The Plight of Today's Investor

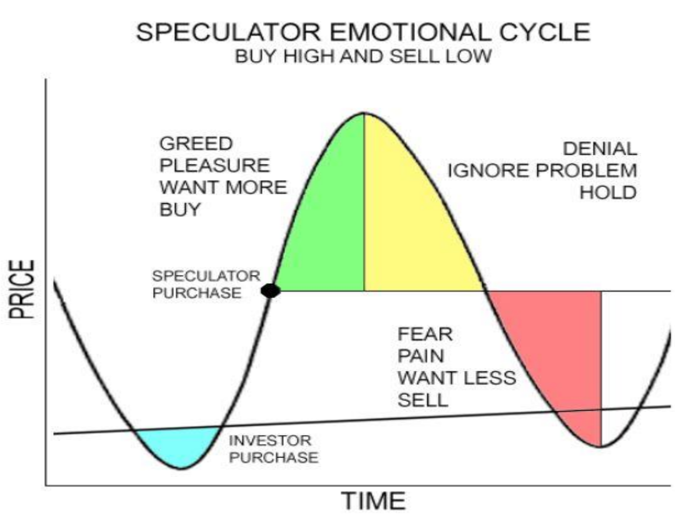
By Patrick Adams, CFA

PVG Asset Management

Financial advisors and clients have a tough job with managing their expectations and financial needs with the underlying fundamentals and risks of the financial markets. It may seem like an impossible task at times. After all, we are only human, and it is a human instinct to be greedy at market tops and conversely, believe the world is coming to an end at market bottoms. It's interesting how many clients were saying four years ago, that they couldn't afford for their portfolios to experience another bear market. Now that the Dow and S&P 500 are hitting new all time highs, many investors are saying they can't afford to not be in the market. Or, clients might just simply be thinking it must be okay to now come back into the stock market for fear of missing a bull run.

Wouldn't it be nice if the market went up when the majority of investors wanted it to go up? Investor sentiment is one of the best contrarian indicators. What is a financial advisor to do when he is given money by clients to put into the market after one of the biggest four year cyclical bull markets on record and the markets are back to all-time highs? Life was so much easier when diversification actually reduced risk in a bear market. Diversification obviously helps reduce the risk of owning an individual security from having a major impact on a portfolio, but the world economies are now all linked together due to a more global economy. It is hard for financial advisors to sleep well at night knowing their client's hard earned money is exposed to an asset class that fell 50% in the last bear market and practically all asset classes were down big as well.

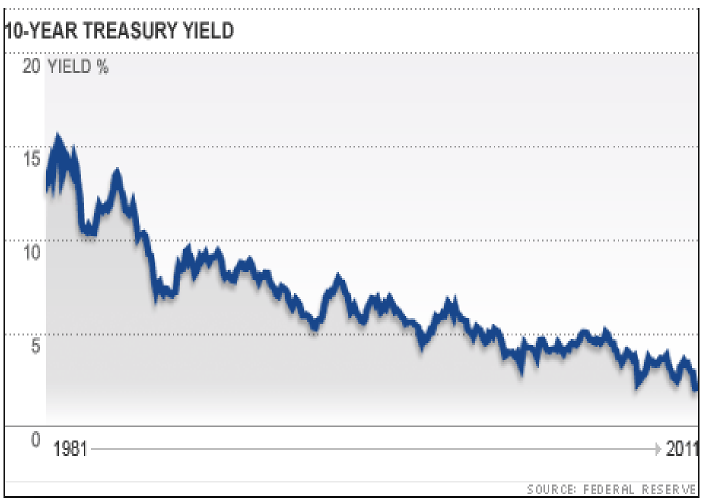
The markets perhaps are, correctly so, finally back to where we started in 2000, and to where we were in 2007. What a roller coaster ride it has been. It seems we have seen this picture before. The institutions have been invested and have benefited from a great rally during the past four years. Now the individual investor is coming back into the market. During these blow off phases you can have dramatic moves up like in 1999, and it's hard to find a bear that hasn't been crushed by the market. It appears we are in the blow off phase unless some major unforeseen policy shift comes out of Washington that changes the underlying trajectory of growth for



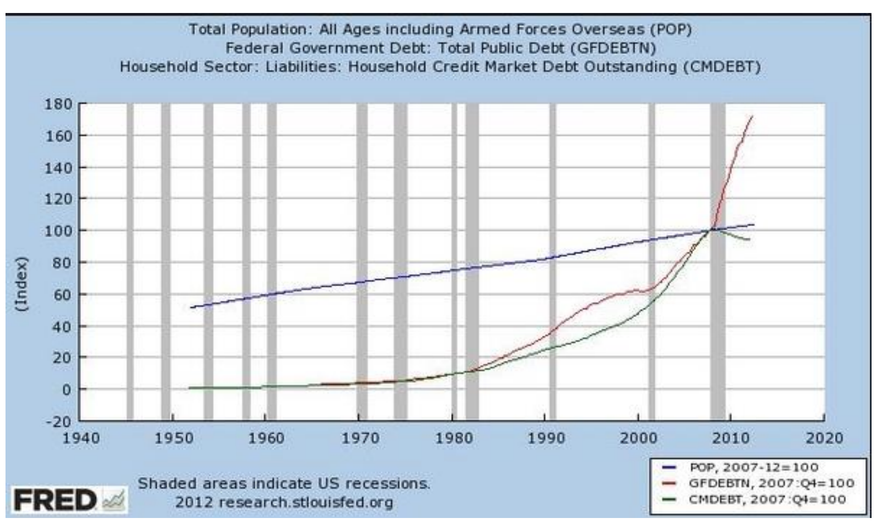
the economy and the fundamentals actually start to get better. We know the odds of that happening are low.

Recently, a strategist at one of the major U.S. banks said many of their 15,000 financial advisors were seeing their clients pull money from money market accounts or from bonds and are instructing their advisors to invest in the stock market. It is almost too predictable isn't it? Sure the advisor wants to make more management fees, and the bank doesn't want to lose deposits or assets under management, so the assets need to be invested.

The financial advisor and clients must seek solutions outside of traditional asset class diversification. Most firms believed that diversification of asset classes would weather any storm; that has proven to be a flawed strategy in the last bear market. The world has changed since the Efficient Market Theory was developed in the 1950s. In a rising market no one cares about diversification or risk management, hence the blow off phases mentioned above. In our view, it is okay to put money into the market now, but if you do so at this point in the cycle, the market risk itself needs to be managed diligently.

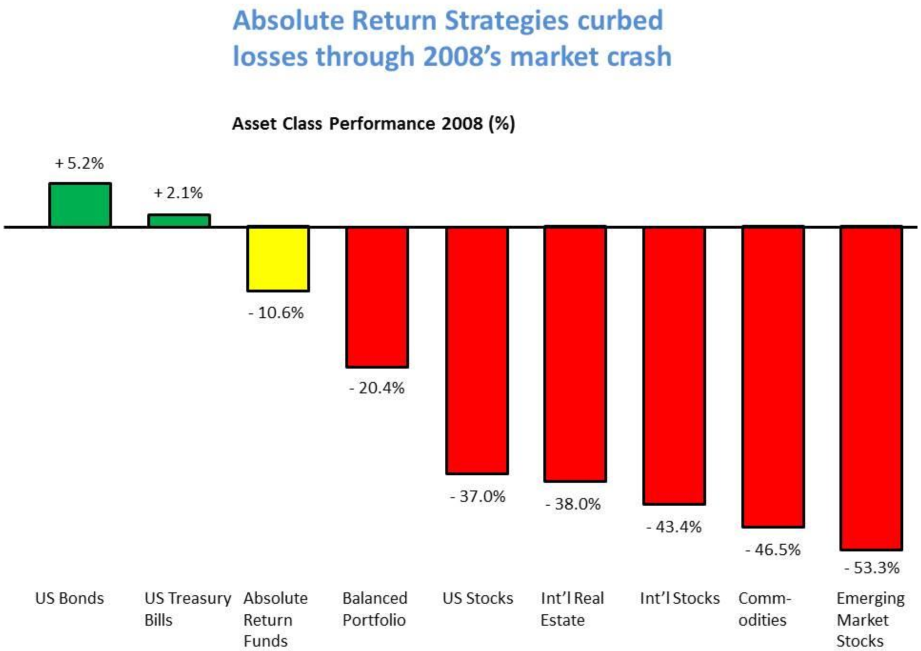


Another major problem for advisors and clients is the traditional method to reduce risk with the use of bonds. Unfortunately, the bond market has potentially the most risk of any asset class due to the secular risk of rising interest rates. We keep hearing about the potential great rotation, and if the Fed keeps nudging the investing public toward riskier asset classes, there will surely be an impact to the bond market. The reality of the fundamentals is, not a lot has substantively changed from 2008, except for the fact that debt has moved from the consumer to the government and then some.



There are solutions for financial advisors to get reasonable returns for their clients and have protection if another bear market were to occur.

Tactical money management: This philosophy allows portfolio managers to create extra value by



taking advantage of certain situations in the marketplace. It's characterized as a moderately active strategy since manager's return to the portfolio's original strategic asset mix when desired short-term profits are achieved.

Tactical money managers can lessen the downside in a bear market as they can, "go to cash" or find safety if necessary. There are many different types of tactical managers, several are market-timers, some sector rotate, and others attempt to reduce risk with active asset allocation. A low risk tactical manager will have the goal of an absolute return. Clients certainly understand this mandate and like the fact that the goal is to make money in a variety of market environments, and not to try and outperform a given index. Most clients have a hard time understanding why a manager, not a tactical manager, would refuse to protect the portfolio in a bear market, which is simply not their objective.

Many tactical portfolios are complex and hard to understand, or difficult to recognize why they are doing what they do, or how they time the markets. It is important to find a tactical manager that has a style that makes common sense, and can be translatable, or easily explained to your client. For example, PVG's most popular strategy, the Loss Averse Equity Income strategy holds a portfolio of high quality dividend paying stocks and protects the portfolio against bear markets with the use of inverse ETFs or stop losses.

We believe the best place to invest currently is in the U.S. stock market, however that does not mean we are in a bull market, nor has the roller coaster ride of the last decade gone away. In fact we believe it is highly likely another bear market may very well be around the corner. Investors who desire to allocate new money into the stock market now need to exhibit some caution.

Again, financial advisors and clients have a very tough job, particularly in this current point of the cycle. Clients are seeking good advice from their advisors. These cycles are almost too predictable. As many tactical managers can show good results in prior corrections or bear markets, they may be a good solution in an ever increasing irrational financial market.