

Investment Strategy, General Comments for 1Q 2012

Equity markets have rallied since mid Dec 2011 as the ECB began its QE(stealth) and the US economy continued to recover. It appears that equity markets want to take a breather. This could last between a matter of days to a couple of weeks. The trend is up.

Investing or trading, call it what you will, is tricky business. One thing for sure is that if one is wedded blindly to fundamentals, losses lie in store. Asset prices are linked to fundamentals through psychology. Unless you intend to redeem a bond at par, buy out an entire company, wrest control of one or practice arbitrage, fundamentals are only useful insofar as it provides all the possible viewpoints available to all investors. Understanding which viewpoint will ultimately motivate the marginal buyer or seller provides insight into future price movements. One only buys (shorts) something with the expectation that someone else will buy (sell) it from (to) them at a higher (lower) price.

This can mean that some of the most profitable trades seem to be the least rational ones.

- when there is a bailout buy the lowest quality and short the highest quality.
- as the ECB prints money, implying a debasement of currency, the immediate relief reaction is a stronger Euro.
- buy European sovereign bonds as the ECB prints money. Front run the banks who are the agents of the ECB's printing press.

- the US is recovering, buy China exporters.
- China is slowing, buy resource companies. Unable to restructure its economy towards domestic consumption, under pressure in a change of management year, China will flex its fiscal muscles the only way it knows how. Having built staircases going up, it will now build staircases going down. And railways and highways.

Do look at technicals but never in isolation. Causality is far more important than correlation. It is also far more difficult to envisage and validate.

Pre-empt the news and events. Don't trade in anticipation, at least not in size. Build plausible scenarios based on common sense and understanding the motivations of all participants in the game. Then set milestones that confirm or confound the thesis.

For example, in Dec 2011, with the thesis that the ECB was printing money, trade long. Set signposts to validate and stay long as long as these signposts are met. In the meantime look for a reason the market might reverse. Set signposts again. If signposts are not met and the market turns, it's likely a buying opportunity. If bear signposts are met, reduce exposure and possibly turn short.

Constantly build scenarios, set milestones and signposts, trade as planned and use the milestones and signposts to validate or invalidate the thesis. If in a trend, build the reversal scenarios and look for the signs that validate.

And even then you'll get it wrong. But your mistakes and losses will at least be unavoidable ones. It is wasteful to make avoidable mistakes.

And to the value investors who chant the value mantra as their portfolio NAVs keep falling, I agree totally that the value is getting better but here's the thing, where is your purchasing power?

By the way, even as risky asset markets rise and are likely to continue to rise, in my view, the real economy is in real serious trouble and there will come that point in time, again, when reality bites. On fundamentals alone, one would either be short risky assets or simply out of the way of the coming train wreck. The psychology

tells us to play this game of chicken with all the other players in the great game.

Good luck at the tables...