INSIGHT
WEALTH
MANAGEMENT

WORKSHOP: IMPLEMENTING AN ECONOMIC TRENDS-BASED INVESTMENT STRATEGY USING ETFs

Presented by

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President, Insight Wealth Management, Inc.

The AAII Washington DC Metro Chapter

Saturday, July 17, 2010

This slide show, presentation, related discussion, and all other materials provided are to be considered general educational information rather than investment advice for any individual or group of individuals. Specific investment advice for any individual or group of individuals must be based on a detailed evaluation of their personal needs and circumstances.

Bob Pugh, CFA, CFP® Brief Biography

- President, Insight Wealth Management. Inc in Gainesville, VA, providing independent wealth and investment management, and financial planning services to individuals, families and charitable organizations. Member of the Schwab Institutional network of select independent advisors.
- President of the CFA Society of Washington, DC, 2005 to 2007, and current Eastern Region Presidents Council Representative, CFA Institute.
- Over twenty years of experience as a financial educator and analyst, and portfolio manager in the private and public sectors, including the Central Intelligence Agency, director of investment research at another firm, and senior financial analyst with the Prince William County government.
- Graduate degrees in global political economy from the Johns Hopkins University, School of Advanced International Studies, and in financial economics from the University of North Carolina at Greensboro
- Faculty member; Johns Hopkins University's Carey School of Business teaching graduate-level courses in investment analysis, portfolio management, and corporate finance from 2001 to 2008
- Community Volunteer, including serving as President of the Prince William Symphony Orchestra for four years, and over ten years service with the Prince William County Personal Finance Program
- Contact information available at www.insightwealth.com

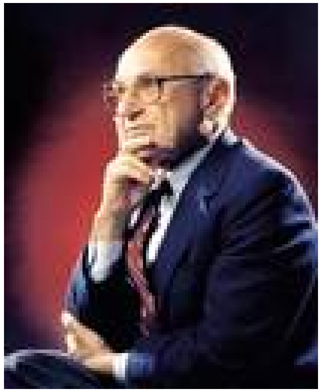
Upcoming Radio Show

- Weekly Internet radio show begins September 20 at 10:00 AM
- Visit www.voiceamerica.com
- Range of topics and guests on investing, financial planning and wealth management

Economics

"Positive economics is in principle independent of any particular ethical position or normative judgments. As Keynes says, it deals with 'what is,' not with 'what ought to be.' Its task is to provide a system of generalizations that can be used to make correct predictions about the consequences of any change in circumstances. Its performance is to be judged by the precision. scope, and conformity with experience of the predictions it yields. In short, positive economics is, or can be, an 'objective' science, in precisely the same sense as any of the physical sciences."

Milton Freidman, "Essays in Positive Economics," 1953



Economics

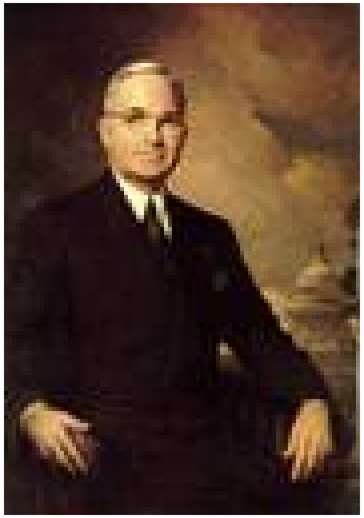
"The economic world is driven primarily by random jumps. Yet the common tools of finance were designed for random walks in which the market always moves in baby steps. Despite increasing empirical evidence that concentration and jumps better characterize market reality, the reliance on the random walk, the bell-shaped curve, and their spawn of alphas and betas is accelerating, widening a tragic gap between reality and the standard tools of financial measurement."

Mandelbrot and Taleb, 2005

Economics

"If you lined all the economists in the country up end to end, they would still point in all directions."

President Harry S. Truman



Economics

Economics is an art rather than a science. Some try to quantify economic relationships in the same way as physicists analyze the natural world, and to assume away all other aspects of human existence, but such efforts are in vain. The best economic analysis comes from those with the broadest view of the widest range of factors, and who are able to integrate and synthesize that information into a coherent, actionable conclusion.

Top-Down Analysis

Global, Regional or National Macro Economy/Market

Asset Class/Sector/Industry

Firm

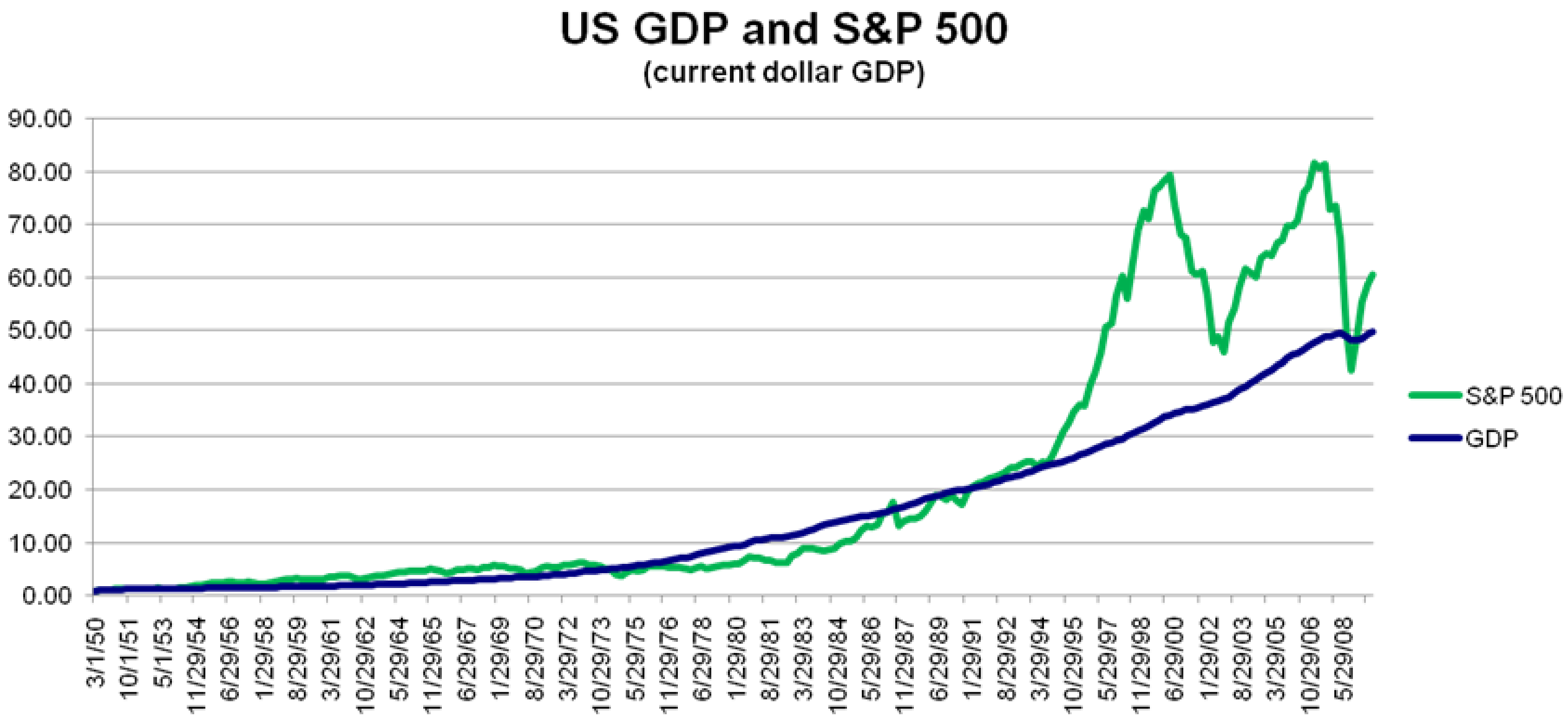
Exchange-Traded Funds (ETFs)

- Inexpensive
- Diversified
- Exposure to a multitude of asset classes, sectors, styles and economies
- Trade like stocks
- Can be shorted
- Liquid
- Transparent

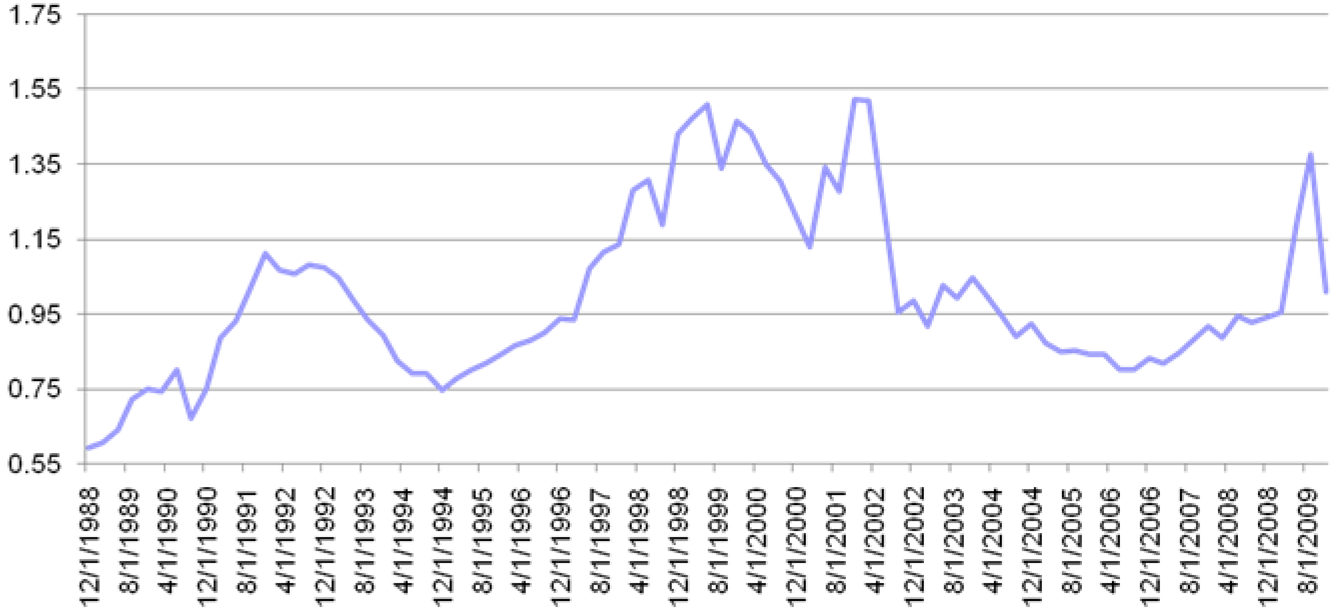
Equity

- Equity (Stock or index) Price Composed of:
  - **Earnings per share** – objective, measured from financial statements, depends on economic and sectoral performance
  - **Price multiple** – psychological, difficult to predict, expectations driven by economy to some extent, major shift in mid-1990s

Stocks and the Economy



P/E Ratio
(Normalized to Period Average)



Business Cycle

Peak ↘

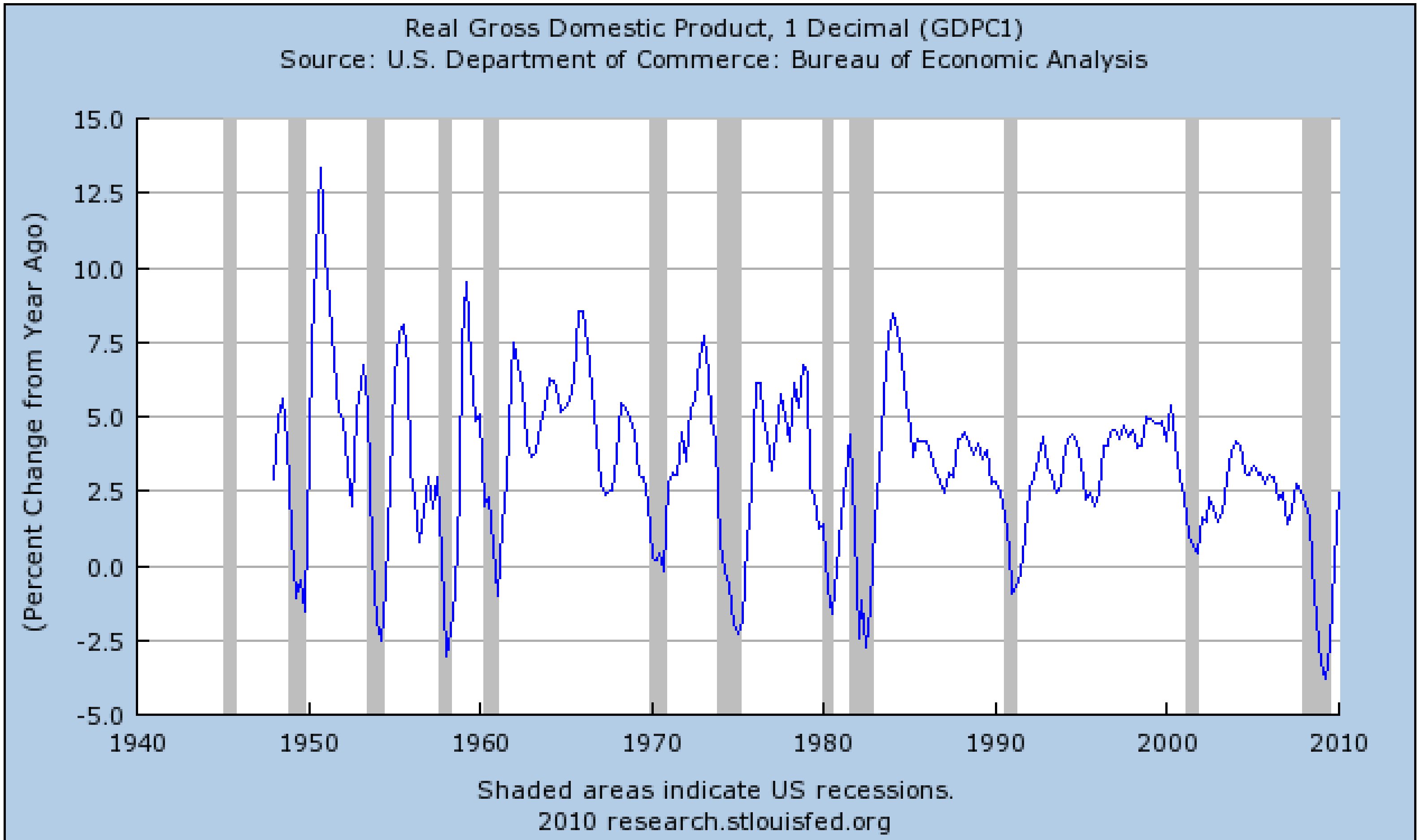
Contraction/
Recession ↘

Trough ↗

Expansion ↗

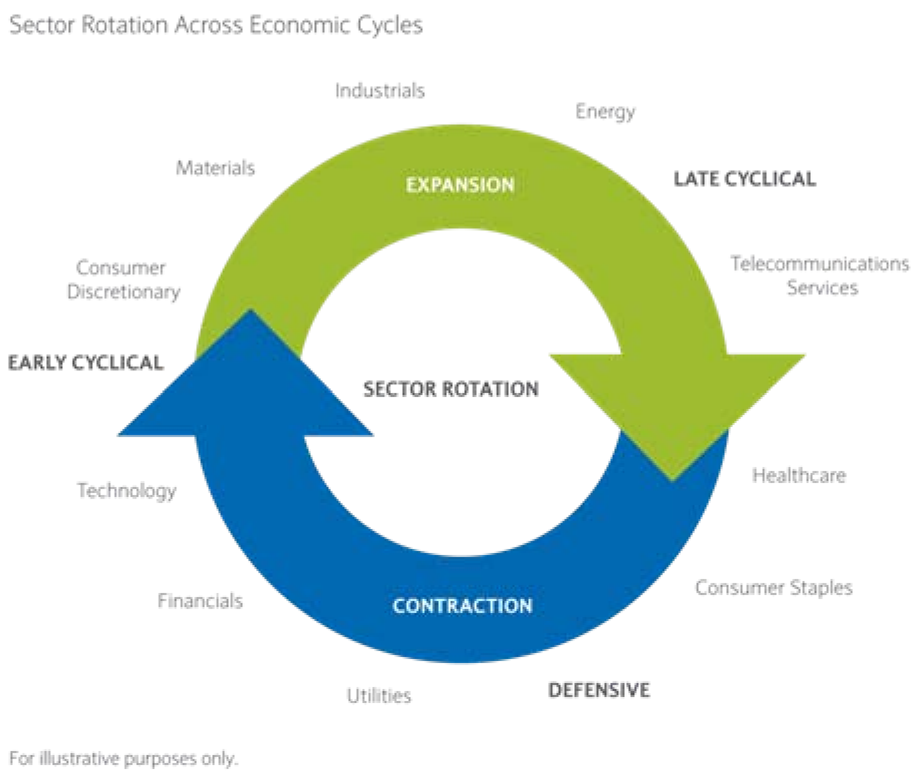
Peak

Real Gross Domestic Product



Business Cycle and Sector Rotation

(graphic courtesy of iShares/Blackrock)



Business Cycle and Sector Rotation

(graphic courtesy of iShares/Blackrock)

EXPANSION
10/13/02–10/13/07
DOW JONES U.S. INDEX: 113.3%

TOP THREE	
Oil & Gas	280.5%
Utilities	186.0%
Basic Materials	171.3%
BOTTOM THREE	
Consumer Goods	81.7%
Consumer Services	72.4%
Healthcare	62.0%

RECOVERY
3/8/09–3/31/10
DOW JONES U.S. INDEX: 65.4%

TOP THREE	
Financials	143.8%
Basic Materials	123.5%
Industrials	105.4%
BOTTOM THREE	
Oil & Gas	45.4%
Utilities	39.5%
Telecom	28.5%

DOT-COM COLLAPSE
3/26/00–10/12/02
DOW JONES U.S. INDEX: –41.3%

TOP THREE	
Consumer Goods	16.4%
Financials	–6.4%
Healthcare	–9.1%
BOTTOM THREE	
Industrials	–46.3%
Telecom	–70.8%
Technology	–81.4%

FINANCIAL CRISIS
10/14/07–3/7/09
DOW JONES U.S. INDEX: –49.9%

TOP THREE	
Healthcare	–36.5%
Consumer Goods	–40.5%
Utilities	–43.5%
BOTTOM THREE	
Basic Materials	–60.8%
Industrials	–61.1%
Financials	–77.8%

Sources: BlackRock, Morningstar, as of 3/31/10. Sector performance is represented by Dow Jones U.S. Sector Indexes.

Index returns are for illustrative purposes only and do not represent actual iShares Fund performance. Index performance returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

For actual iShares Fund performance, please visit www.iShares.com or request a prospectus by calling 1-800-iShares (1-800-474-2737).

Investing Styles and Allocations During the Business Cycle

- Early Expansion – aggressive, cyclical, growth equity, small cap; avoid fixed-income as yields rise
- Expansion – increasingly conservative as peak nears; value, large cap equity; increase fixed-income as interest rates stabilize
- Peak through Contraction – defensive, counter cycle, high-dividend equity; increased allocation to fixed-income as yields fall

Time Horizons and Economic-Based Investing

- If you are going to invest for a 30-year time horizon and have no concern about volatility in the meantime, buy an emerging market fund, forget about it, and go fishing

- Problem is that most portfolios have a much shorter time horizon, need to generate income, have risk constraints, and can't ignore volatility

Time Horizons and Economic-Based Investing - Short-Term

- Neither technical analysis nor fundamental analysis because indicators are broader than market data
- Economic fundamentals have little impact over short periods
- Generally, less than a full business cycle or even a phase of the cycle
- Indicators can fluctuate wildly
- Examples:
  - Volatility (VIX)
  - Fund Flows
  - Relative Value
  - Fed Model (spread between Treasuries and AAA or BBB bonds)
  - Sentiment Surveys
  - Insider Trades
- These and many more indicators and their use described in Sipley's book

Time Horizons and Economic-Based Investing – Long-Term

- The long-term refers to time periods longer than a single business cycle. Potentially most rewarding for the patient investor.
- Most economic indicators are useless this far out.
- Relevant factors include secular trends such as globalization, climate change, politics, demographics, and flows of capital and other resources.
- Based on growth of productive capacity in economies and industries around the world.
- Study of history vastly more useful than mathematics and statistics.
- Books include Friedman, Zakaria, Chandler, and Kotlikoff and Burns.
- Periodicals include "The Economist," "Foreign Affairs" and "Foreign Policy."

Time Horizons and Economic-Based Investing – Medium Term

- The medium-term is defined as a single, full business cycle.
- The business cycle is the context for which economic indicator analysis is most useful.
- Put together the pieces of a complex, dynamic puzzle to project a picture of the economy.
- Different analysts use and/or emphasize different indicators
- Process is largely a “Rorschach Test” and people derive different conclusions from the same indicators

Time Horizons and Economic-Based Investing – Medium Term

Useful indicators fall into several categories:

- GDP and components
- Indexes of leading, lagging, and coincident indicators
- Employment
- Productivity
- Industrial production
- Capacity utilization
- ISM indexes
- Manufacturers'' shipments, inventories and orders
- Inventories and sales
- Residential construction and home sales
- Consumer confidence and sentiment indexes, and consumer spending
- Retail trade and food service sales
- Personal income and spending
- Prince indexes
- Commodities data
- Federal Reserve and monetary data
- Trade
- International
- Others

Time Horizons and Economic-Based Investing – Medium Term

- Impossible to cover all of these indicators in a three-hour workshop
- Every investor and analyst needs to find the niche where they are most comfortable
- We’ll cover one example of developing expectations for inflation and interest rates for approximately one year forward
- As part of this process, we’ll examine many of the popular indicators

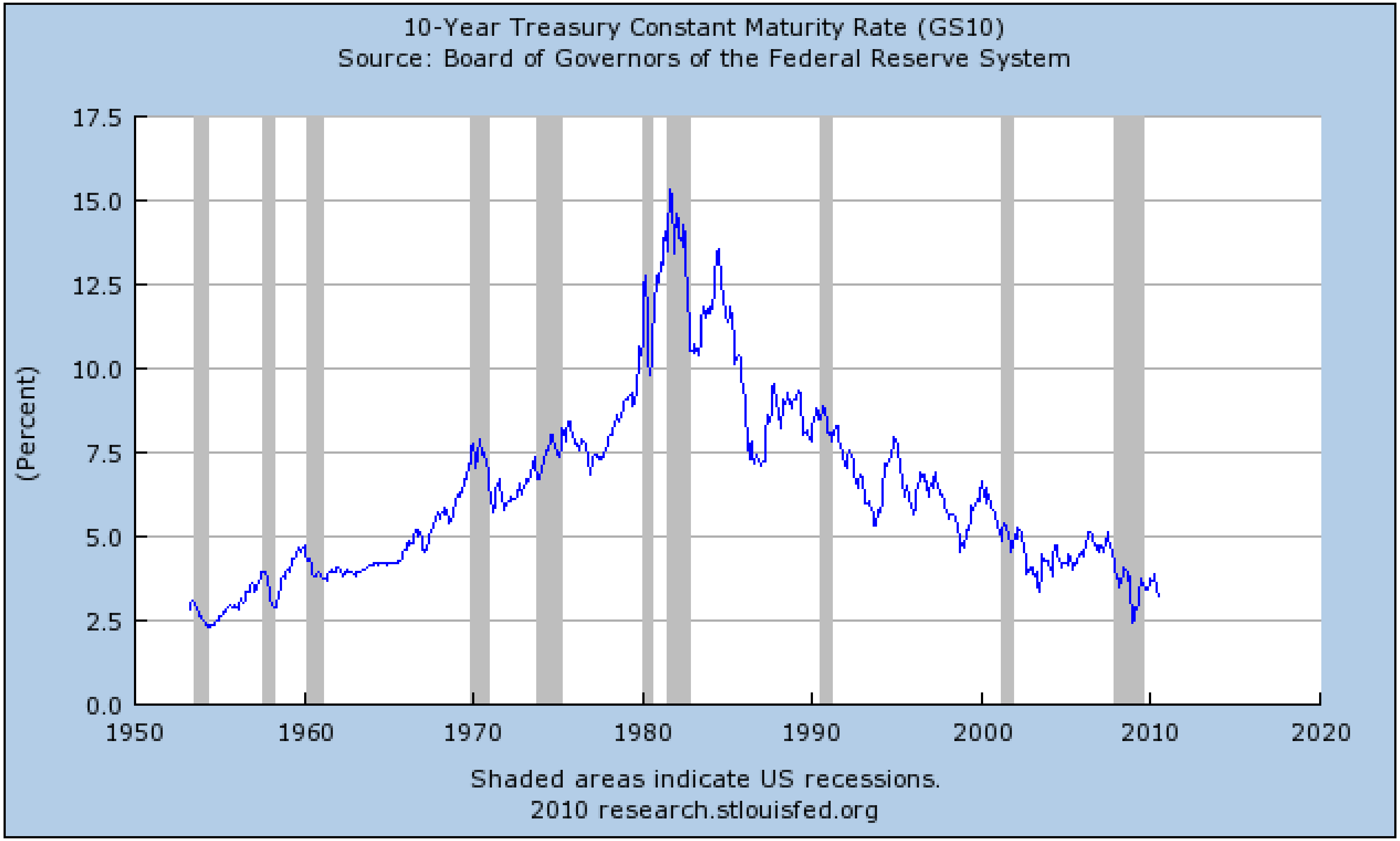
Example – Inflation and Interest Rates

- Interest rates are comprised of a real interest rate component, and a component for inflation or expected inflation
- The real interest rate is relatively stable, increasing only moderately in an expanding economy
- The inflation component is sensitive to the business cycle

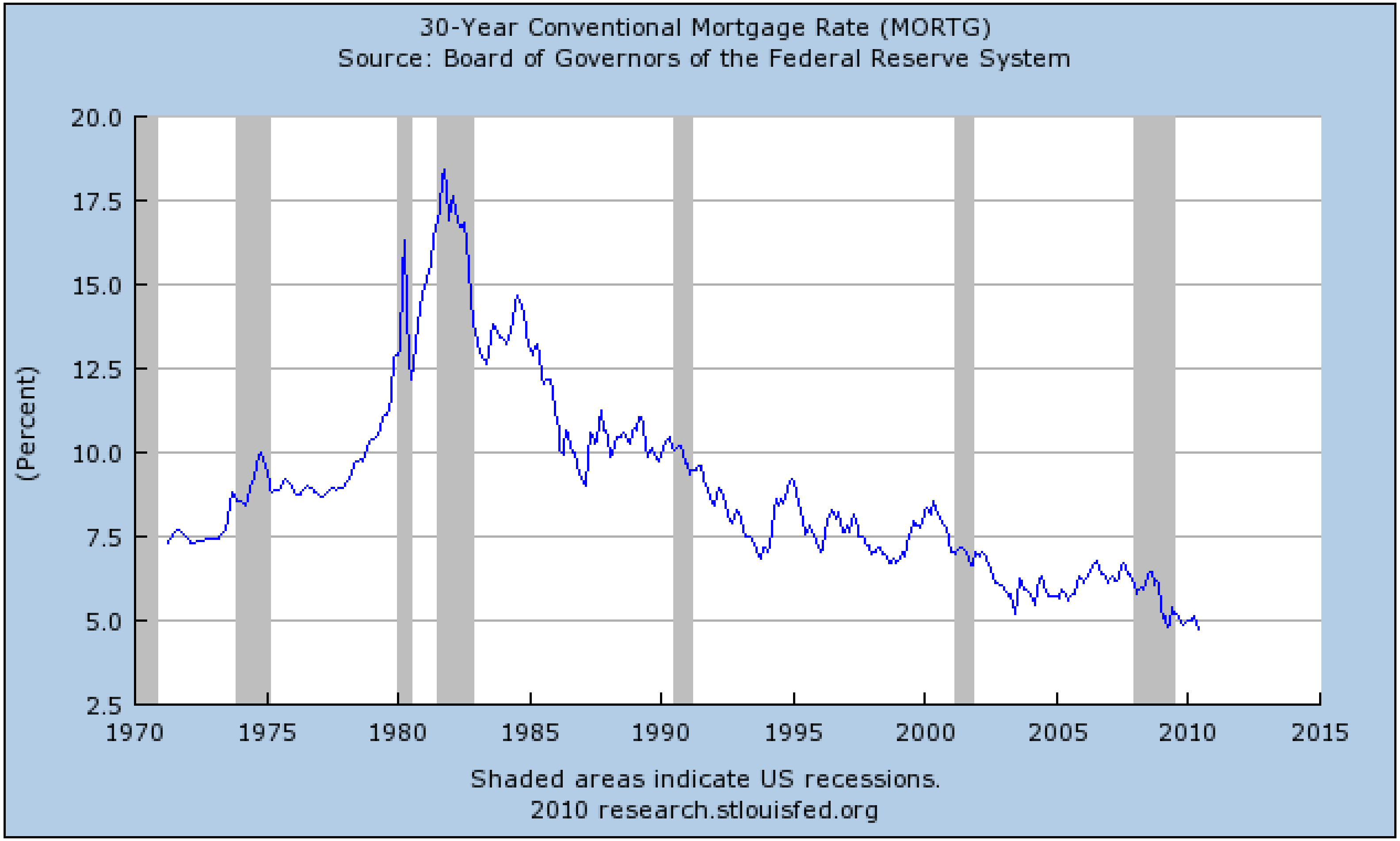
Example – Inflation and Interest Rates

- Inflation results from aggregate demand growing faster than aggregate supply.
- Look at indicators relevant to aggregate demand and aggregate supply, and potential near-term economic growth.
- If inflationary pressures are building, even in the absence of real economic growth, interest rates will rise.
- If real economic activity is strengthening, the real interest rate could rise somewhat also.

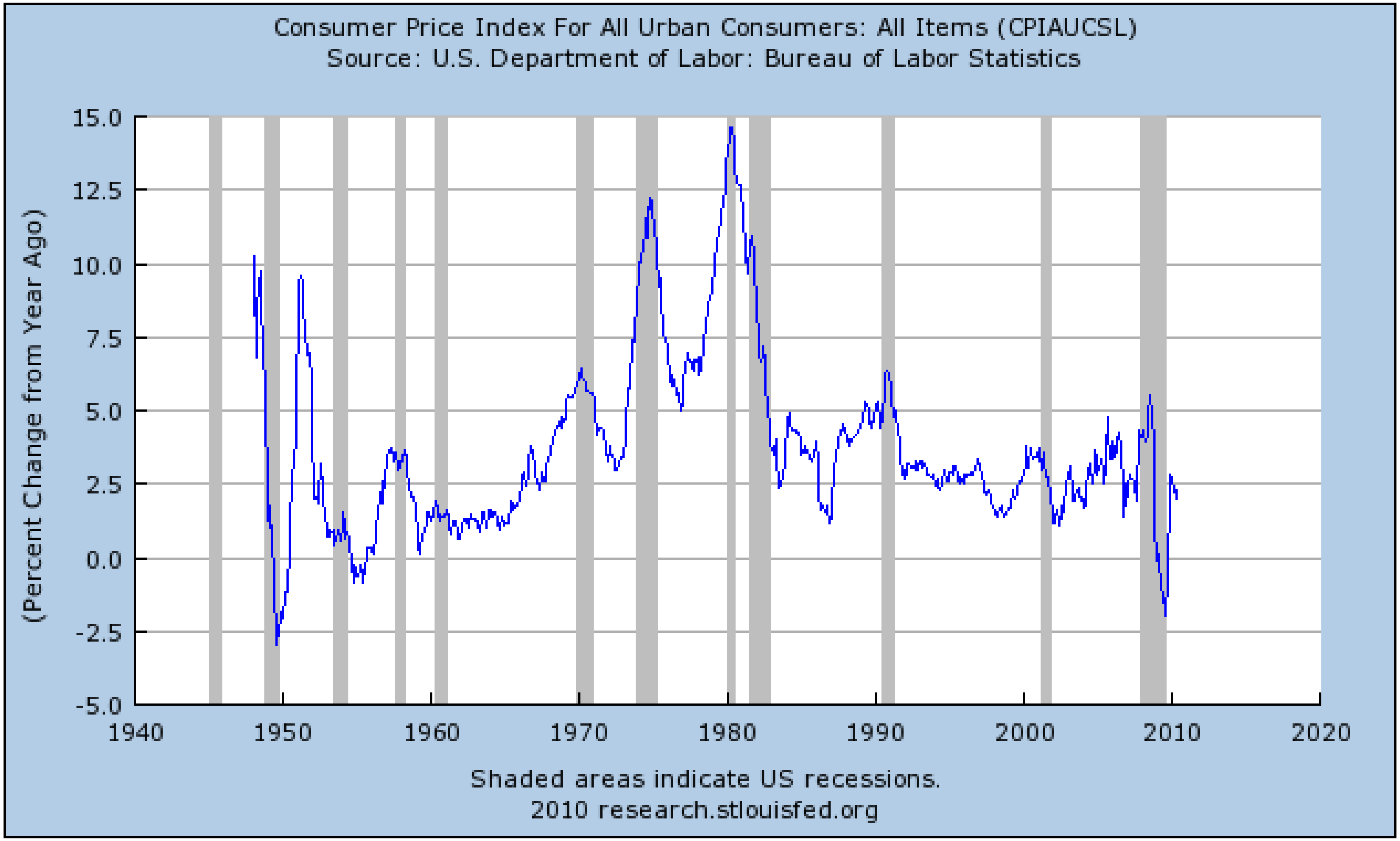
Interest Rates



Mortgage Rates

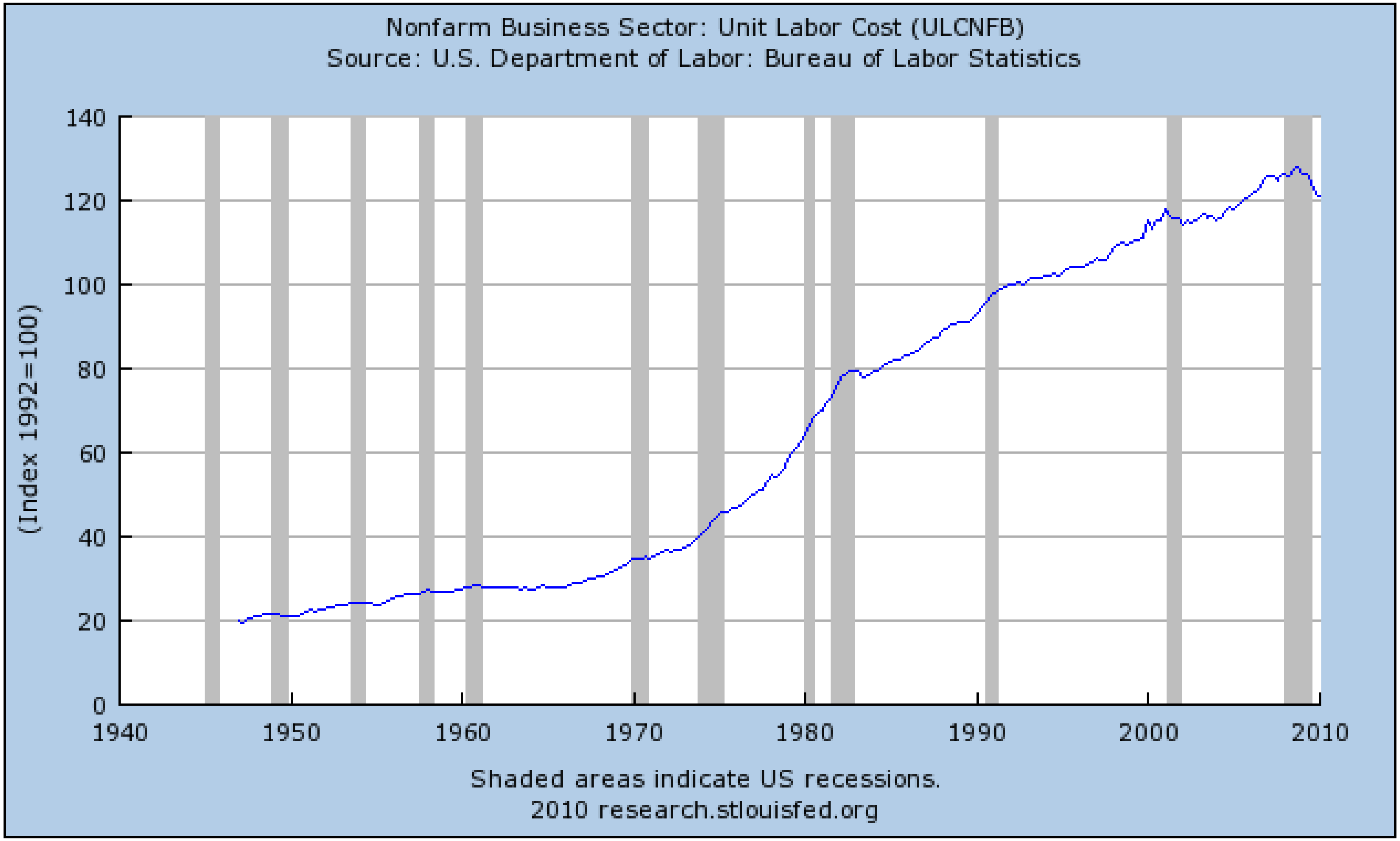


Inflation



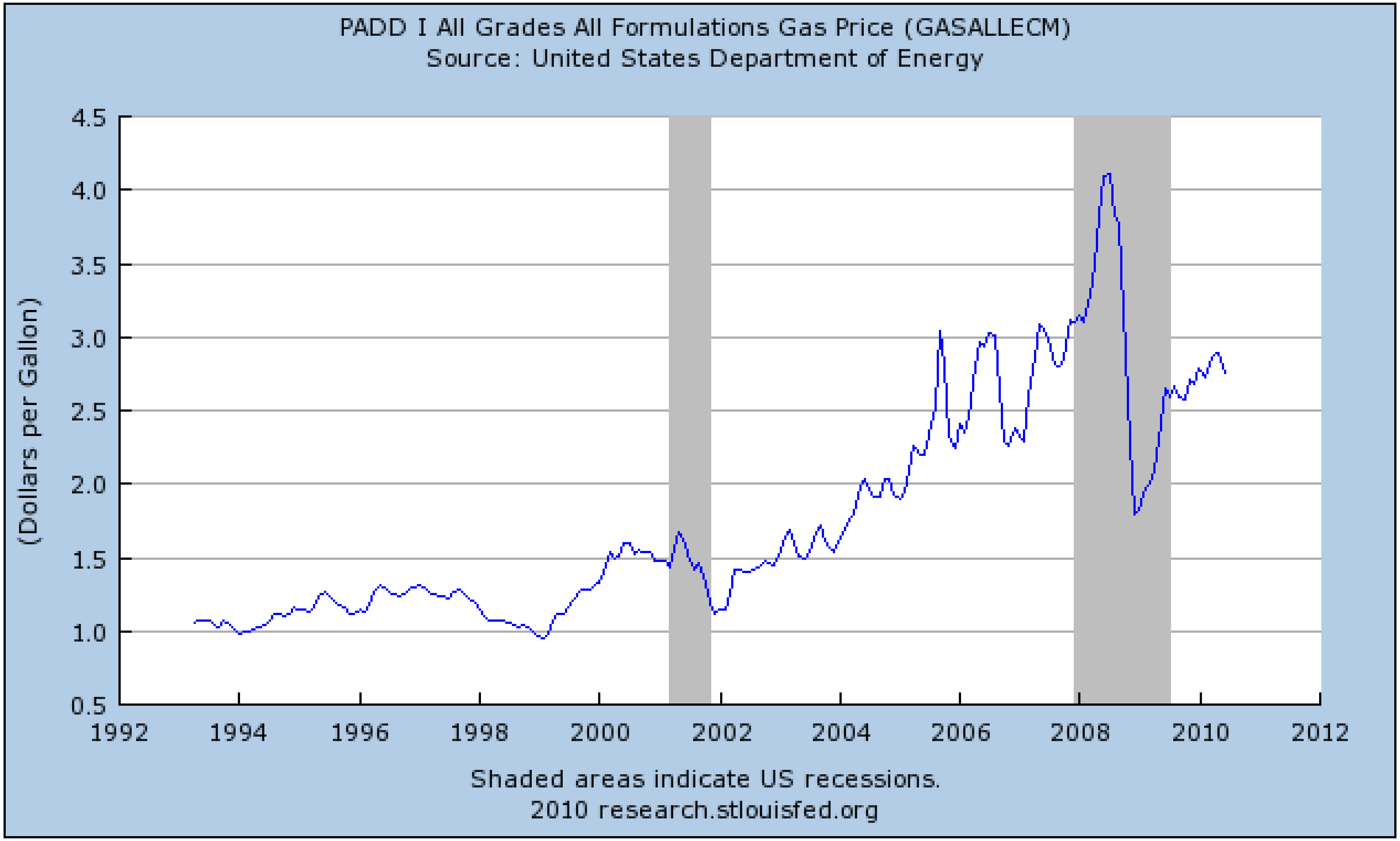
Consumer Price Index For All Urban Consumers: All Items (CPIAUCSL)
Source: U.S. Department of Labor: Bureau of Labor Statistics
(Percent Change from Year Ago)
15.0
12.5
10.0
7.5
5.0
2.5
0.0
-2.5
-5.0
1940
1950
1960
1970
1980
1990
2000
2010
2020
Shaded areas indicate US recessions.
2010 research.stlouisfed.org

Inflation



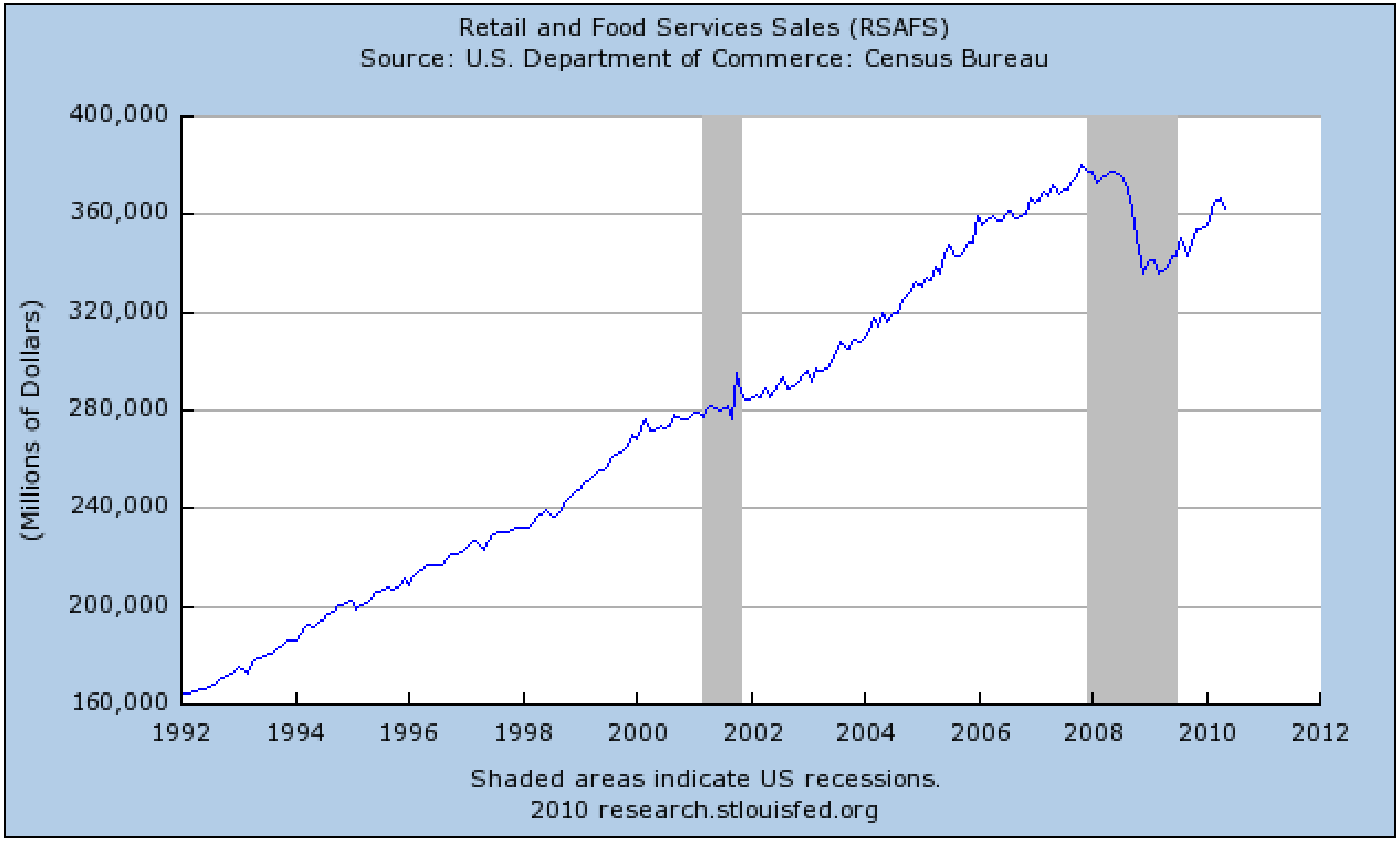
Nonfarm Business Sector: Unit Labor Cost (ULCNFB)
Source: U.S. Department of Labor: Bureau of Labor Statistics
(Index 1992=100)
0
20
40
60
80
100
120
140
1940
1950
1960
1970
1980
1990
2000
2010
Shaded areas indicate US recessions.
2010 research.stlouisfed.org

Inflation



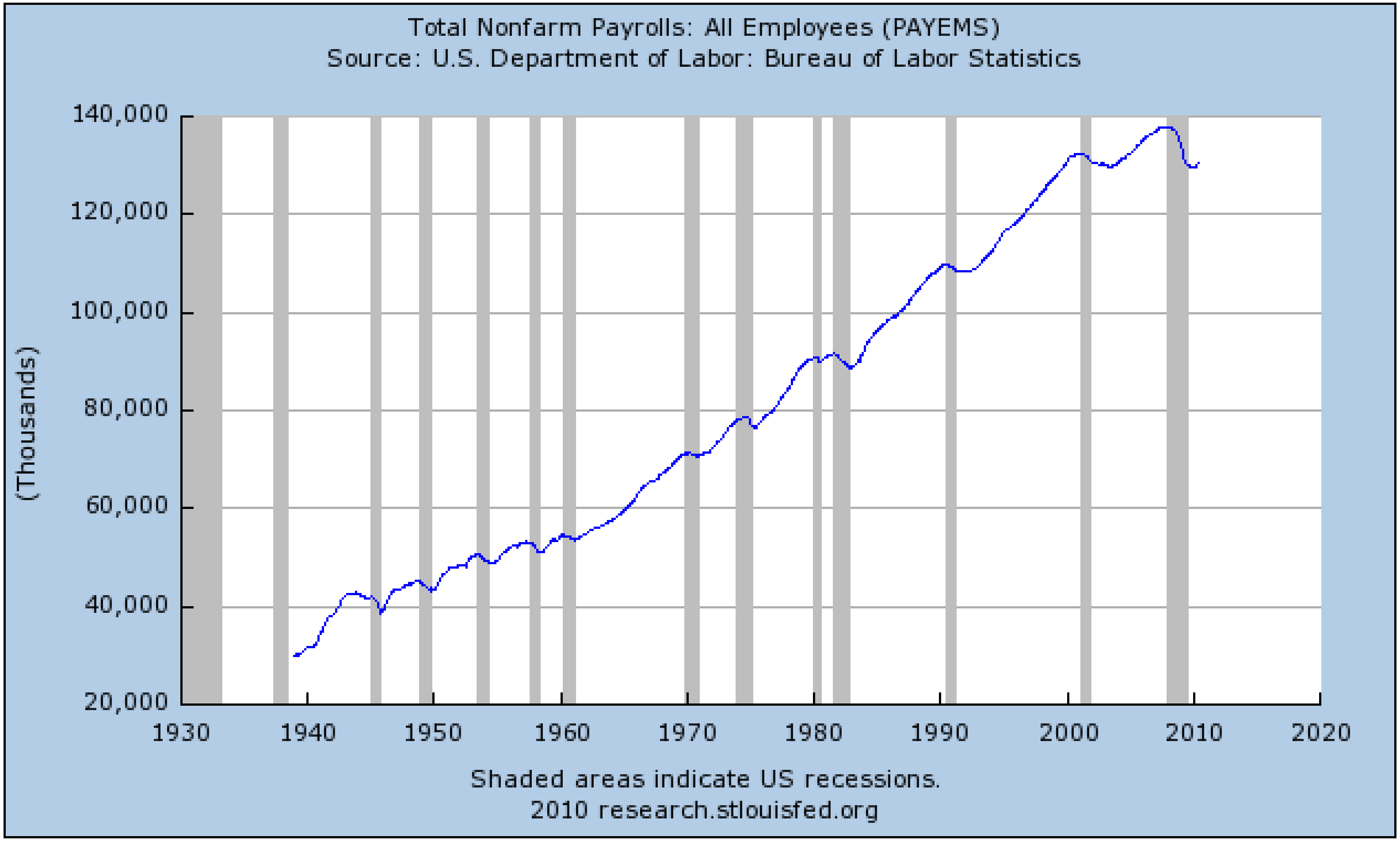
PADD I All Grades All Formulations Gas Price (GASALLECM)
Source: United States Department of Energy
4.5
4.0
3.5
3.0
2.5
2.0
1.5
1.0
0.5
(Dollars per Gallon)
1992
1994
1996
1998
2000
2002
2004
2006
2008
2010
2012
Shaded areas indicate US recessions.
2010 research.stlouisfed.org

Demand

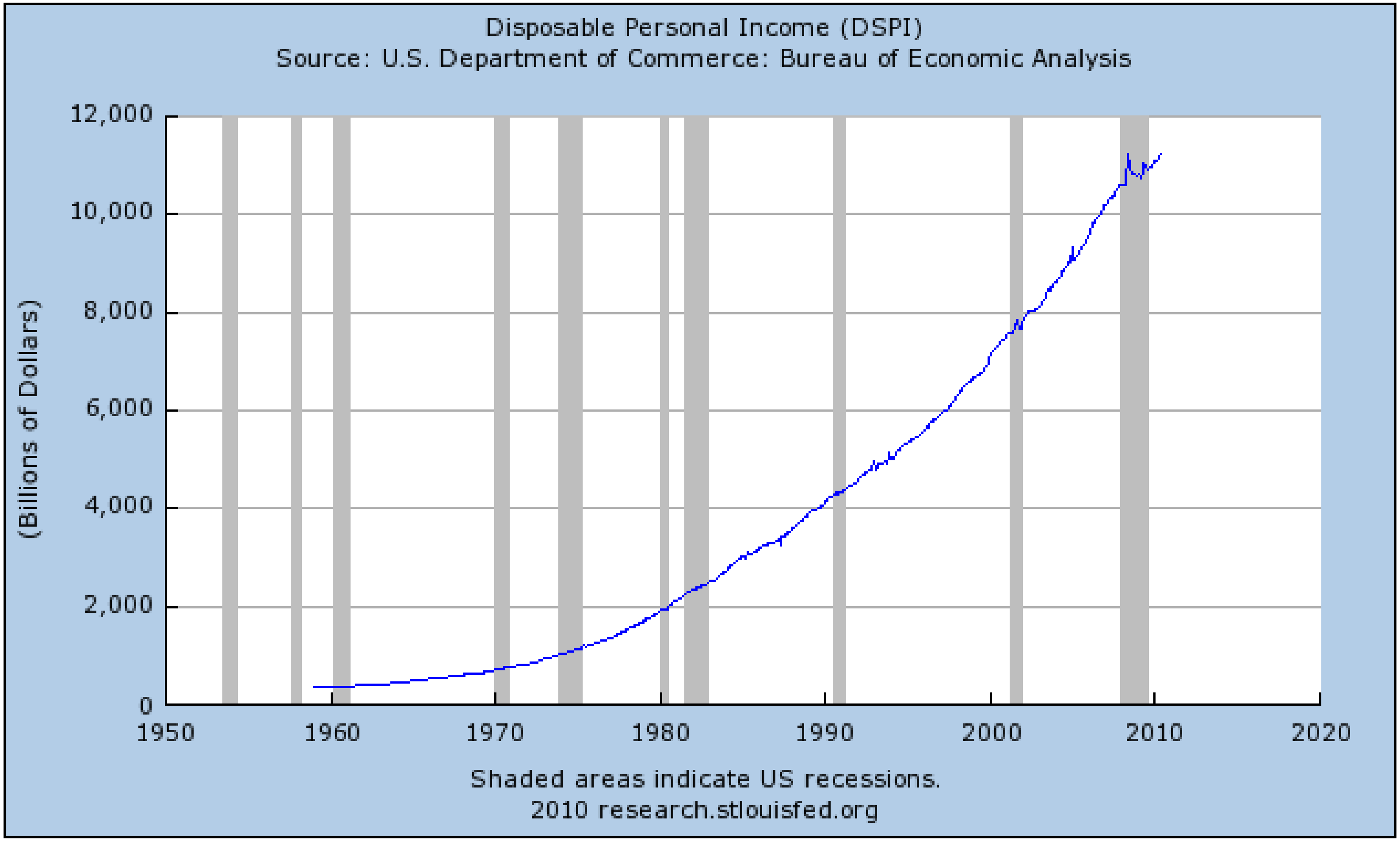


Retail and Food Services Sales (RSAFS)
Source: U.S. Department of Commerce: Census Bureau
400,000
360,000
320,000
280,000
240,000
200,000
160,000
(Millions of Dollars)
1992
1994
1996
1998
2000
2002
2004
2006
2008
2010
2012
Shaded areas indicate US recessions.
2010 research.stlouisfed.org

Demand

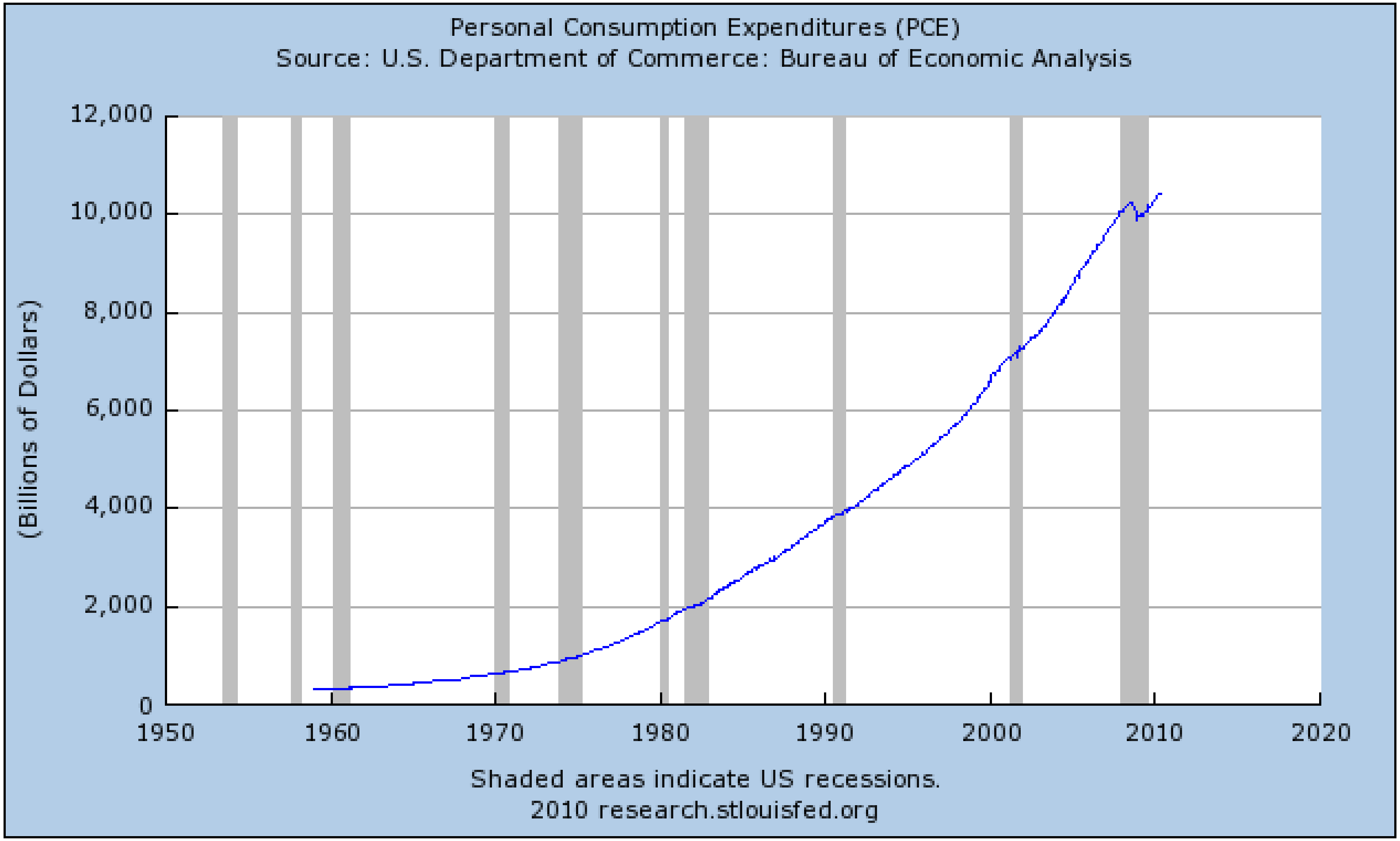

Total Nonfarm Payrolls: All Employees (PAYEMS)
Source: U.S. Department of Labor: Bureau of Labor Statistics
(Thousands)
140,000
120,000
100,000
80,000
60,000
40,000
20,000
1930
1940
1950
1960
1970
1980
1990
2000
2010
2020
Shaded areas indicate US recessions.
2010 research.stlouisfed.org

Demand



Disposable Personal Income (DSPI)
Source: U.S. Department of Commerce: Bureau of Economic Analysis
12,000
10,000
8,000
6,000
4,000
2,000
0
(Billions of Dollars)
1950
1960
1970
1980
1990
2000
2010
2020
Shaded areas indicate US recessions.
2010 research.stlouisfed.org

Demand


Personal Consumption Expenditures (PCE)
Source: U.S. Department of Commerce: Bureau of Economic Analysis
(Billions of Dollars)
12,000
10,000
8,000
6,000
4,000
2,000
0
1950
1960
1970
1980
1990
2000
2010
2020
Shaded areas indicate US recessions.
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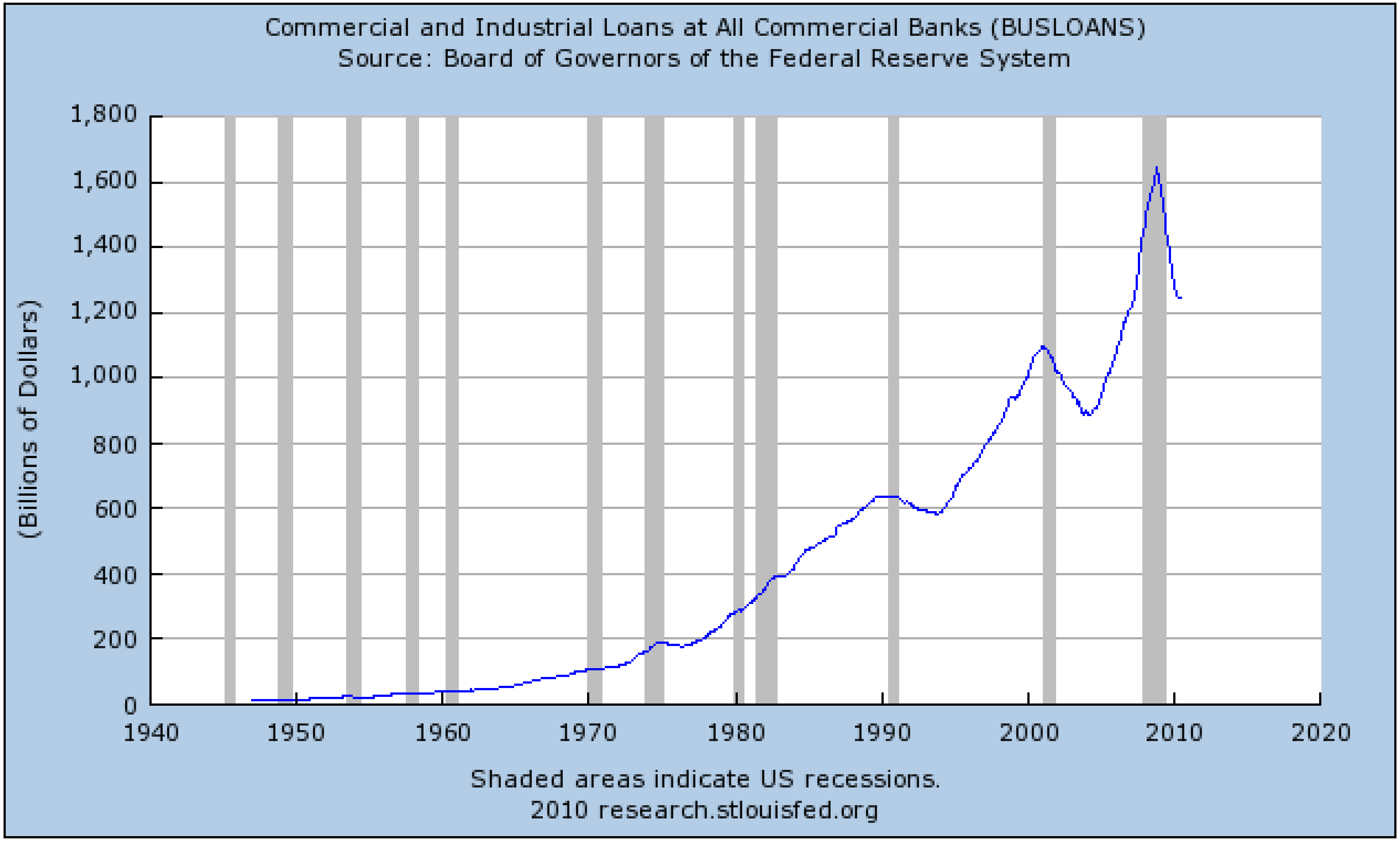
Demand



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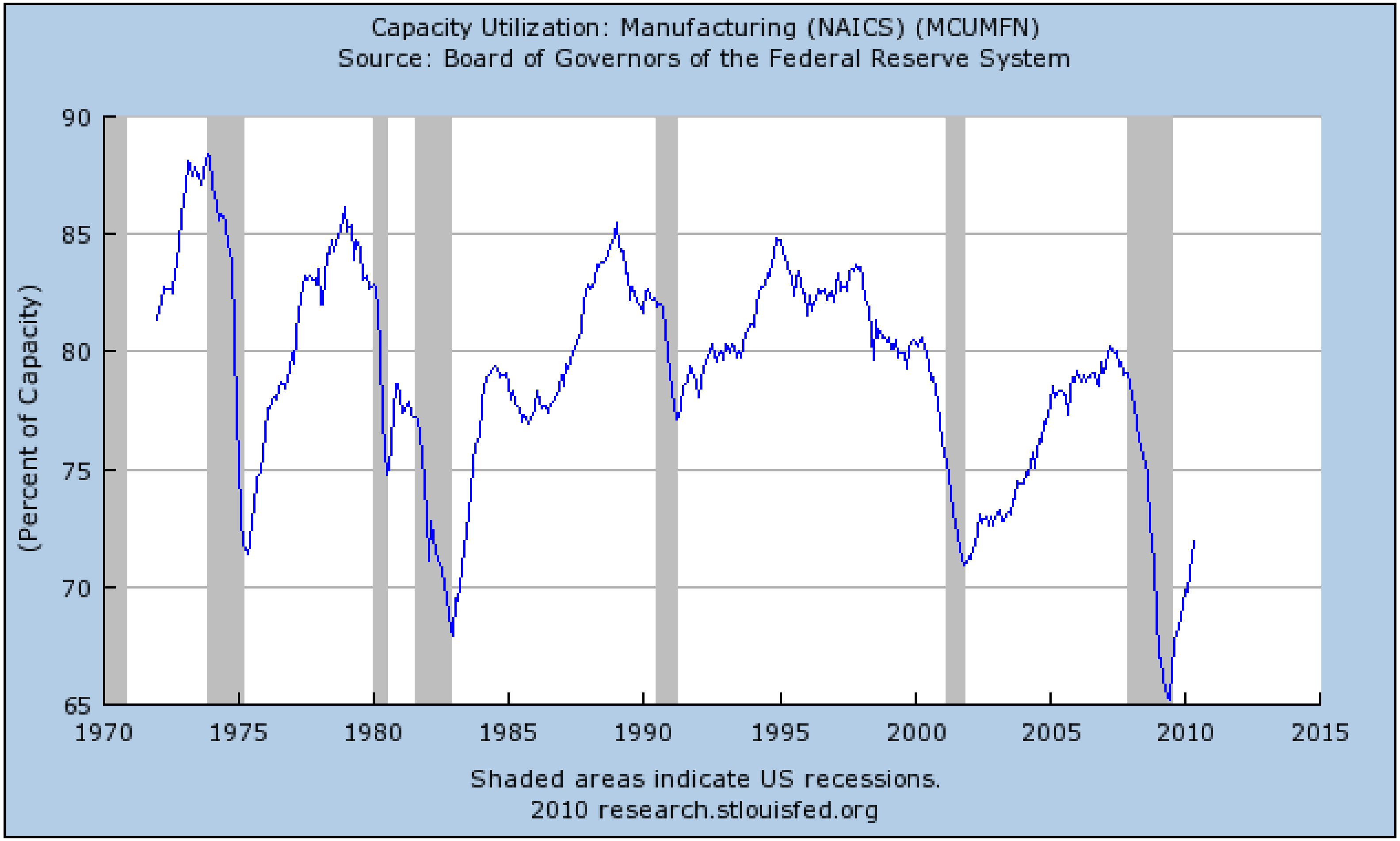
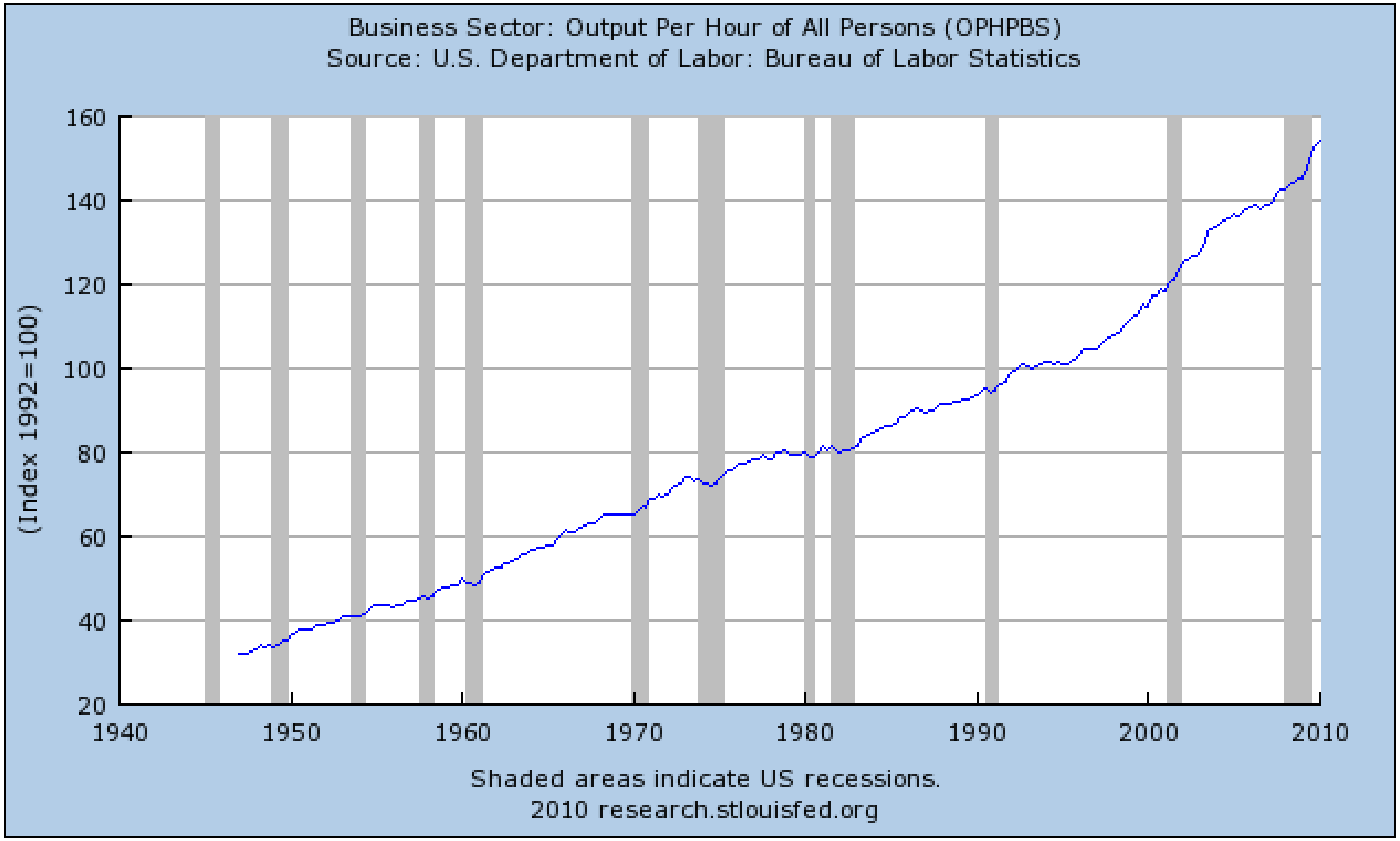
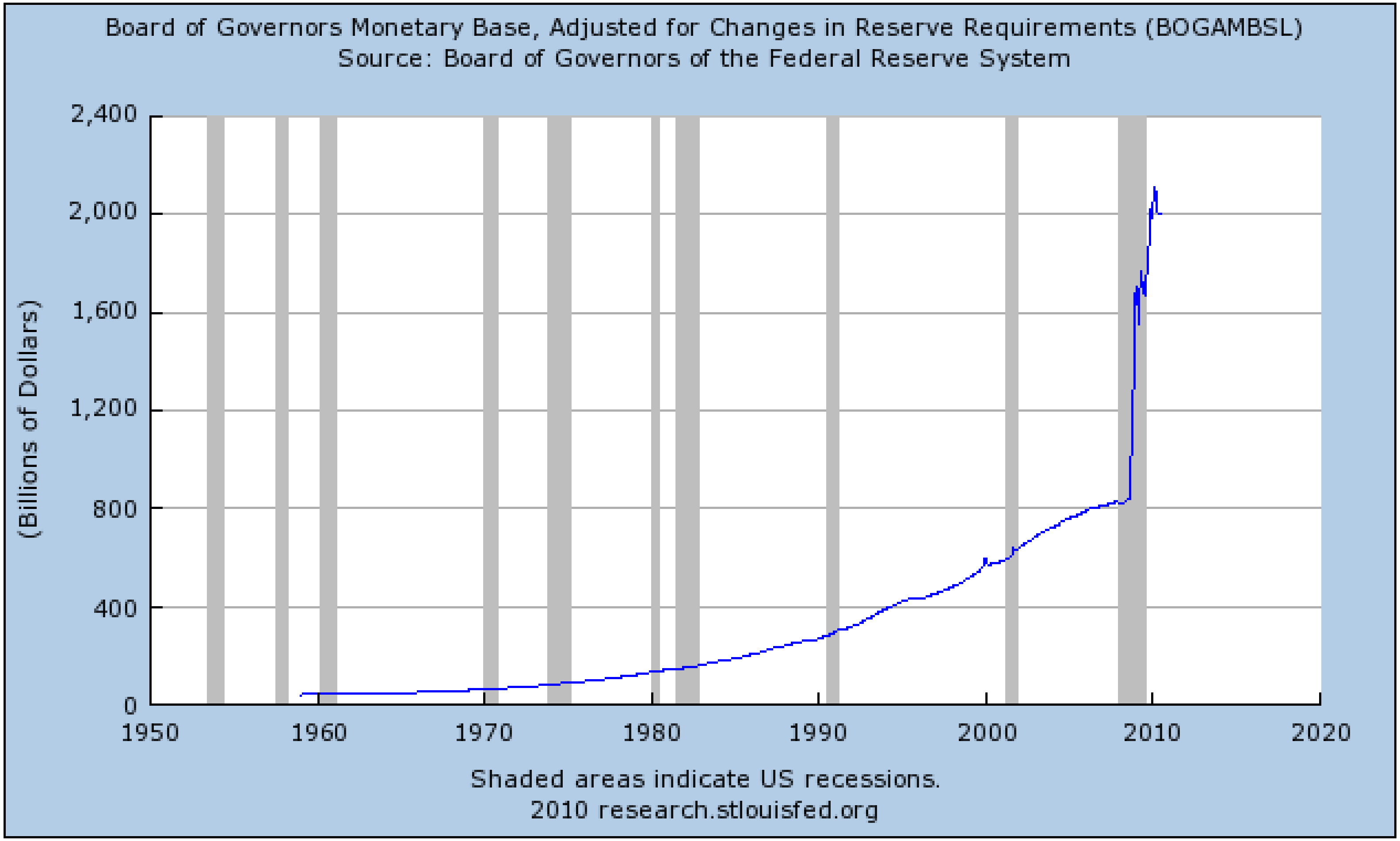
Supply


Capacity Utilization: Manufacturing (NAICS) (MCUMFN)
Source: Board of Governors of the Federal Reserve System
(Percent of Capacity)
90
85
80
75
70
65
1970
1975
1980
1985
1990
1995
2000
2005
2010
2015
Shaded areas indicate US recessions.
2010 research.stlouisfed.org

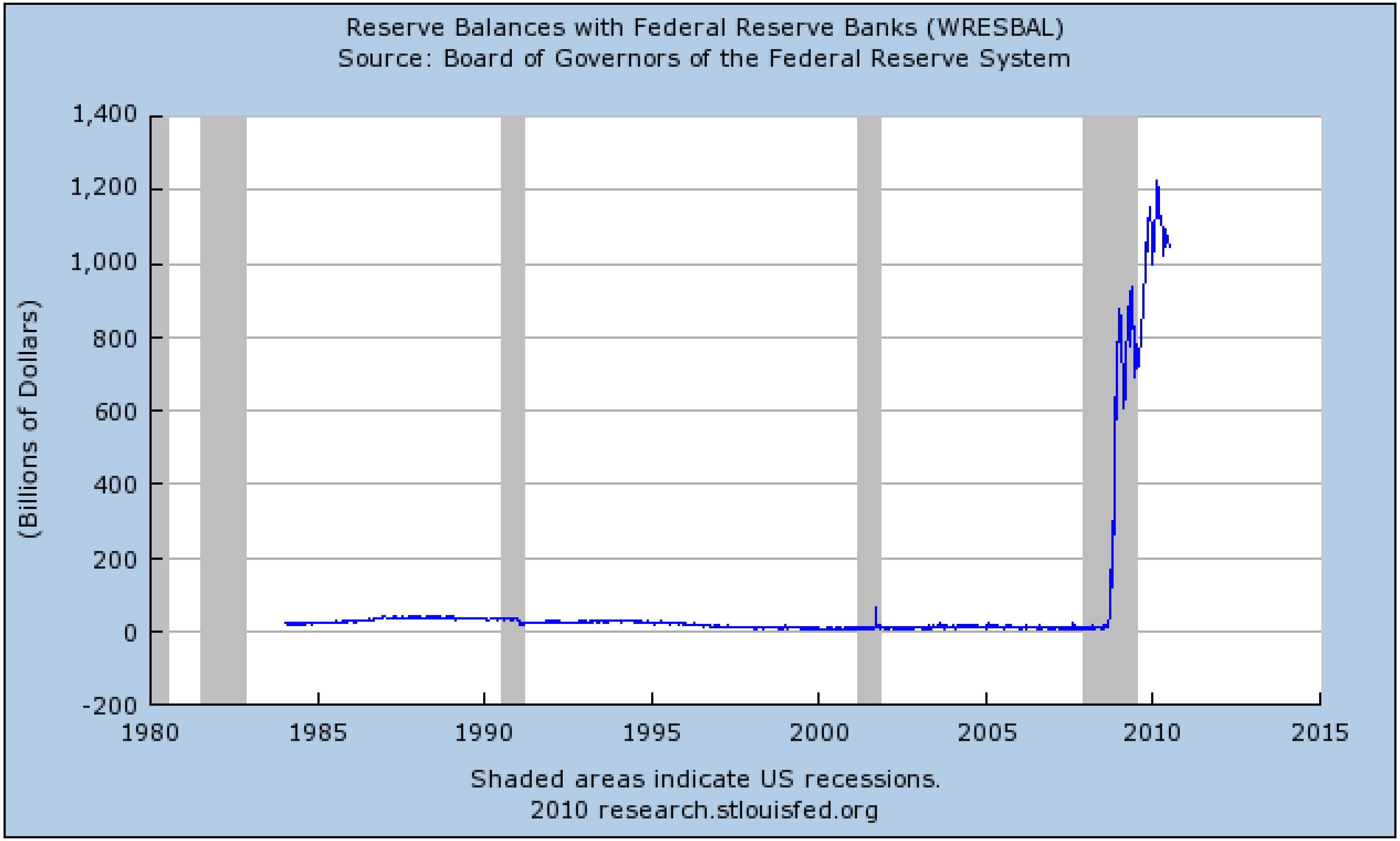
Supply


Business Sector: Output Per Hour of All Persons (OPHPBS)
Source: U.S. Department of Labor: Bureau of Labor Statistics
160
140
120
100
80
60
40
20
(Index 1992=100)
1940
1950
1960
1970
1980
1990
2000
2010
Shaded areas indicate US recessions.
2010 research.stlouisfed.org

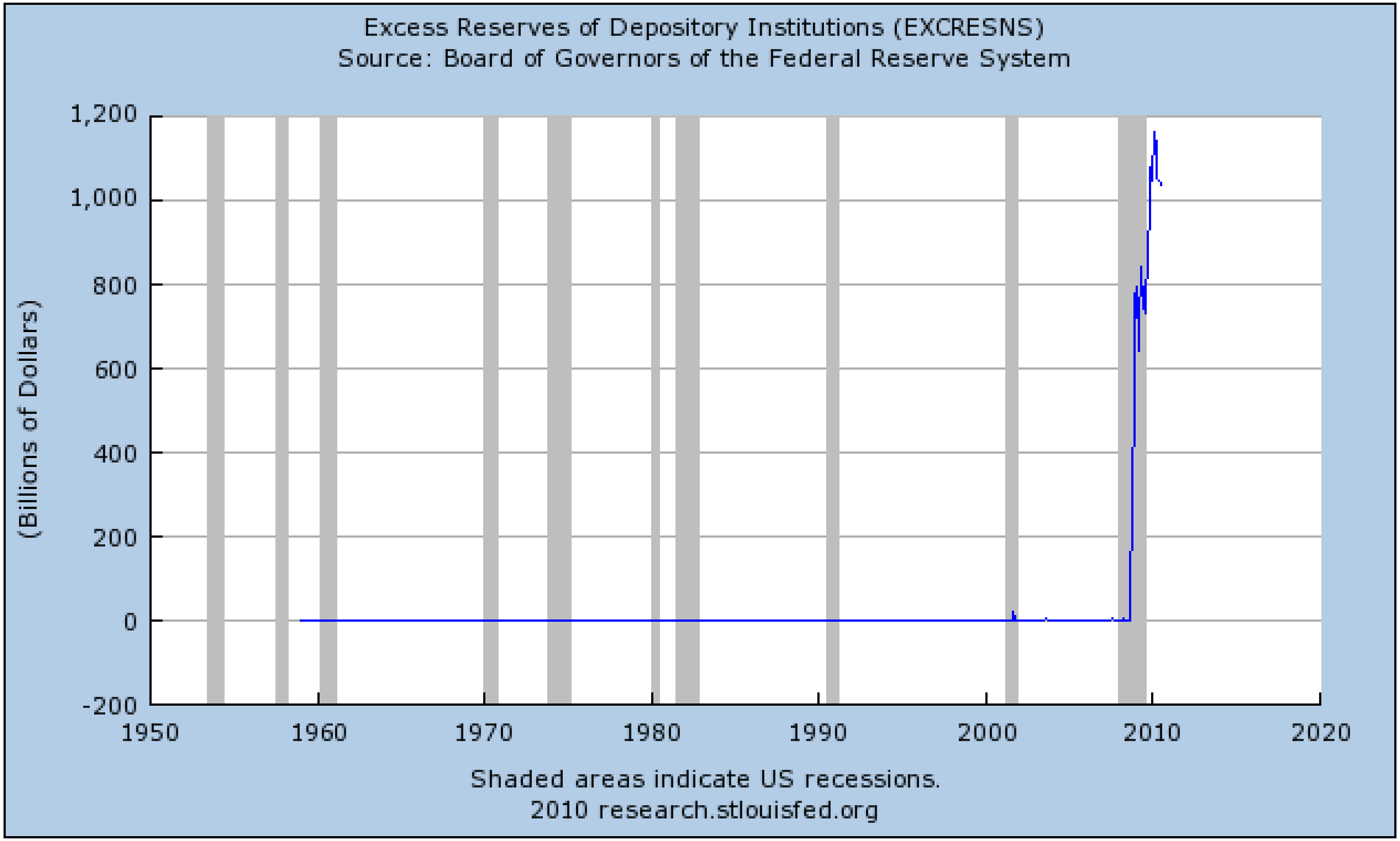
Monetary Policy



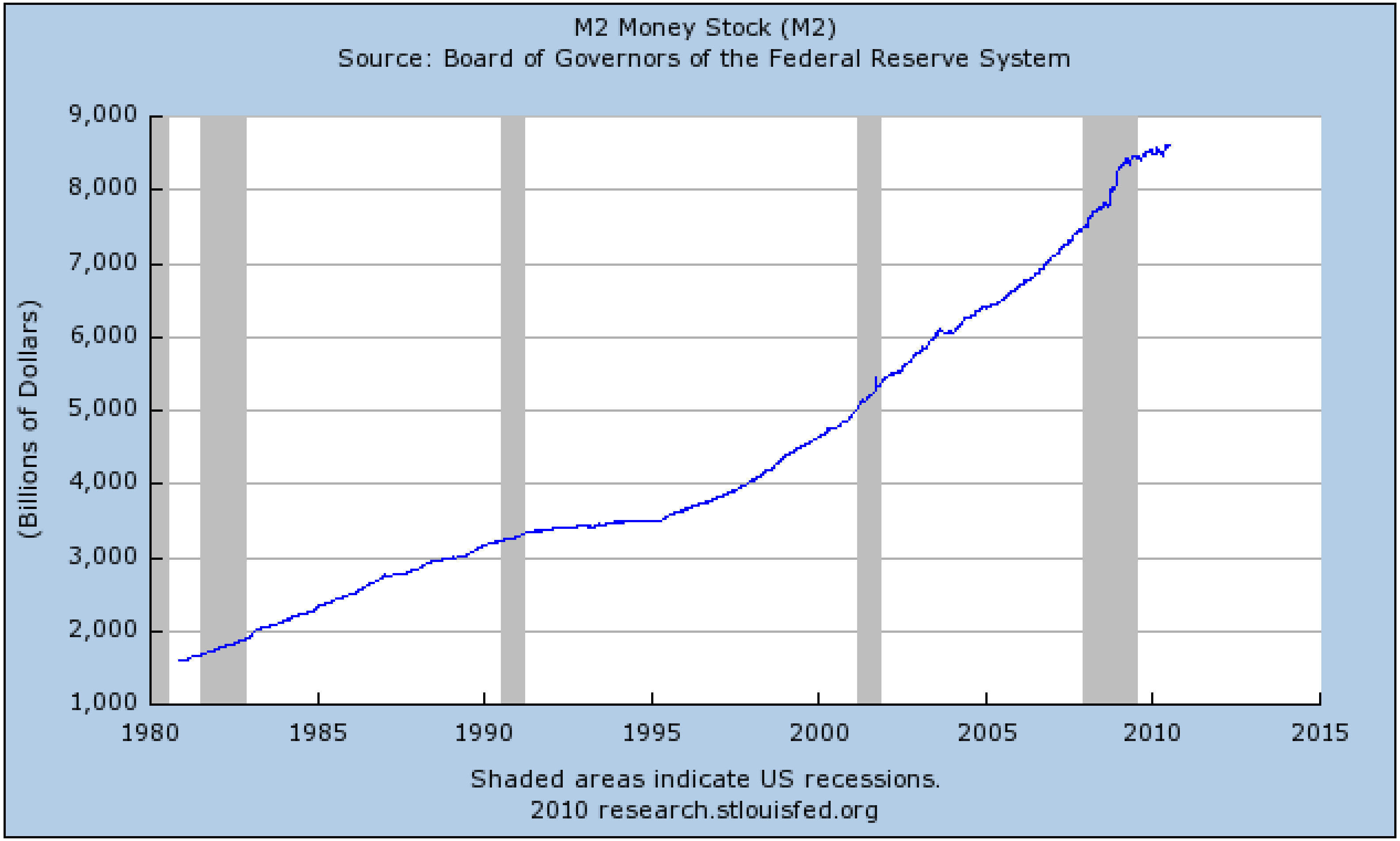
Monetary Policy



Monetary Policy



Monetary Policy



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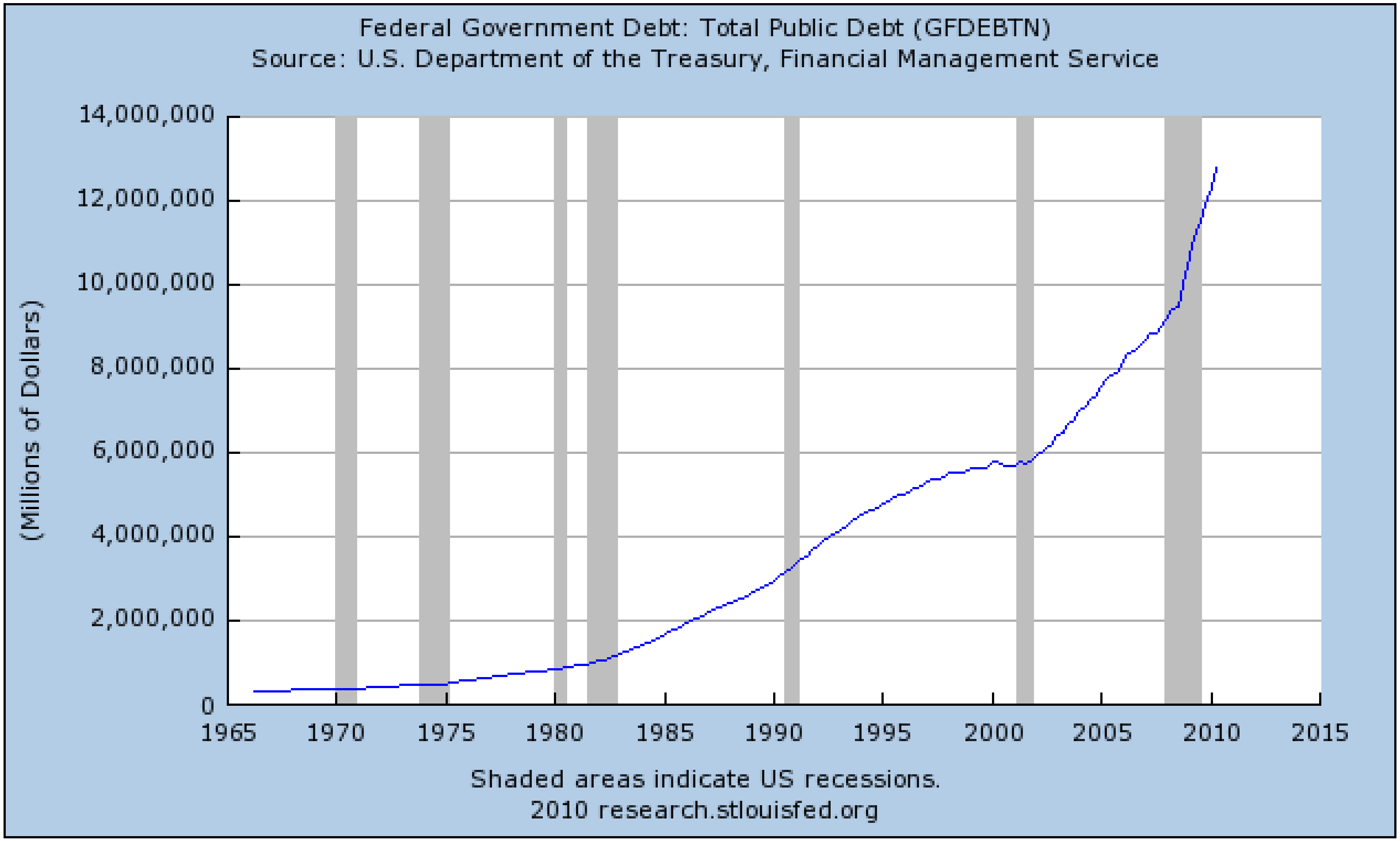
Fiscal Policy



Political Factors

Friday, July 02, 2010, Rasmussen announced the results of a poll saying:

- Only 25% of voters nationwide believe the economic stimulus package created jobs and voters are counting on decisions made by business owners more than government officials to create the jobs needed by the nation.
- Only 29% believe last year's economic stimulus plan has helped the economy while 43% believe it hurt.
- By a 69% to 15% margin, voters believe tax cuts is a better way to create jobs rather than more government spending.
- 65% say that decisions made by business owners seeking to grow their business will do more to create jobs than decisions made by government officials. Just 23% expect the government officials to have a bigger impact.
- 82% of adults nationwide believe it's important to cut the federal deficit in half by 2013 although only 23% believe that's even somewhat likely to happen
- Most Americans clearly prefer that the deficit cutting be accomplished primarily by cutting spending, but believe that Congress is more likely to raise taxes.
- Only 18% of Americans are willing to pay higher taxes to lower the federal budget deficit.

Conclusions

- Economic recovery proceeding slowly
- Demand growing somewhat
- No supply pressures
- Reserves not being converted into money
- Little or no inflationary pressure building this year
- Little sign of substantial increase in interest rates in 2010
- Current expansive monetary and fiscal policies could lead to significant inflation when economic growth strengthens
- Americans dissatisfied with progress toward recovery and unhappy with leadership in Washington, DC. Possible consequences of changes in Congress after 2010 election?

Next Steps

- For investors using primarily technical analysis or who focus on short-term trading, buy the Sipley book and integrate ideas from it into you process.
- For investors using primarily fundamental analysis or who focus on time horizons encompassing multiple phases of or the entire business cycle, buy one of the following books and integrate ideas from it into your process.
  - Baumohl
  - Yamarone
  - “Economist” Guide to Economic Indicators
- Start surfing the web sites with free economic data and research to find the resources and material that fit your investing style
- Bob is always happy to talk to you and answer your questions after the workshop

Sources of Free Economic Data

- Federal Reserve Economic Data
- http://research.stlouisfed.org/
- Federal Reserve Board
- http://www.federalreserve.gov/econresdata/default.htm
- Census Bureau Economic Indicators
- http://www.census.gov/cgi-bin/briefroom/BriefRm
- Census Bureau
- http://www.census.gov/
- Bureau of Labor Statistics
- http://www.bls.gov/
- Bureau of Economic Analysis
- http://www.bea.gov/
- Bank for International Settlements
- http://www.bis.org/about/index.htm
- International Monetary Fund
- http://www.imf.org/external/data.htm
- S&P Market Attributes
- http://www.standardandpoors.com/indices/market-attributes/en/us
- Rasmussen
- http://www.rasmussenreports.com/

Further Reading – Web Sites

- St. Louis Federal Reserve Publications
- http://www.stlouisfed.org/publications/research_and_data.cfm
- Federal Reserve Board
- http://www.federalreserve.gov/publications/default.htm
- National Bureau of Economic Research
- http://www.nber.org/
- National Association for Business Economics
- http://www.nabe.com/

Further Reading – Books

(all available on Amazon as of 7/12/2010)

- Baumohl, Bernard, ***"The Secrets of Economic Indicators: Hidden Clues to Future Economic Trends and Investment Opportunities,"*** Eleventh Printing, Wharton School Publishing, 2010.
- Chandler, Marc, ***"Making Sense of the Dollar: Exposing Dangerous Myths about Trade and Foreign Exchange,"*** First Edition, Bloomberg, Press 2009.
- Friedman, Thomas L., ***"The World is Flat: A Brief History of the Twenty-First Century,"*** Third Edition, Farrar, Straus and Girous, 2007 .
- Kotlikoff and Burns, ***"The Coming Generational Storm: What you Need to Know about America's Economic Future,"*** MIT Press, Paperback Edition, 2005.
- Sipley, Richard, ***"Market Indicators: The Best-Kept Secret to More Effective Trading and Investing,"*** Bloomberg Press, 2009.
- The Economist, ***"Guide to Economic Indicators: Making Sense of Economics,"*** Sixth Edition, Bloomberg Press, 2007.
- Yamarone, Richard, ***"The Trader's Guide to Key Economic Indicators,"*** Expanded Edition, Bloomberg Press, 2007.
- Zakaria, Fareed, ***"The Post-American World,"*** First Edition, W.W. Norton & Company, Inc., 2009.

Further Reading – Periodicals

- Available at most libraries
  - “The Economist”
  - “Foreign Affairs”
  - “Foreign Policy”
- Federal Reserve Board and Banks, and Other Government Agencies
  - Numerous useful publications, mostly free and available online