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Third Quarter Market Summary – Dr. Ray Hofshi

During the third quarter of 2009, the stock market exploded to the upside. The probability that we are in a new Bull market has been increasing over the past few months. As a result, we have been reducing our cash positions over that time frame. The speed and magnitude of this advance, however, was not predictable. In spite of the fact that our portfolios still have roughly 9% cash and one or two positions hedged with calls, we were able to hold our own in this market advance. Many of those who tried to time this market, by moving to safe havens, have been left in the dust.

During the third quarter the S&P 500 with dividends and Value Line Composite indices increased by 15.61 and 22.09 percent respectively. Over the last twelve months the S&P 500 index with dividends has declined by 6.91 percent. The Value Line index has declined by 14.450 percent over the same time period.

My portfolio actions during the third quarter were designed to reduce our cash position to roughly one portfolio position (i.e. 7-10% cash depending on the size of the portfolio). In some portfolios this was done by purchasing additional shares of depressed stocks already owned (re-balancing). In other cases, new portfolio positions were added from my buy list. The two new stocks presently on my buy list are Corning and Advanced Auto Parts.

TIMING MODEL

Due to the rapid rise in the market, the Timing model softened during the third quarter. It went from a reading of 60% last quarter, to a reading of 55% in the third quarter. Thus, it predicts a 55% chance of continued appreciation and a 45% chance of a decline over the next 3-6 months. After seven months of rapid appreciation, it would not be uncommon to have a significant correction (i.e. 10-15%) over the next month or two.

MARKET OUTLOOK & STRATEGY

We are now working in an environment in which the US recession is over, and a new Bull market has begun. Third quarter GDP declined at an annual rate of about 1 percent. The consensus economic estimate for fourth quarter US GDP is an annual growth rate of roughly 2 percent. Similarly, it is expected that the US economy will grow at a rate of 2-3 percent in 2010. Thus, while the economy is on the mend, the recovery is expected to be slow. Retail sales are recovering very slowly because the real unemployment rate is above 10 percent and still rising.

On the other hand, since the stock market bottomed in March, it has recovered roughly half of the loss generated by the recession. If measured from the March lows, the S&P 500 index has appreciated by more than 50 percent. Usually, markets don't move that far without having a major correction. Thus, over the short term, there appears to be a disconnect between the real economy and the stock market. It is easy to argue that the market has come "too-far too-fast". The potential for a significant correction tells me that it is still prudent to maintain a cash reserve and covered calls to cushion the portfolios in the near-term.

Over the longer-term my strategy will become more aggressive. I believe that we are in the early stage of a major Bull Market. Major Bull markets typically last four to seven years. Over time, I will structure our portfolios to have only one or possibly none of our stock positions covered with calls. Where permission is granted, I may also have one stock position purchased on margin (i.e. borrowed money). The combination of one hedged position and one position on margin will essentially provide us with a fully invested and diversified portfolio. In that configuration, the Stock Selection model has out-performed the S&P 500 index roughly eighty percent of the time, over a thirty year period.

Sincerely yours,

Ray Hofshi

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