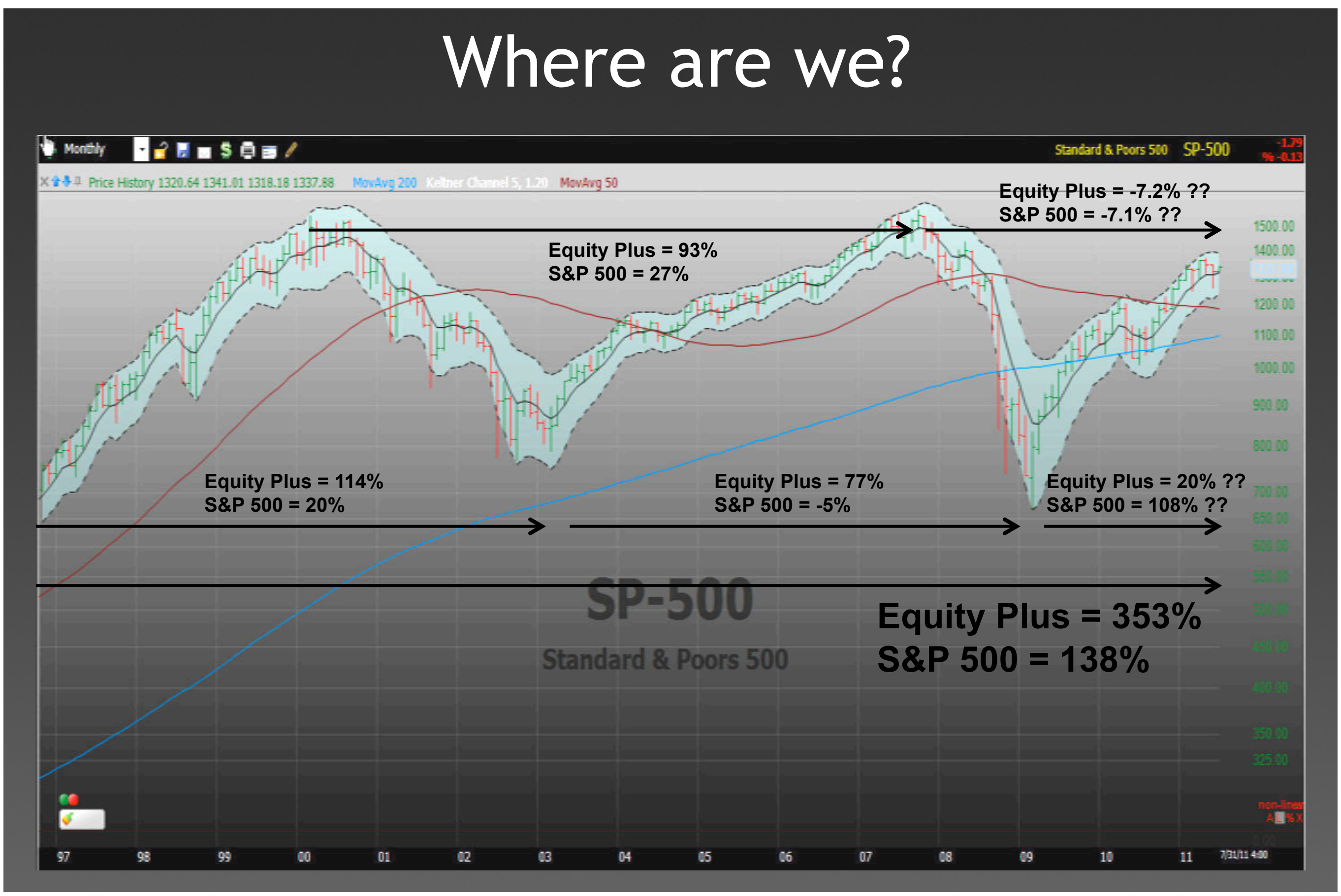
Portfolio Manager Commentary: Second Quarter 2011

Our tactical style of money management continues to struggle against a market and economy that PIMCO's Mohamed El-Erian euphemistically dubbed "the new normal" a couple of years back. Unfortunately he was right. The New Normal has indeed turned out to be a world of muted growth, where the public sector is the key provider of goods at the expense of private business. Here the political trumps the practical, and government (i.e., policy makers, central bankers and regulators) sets the agenda. [For more on this, see Portfolio Manager Alan Alpers' new piece detailing the government's impact on the markets, entitled, "The Not-So-Secret Invasion". It can be found in the spotlight section of our website at www.ncm.net]. When it comes to *Industry*, private companies are playing supporting roles, reshaping business to meet the changing requirements of government. With hundreds of new rules yet to be written for laws already passed is it any wonder business declines to invest?

Regardless of the fact that we don't care for the business climate much, we're of the opinion we should be making more money from it. In the big picture, corporate profits drive stock prices and profits have been good! But the facts are that Niemann's time-tested strategies are having a hard time capturing what this market has to offer.



Source: Worden Brothers

The chart “Where are we?” (in the scheme of things) is a cautionary tale; markets as a whole have been going sideways for years. When bear trends appear they seem to be getting more vicious, risk is growing as the market presses into the top end of its range, and most uncomfortably—Equity Plus is not delivering the upside as usual this time. Has Niemann found its own private new normal? We think not. But what matters in the end is what you, our valued clients, think.

We can assure you that in the face of adversity we have been moving to control everything within our purview: from incubating new alternative strategies, to acquiring an advanced electronic equity trading platform, to asking hard questions of ourselves and our methodology. Yet despite these efforts—or maybe because of them—at this writing we remain dissatisfied with and impatiently anticipating more progress.

Why Our Flagship Strategy is Struggling

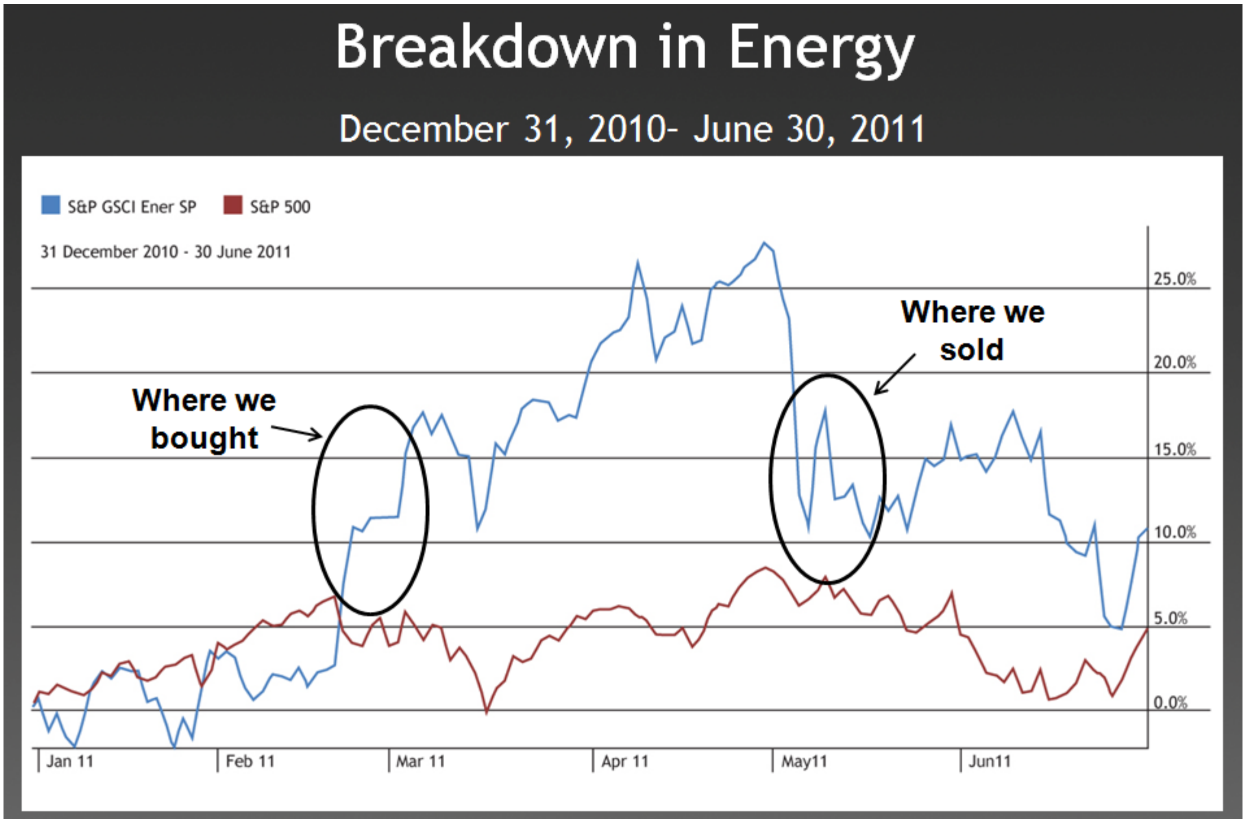
Niemann is a quantitative manager, which means we employ a structured, systematic approach to the investment process. We’ve been doing the same things for the same reasons day in and day out for over twenty years. Clearly, this time the outcome is different: We’re not capturing the profits we’ve become accustomed to over past cycles. What is it about this market that defeats our efforts?

Being *quants*, we look for answers in our analytic process and trading history, already intuitively knowing what we’re likely to find. By going back over our work and decision-making, what we’re really searching for are options that may improve the outcome. The evidence comes in as suspected: We’re not getting paid as we normally do for rotating assets to market leadership. We’re paying more for risk management in the new normal. Neither of these conditions is new; each has manifested itself in the past at one time or another—just not together and for so long. Even though our investigation didn’t yield a revelation for us or perhaps for you, it’s nonetheless worthwhile and valuable to examine how we’re thinking about this so you may truly understand the facts on the ground.

Rotate to Strength

Whether it’s Energy, Technology or Healthcare fueling a market advance, our analytic process is designed to find and get us rotated towards the market’s strength. Our examination of trading found it is doing just that; our investment selection process is working as well as it ever has in terms of moving to market strength. But while we’re finding the place to be in this market, our inquiry also uncovered why we’re not adding our customary outperformance. It has to do with time.

Over the years our holding period for a position in a managed account has typically run nine to 15 months. This intermediate time frame gives our methodology its best chance for success; to identify emerging trends, validate their authenticity, invest in the leadership and then capitalize on it. Time has become our enemy in the new normal as these leadership trends have become compressed in time frame. It is the main reason we’re not being compensated for our work. To illustrate the challenge let’s investigate our foray into the Energy sector earlier this year.



Source: Stockcharts.com

You see in the chart "Breakdown in Energy" (above) where we entered the sector after it broke out versus the market (S&P 500) in February. The market (red line) proceeded to trade sideways in a 7-8% range over the following several weeks while our positions progressed nicely through the spring. Then abruptly in May, energy collapsed and we were forced to sell out of our positions with minimal gain. You will find no general market sell-off causing this—in fact the market remains range bound in the same vicinity today. This is a litany that's been repeating itself for well over a year now; a chorus of abbreviated and sometimes truncated trends where we end up leaving much or most of our profits on the table. Why is this happening?

The short answer is lack of conviction. U.S. markets are well into their third year of central planning *Washington style*, and one would think as a consequence of trial and error alone, a concept as simple as 'business thrives on certainty' would be conventional wisdom by now. One would be wrong. Lack of certainty is a major barricade on the path back to the old normal. High profile examples of this are the *illegal* moratorium the *U.S. Justice* Department slapped on drilling in the gulf, virtually shutting down the industry overnight (see: Gulf Drilling Moratorium). Or consider the consequences from the EPA throwing Shell out of Alaska after their $2 billion investment (see: "Energy in America: EPA Rules Force Shell to Abandon Oil Drilling Plans," Fox News, April 25, 2011). Could the latter offense have had anything to do with the 'breakdown in energy'? The point is it's next to impossible to develop conviction when an interventionist government changes business fundamentals *by fiat* to fit their ideological view of the world. This is happening on many fronts.

Risk Premium Redux

The other main drag on our performance recently has been the cost of active risk management. Our analytics are geared to take money out of securities, sectors and markets when their health begins to fail past a certain point. Over a typical bull market we'll end up cycling to higher levels of cash three or four times before the final top is reached (which by the way, one only identifies in hindsight). Why do we keep doing it? Look closely at the trading footprint of energy versus the S&P around and after its high in May. A violent correction in market leadership may hardly cause a ripple in the 'major averages', but if you happen to own those leaders as we often do it's a different story. We've seen some leadership groups decline over 20% in a very short amount of time. Can one effectively manage risk AND allow positions to fall 20+%? Not with great success. So we follow our discipline. And the difference between where we sell and where we're able to reenter the market safely once more is what we call the risk premium—*the hit we take in performance relative to our benchmark* to manage risk. The cumulative costs are higher in the new normal because without conviction, blowups are more frequent—investors tend to shoot, no questions asked. Here's the question you must answer: Is this insurance worth it? Obviously no one needs insurance until the house burns down. Check out our strategies in the bear trends of 2000 through 2002 and 2008 to form your own opinion.

How Are We Going to Fix This?

We actually began development of one possible remedy to our performance malaise before we really even knew it existed. In mid-2009 and 2010, we placed two new equity strategies into incubation and began trading them in pilot accounts. We were motivated by the escalating challenges we were having trading with our mutual fund counterparties (prior to our migration to ETFs). Our theory on these strategies is that by pushing analytics down to the individual security level, we would be able to construct portfolios from the bottom up, which would be more dialed into existing market conditions and thus, much more effective. We're very pleased with the progress here.

Frankly, the game changing ingredient appeared by accident in early 2010 when Fidelity released a short list of no-transaction fee ETFs. Schwab soon followed suit and we moved immediately to introduce these securities into the mix of our core strategies. Finally something we could use to improve within our existing structure! Though limited to a handful of ETFs, we soon found their addition extremely liberating. For the first time *in years,* we could enter the market knowing that if we were wrong we could unwind our position—*the next day* if we wished.

What a profound change from how our strategies operated over the past decade, when putting on a position meant a minimum three month marriage to satisfy fund family relationships! In the summer of 2010 we put a stake in the ground to reorganize our structure and gear up operations to handle equity/ETF trading on a scale to accommodate our strategies (we trade hundreds of thousands to millions of shares at a time). We brought this project to conclusion this past March as we opened up the entire universe of ETFs to our strategies. The main accomplishments: our core strategies are far more flexible in how they can attack the markets and we're now incredibly nimble in how we can tailor our execution plans. We're in a *better position* to maximize profits, and cut losses, than we have been in many years.

This list of initiatives goes on: we're partnering with an ETF sponsor to develop a strategy designed to manage sector rotation in emerging markets. This is an intriguing concept since many strategists see the best opportunity for future growth residing in emerging and frontier economies rather than the larger, more developed ones. There are more.

Back to Equity Plus

Yet despite all of the above being said—and done—we know the rubber hits the road on profits. Inquiring minds want to know when we're going to start manufacturing some of them. What adjustments can we make that will amp up our core strategies? Our aforementioned research project uncovered two ways to effect an immediate change in our strategies; shorten our time frames in an attempt to harvest profits faster, or lengthen them so that we can hold positions through more adversity.

Shortening time horizon makes sense at first blush and could fit in with our core policy of 'avoiding catastrophic loss'. A shorter time frame makes us quicker on the sell side and better at managing position level risk. The downside lies in the considerable uptick in trading activity. If our trading profile over the past several months seems like death by a dozen cuts, shortening the time frame would turn it into death by a thousand in the bigger picture. We've crunched the numbers during dozens of tests, incrementally shortening time frames, reorganizing and dialing in tactics. It's almost certain we can enhance performance by adjusting to a shorter time frame as long as current market conditions persist. But this would be at the expense of far less profitability should markets revert to the old normal, become healthy and trending again as in years past. And as the superior investor knows and history has proven, the BIG money is made by taking advantage of trending markets.

The other option, lengthening timeframe, means holding on to positions through greater adversity in an effort to reduce the cost of managing risk. This adjustment would actually improve returns under a majority of circumstances. It just fails miserably in a breakaway bear market, giving back everything saved and then some. This tactic makes less sense because it elevates the risk of violating a central tenant of our core philosophy; keeping losses recoverable.

Our Conclusion

While it's hard to watch our flagship strategy struggle as it has in recent quarters, the truly frustrating aspect is we understand what's not working particularly well but don't have a good solution for it. Our strategies are designed to take advantage of healthy, trending bull markets animated by innovation and improving business fundamentals (these define sector leadership). We've hammered on the analytics. Changes which would help book more profit near term would also serve to degrade long term historical performance, making these strategies less appealing overall.

We simply don't believe it makes sense to adjust Equity Plus so that it handles a (transient) new normal at the expense of its lifetime 353% to 138% beat down of the S&P 500 after fees.

Controlling What We Can Control

What does make perfect sense is to control that which can be controlled. We continue to work *hard* to improve our trading systems, product lineup, and angles of attack on this market. We have equity and ETF strategies almost ready to roll out that not only offer different objectives (like dividend growth and fixed income) but actually work differently from the strategies we currently manage.

Most importantly, we've worked our way into a *far superior position* to be able to take advantage of opportunity than we have been in many years. We are anxiously searching for good opportunities to leverage our new found trading capabilities. Meanwhile we remain true to core principles forged by decades of grappling with different types of markets: keep losses recoverable, manage risk in ALL market conditions, and take advantage of opportunity when it presents itself.

Perhaps there is a karmic reality buried somewhere in all this adversity; we've always said the true test of an investment strategy is how it works over a complete market cycle. Perhaps a complete market lifetime would have been more fitting.

We thank you and very much appreciate your continued support!

Don Niemann
Chief Investment Officer

S&P 500 Index- Assumes reinvested dividends: The S&P 500 Index is a capitalization weighted, unmanaged group of 500 stocks as selected by the Standard & Poor's Publishing Company. They are usually the 500 largest companies in terms of market capitalization and are chosen to represent the entire market's value. The S&P 500 is used by many institutional investors as a performance benchmark representing the "stock market" return.

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