

# 2011 Third Quarter Review and Market Outlook



September 30, 2011

## Volatility “The New Normal”

In 2010, PIMCO’S Bill Gross and Mohamed El-Erian coined the phrase “The New Normal” to describe expectations of slower growth in US GDP going forward. However, today “The New Normal” is just as apt to describe the heightened volatility we are now experiencing in the US and global stock markets. For example, since August 2<sup>nd</sup> three out of four trading days have resulted in a negative or positive triple-digit close in the DJIA. Roughly translated, that equals a 1% daily move.

It is no surprise then that with this extreme volatility in the third quarter stocks suffered their worst quarter since the 2008 credit crisis. Investors wiped out \$2.2 trillion of market value from the stock market in a matter of months. The S&P 500 Index lost 13.9%, the DOW fell 11.5% while international stocks fared no better with the MSCI EAFE index declining 18.9%. The CBOE SPX Volatility Index (VIX), a measure of market volatility, rocketed 160%.

Figure 1: CBOE Volatility Index YTD Q3/11



Source: Stockcharts.com

There were a variety of reasons for the high volatility over the quarter. First and foremost is the ongoing uncertainty in Europe and what appears to be the never ending saga of whether Greece will default and contagion ensue. Nobody knows for sure what will happen if Greece defaults, but we do know from our painful Lehman experience back in 2008 that it will have a negative impact on the stock market.

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To better explain the situation think of the European countries as you did of the major US banks in 2008. For example, Greece would be our Lehman Brothers, Germany our Goldman Sachs and Spain our Merrill Lynch (ML), before it was acquired by Bank of America. (Let's assume in this example that Spain isn't invaded by another country like France as Merrill Lynch was by BOA). Like banks, there are countries that are solvent and liquid like Germany , countries which are solvent but not liquid such as Italy, and countries that are both insolvent and illiquid such as Greece . Europeans are first trying to identify the real economic status of each country in order to devise a master plan to help provide liquidity to countries with similar solvency issues. The goal is that when Greece defaults, which we believe is now inevitable, there will be a mechanism in place to prevent further contagion. We believe the most likely solution is a European type of TARP, similar to what the one the United States put in place for the banks in 2009.

Adding to the uncertainty of Greece were more pressing domestic problems about whether we would have a federal government shutdown due to the debt ceiling impasse. As the debt ceiling crisis dragged on, investor confidence plummeted. Although the debt ceiling was eventually resolved at the last minute, the damage had already been done and Standard & Poor's downgraded the U.S.'s credit rating a notch. America's AAA rating could survive two World Wars and a Great Depression but not the bickering and games being played in Washington in both Congress and the White House .

Investors clung on to hope that the Federal Reserve would announce another round of quantitative easing as economic indicators showed signs of deterioration, but it was not to be. Instead the Fed announced "Operation Twist," which involves the Fed selling \$400 billion in short-term treasuries in exchange for longer duration bonds which effectively forced down long-term interest rates that were already at record lows. The Fed did not pump additional money into the economy. Disappointed investors sold on the news, pushing down markets another 3% by the end of the quarter.

The rather sad state of global markets and anemic world economies suggests a global recession may be on the horizon. Investors are reflecting those beliefs by driving down yields of U.S. treasuries and selling off industrial commodities like copper. These traditionally accurate indicators of the health of the economy suggest an increasingly dismal economic backdrop.

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## It's Not "Greek" to US

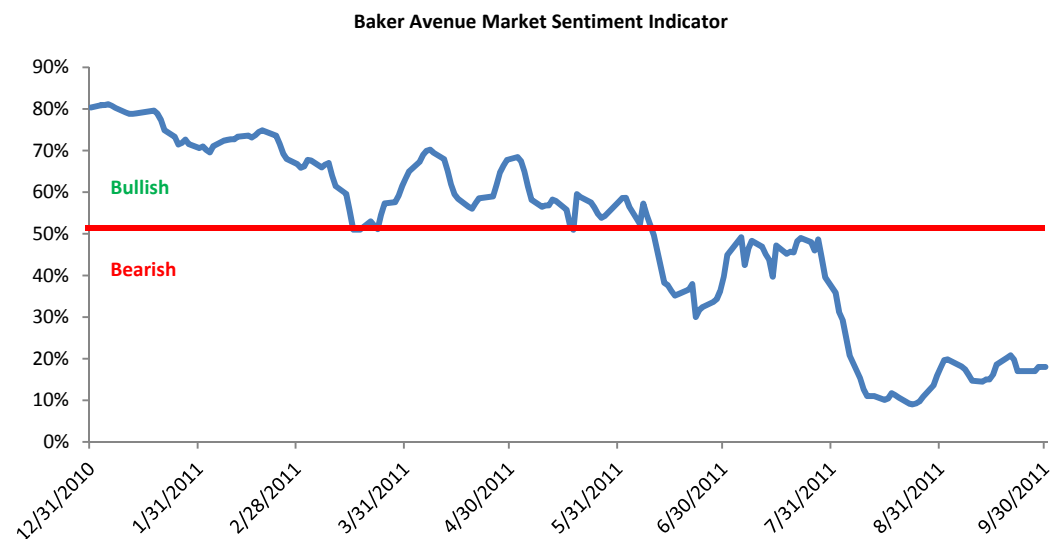
There are always going to be macro economic events, such as Greece impacting the US market, that provide investors with seemingly good reason not to invest. The question we must ask ourselves is "what's the risk/reward tradeoff of investing in the market?"

Baker Avenue Market Sentiment Indicator (BAMSI) turned negative on June 13th and remained in negative territory throughout the third quarter. The BAMSI measures the overall bullishness or bearishness of the market on an index of over 4,000 stocks. When greater than 50% of stocks in the index are showing positive trends, it indicates a positive market sentiment or, said another way, the risk/reward of owning equities is favorable. In this environment capital appreciation is our objective across all strategies.

When the BAMSI is negative (less than 50%) the risk/reward of owning equities is not favorable and higher levels of cash are warranted. In this environment, capital preservation becomes the main objective. This past quarter would be a good example of such an environment.

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**Figure 2: Baker Avenue Market Sentiment Indicator (BAMSI) YTD Q3/11**



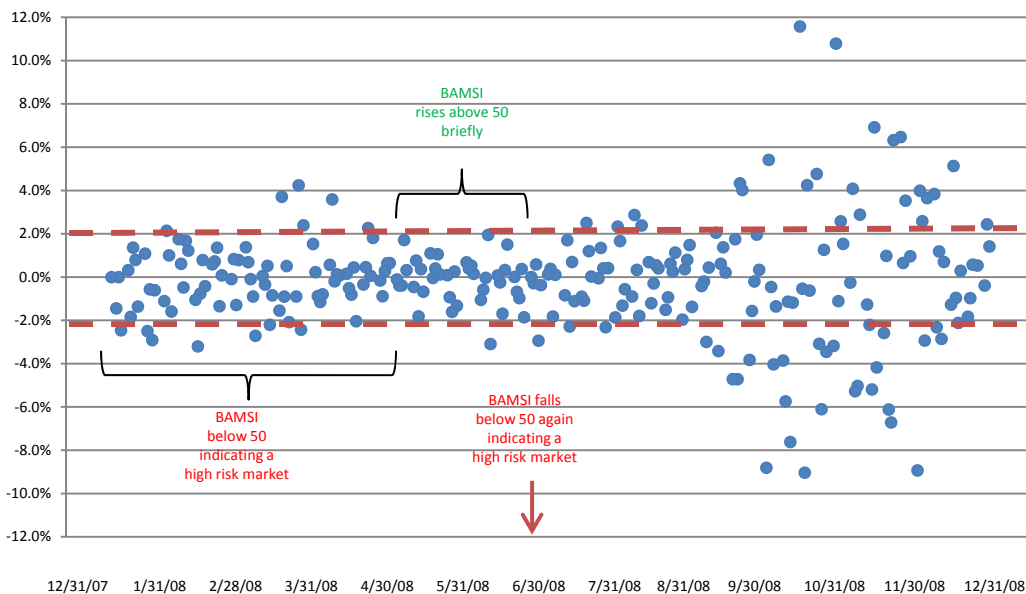
Source: Baker Avenue



## Volatility “Friend or Foe?”

Over 40 years of market data indicate that market risk is greater and volatility is higher when market sentiment is negative. A powerful illustration of how market risk increases when the BAMSI turns negative can be shown by analyzing the plots of daily market returns during risky markets. In figure 3, we analyze the daily market returns of the S&P 500 in the 2008 bear market and credit crisis. In a market of low to normal market volatility (BAMSI >50), daily market returns are usually centered on plus or minus 2%, as indicated by the red dashed lines. When the BAMSI is negative, volatility increases dramatically as clearly shown by the wide dispersion of market returns greater than the 2% boundary.

**Figure 3: Plots of 2008 Daily Returns**



Source: Baker Avenue

In these types of volatile markets, there is a high probability of market losses due to the “domino effect” of stock liquidations. Individual investors who are concerned about market volatility may sell their stock holdings or redeem their mutual funds. This causes fund managers to forcibly liquidate portfolio holdings to raise cash to meet the redemptions. These liquidations may in turn trigger margin calls which further exacerbate the forced selling in the market. The cascade of sell orders produces a vicious circle of liquidations which is why we see the market usually fall faster

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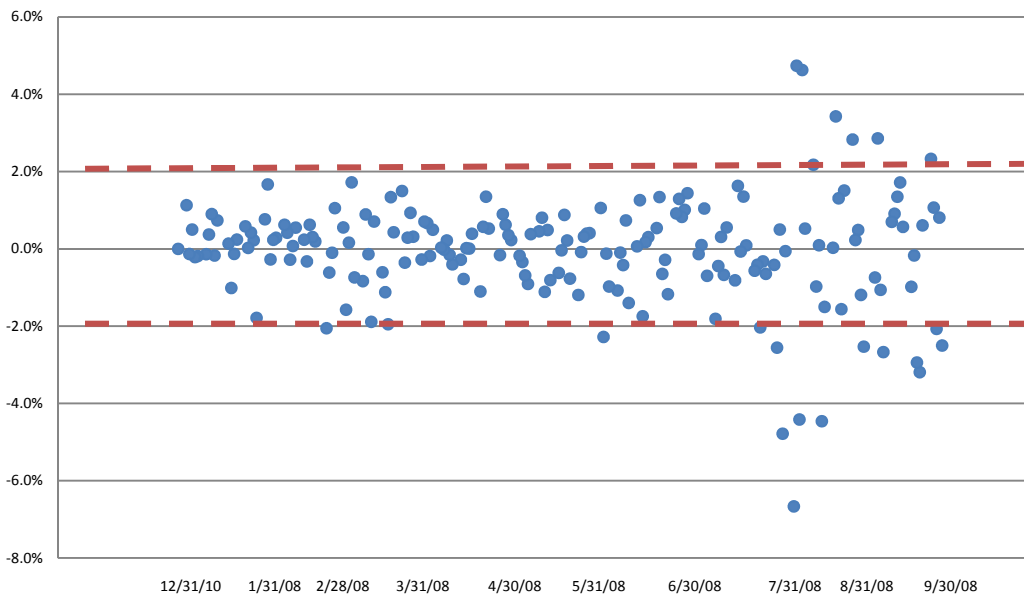


than it rises. Investors tend to lose money in volatile markets; therefore investors are better off avoiding these types of markets by moving to cash.

Although we are facing a different set of problems today, the market’s behavior to risk is the same, which is why at the time of writing this letter we remain in a defensive posture across our investment strategies.

In figure 4, we analyze the daily market returns of the S&P 500 through the end of the third quarter this year. What we see is a remarkable similarity to the 2008 graph of volatile daily market returns. This is not to say that 2011 will share the same ill fate as 2008, but it does reflect the possibility of such an event.

**Figure 4: Plots of 2011 Daily Returns Through Q3**



Source: Baker Avenue

**Our proprietary market sentiment research also indicates that periods of severe market declines are in large part predictable.** In other words, successive losses tend to exhibit the ability to predict future returns. In figure 5, we highlight the phenomenon of bad returns clustering together. The most recent evidence of this “clustering” of bad returns happened in the quarter

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between July 22 and August 8, 2011. The Dow Jones Industrial Average plummeted nearly 15% in just 12 trading days, an average loss of over 1.2% per day. This risk was not a random phenomenon. *Before* this steep decline occurred, market volatility as measured by the CBOE SPX Volatility Index (VIX) already had started to increase. Furthermore, our Baker Avenue Market Sentiment Indicator (BAMSI) also turned negative weeks before indicating a high risk market.

**Figure 5: Periods of Severe Market Declines are Often Clustered Together**

Historical Drawdown's in the Dow Jones Industrial Average 1914-2011

Rank	Date	Duration in Days	Decline in Percent
1	10/1987	4	-30.7
2	7/1914	2	-28.8
3	10/1929	3	-23.6
4	10/2008	8	-22.9
5	7/1933	4	-18.6
6	3/1932	8	-18.5
7	11/1929	4	-16.6
8	11/1929	2	-16.6
9	7/2011	12	-15.0
10	8/1932	1	-14.8
11	12/1931	7	-14.3
12	9/1932	3	-13.9
13	9/1974	11	-13.3
14	6/1930	4	-12.9
15	9/1931	5	-12.4
16	8/1998	4	-12.4

Source: Didier Sornette / Baker Avenue Asset Management

## Managing Risk

### All Cap Core

The All Cap Core strategy remained heavily in cash throughout the third quarter after having moved 100% to cash at the end of the second quarter when the BAMSI turned negative. When the BAMSI entered the “Blue Buy” territory it indicated that the market was very oversold and as such we began to add some modest equity exposure in defensive counter cyclical stocks. Counter cyclical stocks are defined by their ability to withstand an economic slowdown. Traits of these

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stocks are positive cash flow and healthy dividends. McDonalds (MCD) with a positive cash flow of \$6.9 billion and a 3.3% dividend yield along with Philip Morris (PM) with \$10.5 billion in free cash flow and a 4.4% dividend yield are good examples.

**Figure 6: All Cap Core Cash/Equity Ratio YTD Q3 2011**



Source: Baker Avenue

The chart above shows the cash versus equity ratio in our All Cap Core strategy since January. As a tactical manager our defensive move to cash allowed us to minimize losses in the strategy to just 2.3% for the quarter. In comparison, a traditional buy and hold manager who experienced losses similar to the S&P 500 index would be down 13.9% for the quarter (Figure 7).

Secondly, by keeping high levels of cash throughout the quarter, we were successful in minimizing the drawdown experienced in the strategy. The advantages of minimizing drawdowns means a) It will be easier to recover the loss when the market rebounds and b) we will have the buying power to take advantage of any potential market opportunities.

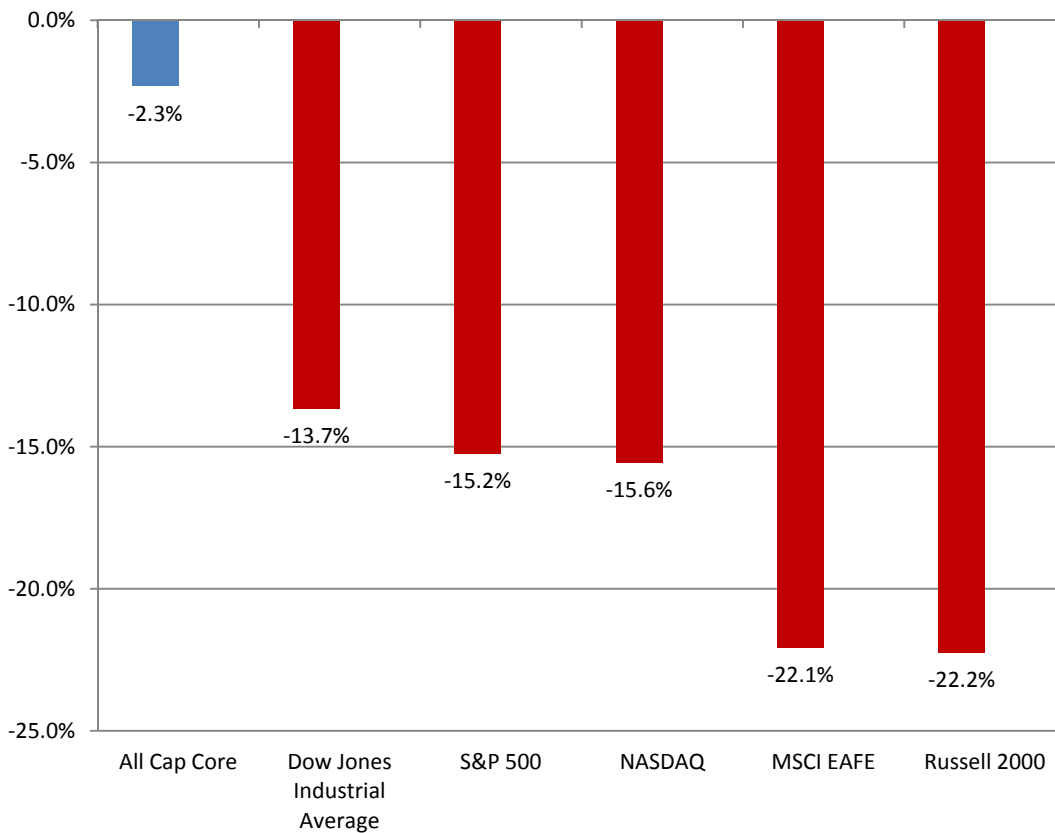
### Global Tactical Indexing

In the Global Tactical Indexing strategy, we maintained a defensive posture with high levels of cash in the quarter as the BAMSI indicated that market risks were high. Precious metals such as gold and silver also helped to hedge the portfolio. Like the All Cap Core, it was successful in minimizing the drawdown experienced during high levels of market volatility. However, because of a longer duration trigger to move to cash, the strategy experienced slightly higher drawdowns that affected performance for the quarter.

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**Figure 7: All Cap Core Versus Market Benchmarks Q3 Drawdowns**



Source: Baker Avenue / Bloomberg. Please see disclosures.

### Dividend Opportunities

The dividend strategy also raised cash levels as the quarter progressed and continued to transition to capital preservation mode as our indicators shifted negative in mid August. We find that dividends serve as a defense mechanism when fears of a recession start to percolate, as they did in the third quarter. Looking at sector performance, it is no surprise that the top performing sectors are also the highest yielding. Historically, these lower risk sectors are prone to moments of panic and August proved no exception. Despite actually posting a small gain on the quarter, the utilities sector was at one point down over 11% in mid-August. As described above, the forced selling to meet margin calls and redemptions is visible in the chart. The current capital preservation posture in the dividend strategy will likely continue until sentiment turns positive.

## Blue Chip Core

The Blue Chip core progressively raised cash during the quarter finishing September with a 50% weight to cash. As a reminder, the Blue Chip core utilizes longer term indicators to raise cash. This longer duration perspective proved beneficial in late June and early July as equities held on to gains despite sentiment turning negative. However, as the severe selloff in August became a reality, the benefit quickly evaporated. We raised cash in August and reduced exposure to financials which proved to be the most vulnerable sector. Looking ahead, there are many opportunities in the wake of Q3. Volatility will eventually subside and best of breed companies will be available at steep discounts.

## Fixed Income

Fixed income returns were good in the third quarter as bonds became a safe haven from stock market volatility. Longer duration bonds outperformed shorter duration bonds as investors priced in a high likelihood of a double dip recession which drove down yields across the yield curve. Despite the decline in commodity prices, treasury inflation protected securities (TIPS) gained 4.6% on the quarter as inflation expectations remained high. The worse performing bond segment were high yield bonds which declined 7.6% due to concerns that a recession would increase default rates. Despite the volatility, high yield bonds are down only a modest 3.5% as their high yields have helped cushioned some of the volatility. We believe short to intermediate high quality corporate bonds remain the most attractive segment of the bond market in terms of risk and reward and continue to overweight this asset class. On the other hand, we are avoiding long duration treasuries as we believe they are extended and the risk versus reward is not compelling.

## Market Outlook

Until the situation in Europe comes to a resolution, we believe investors can continue to expect high volatility in the coming weeks and months. Global macro events will continue to drive investor emotion and behavior. If Greece defaults, it could potentially trigger a global recession that already looms on the horizon. The chances are global economies would not be able to avert it. As we write this letter, third quarter earnings season is about to start which could also add to recent market volatility should companies materially cut earnings guidance.

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Although we believe these factors continue to warrant a defensive posture, we do believe the markets already reflect much of the uncertainty that exists. Global price-to-earnings ratios are back to their March 2009 lows and in many cases even lower, suggesting that stock market valuations are not expensive. There have been high levels of insider buying activity recently, the most since the over \$1 billion of insider purchases back in the market bottom of March 2009. This is significant as heavy insider buying preceded two years of strong gains in the market up until this year. Since World War II, quarterly losses exceeding 14% (the third quarter's slide was 14.3% not taking into account dividends) have been followed by consecutive quarter rebounds 89% of the time for an average quarterly gain of 5.3% (Ned Davis Research).

## Conclusion

This quarter will go down in the record books as one the most volatile periods for investors in recent memory. As discussed, multiple macro factors contributed to what may be considered a perfect storm of volatility for investors. Looking ahead to Q4 the markets violent swings may well continue, with investors torn between reasonably valued stocks on one hand, and the uncertainty caused by Europe's debt contagion on the other.

Instead of just riding through the storm, at Baker Avenue we will continue to tactically manage market risks by using our market sentiment indicator (BAMSI) to determine market exposure. If necessary we will continue to hold high levels of cash across all our equity investments until either a) volatility has subsided and our market sentiment turns positive or b) there is a complete capitulation in the equity market and it becomes so oversold that the risk/reward metrics of additional equity exposure are warranted.

We hope to report news of positive Q4 performance and more clarity in our outlook in our next newsletter.

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Disclosures:

The Baker Avenue Asset Management (“BAAM”) All Cap Core (“ACC”) Equity Composite is designed to generate a positive return over the medium to long term, with a focus on capital preservation. For comparison purposes, the composite is measured against the S&P 500. We believe the index that best replicates the market capitalization of securities we purchase for clients in the ACC are best represented by this index. The S&P 500 Index measures the performance of 500 leading companies in leading industries of the U.S. economy, which represents over 80% of the investable U.S. equity market. The index is presented as total return (reflect reinvestment of dividends, interest and other income) and is unmanaged, cannot be invested in directly and is never comprised of a cash allocation. BAAM may or may not trade in securities that are represented in this index. No representation is made that the performance or volatility of the ACC will track or otherwise reflect a particular index.

Past performance is not indicative of future results.

The minimum account size for inclusion in the composite is \$100,000. The U.S. Dollar is the currency used to express performance. Returns are presented net of a Model Advisory Fee and net of transaction costs. Returns are total return, i.e., they include the reinvestment of dividends, interest and other income. The composite includes both bundled-fee (wrap fee) and non-bundled fee portfolios. As a result, the returns presented are net of a model investment presented net of an annual fee of 1.5% applied monthly which represents the highest annual fee currently paid by a portfolio in this composite. For bundled accounts in the composite, this fee includes management fees, brokerage commissions, portfolio monitoring, consulting services and in some cases custodial services. The composite includes accounts that did not pay an advisory fee; since the completion of the first year, less than 2% of assets in the composite have been from non-fee paying accounts. BAAM may waive or reduce the management fee with respect to one or more clients or agree to apply a different management fee for a client. Full details of the fees charged are available in our ADV Part 2, available upon request.

The BAAM All Cap Core Equity Composite was created on January 1, 2005. The annual composite dispersion is an asset-weighted standard deviation calculated for the accounts in the composite the entire year. The composite consists of fully discretionary fee paying accounts that invest in all cap equities and cash. Portfolios are included after one full calendar quarter under management; terminated accounts (those no longer with the firm) are included through the last full calendar quarter prior to termination. Carve-outs are included in this composite from inception on January 1, 2005 until March 31, 2009. After March 31, 2009, only pure accounts were included in the composite. The portfolio accounting system automatically allocates 100% of the total cash to the carve-out. Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. Additional information regarding policies for calculating and reporting returns and copies of prior verification reports are available upon request..

We may move to cash at times when the risk is not appropriate. However, there is significant dispersion between the performance of our composite and the index as the index is unmanaged and cannot move to 100% cash as we may do for our clients (and thus, this is reflected in our composite). For the time periods stated below, 1/1/05 through 9/30/11, the following time periods reflect when the Composite had a 100% cash allocation as a defensive component in the ACC. As a result, the negative performance of the S&P 500 is not reflected in our performance as we did not have the market exposure. Time periods are 27 days from 3/29/05 through 4/20/05, 49 days from 9/29/05 through 11/17/05, 27 days from 5/18/06 through 6/14/06, 30 days from 3/9/07 to 4/8/07, 23 days from 7/27/07 through 8/19/07, 62 days 11/8/07 to 1/10/08, 19 days from 6/19/08 through 7/09/08, 39 days from 2/20/09 through 4/1/09, 24 days from 5/20/10 through 6/13/10, 21 days from 7/13/10 through 8/3/10, 25 days from 8/26/10 through 9/20/10 and 60 days from 6/14/11 through 8/15/11. In total from 1/1/05 to 9/30/11 we were in 100% cash for 408 days.

Market data is sourced from Bloomberg. When believe the data to be true and accurate at the time of publication.

Baker Avenue Asset Management, LP is an independent registered investment adviser. The firm maintains a complete list and description of composites and models, which are available upon request to [info@bakerave.com](mailto:info@bakerave.com).