

“That’s another fine mess you’ve gotten me into.” Oliver Hardy

July 21, 2008 Summary: We finally saw extreme negative investor sentiment last week as the combination of news from the Banking sector and FNMA/FNM motivated investors to negative extremes. These negative extremes are necessary to flush out the last of the resilient sellers and create a market bottom. For example, the weekly survey of financial newsletter writers polled at 48.9% bearish, the largest bearish reading since 1995. Despite the failure of Indymac bank, which ranks amongst the top 5 bank failures of the last 35 years, the history of market performance going forward after bank failures is actually very bright (it’s the preceding months leading to the failure that are dismal). Supporting data by Sundial Capital Research; “The average return in the S&P 500 six months after these five failures was +19.5%. The maximum loss during those half-years averaged only -2.0% compared to an average maximum gain of +22.6%, more than ten times as large”.

The long term is looking pretty good and now appears to be the time to increase market exposure. There is a plethora of data that suggests the coming 12 months should be very profitable. The rally of last week appears to have placed a bottom in the market and oil prices have moved down sharply. The dominos are falling in place for a significant rally and an end to the Bear Market.

S&P 500 Peformance When Up 1% On NYSE Volume That Is Double Its One-Year Average, While S&P Is In A Downtrend

Date	5 Days Later	10 Days Later	1 Month Later	3 Months Later	6 Months Later	12 Months Later
01/10/75	↓ -2.3	↑ 0.5	↑ 7.9	↑ 15.9	↑ 30.4	↑ 30.8
01/27/75	↑ 3.3	↑ 4.0	↑ 6.6	↑ 14.4	↑ 17.7	↑ 32.3
02/13/75	↑ 2.0	↑ 0.7	↑ 6.2	↑ 12.8	↑ 5.7	↑ 23.8
04/14/78	↑ 1.5	↑ 4.2	↑ 6.3	↑ 5.0	↑ 12.9	↑ 9.8
08/17/82	↑ 5.8	↑ 9.6	↑ 13.5	↑ 25.7	↑ 36.6	↑ 50.1
10/07/82	↑ 4.5	↑ 8.0	↑ 10.4	↑ 12.8	↑ 17.8	↑ 30.2
08/02/84	↑ 4.8	↑ 3.7	↑ 5.5	↑ 5.1	↑ 13.7	↑ 21.6
01/17/91	↑ 2.1	↑ 4.9	↑ 12.5	↑ 18.4	↑ 17.5	↑ 27.5
07/24/02	↑ 8.1	↑ 4.0	↑ 14.1	↑ 5.5	↑ 5.2	↑ 16.4
01/23/08	↑ 1.3	↓ -0.9	↑ 1.1	↑ 3.1		
03/20/08	↓ -1.1	↑ 3.1	↑ 4.4	↑ 1.0		
Average	↑ 2.7	↑ 3.8	↑ 8.0	↑ 10.9	↑ 17.5	↑ 26.9
% Positive	82%	91%	100%	100%	100%	100%
Max Gain	8.1	9.6	14.1	25.7	36.6	50.1
Max Loss	-2.3	-0.9	1.1	1.0	5.2	9.8

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The trading volume of the week of July 14th would suffice to be added to the chart above. This kind of behavior from the markets indicates there his a high probability that we could be at the initial stage of a meaningful rally.

But consider the economic backdrop, let’s see: The economy is a mess (we now have movement from the government on housing), we have no energy plan (but oil has pulled back from \$147.90 to \$124.30 in a week), banking is in crisis (there is a good chance the worst is behind us now), Ford and GM are on the precipice (still no change there) and we have an administration that’s not only out to lunch, but dinner, drinks and a late night snack (but change is coming soon).

Despite a truly horrid June, RMHI client accounts did quite well. The S&P 500 index fell 9% in June losing all the gains made in April and May. This was not a surprise as the average bear market rebound generally lasts about 54 days. Anticipating this decline, I enacted a hedge strategy that I had been working on and testing for over a year which employed the use of Proshares Inverse Exchange Traded Funds (ETF's). Indices are now back and back to where they were in March but we retained the bulk of appreciation from April and May. We did so well that most accounts have now moved ahead of the S&P 500 for 2008 in terms of performance whereas we did lag in the 1st quarter. Although accounts are still in the red for 2008, the net loss is modest to the point where an intermediate termed (40-60 trading days) should place accounts close to net positive for the year. Our out performance has not been a random event but by a careful and deliberate shift in strategies which employ the use of "Hedging" which are designed to reduce risk and buffer intermediate and long term market declines.

According to Webster's Dictionary: "*Hedging*": *Taking two positions that will offset each other if prices change and so limiting financial risk.*

Investing today is becoming increasingly like investing in the 1970's when the term "stagflation" was coined. It was defined as a period where there was little or no growth in the economy paired with rising inflation. During this period, the stock market went exactly no place for over a decade and bonds were a financial black hole. Yet, it was possible to make gains in portfolios by shedding the perma-bullish / "buy and hold" view and adopting a neutral, agnostic strategy.

Since RMHI is an independent firm we have the advantage of being flexible in our investment approach. We can utilize useful financial products that would be barred at other firms since a competitor created these products. Could a manager at Fidelity use a product created by Vanguard?

Two years ago Proshares created a series of ETF's (Exchanged Traded Fund – a mutual fund that trades on the exchange like a stock) that moved *inversely* to the stock market. In other words, the value of these inverse ETF's rose as the stock market declined. Previous to the invention of these inverse ETF's an investors only real option to hedge the portfolio against a market decline was to either buy put options, short sell a futures contract or simply raise cash by selling stocks. The first two options are not allowed in most IRA's and pensions since they generally ban options and futures trading. Short sales of index ETF's was not allowed since they required a margin account. So what was an investor to do? The only option that remained was selling a large percentage of stocks.

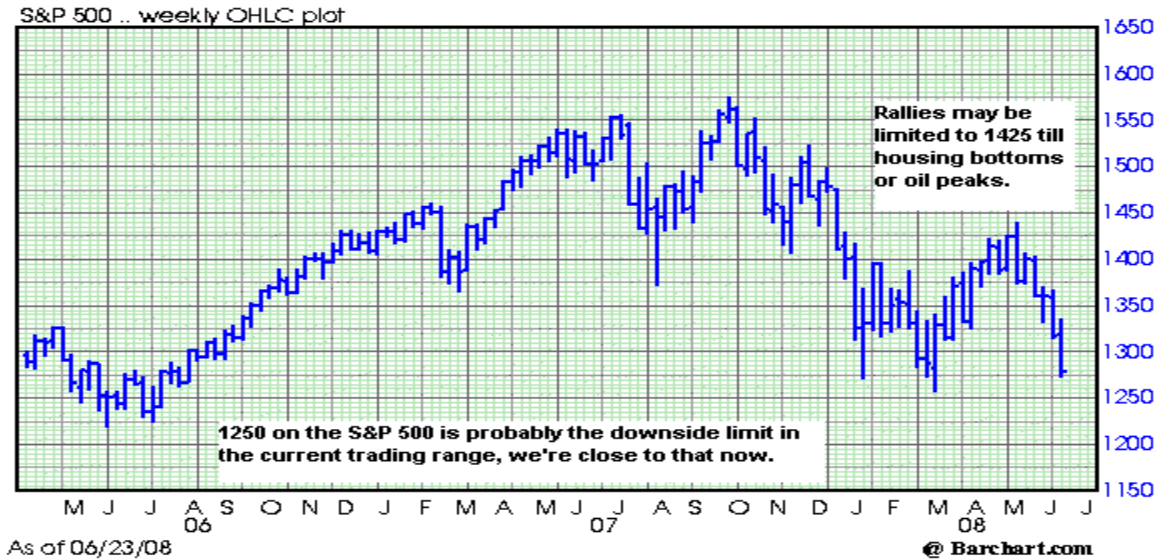
The gap in sensible options available to hedge against a market decline was closed by the by Proshares in 2006. Their creation Inverse Market ETF's, especially the Ultra-short S&P 500 ETF's that moves 2X the rate of the S&P 500 gave us a tool that would allow us to endure a market decline. The purchase of the Ultra Short S&P 500 (SDS) or the Ultra Short Nasdaq ETF (QID) in a portfolio will help to preserve the value of an account by offsetting losses in existing stocks should the markets decline.

To use a phrase commonly heard back in the 70's: "Let me be perfectly clear" – Hedging with the use of Inverse exchange traded funds (ETF's) reduces risk and volatility when incorporated with an existing stock portfolio.

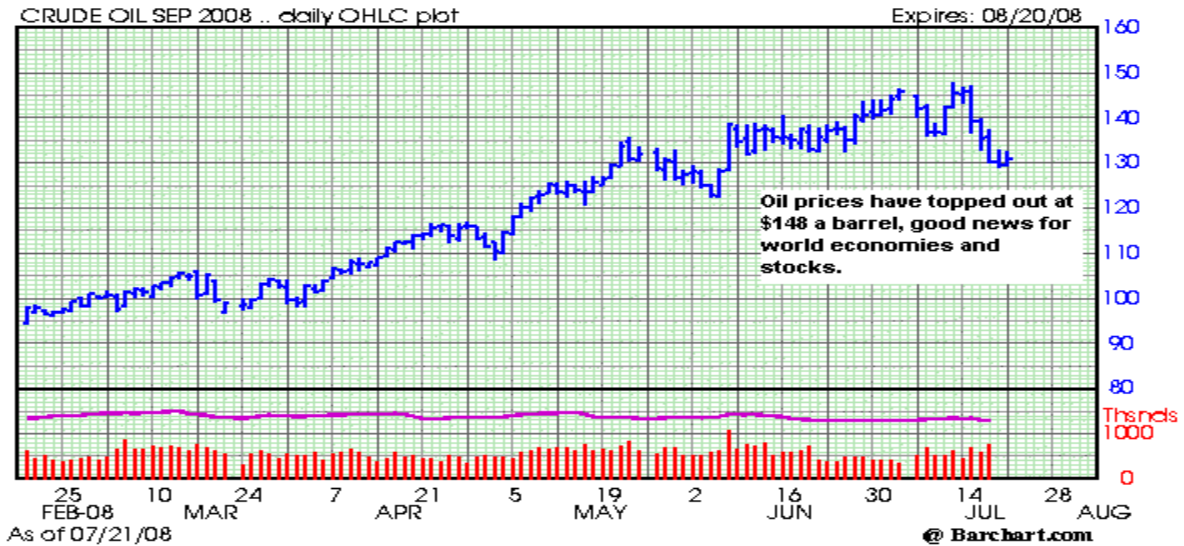
In my opinion, only an extremely small percentage of management firms or mutual funds utilize any form of effective hedging. They are forced to rely upon a rising stock market to create gains for their clients. As I've said previously, the evidence is substantial that we are in a sideways/sawtooth trading environment, at least until the housing industry bottoms and/or oil tops out.

The bottom line: When you become agnostic to market direction, trends become easier to see and strategies to achieve success are easier to employ. By nature, I tend to prefer to be a "bullish" investor so it wasn't without a great deal of preparation that I undertook this transformation in bias. My obligation to you, my client motivates me to create strategies that will ultimately succeed in any investment environment: bullish or bearish. I believe to succeed in the coming years will require to both a bull and a

bear depending on circumstances. Your future is too important to let the flow of events determine your financial success without taking proactive measures.



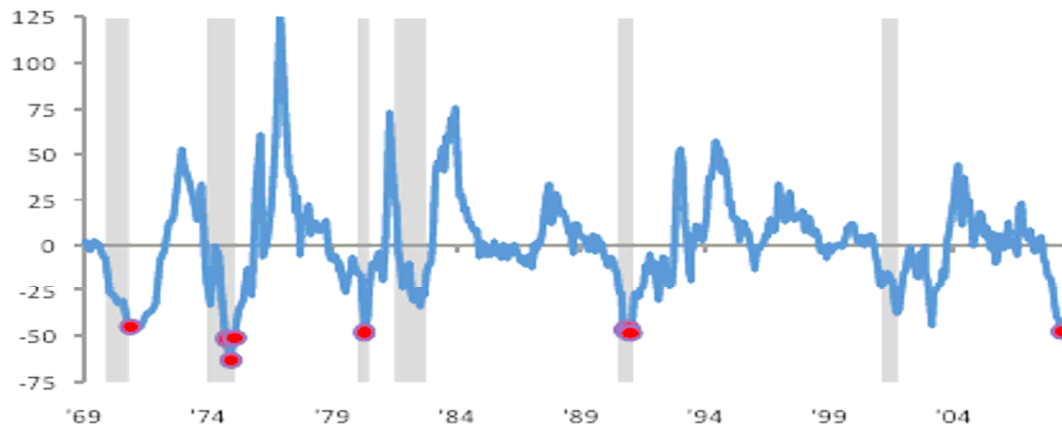
The upward march in crude appears to have peaked at \$148. It has been impossible for me to believe in any long last stock rally till a top in oil was in place, we may now have reached a peak.



“Come what may, all bad fortune is to be conquered by endurance.” Virgil

This period too will pass. On the bright side of things, if you can conceive of gallows humor being reason for optimism, investors and the public have become so bleak that sentiment has become favorable.

Y/Y Consumer Confidence & Recessions: 1969 - 2008



Gray shading indicates recessions.
Red dots represent Y/Y declines of 45% or more.

S&P 500 Performance Following 45% Y/Y Declines in Consumer Confidence: 1967 - 2008

First Month	Max Y/Y Reading During Period	S&P 500 Performance (%)			
		Prior 12 Months	Next Three Months	Next Six Months	Next 12 Months
Dec 70	-45.11	0.10	8.86	7.24	10.79
Oct 74	-62.79	-31.76	4.55	15.89	20.49
May 80	-47.81	12.17	10.01	26.01	19.19
Oct 90	-48.26	-10.68	10.47	22.91	29.10
May 08	-47.28	-9.99	-	-	-
	Average	-7.54	8.47	18.01	19.89

Graphs courtesy of Bespoke Investment Group.

It's probably a decent assumption that we're in a recession now and in years past we have experienced drops in consumer confidence comparable to our current decline. But what matters at this stage is how declines in confidence affect the future. Sentiment data is a reflection of how people react to the present, but we all know that "change" can be relied upon.

My interpretation of the Consumer Confidence data along with the following investor sentiment data is that we could experience an explosive market rally once housing and/or oil stabilize. This shift in sentiment and its affect upon markets holds true even in the worst of times, as the December 1970 and October 1974 were bleak periods within a stagnating economy coupled with inflation, not unlike our present times.

In sum, the markets appear to have digested an anvil load of depressing data but now much of this dismal news might be "baked in the cake". I expect the relief that we experienced last week to continue and its quite possible that a major market bottom has just been installed and it couldn't have happened soon enough.

Warm regards,
Brad Pappas