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Investment Strategy

One for the Road

> "Our approach to asset allocation is focused on wealth preservation by controlling the overall exposure to risk assets in relation to macro conditions, valuation and market psychology. We are not attempting to forecast the specific performance of various asset classes as a means of facilitating market timing decisions, as history has shown that this is rarely a winning strategy. Rather, we will attempt to provide analysis that will help investors play a more active form of defense and offense with their portfolios. In order to achieve these goals, we favour a dynamic approach to asset allocation, reviewing the portfolio and making adjustments on a quarterly basis or as conditions evolve, rather than sticking with fixed allocations come 'hell or high water.' Systemic risk in the global economy is far higher than in the previous post-World War II years, volatility promises to remain extraordinarily high and the financial system may be subject to major shocks. This is a major theme running through The Great Reflation. In such an environment, a buy and hold approach to asset allocation will carry a lot more embedded risk than most people expect."
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> "In practice, the execution of dynamic asset allocation is subjective and highly complex for global investors. Many attempts have been made to create models or algorithms that rely on indicators to calculate an optimum asset allocation. However, this sort of quantitative approach inevitably breaks down as the assumptions that underpin the model cannot fit every set of economic conditions. We use indicators selectively to inform decision-making, but at its core, asset allocation is an art, involving equal measures of analysis, intuition and common sense. Above all, investors must have a clear idea of their tolerance for risk, exercise discipline and stick to a plan. Some prefer one of rigid allocations and the literature tends to support this approach. We favour a dynamic allocation process which allows for some flexibility in order to better control risk at important market junctures (e.g. stocks in 1999, housing in 2006-2007)."
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> . . . Tony & Rob Boeckh, *The Boeckh Investment Letter*

I have often opined that asset allocation is the key to bringing *alpha* (read: outperformance) to portfolios. I have also stated I am not dogmatic about asset allocation. For example, I have not owned bank stocks for eight years. I "missed" them going down and have "missed" them going up. Obviously, I agree with the Boeckh's more "dynamic approach to asset allocation." To be sure, for years I have advised participants to think of investing for the future as an automobile, conveying investors to their financial goals. The investment portfolio is its motor, the asset allocation model is the fuel mixture, and the invested assets are the fuel. As John Valentine, of Valentine Capital, notes:

> "The more efficiently the motor runs, the greater the speed with which the whole vehicle travels toward the destination. Should the fuel mixture, or asset allocation, run too rich, the motor wastes precious fuel. Should it run too thin, the car has trouble achieving enough forward momentum. . . . Many individuals on the road to their financial goals fail to make these periodic adjustments and still eventually arrive. Not surprisingly, the investor who rebalances his portfolio at regular intervals may arrive sooner and with more fuel in his tank. . . . Rebalancing a portfolio is crucial to the investor seeking to reduce the volatility in a portfolio and increase cash flow simultaneously. . . . The longer a portfolio is left unbalanced, the more compromised its asset allocation may become. There are two potentially negative repercussions associated with a compromised allocation: being overexposed to the downside and underexposed to the upside. Don't let this happen to you!"

I revisit asset allocation today because I think we are approaching a point where rebalancing portfolios may be in order. To wit, the June "closing highs" for the DJIA (INDU/10424.62) and the DJTA (TRAN/4369.71) were 10450.64 and 4467.25, respectively. Currently, both averages are approaching those levels. Either both averages will break out above their June highs (a Dow Theory buy-signal), one will break out and the other won't (an upside non-confirmation), or both will fail to close above their June highs (trouble). Meanwhile, my proprietary intermediate-term trading indicator is still flashing caution, as are the stochastic and 12-month moving average indicators. That said, I have been constructive on the stock market since the beginning of July despite the parade of negative indicator events registered since the April peak. My bullishness was driven by the most oversold reading since

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the "capitulation alert" of October 10, 2008 when 93% of stocks traded on the New York Stock Exchange made new annual lows. Regrettably, the extreme oversold condition that existed three weeks ago has now been largely erased. Accordingly, this week shapes up as a pivotal week and I will be watching the action closely.

While in the short-run the stock market is a beauty contest (picking the "prettiest" stock), over the long-run it is a weighting machine. Plainly, the "weighting machine's" metric is earnings. To that point, this earnings season has been pretty good with about 76% of the S&P 500 companies reporting positive earnings surprises and ~70% showing upside revenue surprises. Interestingly, of the S&P's 10 macro sectors, Technology's weekly forward earnings per share are at a record high. Since the bottoming process began (October 2008) I have emphasized technology stocks. Most recently, I have talked about Microsoft (MSFT/$25.81) and the potential for a huge upgrade cycle. Coincidentally, the invaluable GaveKal organization wrote this last Friday:

> "In a recent ad hoc comment (Is It Still Time to Overweight Tech?), we highlighted that the average PC used in US companies is now six years old and has a DRAM memory of 2.5GB – both of which lag US consumer PCs. Along the same lines, it is estimated that 75% of US business PCs still use Windows XP . . . a point that came home to roost yesterday with Microsoft's very impressive earnings: thanks to a +21% YoY jump in global PC shipments last quarter, Microsoft reported sales of 175mn copies of Windows 7, making this latest flagship product the fastest selling operating system ever. And given that Windows 7 is not even twelve months old yet (the typical span of time for CTOs to appreciate a new operating system and decide whether to upgrade their firms' software and PCs), there could well be a whole lot more to come. Thus, Microsoft's numbers, coming hard on the heels of similarly strong numbers out of Intel, raise the possibility that we could be witnessing the dawn of a new PC cycle."

I like tech! Using my proprietary intermediate-term trading indicator, I screened all of the technology stocks in our Analysts' Current Favorites list and found the following tech stocks to be favorably positioned: Iridium (IRDM/$10.26/Strong Buy); NII Holdings (NIHD/$39.88/Strong Buy); Nuance (NUAN/$16.95/Strong Buy); and PAREXEL (PRXL/$24.29/Strong Buy). Remember, however, that in the short-run the stock market is a beauty contest and what happens this week, as we approach the June reaction highs, should determine the near-term price action for most individual stocks.

The call for this week: When I entered this business, some 40 years ago, one of my mentors told me to put 20% of my money into Treasury Bills, 20% into stocks, 20% into bonds, 20% into precious metals, and 20% into real estate. Clearly I have not followed that advice, although vetting it over a long-cycle shows it has a pretty decent track record. More to my liking is the attendant asset allocation chart, which has nothing to do with ANY of the Raymond James Asset allocation models, but rather how I would structure a "businessman's risk" portfolio. For international exposure, I would use funds like MFS International Diversification Fund (MDIDX/$11.71), which just got the mandate to increase its exposure to emerging markets. For fixed income, I would use funds like Putnam Diversified Income Fund (PDINX/$7.95), which as a side note was included in a report from our Mutual Fund Research Department last week. And for precious metals, I continue to like OCM Gold Fund (OCMGX/$24.21), which is managed by my friend Greg Orrell. And don't look now, but crude oil ($78.98/bbl. basis September future) traded above its 200-day moving average ($77.69) last week, which is a step in the right direction for our energy investments.

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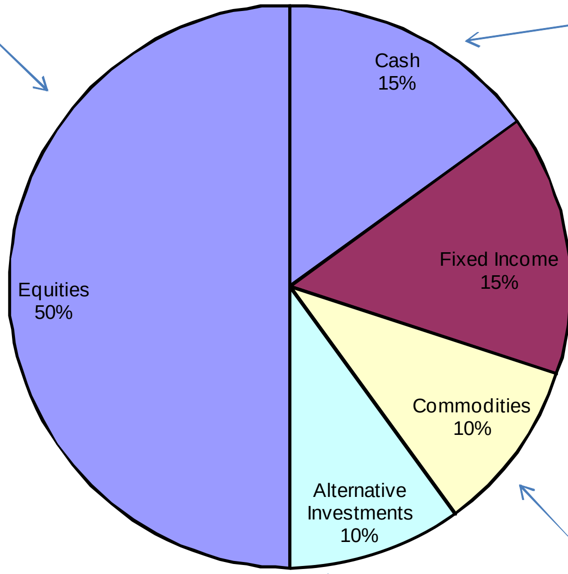
Asset Allocation

* I prefer emerging and frontier markets to most developed markets

* Within the U.S., I prefer large/mid caps to small caps; and growth over value

*My preferred sectors are IT, Energy, Utilities, Healthcare, and Consumer Staples

*Low yield, but safe place to wait for risk aversion to abate



*U.S. preferred over non-US fixed income
*Corporates over Treasuries

*Precious and base metals, soft commodities and crude oil

*Included in portfolios for diversification purposes

Source: Jeffrey Saut, Raymond James & Associates.

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Market Perform (MP3) The stock is expected to perform generally in line with the S&P/TSX Composite Index over the next twelve months and is potentially a source of funds for more highly rated securities.

Underperform (MU4) The stock is expected to underperform the S&P/TSX Composite Index or its sector over the next six to twelve months and should be sold.

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Sell (4) Expected absolute drop in the share price of more than 10% in next 12 months.

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