How to Deal with Volatility in Extraordinary Markets

Introducing the CMG Absolute Return Strategies Fund

By John Mauldin

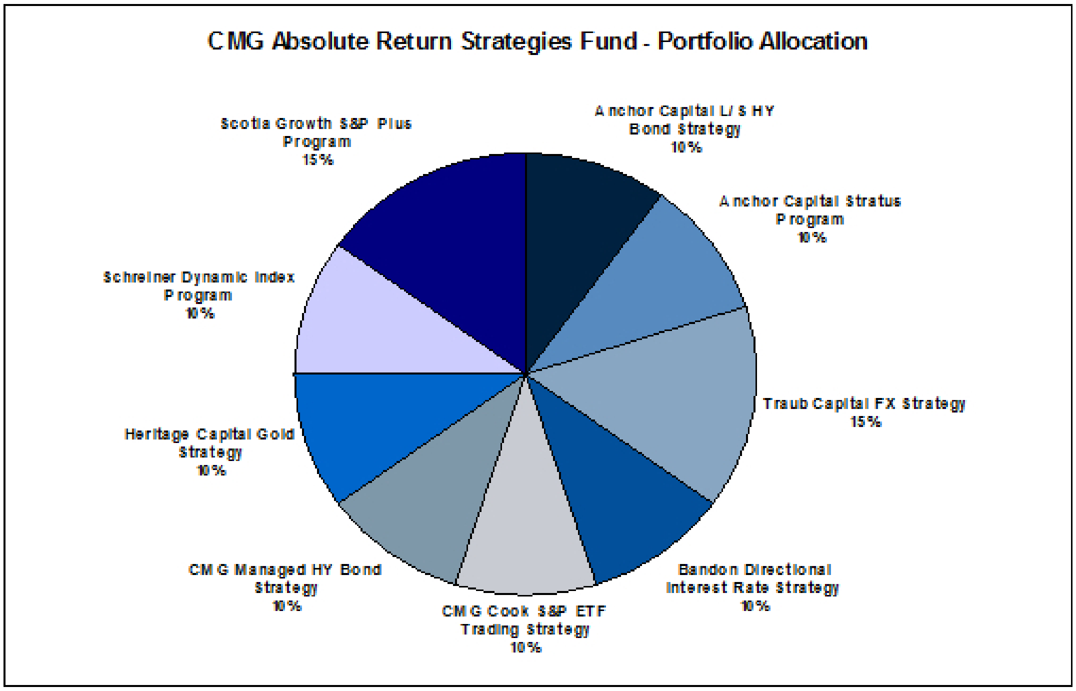
There are not many times in a career when you can say that something new has been created in the financial services industry and that you have been a part of it. But now I can say that, and I must admit, with a little pride in helping to bring a new creation into the world.

For years, Steve Blumenthal and I have shared a passion for bringing Absolute Return Strategies to all investors, not just the wealthy and institutional investors.

I want to introduce you to a new mutual fund, one that is different than the typical long only equity mutual fund. My friends and partners at CMG have created a mutual fund that is comprised of 9 different distinct trading strategies, a "fund of trading strategies," so to speak and is one that I believe could be strategically suitable for the economic environment that I think we face. And as a mutual fund, it is open to all investors. Let me give you the quick synopsis, and then we will go into the rationale and philosophy behind the fund, and then talk about return expectations.

The CMG Absolute Return Strategies Fund is currently composed of 9 carefully selected trading managers who use different systems and trade different markets. In this fund there are managers who trade various and different equity markets, traditional fixed income and high yield bond markets, currencies and the gold equity market. None of the managers depends solely on a rising market in their chosen field of opportunity. Most have the option of trading the various markets directionally long, directionally short or patiently positioned in cash waiting for the next trade to set-up. Some are very short term traders, moving in and out of their markets quite quickly. Others take a more intermediate term view of a few weeks to a month. But whatever their system, they are not "buy and hold." They do not depend upon a rising market for the potential to make a profit. In fact, most of them have a preference for volatility.

Below is a graph of the initial allocation for the fund.



The fund initially has about 45% of its assets managed by advisors who trade in the equity markets, 30% by managers who trade in the fixed income markets, 15% exposed to a currency trader and 10% allocated to a gold specialist. That mix will of course change over time as some managers may be successful and some may not be. The portfolio will actively "re-balance", as well as add (or fire) a manager, so the above graph is indicative of what the general thinking at the time of the launch of the fund is. Also, later on I talk about how you might create your own blend of managers tailored to your needs via a managed account with CMG.

Buy and Hold is Not a Strategy

But first, let's look at the rationale behind a fund of trading strategies. The "conventional wisdom" is that an investor should buy and hold stocks for the long run. That is what the very large majority of money managers and academics will tell you. Depending upon which set of statistics you use, and when you start your study, many studies show that stocks over the last 70-110 years have averaged anywhere from 6-8% real returns (net of inflation) a year[1]. A rather famous study by Yale Professor Roger Ibbotson suggests that stocks will yield 10.7% on a nominal basis, based on analysis from 1926 through 2001[2]. Ibbotson does an annual update and the return through 2008 is down to 9.6% on a nominal basis.[3]

The problem, as we have experienced in the last ten years, is that those returns are "lumpy." There are long periods of time where returns average far above that 6-8%, and then there are long periods of time where returns are flat or negative. For instance, if you bought the Dow-Jones Industrial 30 stocks in 1966, you would not have had a positive return for 16 years, and you would not have had a "real return" (net of inflation) for 26 years. Many would call that the long run. In fact, my friend Rob Arnott recently did a study that shows if you had bought a 20 year treasury bond in 1966 and rolled it over every year you would have done better than buying and holding the S&P 500 through December of 2008[4]. Many investors would consider 42 years to be the long run, indeed.

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[1] The variances can be even wider. "While users of risk and return models may have developed a consensus that historical premium is, in fact, the best estimate of the risk premium looking forward, there are surprisingly large differences in the actual premiums we observe being used in practice. For instance, the risk premium estimated in the US markets by different investment banks, consultants and corporations range from 4% at the lower end to 12% at the upper end." Aswath Damodaran, Stern School of Business, New York University. Professor Damodaran shows why there is such a variety of results in his paper at http://pages.stern.nyu.edu/~adamodar/pdfiles/papers/riskprem.pdf .

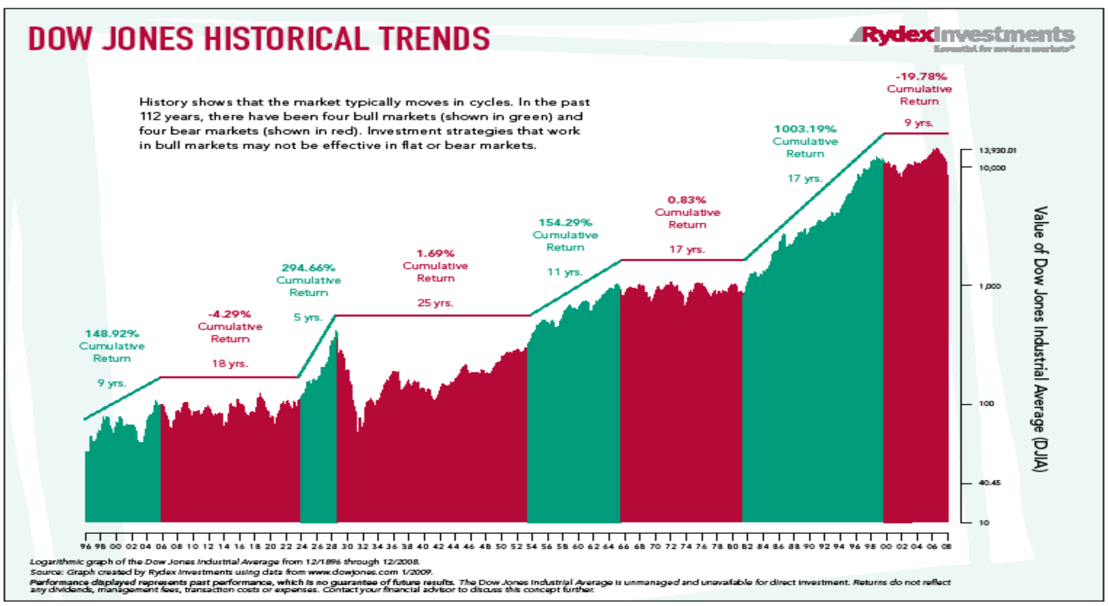
[2] The Equity Risk Premium, Essays and Explorations, Rober G. Ibbotson, page 212, available for free at Google books for those interested.

[3] The 2009 Ibbotson SBBI Classic Yearbook (published by Morningstar; relating to 1926-2008) on page 32, Table 2-1, geometric mean total return for large company stocks.

[4] This was in a study done for the Journal of Indexes at www.journalofindexes.com, May-June 2009. You can read my review and summary at http://www.2000wave.com/article.asp?id=mwo032809.

Of course, if you bought stocks in 1982, you would have been up over 13 times by the end of 1999. Now, I think that is an impressive return and I believe many investors made a great deal of money during those years. And as the field of money management matured during those decades, it allowed many financial professionals to argue that one should buy stocks on the dips and hold for the long run. More than a few advisors quoted the Ibbotson data mentioned above. And after the stock market crashed in 2000-2002, they felt they had been proven right, as the stock market rose back to its former heights by the middle of 2007. And then, as we painfully know, the housing crisis and the credit crisis have taken the market back to new lows and a very volatile overall environment. For now, I believe the buy-and-hold approach is a difficult bet to make. Let’s see why I think this is the case.

I argued in Bull’s Eye Investing, published in 2004, for another approach to understanding the ebbs and flows of the market. If you look at the stock market in terms of valuations (typically the price to earnings ratio, or P/E) rather than price, there is a pattern of markets going from high valuations to low valuations and back to high again. These are very long cycles, on average of 17 years, and are called secular bull and secular bear markets. In general, I think we should view a secular bull market as a period of rising valuations. A secular bear market therefore is a period of falling valuations. The graph below, which starts in 1896, shows various cycles for the DJIA[5].



Note the rather long periods of secular-bear markets. In the secular bear market of 1966-82, valuations as expressed in P/E fell from 23 to 7, even as earnings rose nominally by over 300% over the period and inflation was 298% over the period[6].

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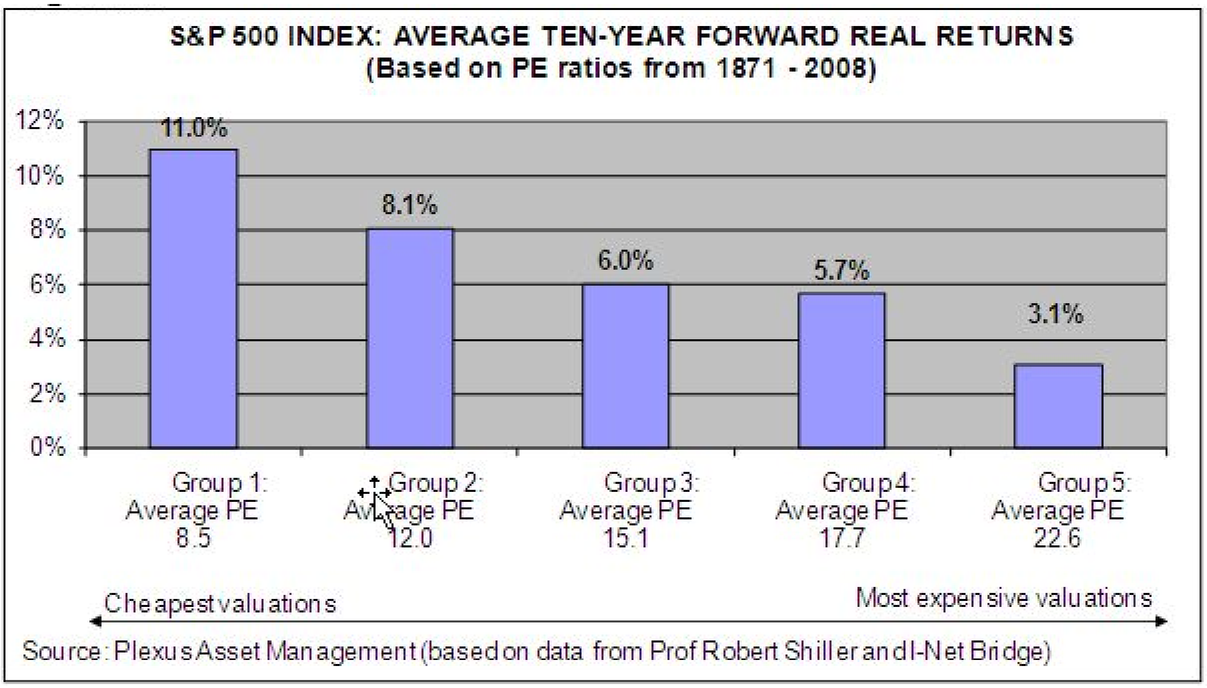
[5] Note there are some minor differences in valuations between Katsenelson and Ed Easterling at Crestmont Research mentioned above. This is due to somewhat different methodology and dating, but the principles are the same.

[6] All data available at www.crestmontresearch.com under the stock market graphs.

From 1982 until 1999, valuations (on the S&P 500) rose from that 7 to 42. Inflation was down to 78%. A good part of the bull market was simply from rising valuations and inflation. Real earnings (after inflation) was a smaller contributor than either rising valuation multiples or inflation.

Obviously, entering the market when valuations are low is a good longer term strategy. The next graph gives us an idea of just how much a difference that can make. If you buy for the long term when markets are in an average P/E range of about 8.5, your return the following ten years would be 11%. That is almost 8% more than your return if you buy when stocks are in the top 20% of their value range. How much does that 8% compounding get you? Over about 18 years, you would have a portfolio that would have been four times larger than by buying when stocks are their most expensive (in terms of P/E ratios)[7].



But that leads to the question, which is the subject of serious debate, as to when are stocks cheap and when are they expensive? You can read in various investment papers or hear on TV that stocks are cheap or expensive or at fair value all in one day. There is no generally agreed upon definition as to how you should measure P/E ratios in the present and compare them to the past, thus giving analysts a very large room to create their own interpretations. Do you use real as reported earnings or operating earnings? Do you use trailing 12 month earnings or forward projections (which are notoriously wrong!)? Do you use a ten year average to smooth at annual volatility or just the current year?

These and dozens of other variations mean that analysts can make valuations appear to be what they want them to be, depending on their biases and basic assumptions. For instance, if you

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[7] The graph is provided by Plexus Asset Management based on data from Professor Robert Shiller of Yale and I-Net Bridge.

use trailing 12 month as reported earnings for the S&P 500, you would find that in the late summer of 2009, the P/E ratio is over 130 (with the S&P 500 at 1025), or the highest it has ever been (due to onetime massive losses in the 4th quarter of 2008), before going back to an estimated 30 (by S&P) at the end of the fourth quarter. That still sounds very expensive from a historical perspective. But if you used ten year smoothed earnings (the Shiller "normalized" methodology), you would find that the P/E ratio is closer to mid-range. Maybe it's time to buy. But then you would be assuming that earnings at banks and financial companies were "normal" over the last ten years.

So, what's an investor to do? Are we in a secular bear or has another bull started? As the saying goes, they seldom ring a bell at the top or the bottom.

But that is the nature of these secular cycles. Where do I come out? I and a small yet growing body of investment analysts argue that we have been in a secular bear cycle since 2000 and one that has not yet finished its work of bringing us to a period of low valuations. That is not to say the market has not put in a price cycle low. In the last secular bear market of 1966-82, the price low was in December of 1974, but the valuation low was in 1982. But it was a very rough, choppy ride during those 8 years with very mixed returns.

In general, if you believe we are in a secular bear cycle, you will want to look for active management styles and trade your own stock portfolio more tactically (yet know that this takes time and discipline). It you think we are back to a secular bull, you would want to weight the stock market portion of your portfolio more to a relative return portfolio and overweight buy-and-hold. But that all depends upon your concept of risk.

There is a brewing debate in the money management industry about the measurement of risk and the nature of market cycles. Let's look at a few paragraphs from Kenneth Solow's new book, "Buy and Hold is Dead (Again)."

"While the academic and financial planning definition of risk is changing at light speed, the notion of what constitutes a risky investment strategy for informed investors is stuck in the dark ages. The underlying assumption of the models that are used to build modern portfolios are the same as they were 50 years ago, and in many cases were originally "discovered" in the early 20th century. The notion of what constitutes "risk" has certainly not changed for investors who follow the acknowledged, status quo method of investing, which is to buy and hold a diversified portfolio of common stocks and bonds. Using the well-known buy-and-hold techniques, the biggest risk that an investor can take is to not own stocks, because stocks have offered investors the highest real, or inflation adjusted rates of return over long periods of time, typically analyzed over ten-to-twenty year time periods. In the buy-and-hold world, the outperformance of the stock market as an asset class is not free. It comes with a cost of high short-term volatility that presumably cannot be avoided. However, the long-term return premiums offered by equity investing are considered to be a given, a gift, a risk-free bonus of return that is available to investors regardless of *when* they invest, as long as they hold on to stocks for the long run. This gift is theirs for the taking because the buy-and-hold paradigm of investing also comes packaged with the notion that markets are efficient, and therefore past return premiums for owning stocks will always be available to investors in the future."

"As an investor who was thoroughly trained in the modern portfolio theory approach to building buy-and-hold, diversified, multiple asset class portfolios, I now realize that the old way of investing is a higher risk strategy than most classically trained investors believe it to be. The investment industry still promotes the buy-and-hold strategy as the most professional methodology to manage portfolio risk, but change is coming very quickly. While there are many roadblocks to change, make no mistake about it, change is inevitable. Why? Because the notion of efficient markets, as well as virtually all of the other assumptions that provide an academic and philosophical basis for buy-and-hold investing is fatally limited, because it only works in one market condition, bull markets. Since we are now experiencing the fifth secular, or very long-term bear markets since the 1900s, it is no surprise that once again the idea of buying-and-holding is being criticized. In fact, I would go so far as to say that buy-and-hold is dead, at least for the moment, although it may take the investment industry a little while longer to figure it out."

Solow continues stating, "The idea that the buy-and-hold investment strategy has come to an end may give the buy-and-hold methodology more credit than it due. I don't believe that buying and holding asset classes and passively waiting for past returns to magically rematerialize rises to the level of an investment strategy at all. It's almost a religious belief, based more on faith than fact. In practice, the buy-and-hold strategy asks investors to suspend rational judgment about the current structure of the economy and the value of investment markets. Instead, this faith-based approach requires investors to believe that the world is a static and unchanging place where the past is guaranteed to eventually repeat itself if we simply wait long enough for past returns to reappear. More accurately, the buy and hold plan is a highly stressful (and unsuccessful) approach to managing money when markets are expensive. In these volatile times, it is not a strategy, it's a prayer."

I couldn't have said it better. Now, I want to introduce to you one way that I think holds the potential for success in these types of markets. Whether you are looking for a way to hedge your traditional portfolio risk or for a way to diversify your portfolio, I would like to recommend you consider the CMG Absolute Return Strategies Fund.

Introducing the CMG Absolute Return Strategies Fund (CMGTX)

I have been good friends and business partners with Steve Blumenthal of CMG for about nine years. Steve has been an Absolute Return Strategy manager since 1991 with a great deal of experience in this space. He began his career on Merrill Lynch's option arbitrage desk in 1984. He has built an experienced due diligence team and has personally been invested in more than 50 hedge funds over the years. I am excited to serve as a consultant to CMG Capital Management Group, Inc., the advisor to the CMG Absolute Return Strategies.

Several years ago, we started looking for ways to help "smaller" investors gain access to absolute return type strategies. The result was that 2007 CMG created a platform consisting of a select group of investment advisors, who could manage smaller amounts of money, typically accounts with a $100,000 minimum investment. The platform was structured in such a way that an investor could diversify their portfolio among a variety of the strategies available on the platform all within one investment account. We feel the response was very gratifying.

Interestingly, a large response came from the professional investment advisor and broker dealer community, as they were looking for ways to diversify their client portfolios. The problem was that it was not practical for many of them to open up an additional 200 (or whatever their client base was) new individual client accounts at CMG's platform custodian, Trust Company of America, while keeping existing accounts in place at their current custodian and then consolidating and explaining two different account statements to each of their many clients. In an effort to bring the platform to them, CMG created the CMG Absolute Return Strategies Fund so that advisors could access these strategies blended together in one mutual fund.

Further, the mutual fund structure allows CMG to consider managers that could not work on the managed account platform through Trust Company of America due to the types of securities traded, logistical issues tied to trade execution, and/or the nature of their absolute return strategies. Today, CMG has a fund composed of 9 different non-correlating strategies, utilizing a wide variety of trading styles and markets. As noted above, CMG expects to add and subtract managers over time. (If you would like to be considered as a sub-advisor, you can email pj@cmgfunds.com. CMG is constantly reviewing new managers, although actually finding one that fits into the criteria CMG is looking for is no small task.)

I know that a lot of readers would like to see some kind of hypothetical track record. We don't provide one for two reasons. It would be pointless, for reasons I will go into below, and the regulatory rules (quite correctly I think) do not allow it.

Here's the problem with showing some type of hypothetical past performance. CMG could make the past look very good by "optimizing" the mix of advisors, but it would have no bearing on the future. The environment that produced the past results is very unlikely to be the same one going forward, so that means the returns are likely to not look like the past as well (of course, this is true for every investment everywhere). And as CMG adds and subtracts managers, the hypothetical would change. If we were dealing with a fund that had just one manager, it might make sense to look at past trading records, but a hypothetical past performance blend of 9 managers would not really give us any idea of future performance.

That doesn't mean CMG didn't do all types of analysis, especially correlation analysis, in deciding what mix of advisors and what allocations they would use. (There was a lot of analysis in putting together this particular mix of advisors.) It just means that in their professional judgment, this is the mix they wanted to go with. CMG believes it is important to understand a strategy's edge, investment process, and the ability and discipline of the manager to trade his process.

If you looked at some of the performance records, you would see that a few of the managers have not been all that impressive for the last two years, and wonder why we would include them? Basically, most of these are managers have been in the business for quite a long time. Their styles will go in and out of favor. The problem is that we don't know when that turning point will be. The correlation of the underlying strategies is a key component to the success of the fund and the separately managed account platform. Though these are absolute return-based managers, I believe each one has a "sweet spot" or ideal market environment where they will be at their optimal best.

Based on this information, CMG chose a blend to give investors what they believe will be a reasonable return for the risk taken and the type of economic environment we believe we will face. If CMG chose the four hottest managers in terms of recent performance, there is no (as in zero) assurance that they will remain hot. In fact, experience suggests the opposite. There is as much art and experience in this process, if not more, than there is math.

That being said, this is a diversified portfolio of non-correlated managers. There may be some investors who have different needs other than this particular blend. For instance, if you just want exposure to the advisors who trade in the equity markets, you might want to call CMG up, talk to one of their professionals and see about establishing your own directly managed account. You can look at the individual manager performance and decide if a different mix than that in the fund would be right for you. You might want the more volatile advisors, or maybe those with less past volatility (remember, past performance is not indicative of future results).

And if you are an investment professional and would like to see how you can put a portion of your client's portfolios with them, please feel free to call CMG at 610-989-9090 and ask to talk with one of their professional representatives. And as a professional, there is additional information on the fund available to you.

How to Invest

If you want to invest in the fund simply click here and you will be taken to the online new account application form page where you can invest directly in the fund.

In general, you want to invest in the Class A shares at NAV with no load. The ticker for the Class A shares is CMGTX. Be sure to click on the NAV box and write in that the reason for waiver of commission is: CMG direct

The CMG Absolute Return Strategy Fund is also available on the following mutual fund platforms: Fidelity, Schwab, National Financial, Pershing, TD Ameritrade, Rydex Financial Services, E-Trade, Scott Trade, Trust Company of America and CMG will be adding more as time goes on.

You can read more about the details of the fund and get a copy of the prospectus by clicking here. There is an explanation of the various strategies used by the various managers. Please read the prospectus carefully. To link to CMG's home page, please click here.

If you would like someone from CMG to call you directly, please send a quick email to sales@cmgfunds.net.

Finally, please note that if you invest in the fund, I serve as a consultant to the fund's advisor, CMG Capital Management Group, Inc., and will receive a portion of the fees earned by CMG.

Your quite excited about this fund analyst,

John Mauldin

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Mutual Funds involve risk including possible loss of principal. An investor should consider the Fund's investment objective, risks, charges, and expenses carefully before investing. This and other information about the CMG Absolute Return Strategy Fund is contained in the fund's prospectus, which can be obtained by calling 1-866-CMG-9456 or clicking here. Please read the prospectus carefully before investing. The CMG Absolute Return Strategy Fund is distributed by Northern Lights Distributors, LLC, Member FINRA / SIPC.

The Fund may invest in small, less well-known companies, which may be subject to more erratic market movements than large-cap stocks; foreign securities, which are subject to currency fluctuations and political uncertainty; and derivative securities, which may carry market, credit, and liquidity risks. These risks may result in greater share price volatility.

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