March 1, 2014

the X-factor Report

by Lance Roberts

Market Strategies, Economic Analysis, Risk Management

Bull Market Resumes

After a very brief respite in the forward momentum of the market, the market was finally able to break above overhead resistance on Friday. As I stated previously, such a breakout above resistance would confirm that the current *"bull market"* trend remains intact.

However, as I write that, it is also important to keep the current bull market in perspective. Valuations are stretched, economic data has been weak and the Federal Reserve is in the process of extracting liquidity from the markets. Contrary to what logic would suggest, the markets have rallied in recent weeks in the face of weaker economic data. However, in the markets today, *"bad news"* is welcomed as it will potentially keep the Fed passing out "dime bags" of *"liquidity goodness"* for a while longer. However, that sets the market up for disappointment if the Fed continues to *"taper"* their bond purchases on schedule to end the current QE program by October.

With the markets still on a valid short term *"sell"* signal I am not going to adjust the model back to full exposure as of yet. However, I am going to suggest beginning to slowly build equity exposure in portfolios in anticipation of a reversal of those *"sell"* signals.

Important note: *There is a high degree of risk in doing this. Therefore, if you are more conservative and/or do not pay consistent attention to your portfolio, then I would suggest awaiting a confirmed reversal of the current sell signals.*

As I will discuss below, this is not the first time that the market has broken out to *"new highs"* only to fail once again in a very short time frame. Such a reversal would entail a reversal of any *"buys"* made which is why I am suggesting that if you are NOT paying close attention to your portfolio – you may just want to be patient for a little while longer

"Prediction is very difficult, especially if it's about the future" – Neils Bohr

Inside This Issue:

Suggested Reading

- 5 Things: Reality Check
- Bull Sentiment Reverses
- Housing: Just Weather?
- Confidence & Retail Sales
- Benchmarking Is A Bad Strategy

Sector Analysis

- ***Will Return Next Week In A New Format***

401k Plan Manager

- Click Here For Current Model Allocation.

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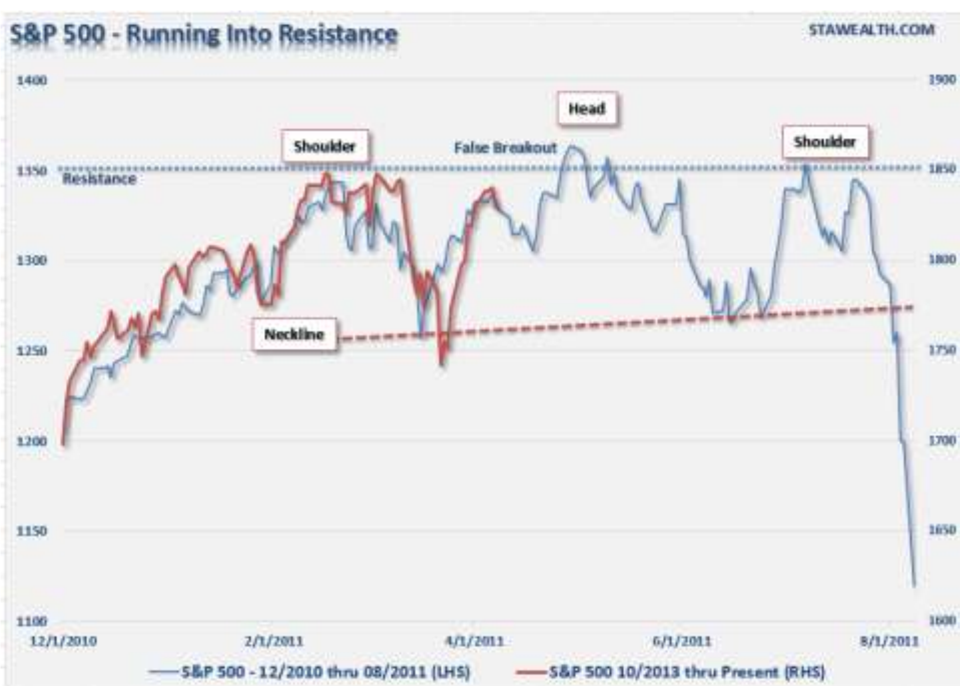
Breakout Or Fake Out

This past week the market broke above resistance for the first time since the beginning of this year.

Technically speaking breakouts above key resistance levels are *"bullish"* and normally suggest that markets will head higher in the near term. However, this is not ALWAYS the case. As I discussed recently in [*"Retracing A Top:"*]



"What is interesting about the chart above is that in late 2010 the markets were rising strongly as the Fed's second quantitative easing program

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was fully engaged. Complacency among investors was high as the economy plugged along. Much the same as we are witnessing currently. Then, in March of 2011, the Japanese trifecta of economic disaster struck as an earthquake caused a tsunami which led to a nuclear plant chain reaction. The only thing missing was a 90 foot tall lizard sending citizens fleeing from the city.

The domestic economy was quickly impacted by the shutdown of Japanese manufacturing. Economic data began to wane at the same time as the Fed's liquidity program approached its early summer expiration. As the market anticipated the reduction in liquidity flows from the Federal Reserve, stock prices began to struggle. However, for a while they managed to hold above important support. Then, in the middle of summer, President Obama squared off with Congress over a heated debt-ceiling debate. Threats of a government default filled media headlines while market participants watched helplessly from the sidelines. While there was never any real threat of a default, as witnessed by the plunge in U.S. interest rates to record lows at the time, the markets plunged sharply over just a few short weeks causing investors to flee for safety.

That was then. Interestingly, we are currently witnessing similar events."

With many of the same events in play it is possible that the current *"breakout"* could turn into a *"fake out"* as it did in 2011.

However, for now, the trend is clearly positive. The chart below shows the current bullish trend which has remained confined between the bullish trend line that was broken during the summer of 2011 and the bullish trend that started in October of that same year.

Importantly, the market is currently trading at the top end of that trading range which has historically marked short term peaks in the market.

I make this point to support the premise that adding portfolio exposure here contains a fairly high degree of risk.

Think about the following points:

RECOMMENDED READING

[5 Things To Ponder: Reality Check]

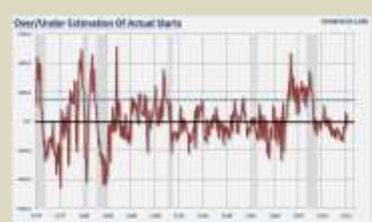
One of the best things to read this weekend is GMO's study on valuations.

[Quick Reversal In Bullish Sentiment]

From Bear To Bull into 60 seconds.

[Housing: Is It Really Just The Weather?]

Is the recent weakness in housing really just a function of the weather?



On the bullish side of the argument:

1. March, April and May are historically fairly strong months of the year.
2. The Fed is still injecting liquidity into the markets.
3. There is likely going to be a mild bump in economic activity as soon as the winter weather subsides.
4. Earnings, while not great, have not been horrible.
5. Stocks have momentum and investors are once again piling into very risky stocks (ie. Biotech)

On the bearish side of the equation:

1. Stocks are once again grossly overbought short term.
2. The Fed is extracting liquidity from the markets.
3. Economic activity could very well disappoint the bullish outlook.
4. Investors are chasing the riskiest of assets.
5. Margin debt ROSE last month when the market rout should have seen it decline. *(a sign of investor exuberance)*
6. This is a mid-term election year which often leads to increased market volatility.

These are just a few of the many points that I am thinking about currently, but you get the idea. Arthur Hill summed my view up well this past week:

> *"**Even though stocks are getting overbought again**, the bulk of the evidence remains bullish for the stock market. In fact, I should refer to the 'bearish' indications as mere 'concerns' because **they have to do with relative performance and economic let downs.** For example, the Dow Industrials is underperforming because it has yet to confirm the new high in the S&P 500, but the Dow is still in an uptrend. In addition, chartists should weigh the positives against negatives.*
>
> *It is like a game of **tug-o-war with the bullish evidence on one side and the bearish evidence on the other**. Will relative weakness in the Dow and Finance SPDR drag the broader market down? Or, will new highs in the Russell 2000, Nasdaq, S&P 1500 AD Line and S&P 1500 AD Volume Line pull the other groups higher. The bullish indicators clearly have more firepower and are likely to pull the remaining negative indications over to the bullish side**. Once everything is aligned on the bullish side and there are no more bears left, we can breathe a sigh of relief. And then the correction will likely begin. That's just the way is works sometimes."***

It is at these late stages of bull market cycles that it becomes both difficult and risky to allocate new money to the markets. This is why we do it with caution AND with a strong sell discipline.

***(Note:** I am working on a set of very specific trading rules and an investment discipline that I will be publishing here soon for you to follow. As always, the most difficult part of investing is following a discipline particularly when it seems to not be working. However, it is what separates winners from losers in the long game.)*

RECOMMENDED READING

Chart Of The Day: Confidence And Retail Sales

The dislocation between retail sales and consumer confidence has finally started to reconnect. What does this mean in the future?

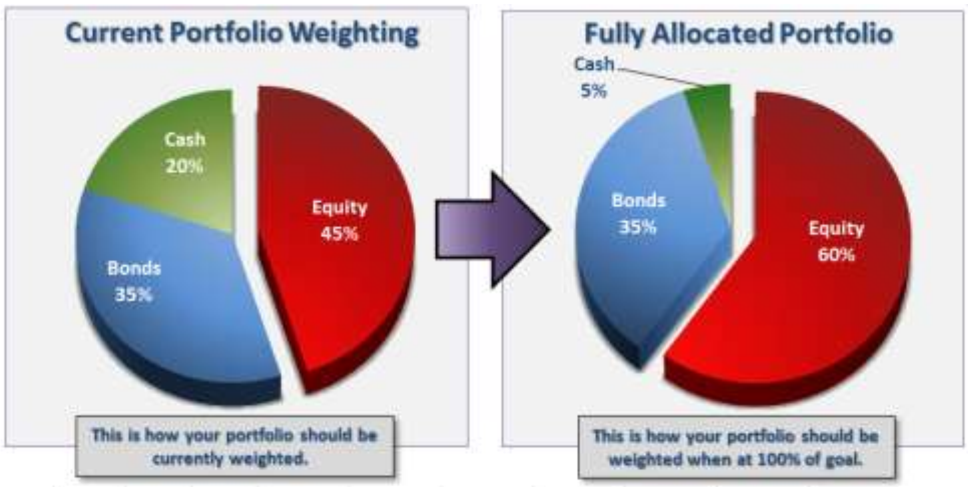
Revisiting Why Bench Marking Is A Bad Strategy

It is time to put benchmarking as part of your analysis "out to pasture."

Preparing To Upgrade The Allocation Model

As I stated above I am not yet ready to *"officially"* upgrade the allocation model as of this weekend. While the market DID breakout last week, it was not a *"convincing"* breakout. That does NOT mean that the breakout was not valid, I just wanted some conviction behind it.

However, the chart below illustrates the pending change to the portfolio allocation model. *(Review last week's newsletter for more details on WHY I use the model allocation below.)*



The table below shows the upgrade to the allocation model below in terms of *"where"* to allocate funds.

Current 401k Allocation Model	
5.00%	**Cash + All Future Contributions**
	Primary concern is the protection of investment capital
Examples:	*Stable Value, Money Market, Retirement Reserves*
35.00%	**Fixed Income (Bonds)**
	Bond Funds reflect the direction of interest rates
Examples:	*Short Duration, Total Return and Real Return Funds*
60.00%	**Equity (Stocks)**
	The vast majority of stock funds track an index. *Therefore, select on ONE fund from each category.* *Keep it Simple.*
20%	***Equity Income, Balanced or Conservative Allocation***
20%	***Large Cap Growth (S&P 500 Index)***
10%	***International Large Cap Value***
10%	***Mid Cap Growth***

A quick note about portfolio management:

As you will note above I suggest only buying ONE fund to represent each area of the portfolio. This is for several reasons:

1. *The MAJORITY of mutual funds track their underlying index. You are NOT gaining diversification by owning 5 different large cap stock funds.*

2. *By owning multiples of the same type of fund (ie large cap growth) you increase what is known as "overlap" risk where you own the same stock multiple times. For example, you own 5 funds all of which overlap with each fund holding IBM.*

3. *By owning multiples of the same fund you potential increase internal costs with no underlying change in performance.*

4. *Rather than buy a specific fund to address a specific portfolio need – most individuals buy which funds performed best LAST year. This strategy never works out very well in the long run.*

5. *The more funds that you own, the more difficult it becomes to understand and manage the internal allocation.*

Risks to the breakout:

If the markets continue to rally during the coming week, then it is likely an early stage reversal of the current *"sell"* signals will begin. However, that will depend much on the currently brewing situation in the Ukraine. If a conflict starts, it could put downward pressure on the markets in the short term nullifying the recent breakout.

Furthermore, there is another winter blast that is likely to dump snow over 1300 square miles of the Northeast. This will put further downward pressure on economic growth in the short term. While *"bad news"* has been *"good news"* for stocks as of late – the combination of events could potentially rattle markets.

With this in mind it is important that any additions to portfolios in the coming days ahead be done cautiously. The sample table below shows how to potentially transition your current portfolio into a more streamlined model.

Current Allocation Model	Wgt.	Transition	New Model	Wgt.
Stable Value Fund	15.00%		*Stable Value*	5.00%
Retirement Savings Fund	5.00%			
Intermediate Bond Fund	10.00%			
Long Duration Bond Fund	10.00%			
Total Return Bond Fund	15.00%		*Total Return Bond Fund*	35.00%
Large Cap Growth Fund	5.00%			
Large Cap Value Fund	5.00%			
S&P Index Fund	5.00%		*S&P Index Fund*	20.00%
Equity Income Fund	5.00%		*Equity Income Fund*	20.00%
Small/Mid Cap Growth Fund	5.00%			
Small Cap Growth Fund	5.00%			
Emerging Markets Fund	5.00%			
Mid Cap Growth Fund	2.50%		*Mid Cap Growth Fund*	10.00%
Mid Cap Value Fund	2.50%			
International Growth Fund	2.50%			
International Value Fund	2.50%		*International Value Fund*	10.00%
Total	**100.00%**			**100.00%**

This is an actual example of a 401k plan I was emailed last week. So, if this looks familiar – it might be yours.

As I stated previously, such a major revamp should be done slowly and deliberately. With the markets overbought, extended and overvalued the risks to the downside outweigh the potential upside reward. However, in the example above:

- *Reduce Stable Value to 5%. The difference is then split into the MidCap Growth Fund and International Value Fund.*
- *Retirement Savings Fund is moved into the S&P 500 Index Fund*
- *The Intermediate and Long Duration Bond Funds are collapsed into the Total Duration Bond Fund.*
- *Large Cap Growth and Large Cap Value are consolidated into the S&P 500 Index Fund*
- *Small Cap and Emerging Market Funds are reallocated into the Equity Income Fund (This move lowers the overall volatility of the portfolio to reduce downside risk.)*
- *MidCap Value is combined with the MidCap Growth Fund.*
- *International Value is combined with the International Value Fund.*

As you can see the new streamlined model is much easier to understand and manage as market risks change. It is suggested that such a major revamp to a portfolio model be done on dips in the market over the next couple of months.

It is likely that as we approach summer we will begin seeing signs, once again, of a market under pressure and the restructuring of the portfolio will have reduce overall volatility and exposure to downside risks.

Looking For Confirmation

The important thing to understand about this week's newsletter is that I am just laying the groundwork for an increase in portfolio allocations. This doesn't mean that the economic framework has improved or that fundamentals have suddenly seen mass improvement. It is simply a function that *"market momentum"* is pushing prices higher and there is no near term evidence that the current cyclical bull market has concluded.

Therefore, next week I will be looking closely for confirmation of the *"breakout"* and looking to slowly increase equity exposure in client portfolios. I will update this analysis next weekend as things develop.

Have a great week.
Lance Roberts

401K Plan Manager

Please read this week's missive above for more details on the pending changes to the 401k model.

As I stated above I am NOT changing the model this week. However, if Friday's breakout in the market is confirmed then I will upgrade the portfolio model allocation next weekend.

However, in the meantime, I have laid out the analysis above to start SLOWLY migrating portfolios in that direction, particularly if the market retests 1850 this coming week without closing the week below that level.

As stated – move slowly and begin migrating your portfolio to the model allocation shown above.

If you need help after reading the alert; don't hesitate to ***contact me***.

[Suggestions Wanted]

I am in the process of revamping the newsletter and the 401k plan manager for the new website. If there is anything that you would like to see added to the 401k plan manager please email me.

Common 401K Plan Holdings By Class

Cash
Stable Value
Money Market
Retirement Savings Trust
Fidelity MIP Fund
G-Fund
Short Term Bond

Fixed Income
Pimco Total Return
Pimco Real Return
Pimco Investment Grade Bond
Vanguard Intermediate Bond
Vanguard Total Bond Market
Babson Bond Fund
Lord Abbett Income
Fidelity Corporate Bond
Western Asset Mortgage Backed Bond
Blackrock Total Return
Blackrock Intermediate Bond
American Funds Bond Fund Of America
Dodge & Cox Income Fund
Doubleline Total Return
F-Fund

The above represents a selection of some of the most common funds found in 401k plans. ***If you do not see your SPECIFIC fund listed simply choose one that closely resembles the examples herein.*** All funds perform relatively similarly within their respective fund classes.

I will modify this list over time as the asset allocation model changes to reflect international holdings, emerging markets, commodities, etc. as the model changes to reflect the addition of those holdings.

Email me if you need further assistance.

Equity
Large Cap
Vanguard Total Stock Market
Vanguard S&P 500 Index
Vanguard Capital Opportunities
Vanguard PrimeCap
Vanguard Growth Index
Fidelity Magellan
Fidelity Large Cap Growth
Fidelity Blue Chip
Fidelity Capital Appreciation
Dodge & Cox Stock
Hartford Capital Appreciation
American Funds AMCAP
American Funds Growth Fund Of America
Oakmark Growth Fund
C-Fund (Common Assets)
ALL TARGET DATE FUNDS 2020 or Later

Balanced Funds
Vanguard Balanced Index
Vanguard Wellington Fund
Vanguard Windsor Fund
Vanguard Asset Allocation
Fidelity Balanced Fund
Fidelity Equity Income
Fidelity Growth & Income
American Funds Balanced
American Funds Income Fund
ALL TARGET DATE FUNDS 2020 or Sooner

Small/Mid Cap
Vanguard Mid Cap Growth
Fidelity Mid Cap Growth
Artisan Mid Cap
Goldman Sachs Growth Opportunities
Harbor Mid Cap Growth
Goldman Sachs Small/Mid Cap Opp.
Fidelity Low Price Stock Fund
Columbia Acorn US
Federated Kaufman Small Cap
Invesco Small Cap

Current 401k Allocation Model

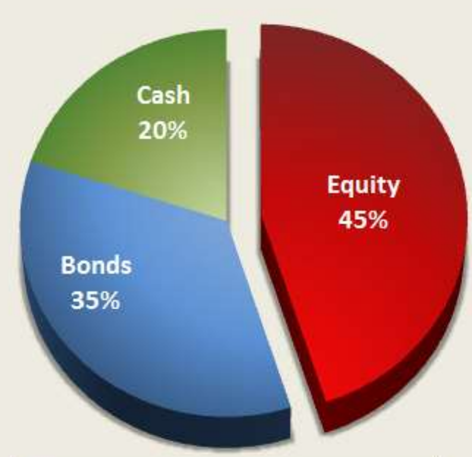
20.00% **Cash + All Future Contributions**
Primary concern is the protection of investment capital
Examples: *Stable Value, Money Market, Retirement Reserves*

35.00% **Fixed Income (Bonds)**
Bond Funds reflect the direction of interest rates
Examples: *Short Duration, Total Return and Real Return Funds*

45.00% **Equity (Stocks)**
The vast majority of stock funds track an index.
Therefore, select on ONE fund from each category.
Keep it Simple.

25% Equity Income, Balanced or Conservative Allocation
20% Large Cap Growth (S&P 500 Index)
0% Mid Cap Growth

Current Portfolio Weighting



This is how your portfolio should be currently weighted.

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