

## INSIDE THIS ISSUE:

Market Overview	1
Real Talk	2 - 3
Portfolio Review	4
Looking Ahead	5

## ELECTION-YEAR FACTS

The US House of Reps decides the Presidential winner when there is a tie. Surprisingly, this has happened twice in history (Thomas Jefferson in 1800 and Quincy Adams in 1824).

The popular vote winner has lost the US Presidential election three times in history with fewer electoral votes (Gore/Bush in 2000, Harrison/Cleveland in 1888, Hayes Tilden in 1876).

Top 3 Wacky US Presidential Forecasting Approaches:

- The taller candidate has won 70% of last 27 races!
- Washington Redskins final home game has predicted with 94% accuracy in last 16 elections!
- And at 100% predictive value: The candidate with a better hairdo (anecdotal)!

Raphael A. Martorello  
415-793-8014  
info@mmmwealth.com  
www.MMMWealth.com

## 2011 In Review: A Storm Before the Calm?

### Market Overview & Commentary

Global equity markets took investors for a wild ride in 2011. To recap the year, we compiled the biggest headlines from a jam-packed year, offset against the S&P 500, which vacillated dramatically in a continued “risk on / risk off” manner. Major investment market price-reversals occurred with a record frequency, especially during the second half of the year (as measured by 90% reversal days – a technical metric that triggers when 90% of stocks in an index move in a unison, opposite in direction to the recent trend). It all made for manic investing, where many banks, investment managers, and individual investors either blew up (e.g. MF global), severely underperformed (e.g. famous hedge fund manager John Paulson reportedly lost over 52% in his Advantage Fund), or just headed for the sidelines (e.g. incredibly low market volume was recorded in 2H/11).

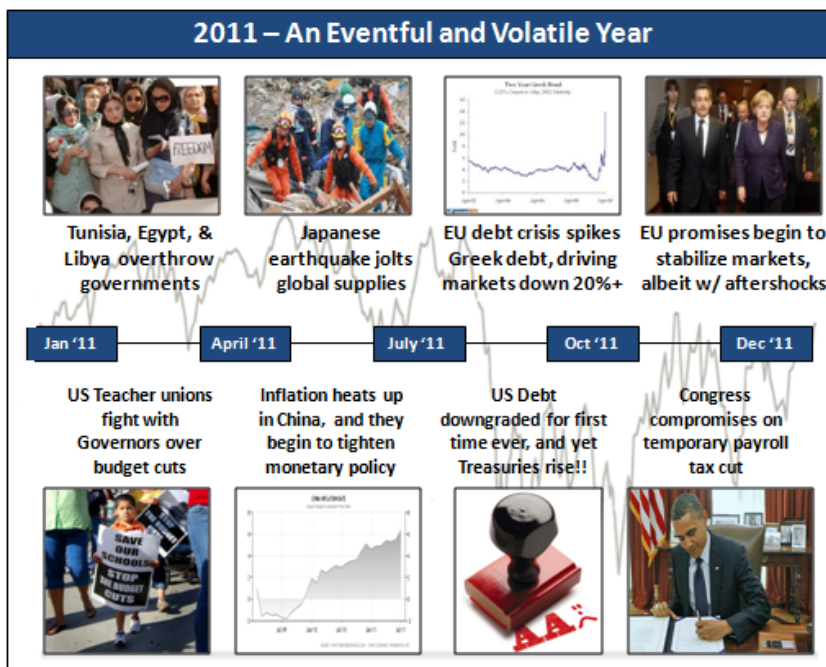
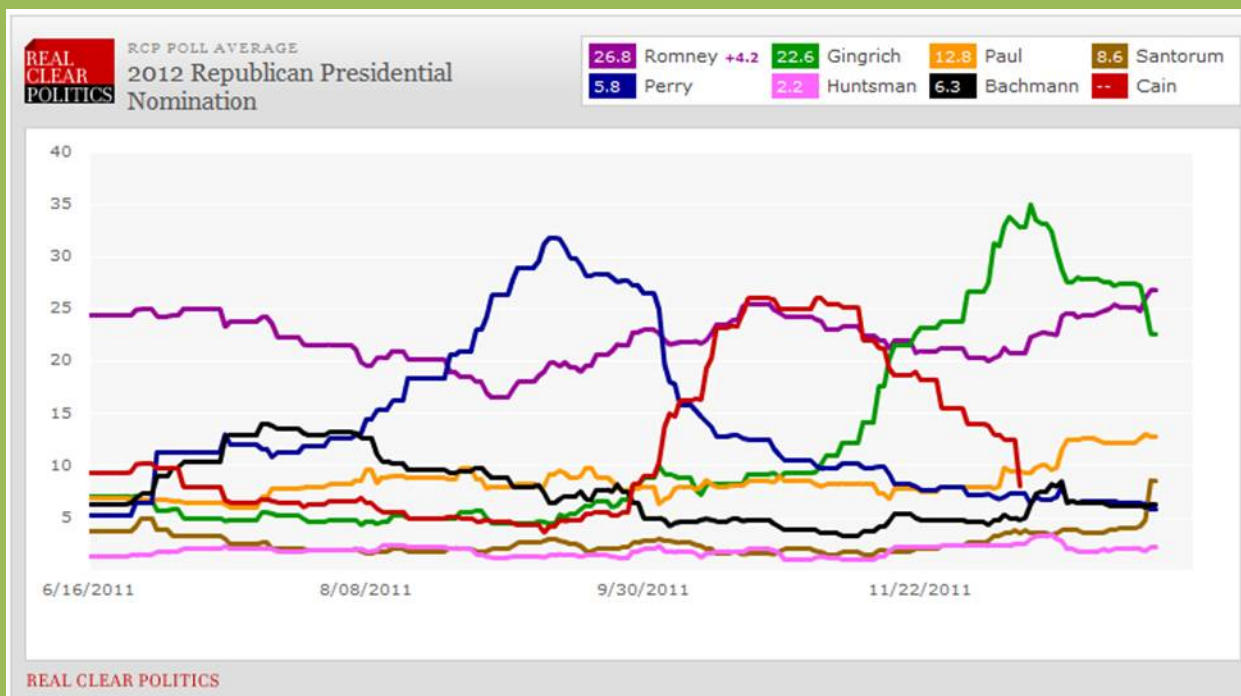


Chart I: 2011 – An Eventful and Volatile Year

Despite posting a flat -0.003% return, US equity markets were the best performing asset class in 2011. This resilience to global turbulence was the direct result of a slowly and steadily improving US economy. Foreign market equities underperformed significantly, with 15-30% declines due to direct crisis impacts, as well as indirect policy tightening in emerging markets to fight surging inflation.

....continued on page 4

# The Pitfalls of Chasing Leaders



It's difficult to ignore the wild changes in poll results among the Republican primary candidates.

Every few weeks there's a new candidate capturing the media's attention and taking the lead, only to fall back to earth after the next flavor of the month emerges to center stage.

The parallels between this roller coaster ride of a primary and that of investor behavior are noteworthy.

It's common this time of year for investors to review their portfolios and search for what's done best over the past year or two. They shift their investments into these leading areas and jump ship from the positions/markets that didn't perform as well.

The obvious result of this is buying high and selling low, the antithesis of good investor behavior, yet it is the path most followed.

Here are a few actual examples:

## 1) The "Best Performing" Fund

CGM's Focus Fund (CGMFX) returned an extraordinary 18.2% annually from 2000 – 2010.

Surely every investor in this fund made phenomenal returns over this time period, right? Not so.

Morningstar published data that measured fund returns while accounting for money flowing in and out of the fund by investors. Here's what the data showed:

**The average investor in this fund had an annual return of -11%.**

That's **negative 11%, a full 29% lower** than the actual return of the fund.

How is this possible?

## The Pitfalls of Chasing Leaders

Very simple, the data shows that in 2007 the fund returned an eye-boggling 80%. This was accompanied by “investors” in the fund pouring an additional \$2.6 billion into it. The fund subsequently dropped 48%, which was followed by an astonishing nearly \$1 billion cash outflow from the fund, likely in search of a safe-haven or the new best performing fund.

### 2) 20-Year Investor Performance

In a similar tale, there is an annual study comparing US market returns vs. real investor returns.

The results published in 2011 for the preceding 20 years reveal the following annual returns:

- S&P 500: **9.14%/year**
- Equity Fund Investor Returns: **3.83%/year**
- Bond Index: **6.89%/year**
- Bond Fund Investor Returns: **1.01%/year**
- Inflation rate: **2.57%**

The examples illustrate a stark reality: momentum investing, performance chasing, and panic selling lead to very disappointing long term results for investors.

Returns hardly outpaced inflation for equity investors, and in fact lost purchasing power for bond investors.

As a result, investors develop a general distrust and disdain for the markets for delivering such poor results.

In reality, it was their own behavior that did them in.

### 3) Top Performing Money Managers

Still not convinced?

In a study of more than 1500 money managers analyzed over a 10-year period commencing in 2010,

600 managers were deemed ‘head of the pack’ based on their relative outperformance of their peers. They beat their peers/benchmark on a relative basis by an average of 3%/year over this 10-year period.

Were they ahead during the entire 10-year period?

- **All** had at least one **12-month** period of relative underperformance
- **85%** trailed during at least one **3-year** period
- **85%** had **six different 3-year** rolling periods of underperformance.
- $\frac{1}{2}$  trailed by **3% or more** in 3 separate periods
- $\frac{1}{4}$  trailed by **5% or more** in a 3-year period
- $\frac{1}{4}$  trailed by **15% or more** in a 1-year period

Clearly, investors in these manager’s funds lost relative wealth at numerous points over the 10-year period, but only those that stuck with their given strategy actually reaped the higher long-term rewards.

### The Bottom Line

Just like voters who are figuring out who to place their confidence in, the same psychology applies to investors.

As A.A. Milne said, “The third-rate mind is only happy when it is thinking with the majority. The second-rate mind is only happy when it is thinking with the minority. The first-rate mind is only happy when it is thinking.”

Those who pursue the latest leading strategy will only underperform over the long run.

Only first-rate minded investors apply thought in making financial decisions – and end up with excellent long term returns.

## 2011 In Review: A Storm Before the Calm?

...continued from page 1

Many Wall Street firms and analysts are prognosticating more fear and volatility heading into 2012. However, while there will undoubtedly be some unexpected twists and turns in 2012, we believe there will be much lower volatility due to some EU resolutions, more reasonable growth globally due to a recovering global economy, and a reflation of assets that were taken to panic lows during 2011 (especially within Emerging Markets).

...see page 5 for our more detailed 2012 forecast

### Early Recovery, But Still Shaky

#### Portfolio Review (Q4/2011)

Heading into Q4, our indicators suggested that US equity markets were fairly valued to slightly undervalued, while Emerging Markets were significantly undervalued following a major Q3 correction. With inflation on the decline, we were on the lookout for a policy easing catalyst from Emerging Market countries.

In fixed income, we remained overweight high-yield bonds and held on to our short US treasuries positions, on the expectation of a relief rally and some modestly rising interest rates. With our Volatility Timing Model, we held our largest possible short position, on expectations that Q4 would calm in comparison to an incredibly volatile Q3.

#### **Q: What worked?**

The following investments contributed positively:

- Allocations to US equities and short volatility contributed positively to absolute and relative returns as US markets rebounded and volatility began to subside.
- Selected stock picks in the US also outperformed equity indexes.
- Rotation out of natural gas and into oil was timely, as natural gas declined 20-30% while oil outperformed.

#### **Q: What didn't work?**

While all portfolios had gains for the quarter, there were areas of relative underperformance. Specifically, the following positions underperformed:

- Major positions in Emerging Market equities underperformed for two of the three months in Q3. While showing some outperformance in November, they disappointed heading into year-end. There are hints of easing to come in early 2012, which would help EMs to once again regain leadership.
- Short US Treasuries positions continued to defy conventional wisdom, with interest rates reaching record low levels as global investors poured into the “safety” of US debt (seems like an oxymoron to us, and one that will come to an end at some point in the near to mid-term future).
- Real estate and diversifiers delivered positive returns, but they lagged US equity benchmarks.

#### **Net Results**

Client portfolios all had positive absolute returns for Q4. However, returns were less robust than expected as two of our three major recovery themes remained depressed (Emerging Markets and Short US Treasuries). We were encouraged that our short volatility position began generating healthy returns, and expect our other themes will get going shortly as well.

The full year of 2011 proved to be challenging. As discussed earlier in this newsletter, many investment legends closed their shops this year due to massive underperformance and sometimes full-on collapse. Given our global exposure to investing, we too shared in the pain as the crisis unfolded. However, these temporary losses were managed within individual client risk profiles, and we expect to gain back ground in 2012 as a recovery plays out and global growth once again resumes.



## Continuing to Climb the Wall of Worry

### Looking Ahead to Year 2012

From a long-term perspective, markets are still recovering from a potential generational low in March of 2009. Portfolios are far higher today than during early 2009, despite record-level market volatility and EU debt crisis aftershocks.

We expect 2012 to continue with the longer term recovery theme. The EU debt crisis will continue, but much of its potential affects are already priced in to expectations, and EU leaders are dead-set on improving stability.

In the US, we would become increasingly bullish if our government began seriously addressing long-term fiscal imbalances. Overseas, our positions will be most influenced to the upside if inflation subsides further, allowing for emerging market policy loosening. On the downside, we will closely monitor events with Iran, as escalating tensions could spike oil prices and cause economic contraction.

Finally, we have made a number of improvements to our investment models heading into 2012. The past year did not disappoint in offering us some humbling new lessons about how markets can behave, which we formally evaluate in our quarterly review process. The two new major improvements are:

- **Improvement #1:** Policy actions are causing greater market movements than have historically been the case. As such, we believe there are certain inflation trigger levels where policy actions tend to be initiated in specific emerging markets. We are now tracking these specific inflation levels on a weekly basis.
- **Improvement #2:** Our Volatility Timing Model is affected by what is called a “futures roll.” Each day a fraction of the current month contract is rolled to the next month, and price differences in these contracts can be in your favor or not. Adding this roll impact to our model helps us to better manage the size of our positions, and to improve the odds of success when we put the trades on.

As always, we encourage you to pursue life’s dreams while we help you achieve your financial goals!

Raphael Martorello

### QUESTIONS

We are available to discuss any questions you have regarding progress towards your financial & investment objectives.

### INTRODUCTIONS

We offer a complimentary 2<sup>nd</sup> opinion service to family members, friends and colleagues of our clients. Please reach out to us if you know someone who may benefit from a conversation with us.

We are accepting new clients through our sister company LotusGroup:  
[www.LGAdvisors.com](http://www.LGAdvisors.com)

### Contact Us

Raphael A. Martorello  
415-793-8014  
[info@mmmwealth.com](mailto:info@mmmwealth.com)  
[www.mmmwealth.com](http://www.mmmwealth.com)