus pools, these sovereign funds should start to gradually diversify. This would compel them to liquidate their current treasury holdings hence putting further pressure on treasuries.
3. The current interest rates in the US are at virtually their lowest levels. The federal government has pumped over a trillion dollars to stimulate the economy. At some point this excess liquidity could show its ugly face in the shape of inflation. The Federal government will then have to use a restrictive monetary policy and raise interest rates. This will also put tremendous pressure on the treasury.

Chart 1 illustrates the relationship between **PST (Proshares Short US Lehman Treasury),** a fund that shorts 7-10 year treasuries and the yield on the 10 year US treasury. I believe that based on the correlation, this fund has the potential to gain between 25-30%, if the 10 year treasury yield returns to the June 2008 levels of approximately 4% from the current level of approximately 2.2-2.3%.

High Yield Income Funds

If we believe in the US economy and hence the future of US corporations, high yield income funds could be a great way to harness attractive yields and potential for capital gains. Following is an example of a bond fund that invest in US coporate debt:

BlackRock Corporate High Yield Fund (COY):

1. **Current Yield: 17.9%, Price = $4.08**
2. 52 Week High- Low: $7.62-$2.65
3. Invests in US Corporate debt with current yield as the main objective.
4. The fund is diversified with bonds amongst Communications, Consumer Cyclical, Basic Industry, Capital Goods and Consumer Non Cyclical sectors.
5. Most bonds held are rated BBB or below, which indicates a high degree of risk.
6. Average duration of the bonds in the fund is 4.04 years.

Chart 2

Chart 1& 2 Source: Fidelity.com

National Municiapl Bond Funds

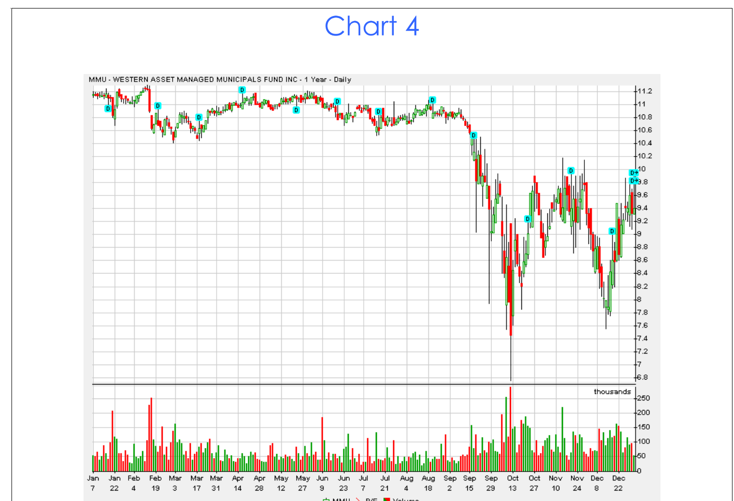
Following are two examples of Municipal bond funds with attractive yields and different time horizons:

Chart 3

EatonVance California Municipal Income Trust (CEV):

1. **Current Yield: 8.59%[3], Price = $7.99**
2. 52 Week High- Low: $14.43-$6.50
3. Tax exempt from Federal and (CA) state for residents.
4. The fund is diversified with bonds amongst Healthcare, special assessment, Education, Insured General Obligations.
5. Rating: 25% AAA, 29% AA and 29% A, 17% BBB or others.
6. Average weighted maturity of the bonds in the fund is 20.50 years.

Chart 4



Western Asset Managed Municipal Fund Inc (MMU):

1. **Current Yield: 5.79%[4], Price = $9.40**
2. 52 Week High- Low: $11.29-$6.75
3. Tax exempt from Federal tax.
4. The fund is diversified with bonds amongst Pre-Refunded, Healthcare, Other Revenue, Housing, Power and Transportation sectors.
5. Rating: 44% AAA, 31% AA and 17.5% A, 6.5% BBB or others.
6. Average weighted maturity of the bonds in the fund is 10.7 years with an average duration of 6.2 years.

The main objective of this Newsletter is to focus on the major market inefficiencies created by the irrationality of investors in the global capital markets during 2008. In addition, it is important to review the opportunity cost of investing in the safest security in the world (US Treasury Bond) vs. the rewards potentially to be reaped by investing in the next best asset classes.

Needless to say, each investor is unique and should invest to compliment their respective financial conditions and objectives.

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Chart 3 & 4 Source: www.Fidelity.com , Data Source: www.ETFCONNECT.com

17991 Lost Canyon Rd., Suite 138
Canyon Country, CA 91387
Manu Walia
Email: manuwalia@cgamadvisor.com
www.cgamadvisor.com
Office: 661-299-1920
Mobile: 661-312-2070