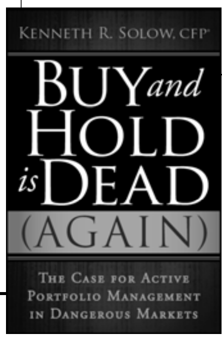
TRACK:	***WEALTH & INVESTMENT MANAGEMENT***
SESSION: *979018*	**BUY AND HOLD IS DEAD (AGAIN)** SUNDAY, OCTOBER 11, 2009 8:15 AM - 9:30 AM
PRESENTER:	Kenneth R. Solow, CFP®, CLU, ChFC Pinnacle Advisory Group Suite 100 6345 Woodside Ct Columbia, MD 21046-3224

Kenneth R. Solow, CFP®, CLU, ChFC, is a founding principal and Chief Investment Officer for Pinnacle Advisory Group, Inc. Ken has offered creative financial solutions to business owners and professionals since 1984. He currently directs the research and tactical investment policy for Pinnacle and continues to work directly as a financial planner for high net worth clients. In May 2009, Ken published his first book, “Buy and Hold is Dead (again), The Case for Active Portfolio Management in Dangerous Markets,” which is an in-depth critique of why strategic asset allocation is a high risk investment strategy in secular bear markets, as well as a thorough “how to” explanation of why and how to actively manage portfolios. Ken has been published in the Journal of Financial Planning, the Kitces Report, The Motley Fool, and featured in several interviews in the Wall Street Transcript on the topic of tactical asset allocation. In 2006, Ken spoke on tactical asset allocation at the TDAmeritrade National Conference in Orlando, Fla., and was the keynote speaker for the Portfolio Construction Conference in Sydney, Australia. He also spoke on New Paradigm investment strategy at the NAPFA Cutting Edge Conference in September in Indianapolis. In 2007, Ken was a keynote speaker at the NAPFA National Conference in Chicago, IL and a panel speaker at the 5th Annual Art of Indexing Conference in Washington DC.



Buy and Hold is Dead (Again)

Presented to:

FPA Anaheim

Presented by:

Kenneth R. Solow, CFP®, Founding Principal and Chief Investment Officer, Pinnacle Advisory Group, Inc.

Three Reasons to Buy and Hold

1. You believe the theory. ☑
2. You don't believe active management is possible. ☑
3. You believe active management is a poor business model.

Questions about Investment Strategy

- What good is an investment strategy where market valuation doesn't matter?
- Does the "scientific" nature of discussions about MPT and CAPM create the illusion of professional money management?
- Will investors do almost anything to avoid qualitative decisions about money management?

Questions about Investment Strategy

- If selling large cap stocks in 2000 constituted market timing, what is wrong with market timing?
- Is there any academic evidence supporting active management and why don't we hear much about it?
- If money management is art, then won't some of us be better artists than others?

Portfolio Managers vs. Money Managers

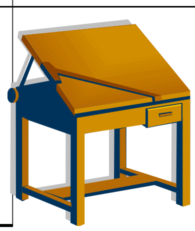
Portfolio Managers

- Invest in all asset classes
- Have arbitrary benchmarks
- Hire or invest in money managers
- Fixed mix of efficient asset classes (MPT)
- Explain money mgr. performance results

Money Managers

- Typically specialize in one asset class
- Have easy to identify benchmarks
- Are constrained by investment style
- Experts at underlying securities
- Media darlings

50 Years of Portfolio Engineering

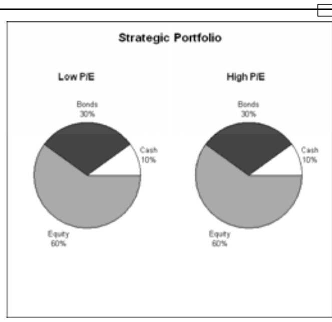


- 3 Input MPT model built in 1950's
- Requires absolutely no understanding of markets or economics
- Results in one portfolio solution for all economic environments
- Emphasis on client relationships vs. market knowledge
- Patience and belief are the major ingredients for success.

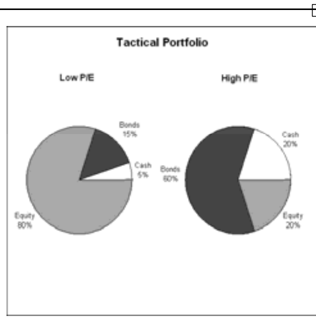
The Two Unbreakable Rules of Investing:

- Do Diversify
- Don't Buy Overvalued Assets

What is Strategic Asset Allocation?



What is Tactical Asset Allocation

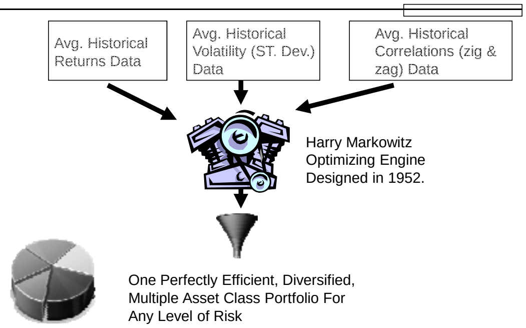


Comparing Strategic to Tactical

Comparison	Strategic	Tactical
Asset Classes	Passive allocation	Active allocation
Fund Managers vs. Index funds	40-year debate over which is better	Choose either based on investment merit only
Selection Criteria	Past Performance	Value Characteristics
Time Horizon	Life-expectancy	Market Cycles
Market Philosophy	Efficient markets	Inefficient markets
Market Timing	Rebalancing only	Yes - in the context of diversified portfolios
Technical Analysis	No	Varies by investor
Ingredient for success	Investor patience	Investor skill

Source: Pinnacle Advisory Group, Inc.

How Modern Portfolio Theory Works



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The Problems with Quant Models

SCIENCE	ART
Quantitative models	Qualitative decisions
Precise	Subjective
Mystical language	Guesswork
Persuasive	Anyone can do it
Expert	Not valuable
Valuable	Market timing
MPT/CAPM/Black Scholes	“Retail”
Hedge Funds	Cause and effect
Probability theory	

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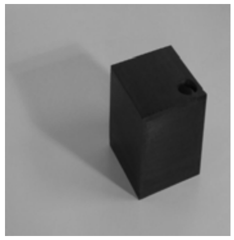
Three Problems with Black Boxes

- Data in is subjective
- What goes on inside the box is too complex to understand.
- The output is not accurate.



MPT/CAPM/Black Scholes: Based on a stochastic view of the universe – probability theory vs. cause and effect.

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Misunderstanding Markowitz

"The process of selecting a portfolio may be divided into two stages. The first stage starts with observations and experience and ends with beliefs about the future performances of available securities. The second stage starts with the relevant beliefs about future performance and ends with the choice of portfolio. This paper is concerned with the second stage."

The beginning of Markowitz's famous paper, Portfolio Selection, 1952, considered to be the mathematical justification for strategic asset allocation, aka, buy and hold investing.

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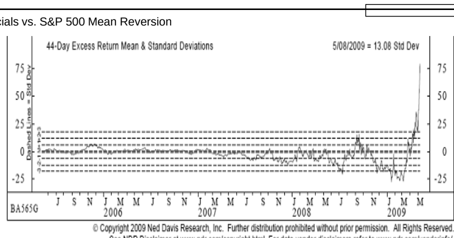
Gaussian Measures of Risk and the Silliness of Efficient Markets

Financials vs. S&P 500 Mean Reversion



"The odds of this relative price move, using the common measure of risk in the industry, standard deviation, is somewhere around (give or take) once per 6,117,160,000,000,000,000,000,000,000,000,000,000,000 times. That's a little less than once per trillion trillions." – Michael Kitces

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MPT and CAPM Assumptions

- No transaction costs to buy or sell.
- Liquidity is infinite.
- Investors are indifferent to tax consequences.
- Investors are rational and risk averse.
- Investors have the same investment time horizon.
- Investors all view risk the same way.

MPT and CAPM Assumptions

- All investors have the same information.
- Investors seek to control risk only through the diversification of their holdings.
- Investors can lend or borrow at the risk-free rate
- Politics and investor psychology don't move the market.

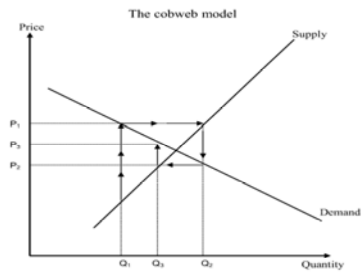
Two Main Axioms of Rational Expectations Pricing Theory

1. Stationarity: Price changes are not only independent of each other, but the forces that govern price changes (the true probability law) are unchanging and fixed forever.
2. Investors know the true probability law.
3. Investor have perfect economic foresight.

The Efficient Markets Hypothesis is the "sloppy" version of Rational Expectations Theory, which is far more rigorous." – H. Woody Brock, Ph.D.

John Muth and Perfect Rationality

Rational Expectations Pricing Theory



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Kurz and Rational Beliefs Equilibrium Theory

1. Investors do not know the true probability law.
2. The economy is stable, but not stationary. Economic regimes change.
3. Endogenous Uncertainty vs. Exogenous Uncertainty

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Kurz: Investors Make Mistakes

"If there is a true and unknown equilibrium probabilistic law underlying the dynamics of the market, and if rational agents have different beliefs about the future, then most may be holding wrong beliefs, leading to forecasting mistakes. A mistake is the difference between an agent's forecast at a particular date versus the forecast that would be made with the correct model, were it known."

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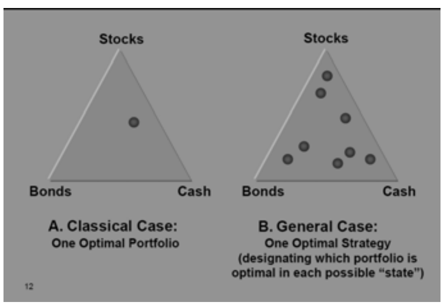
Kurz: Investors Make Mistakes

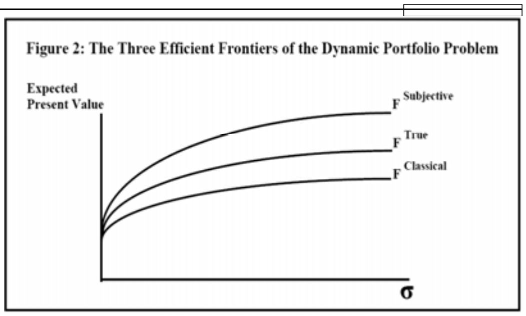
"A mistake is a rule by which rational agents utilize information efficiently, but fail to make the correct forecast. There is no statistical way agents can avoid mistakes. However, agents know that without committing to an investment program that takes advantage of changing conditions of the market, they cannot earn excess returns."

The Logical Justification for Active Management:

H. Woody Brock, Ph.D.,



Woody Brock (continued)



Becoming An Investment Expert

Expertise needed to describe market events.

vs.

Expertise needed to forecast market events.

Three Building Blocks of Developing a Forecast

- Technical Analysis
- Cycle Analysis
- Traditional Valuation Measures

<u>High Conviction Forecast</u> Means Less Diversification, More Deviation from the Benchmark

<u>Low Conviction Forecast</u> Means High Diversification, Less Deviation from the Benchmark.

Develop a Point of View:
Top-Down Analysis

1. The US recession will end 4th QTR 2009
2. The dollar will weaken vs. a basket of foreign currency
3. Yield spreads will narrow w/Gov't intervention
4. Emerging markets are financially sound

1. Sell defensive US sectors – buy cyclical US sectors
2. Buy gold, international bonds – sell US Small caps
3. Buy corporate bonds & junk – sell US Treasury bonds
4. Buy emerging markets, materials, industrials, energy, commodities.

Top-Down: Where to Look

- Consumer Spending:
  - Personal Consumption Expenditures
  - Real Wages
  - NAHB Index
  - New Home Sales
  - Building Permits
  - Credit Conditions
  - Initial Jobless Claims

General Categories:

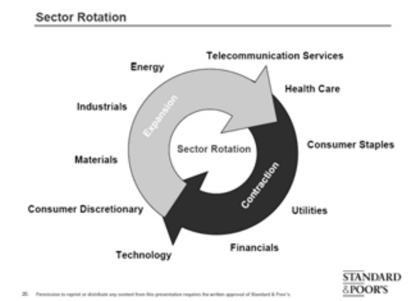
Consumer Spending

Corporate Health

Leading Economic Indicators

Fed Policy

Sector Rotation: Adding Value but Staying in the Market



The Psychology of Being Wrong

Strategic Asset Allocation allows advisors to never be wrong in the lifetime of their engagement with a client. Expected returns are always presumed to be achieved at some undefined time in the future.

Coping With Uncertainty

- Keep Retesting Your Base Case
- Encourage Dissenting Opinions
- Don’t be Dogmatic in your Point of View
- Learn From Your Mistakes
- Think Longer-Term
- Turn off the TV
- Don’t Dwell on Losses
- Take Credit for Your Victories
- Take a Break

Industry Forecast (An Essay)

- Changes in the CFP / CFA curriculum
  - Market Valuation and Long-term Returns
  - The Economy and Financial Markets
  - Stock Market Sectors & Rotation
  - Technical Analysis
  - Behavioral Finance
  - History of Pricing Theory

Industry Forecast (cont.)

- Industry will create new actively managed investment products to meet consumer demand.
  - “Blow up” the Morningstar style box approach to investing.
  - Tactical choices for 401(k) plans (not to be confused with “lifestyle funds.”
- Explosive Growth in the Sub-Advisor Business for financial planners.

Industry Forecast (cont.)

- Educated consumers demanding active management.
  - "Do you believe that markets are efficient?"
  - "When would you consider the market to be overvalued?"
  - "How far will you deviate from your benchmark?"

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