

MDP ASSOCIATES LLC

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Today's Crazy Markets, How We Are Positioned

Normally these interim editions mainly consist of material that would be appropriate for the Perspective section of my quarterly client newsletters. This one is different in that most of it will discuss the holdings in managed accounts. Very briefly, we are much more out of the market than in it, so things like the 500 point drop in the Dow yesterday do not have much of an effect on us.

Before getting down to the specifics, I want to remind you that a lot of what you read and hear about the markets or specific companies may not turn out to be correct. That includes articles by highly reputable publications such as *The Wall Street Journal* and *Barron's* that certainly are not the muck raking types that want to stir up excitement.

Last March as Bear Stearns was going under, Lehman Brothers stock came under pressure. I recall several articles making the point, backed up by data, that Lehman was in a much stronger position than Bear and was not in any danger of going under. I guess that was true for a few months.

This week's *Barron's*, which came out on Saturday, has an article about Lehman and whether American International Group (AIG) and Merrill Lynch were also vulnerable. Bank of America is going to buy Merrill paying with its stock. The article provides a few numbers and analysis of AIG. It concluded saying the calculations presented indicate that AIG "shares are cheap, but investors made similar calculations with Lehman and have seen it shares collapse. AIG and Merrill are stronger than Lehman, suggesting that the panic selling of both Friday may have marked a bottom." AIG closed Friday at 12.14, and today it closed below 4 after having been as low as 1.25 earlier in the day.

I find that the trends of prices are much more useful indicators of the future price of a stock or of an index. The reason that "fundamental analysis" such as that presented in the articles by serious writers often is way off the mark is that there usually are many complex factors that can drive prices strongly in one direction or the other. If the writer does not focus on the ones that will be the

main future drivers, and often those are hard to detect in advance, the analysis can easily be way off target.

Trend Following Models. I apply models in client accounts that trade mutual funds or exchange traded funds (ETFs) that track the S&P 500 index, the Nasdaq 100 index (NDX), or treasury bonds. The model for the S&P has kept us out of that market for the entire third quarter so far, and it is highly unlikely to give a buy signal soon. We had a two-week trade in NDX funds in August, and it lost not quite 3%. For the quarter so far as of Monday's close, both of those indices have fallen about 7%, which demonstrates how trend following models can substantially reduce risk.

The model for trading bond funds had a one-week trade in July that lost a little over a percent. It generated another buy signal in early August, which is still in effect. That trade is ahead by almost 6% so far, and the rates on Treasury securities are continued to fall today, which will translate into higher prices for the mutual fund held in some client accounts.

Sector Fund Trading. There are three varieties that I employ. I suspended trading of the Fidelity Selects funds and moved to cash in June. At that time market conditions had become too dangerous by my analysis and models to justify the risks of trading these funds.

For Rydex funds, I use two methods, one fairly conservative and one that is fairly aggressive. The conservative method, Sector Trading Adverse to Risk (STAR), has been out of the market much more than in it and has not been fully invested at any point this quarter. Currently the only fund it owns is Consumer Products, which was down about a percent as of Monday's close. For the quarter so far these accounts are down not quite two percent.

The aggressive approach, Aggressive Rydex Trading (ART), exited the market to the safety of cash ten days ago. I do that when my evaluations show very risky market conditions and the trading method has a moderately large drawdown, say around ten percent or a little more. In spite of that drop since the end of July, the accounts are up almost seven percent for the quarter to date.

Precious Metals Funds. This is the one area where some accounts have been hurt this quarter. Because these funds can be and have been recently quite volatile in both directions, I limit the exposure of accounts so that substantial drawdowns do not have too large of an impact. Gold has fallen about 20% so

far this quarter, and most mutual funds that hold gold stocks have fallen by considerably more. The model I use, which is based on the relationship of the prices of the metal and the stocks of the companies that produce it, currently shows that the stocks are valued very low relative to gold. That model has proved to be quite effective in the past, but large swings in the price of mutual funds that own primarily gold stocks are not unusual. I expect the relationship to return to its more usual readings, possibly fairly quickly. Even if it does, that does not guarantee a profit. If the relationship normalizes by gold falling by a fair amount while the stocks fall by a far lesser percentage, our holdings will not gain in value. I consider that scenario less likely than the far more profitable one of gold rising and the stocks jumping much more.

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