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THE TEMPO VANTAGE

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Double Dip or Short Term Breather?

The ink had barely dried on the April issue of the Tempo Vantage, in which I touted the remarkably calm stock market, when volatility abruptly returned. Suddenly every day became a seesaw battle reminiscent of the most recent bear market.

During the second quarter most equity benchmarks fell in excess of 11%. As with other declines since 2008 this decline was indiscriminate, taking down nearly every category with exception of high quality government bonds as market participants rushed toward perceived safety. While some days were positively frightening (particularly the “flash crash” of May 6) it is always important to view the big picture.

Looking at previous stock market recoveries following extreme bear markets, there is a pattern.

> Step one: Market rally in excess of 60%.
> Step two: Market retrenchment (which could be as much at 25%).
> Step three: The market settles into a sinusoidal pattern (think of a sound wave).

In the absence of additional information we might conclude that the recent market pullback was nothing more than this pattern playing out. However, if we add a good dose of fear such as the collapse of the euro, a horrible oil leak, and the potential for a double dip recession, suddenly the world seems like it is about to end. Not so.

Although I have not become more optimistic over the years, I do think I have become less pessimistic (can one be less pessimistic without being more optimistic?). Years ago I took the Dale Carnegie course. A technique Carnegie espouses for people who tend to worry is to write down all the things that worry you today. Revisit that list in about six months and you will invariably find that most of them are no longer of concern.

So it is with the economy and the stock market. Do I worry about all the problems facing the global economy? You bet I do! I constantly think of these things and the implications for your (and my) portfolios. As I reflect on my time as an investment advisor, though, I realize that there have always been ills - some minor and some major. Yet the specific ills are constantly changing, and somehow we always find a way to get beyond them.

Perhaps the hardest thing to do in the midst of a plethora of bad news and a declining stock market is… nothing. That’s right nothing. It is easy to over react. It is easy to sell or to alter our portfolios based on short term influences, because that is what the people on TV are telling us to do, because it feels comfortable, and because the market often gives us quick and immediate confirmation that we are doing the right thing. It is hard to stick to your long term plan.

As an example, consider the Dow Jones Industrial Average (DJIA), which reached a post bear market peak of 11,205 on April 26, 2010. Four times since then (5/6, 5/25, 6/8, and 7/2) the DJIA has fallen to a level at or below 9,800. It would have been easy to conclude on each of these dates that we should cut losses and sell. In the first three of these instances the market rebounded between 5% and 11% within a matter of days or weeks, making any short term moves seem over-reactionary. The fourth instance is unfolding as I write this newsletter. (After having fallen the first few days of July, the market has already risen over 5% from the low to back over 10,000.)

From a technical perspective the DJIA does appear to have some support in the 9,800 range and some resistance at about 10,400. Perhaps we have entered the sinusoidal pattern mentioned above? While it is too soon to know which level we will "break through," so called market gurus seem to be split on the issue. Half are concerned about a double dip recession and potential deflation; half feel that the recovery in still on track, that inflation will take hold, and that the market is only taking a breather based on negative news from Europe.

I am in the second camp. Europe is just now taking a serious look at many more banks than they had previously and appear serious (finally) about requiring appropriate liquidity levels (much as we did in our country in 2009). I believe that once they get beyond this testing we will be able to focus again on what matters to the markets – corporate profits – which continue to increase.

Returns for the various Tempo investment strategies are in line with expectations in this declining market. Most vulnerable in declines are **Tempo Lifestyle Portfolios**, which have the longest time horizons and therefore the most risk exposure. As you know Lifestyle Portfolios are customized and your result depends on how aggressive a portfolio you have. Returns generally ranged from down -6% for conservative portfolios to down close to -10% for the most aggressive ones. Taking my own advice I decided that the best action was to make no material changes to portfolios during the second quarter.

On the one hand I am pleased that the **Tempo Dynamic Growth Strategy** only fell about half as much as the overall market (-6%). On the other hand I had thought our positions might hold up a bit better. No, I did not expect to make money in such a negative environment. But, while I am ok with an upside capture ratio (the percentage of a market increase captured by an investment strategy) of 50% in bull markets, I am less pleased with down-side capture ratios of 50% in declines. This outcome is not unusual, though, in markets where the declines are indiscriminate and across the board such as in the fall of 2008 and in this most recent quarter. As of this writing it is still too early to say exactly how positions will evolve with the July rebalance, though I think it is safe to say that the overall risk level of portfolios will be reduced.

The star performed for the second quarter was the **Tempo Dynamic Income Strategy**, which lost just -2%. Thanks to a wonderful first quarter, accounts are also still up year-to-date. As you know we have been fighting an uphill battle in the market since 2008 and so I was very happy at various points in the second quarter when all Dynamic Income accounts had entirely overcome previous losses and were at all time highs. Alas, it was not meant to be as the decline over the last few weeks of June erased the gains. Still we are just a few percentage points away from fresh highs, which is far better than the vast majority of investments (for example, the S&P 500 still must gain over 50% to get back to its pre-bear market high).

Company News

June 20 marked the two year anniversary for Tempo Financial Advisors. Since our inception we have seen steady growth. This growth would not have been possible without you and the fact that many of you have also felt comfortable referring a colleague, friend, or relative. Thank you!

Dan Traub