



ABSOLUTE TOTAL RETURN – SHAWN BLAU

Q4

The 4th quarter this year was almost the exact “mirror-image” of the 3rd quarter. Comparing the charts of the 3rd and 4th quarters, they almost looked like one of those old “Rorschach” inkblot tests that psychologists used to ask people what they saw in it.

In the 4th quarter, our ATR strategy benefitted especially from very strong gains in two of our main asset categories:

- 1) MLP’s – Energy Master Limited Partnerships (represented by the AMZ Index) had peaked in the 2nd quarter and then retreated. In the 4th quarter, the AMZ Index regained all the lost ground and then some, generating an annual total return of approximately 14% for 2011.
- 2) Closed-end Funds – Municipal Bond closed-end funds had fallen in August, with discounts from net asset value (NAV) widening substantially. In the 4th quarter, they rebounded. According to Morningstar, the average leveraged national Municipal Bond closed-end fund returned approximately 21% on a total-return basis in 2011.

The ATR strategy is designed to get the best of both the fixed-income and the equity worlds. Our vision is based on the premise that we are in a long flat market, with continuing periods of high volatility. We take advantage of the volatility to “lock in” reliable streams of income when the markets drop in unison.

We focus on investments that combine the benefits of distributing reliable income, along with the added benefit of achieving healthy growth in market price. Our companies have the cash-flow to maintain reliable yields over the coming one to two years. Like healthy growing shares, they also have the earnings-growth to increase their dividends or cash distributions over time, in order to keep up with (or exceed) the ravages of inflation. It’s not exciting, but it does build wealth by providing reliable streams of income, that can grow steadily over time for our investors to meet their financial obligations.

The striking symmetry between 3Q 2011 and 4Q 2011, can teach us some important technical lessons, and also some important fundamental lessons about how today’s stock market works. So let’s look at it closely, cutting through all of the distracting noise:

Technical Lessons

A) Here are the percentage changes for the 3 monthly periods in the 4th quarter, for the broad-market Russell-3000 Index. The Russell-3000 includes about 98% of the market capitalization of all publicly traded stocks in the United States, so it is the most widely followed broad-market US equity index:

10/3/11 – 10/27/11: Index gained approximately +18%
10/27/11 – 11/25/11: Index declined approximately -10%
11/25/11 – 10/31/11: Index gained approximately +9%

B) Compare this to the corresponding percentage changes for the 3 monthly periods in the 3rd quarter, for the same Russell-3000 broad-market US Index:

7/7/11 – 8/8/11: Index declined approximately -18%
8/8/11 – 8/31/11: Index gained approximately +10%
8/31/11 – 9/30/11: Index declined approximately -8%

Notice how each of the monthly changes in the 4th quarter in percentage terms, are almost the precise opposite of the corresponding monthly percentage changes in the 3rd quarter!

However, this teaches us a crucial lesson of portfolio management: It is much, much more important to out-perform the Index on the downside (in other words, to lose less than the Index on the downside), than it is to out-perform on the upside. This is somewhat counter-intuitive, until we look at it in detail.

Let's look at the math. The Index lost about 18% in July 7 – August 8. However, in order for an investor to make this up, they would have to make a lot *more* than 18% on the upside. Say an investor started with \$100 on July 7 and invested it in the Index. After the 18% decline, they would have been left with only \$82 on August 8. In order to make back that missing \$18, using only the \$82 in capital they had left on August 8, they would have had to gain a whopping 22%. That's a full 4 percentage points more than they lost on the downside!

So, the math tells us that if an investor loses 18% on the downside, they need to make back 22% on the upside, in order to come out even. Gains like that are rarer than hen's teeth in this kind of market. So, the market has taught us the unmistakable lesson that it is much more important to protect your capital in a falling market, especially when the market is volatile.

Fundamental Lessons

A) Don't fight the Fed:

These two "mirror-image" quarters also taught us some important fundamental lessons. The first is to corroborate the old adage, "Don't fight the Fed." The US Federal Reserve completed its second round of quantitative easing ("QE-2") in June 2011. The Fed announced its third round ("Operation Twist") on September 21, 2011.

So from the point of view of equity prices, quantitative easing did work. The month after the Fed's "QE-2" ended, the Russell-3000 Index *declined* 18%. The month after the Fed announced "Operation Twist," the Russell-3000 Index *gained* 18%!

Now, we know that "Operation Twist" is scheduled to end in June 2012. So we need to keep that in mind as we plan our portfolio management strategy. If and when there is another round of quantitative easing in 2012, the Fed may likely focus on the residential mortgage sector.

B) De-leveraging is still with us:

Another fundamental lesson that 2011 teaches us comes from looking at the best-performing sectors for the year. Investors were willing to pay for steady fixed-income yields, and for steady stock dividends.

1) The top 5 best-performing fixed-income ETF's in 2011 were:

Pimco 25+-Year Zero-coupon US Treasury Index (ZROZ) (up 54.22% in 2011)
iShares Barclays 20+-Year US Treasury Index (TLT) (28.82%)
SPDR Barclays Long-Term Treasury (TLO) (25.89%)
Vanguard Long-Term Govt Bond (VGLT) (24.62%)
Pimco 15+-Year US TIPS Index (LTPZ) (20.06%)

2) The top 5 best-performing US diversified stock ETF's in 2011 were:

Wisdomtree Dividend Top 100 (DTN) (up 8.29% in 2011)
Vanguard Hi Dividend Yld (VYM) (7.20%)
Wisdomtree Largecap Div (DLN) (6.36%)
First Tr Value Line Div (FVD) (6.10%)
Spdr Dow Jones Etf Tr (DIA) (5.38%)

The clear lesson is that "de-leveraging" is still with us. Investors are willing to pay for steady fixed-income yields, and for steady stock dividends.

C) Getting cash back from your investments

The third and final fundamental lesson that the market taught us is the following:

Investors need a strategy to get cash back from their investments in the stock market. Most investors ended the year about where they started, after having experiencing highs and lows in between. In order to prosper in this market, investors need to have a solid plan to get cash back from events that might include: dividends, stock-buybacks, mergers & acquisitions, private-equity buyouts, etc., etc.

Conclusion:

The ATR strategy watches these events, in order to maximize the long-term stream of cash returned to investors. As we said earlier, it's not exciting, but it does build wealth and reliable streams of income over time.

And in this kind of economy, we've already had all the "excitement" we can handle, anyway!