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CASH IS STILL KING AS THE BEAR WILL CONTINUE TO HAUNT EQUITY MARKETS IN 2003.

1.GLOBAL ECONOMY

Bear to continue

Reversion to mean.

People still eager to buy.

Gold in a bull but may correct soon

5. INTEREST RATES AND BONDS

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Coffee rallies

Cotton may be running out of steam.

Wheat falls back to long-term support.

Break out portfolio now up 42.5% since Oct 3rd 2000 as Vaxgen and Corvis surge.

In a recent survey of 67 fund equity analysts by Business Week during December, 64 felt markets would rise in 2003. Indeed a casual glance of annual forecasts quoted in Fleet St. reveals the same predominantly bullish consensus with the market ending '03 around 5% to 10% higher being the convenient "safe" forecast.

All this bullishness occurs despite three consecutive years of market falls! Indeed these market falls are cited as the reason for such bullishness by most analysts who point to the historical record -there has been no period of four consecutive years of declines since WW2.

Chance does appear to us as a flimsy argument for investing. After all a coin that comes down heads 10 times in a row remains "evens" to land heads yet again!

Despite being great respecters of historical precedence we are deeply suspicious of the current overwhelming bullish consensus and consequently we would not be at all surprised to see the markets continue the current dominant trend lower.

We are not foolish enough to attempt to predict the level of the equity markets at the end of the year but we do feel that another wild year lies ahead which will be sure to test investor resolve.

Investors should concern themselves with the BIG picture which is an ongoing secular bear market which will not end until stock prices are below their long term historical average as reversion to the mean overshoots. This big picture implies that a long term buy and hold strategy at present, could prove disastrous whether or not markets post a gain in '03.

Reversion to mean revisited.

When we talk of reversion to mean we are talking of the long-term average PE ratio of the major market indices such as the S&P and the Ftse. What we see on both markets historically is a long-term wave action, which swings market average P.E ratio's from lows of around 6 to 10 to highs of 20 to 30 over 10 to 20 year cyclical periods.

So far the major western markets have merely blown the froth of their P.E levels with the UK at around 17 above the long-term average of 14 and the S&P on core earnings at the 30 level with an average of 15 being the norm. Thus prices are still not cheap historically by any stretch of the imagination. Markets as we know often move from "best beloved to most reviled" and as such overshoot the long term norms in both directions as we saw in the late nineties bubble. With this in mind we suspect that markets will slowly work their way down toward the historic low valuation levels over the next decade. So even if equities have the odd positive year (like poor old Tokyo has over the last decade) we believe that grizzly old ursa major will be prowling around the markets until equities are screaming cheap and no one wants to buy.

The chart below illustrates the nature of secular bull and bear markets that appear to last 15 to 20 years each.



Insiders still selling?

Tech stocks have been crushed. Is this the time to buy them? The usual suspects in London and Wall Street may think so, but what are the insiders doing?

"In the past six months, in [the top 10 tech companies]," reports Alan Abelson in Barron's, "there were 137 sellers against three - that's right, three - buyers. All told, the buyers purchased 92,000 shares, while the sellers unloaded 47.6 million shares." Do we need to know any more?

To quote the 1977 hit by Jilted John "Gordon is a moron"

The much maligned President of the US, son of an American **RAF** volunteer during the WWII, might be pushing against a piece of string in attempting to revive the ailing US economy, but at least he realises when your economy is in a mess **YOU CUT TAXES TO STIMULATE GROWTH NOT HIKE THEM AS "THE IRON CHANCELLOR" HAS SEEN FIT TO DO!**

The increases in tax coming this year (and more to come?) and the crowding out of the debt markets by Govt borrowing to fund overblown spending plans will add as a further break on the already moribund economy. We think people are far better at spending their own money than the Government. Come to think of it has any Government ever spent our money more wisely than we the people have?

Despite 3 years of market falls it still amazes us that people are eager to buy. We ask ourselves where is the evidence of an upturn considering the following fundamental failures of the markets. Martin Weiss' Safemoney report is a favourite with us and the following excerpt succinctly answered the question with his nine key points.

Fundamental failure #1. Since 2000, there has been no change whatsoever in the long-term downtrend in stocks. For the evidence, just consider the S&P 500 since 2000.

Fundamental failure #2. Since 2000, government intervention has simply not worked. The Fed has slashed short-term interest rates from 6.50% to

1.25% and increased the money supply by a whopping \$1.753 trillion (as measured by M-3). President Bush announced \$1.4 trillion in tax cuts in 2001. But throughout this period, unemployment has continued to rise and manufacturing has continued to slip.

Fundamental failure #3. Businesses have been cutting capital spending virtually non-stop. This spending is the turbo-engine of the entire economy. When it's slashed left and right, as it has been, it's virtually impossible for the economy to recover.

Fundamental failure #4. No government has been able to stop the spread of deflation. The deflation began in Japan, with consumer prices down 44 months in a row, year over year. Now it has spread to the United States, where producer prices have been down for 12 out of the last 13 months. This is why auto manufacturers can't sell cars without cut-rate financing. And it's also why retail stores cannot attract crowds without massive discounting.

Fundamental failure #5. Retailers are giving away the store. Wal-Mart was mobbed on the day after Thanksgiving. The nightly news broadcast scenes of euphoric shoppers stampeding through the front doors. But it was just another of the great deceptions of our times.

Instead of anxious buyers, the stores were flooded with picky bargain hunters. Instead of selling goods at a profit, the only items truly drawing the big crowds were the loss-leaders or give-aways: 27-inch televisions for \$148 at Wal-Mart ... free \$300 gift certificates at Filene's ... \$15 TV sets with a \$50 cosmetics purchase at Macy's ... and many more.

Fundamental failure #6. The real estate bust is beginning! I warned you about this just last month. Now, cracks have already begun to appear:

* Sales in the homes worth \$1 million or more — a leading indicator of the housing market — plunged 10% in the third quarter, the largest drop since the 9/11 attacks.

* The price increases in single family homes sagged to only 0.84% in the third quarter, the weakest in

over two years. Moreover, prices actually fell in seven states and 33 metro areas.

* The bust in commercial real estate continues. In September alone, commercial construction plunged 18% from the year earlier, to its lowest level since July 1996. In October, it was down 17%, year over year.

Fundamental failure #7. US auto sales are plummeting. October was the worst single month for Detroit's Big 3 automakers in four years. Car sales at Ford fell 36.6%. At GM, sales dropped 40.3%. Even Daimler-Chrysler, which had not pushed the cut-rate financing deals, was off 25.8%.

The car companies are desperate. First, they offered zero-percent financing. That helped goose up sales for a while ... until, that is, nearly all auto companies began to offer similar deals. Then, they added "zero money down," and that also worked nicely to boost sales ... until customers began to expect — even demand — the same deal from everyone.

Now, some of the companies have launched a new drive, called "zero-zero-zero" — zero interest, zero money down, zero payments for up to 12 months.

Result: Profit margins are getting butchered.

Now, the auto stocks have rallied somewhat along with the rest of the market. But nothing has changed. November auto sales showed scant improvement over October. An auto sales bloodbath is in the making.

Fundamental failure #8. The bankruptcy crisis is continuing. Just in the first nine months of this year, 144 publicly traded companies filed for Chapter 11 bankruptcy. But it's not over yet. Another 2,453 publicly traded companies' merit a Weiss risk rating of E+ or lower, implying higher-than average risk of failure.

Fundamental failure #9. US consumers are maxed out. Throughout most of the 1960s and 1970s, American households kept piling on more and more debt. But they could handle it: Their income was rising at approximately the same pace. So for every

dollar of disposable income, they rarely had more than 70 cents in debt.

Starting in the early 1980s, however, that began to change — dramatically! Credit card companies mailed hundreds of millions of unsolicited credit cards — to virtually anyone with an address. Banks and mortgage companies launched aggressive marketing campaigns touting second and third mortgages, equity loans, and most dangerous of all, non-prime loans.

Result: The debt load of average American households literally went through the roof. Now, for the first time in history, Americans owe more than they take home in disposable income.

No wonder the number of personal bankruptcies has surged 15.1%, from 1.3 million in 2001 to 1.5 million in 2002! No wonder credit card write-offs just jumped by more than 35% to their highest level in decades! No wonder mortgage foreclosures have hit the highest level in history!

A view from the forest as Andy B reviews recent action in the gold market.

“Although we remain long term bulls as far as gold is concerned we anticipate weakness in the gold price over the short term. Part of this is down to the our contrarian approach to life generally, we never did as we were told at school so why start now?!”

We have seen a plethora of articles in the press all bullish of the yellow metal and we have also noticed an increasing number of queries from subscribers asking how to climb aboard the latest gold rush. Readers will know that here at the Barmac we subscribe to the News at Ten theory. Put very simply markets only make headline news when they are either at the top or the bottom. Therefore once they make the news we believe you should be prepared to head off in the opposite direction.

It is interesting to see what the gold bulls are saying. It is clear that some believe it is the only game in town. They base their reasoning on a lot of the arguments raised by ourselves here at Barmac. They point to the fact that with the dust finally settling on the biggest market bubble in history, and

the Fed and Big AI denying any role in it, investors are viewing their investment portfolios with increasing alarm. They also point to the fact that political uncertainty, accounting scandals and 9/11 all have seriously undermined (no pun intended) the psyche of ordinary investors.

We have seen how this has lead to investors seeking alternative investments and here in the UK it has lead to the property boom. This has also happened in the US and in both countries there has been a re-awakening of interest in gold as an alternative.

One commentator, David Duval (no, not the golfer) points out that since the start of the bear equities market in March 2000, mutual fund tracker, Lipper Inc has seen that in the US gold funds are up by 68.3%. This is well ahead of the high profile US real estate sector which was 45.4% higher over the same period.

Duval is certainly adamant that gold’s upward trend is sustainable. He cites the following factors for this belief: inflationary growth in US money supply; the rising deficit in the US current account and its’ impact on the US dollar; a loss of faith in paper assets because of accounting and other scandals; the closing of hedge positions by major gold producers; and good old supply/demand considerations.

A study by Beacon & Associates indicates that if gold prices were to remain under \$300 per ounce, world output could fall by at least 25% over the next 5 to 7 years, exacerbating the current supply deficit even more. Today, annual gold demand far exceeds global mine production with most of the present deficit being met by central bank leasing for mining hedges and financial speculation.

Duval points out that central banks have been lending increasing amounts to bullion banks and other speculators who have used complex derivatives to limit their risks and generate additional income. The size of this derivative related short position is officially acknowledged to be approximately 5,000 tonnes but in reality is probably two or three times that. This means that in effect gold has been sold into the physical market and any sudden price increases would force borrowers to replace that gold through

spot purchases at much higher prices. It is estimated that between one third and one half of all central bank gold would no longer be accessible if this happened. This is obviously a volatile scenario and could make the \$850 per ounce gold high in 1980 seem like a minor blip on price charts. And what could initiate this move? Take your choice but the most likely seems to be international conflict (Iraq or North Korea – the latter to us seems to be the most scary) or a terrorist attack of some magnitude.

So the gold bulls seem to have a weighty case. In our judgement it seems to be a lot more convincing than the arguments of the technology bulls in the late 1990's. But being the cynics we are we don't believe either bull or bear markets move in one direction. Bull markets have retracements, bear markets have rallies. Believe us, there are plenty of people out there who believe markets move in one direction only. We speak to them all the time.

So what evidence is there for short-term weakness in the gold price? For starters lets consider gold itself. Whether the gold bulls like it or not, gold is chiefly a commodity. Virtually no one in the western world regards gold either as money or as having any monetary significance. Neither do they view gold as a crisis hedge. It wasn't always this way and there may be a time when we revert back to gold as being regarded as significant in monetary terms.

Understanding this is crucial in terms of gold's recent moves. We believe the news events of the last year cannot explain the gold's price action in gold. Normally you would expect this to be the case. So what has changed? We believe that for some time there is an increasing contingent who have realised that gold's longer-term fundamentals have improved.

The chart on gold shows a narrowing trading range with a descending line of resistance coupled with a rising support level. This indicates a sort of "Mexican standoff" not only between bulls and bears but also between the commodity speculators who are usually the main influence behind gold. These people do not care what you and I think the price of gold should be, they are mainly concerned

with how they can influence the price action in order to make a profit for themselves. Their key tools are technical behaviour and momentum.

The break above \$330 per ounce was looked upon as key. Some commentators referred to this level on the chart as gold's "Maginot Line". Once \$330 was broken they said the gold bull market was established and from hereon in they continued it would all be one-way traffic. As you know we at Barmac love our history (current history books being devoured here are "The Lunar Men" by Jenny Uglow, the story of the men behind the British Industrial Revolution and "Berlin – The Downfall 1945" by Antony Beevor) and therefore we know all about the symbolism of the Maginot Line. We also know that as a line of resistance it was rendered useless!

We have a sneaking feeling that all this could be leading to short-term price weakness. Currently Wall Street is experiencing a New Year rally. There is some optimism as traders return to their desks looking for investment opportunities for the moment they have discounted the fears widely held in 2002 of deflation and anaemic economic recovery. Investors in the meantime will be persuaded to climb aboard the train before it's too late. This may lead to a short-term gold sell off. People will buy the notion (and this is one the short sellers will exploit) that gold is less attractive given that stock markets are back on track. This could lead to a test of the \$330 level. It may or may not hold. If it doesn't our guess is that we could see a plunge to the \$300-\$305 area.

Significantly, the futures market currently presents a very interesting technical picture with speculators holding a multi-year high in net longs whilst the commercials have increased their shorts in the face of recent rises and hold a net short position that is also a multi year record. Thus the question we have to ask ourselves is who will win the standoff? The answer in our view is the commercials (the large inside professional gold market operators) and we see this as huge confirmation that prices will fall sharply in the next month or so.

If gold does break to lower levels then this could well be a glorious buying opportunity. Either way we see

some short-term weakness and ultimately positive long-term prospects for gold.

INREEST RATES

- **Government bonds are susceptible to weakness due to extra supply especially if equity rally continues**
- **Gilts and treasuries have posted at least medium term tops.**

The rise in US 10-year Treasury yields looks like a warning shot across the bows. Of greater concern is the deflation fighting by the Fed and Bush Administration, resulting in increased supply of US government debt. Also, we can expect a massive monetary reflation by the next Bank of Japan Governor, when that yet to be announced individual takes over on 20th March 2003. Euro-bunds are probably safer but their directional move is likely to be dictated by the US market.

Meanwhile, the US dollar price of gold just hit a 3-year high - not a great story for bonds. For government bonds to do a lot better than the considerable bull market that we have already seen, requires at least one of the following interrelated factors: stock markets slump beneath their October lows, the US heads for a double dip recession and the deflation-fighting measures fail. While all three are possible, many bond investors are already positioned for such an outcome. Consequently, the 'shock' for government bond bulls would be a further stock market rally in 2003, massive issuance and a somewhat better economic performance, keeping deflation at bay. Because so many people own government bonds, we feel there is more to lose in this event than there is to gain if the first scenario unfolds. A combination of the above scripts are plausible, in our view, even though we maintain stock markets are unlikely to sustain more than a medium-term rally. Of course share indices could behave in a laterigrade fashion for a lengthy period, in which case quality government bonds should remain generally firm, enabling holders to pocket the yield. BBB rated corporate bonds, which have outperformed higher rated company and also government debt since the stock market rally commenced on 10th October, should generally track stock markets. Bottom line - we would

continue to ease out of bonds, or at least shorten maturities.

The UK gilt future has twice backed away from the 121 levels and this has now become significant resistance. If support at 117/8 is broken then further substantial falls are likely.

UK GILT (weekly)



The US Treasury has developed similar top characteristics to the gilt with 108/9 being major support. When the tightening triangle breaks a substantial move should follow.

US BOND FUTURE (weekly)



EQUITY CHART REVIEW

- **Markets are poised for a 10%+ move once trading range is broken.**
- **If move is positive likely to be bear market rally.**

The August highs are psychologically significant.

European markets seldom uncouple from Wall Street's overall trend, and most have under performed the States throughout the bear market to date and during the rally from October's lows. Consequently an upside lead is required from the S&P 500 and DJIA before a further recovery will be indicated. Many technicians cite long-term downtrends, including moving averages for the indices.

These are certainly relevant but the important psychological levels, in terms of a further recovery, are likely to be the August highs near S&P 960, DJIA 9100. These were tested in early December and they halted the rally. Interestingly, the NASDAQ Composite and NASDAQ 100 indices cleared their August highs but could not remain above those levels. This Bearish divergence if repeated in the current rallies is to be watched for.

Europe's lagging indices now face hurdles from their early-December highs before they can rally towards the August barriers. For the FTSE 100 Index, there is the October to early-December lateral resistance at 4200. If the S&P and DJIA can lead an upside breakout, and this may require uncertainty over Iraq to be resolved one way or another, many more investors will believe that the bear market is over. They will also regard the July to October lows as troughs within completed base formations. This latter conclusion would be correct, but only in terms of an extended rally within the secular bear market, in our view.

So lets review the charts.

The Dow, the Ftse, the Dax and the Nasdaq all display very similar properties with markets trading in ranges just above the lows. Breaks of the marked ranges will likely lead to strong moves in the direction of the breaks. We have lumped all the charts together as they are all displaying similar properties and will act as one.

We would not anticipate the direction of the move, as patience will be rewarded in this set up with what should be a low risk entry point. If you feel the need to trade before the key levels break you run the risk of being swung about in erratic ranging. This can destroy confidence and money needlessly when a clear set up is only around the corner.

DOW JONES



FTSE 100



NASDAQ



The Dax has under performed the other major markets dramatically and may manage a sustained rally only if the index can move above 3500. As with all the above-mentioned markets a patient waiting game is required to avoid whipsaw movements.

DAX (weekly)



The Japanese index continues to steadily erode with as yet no clear reversal pattern established. However momentum is slowing and the technical picture would improve above 9250 completing a small double bottom and breaking a recent trend line. If this scenario were to unfold the market could be carefully bought with a stop at 8750.

NIKKEI (weekly)



SUMMARY FOR EQUITIES.

Await break of current ranges before buying the various markets. The danger is that we may see a downside break.

FOREX

- Dollar weakness to continue but may be getting oversold

- Euro is the pick of the “ugly parade”
- Yen will ultimately fall much further

The euro is still recovering from a previously oversold position after three consecutive years of declines following its launch. Its trough, you may recall, was established following multilateral intervention to support the single currency, which had become an embarrassment for Euroland’s ministers. Today, few people would regard the euro as a choice plum, given Europe’s sclerotic economies, an unwieldy plan to increase the European Union by many more member states, and the European Central Bank’s deflationary mandate. However in this currency contest, it is the least ugly that wins the prize. As for the dollar, everyone knows it was overvalued following the bubble years. Once the US stock market tumbled and interest rates were slashed, a lengthy correction became inevitable. Greenspan has been pumping huge quantities of liquidity into the US financial system ever since the bubble burst and a Fed governor recently mentioned that there would be no limits on monetary policy in the effort to prevent deflation.

Lastly, as the dollar weakens people worry more about the US current account deficit. The yen is no alternative to the dollar, not to mention the euro, despite Japan’s current account surplus, which is the legacy of mercantilist policies over many decades. Yen deposits pay no interest and the economy remains trapped in a destructive deflationary cycle. The Ministry of Finance and the Koizumi Administration want a weaker currency, unlike the Bank of Japan. However in appointing the next BoJ governor, who will take office on 20th March, the Prime Minister has said he wants “someone who has conviction, and someone who will aggressively fight deflation”. We can expect the mother of all reflations from the BoJ next year.

The euro is least ugly in this three-way contest, at least for a while. However it should have at least one stumble on the way to our long-stated target of \$1.10 - \$1.15 next year, and a temporary overshoot is possible, given the nature of markets. Assuming the US does remove Saddam Hussein, the dollar should rally temporarily against the euro. Lesser stumbles for the euro could occur on concern over Euroland’s and especially Germany’s continued economic

decline relative to the US, which will benefit from a somewhat softer dollar. Therefore new US Treasury Secretary John Snow (not the England fast bowler we believe) will be content to see the dollar ease. He won't need to talk it down because the trend is doing quite nicely.

Officially, US spokesmen will repeat, when asked about the dollar, "America's policy is unchanged. We support a strong dollar." Anything else would spook the markets. As the euro appreciates, watch for eventual protests from Euroland's exporters. This will be the first evidence that the single currency has commenced the latter stages of its recovery. Meanwhile, it should move a lot higher against the yen.

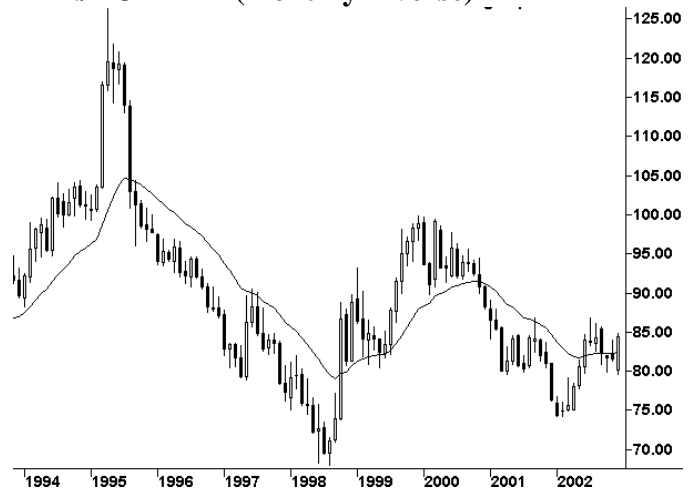
The Dollar has suffered declines against most currencies during the last few months and a huge bearish consensus is being built. We suspect that the dollar index will find support at or around the 100/101 level. A multi-month correction looks likely from there back toward 106.

DOLLAR INDEX (weekly)



Against the Yen the dollar has major support at 87/88 (115) but a break of this level would open the way toward yen 100. We do not expect such a surge but the charts should be watched carefully in case the unthinkable happens!

YEN/DOLLAR (monthly inverse)



Against the euro the dollar has suffered significant multi-month falls toward 1.05 but the rally by the euro may soon begin to tire. The marked trend line has long underpinned the move and we expect at least a pull back to this support in the next month. A complete reversal is unlikely at present bearing in mind the huge supply of dollars swamping the world with paper.

DOLLAR/EURO (weekly)



The pound has struggled to push past \$1.60 over the past few weeks. With the dollar so generally oversold we suspect that the pound may prove to be susceptible to some profit taking with the price likely to fall back to the trend line support (1.56). However, once this excess has been burnt off the dollar bear against most currencies should resume.

POUND/DOLLAR



Sterling Yen has also seen a stalling in progress over the past month or so. The pound needs to break cleanly above 195 to signify further short-term strength. Support should be found at 185/190 trend and ultimately higher prices will follow as Japan seeks competitive devaluation.

POUND/YEN



The pound has slipped below the key multi-year support at 1.55. This break of the triangle has been bookmarked in these pages for at least 12 months. We may see the pound temporarily rally back toward the breakout level to “kiss goodbye” before a dynamic move takes hold pushing the pound down to below 1.50. The Euro is being driven by global investor demand that are frightened by US fiat money policies and Japanese promises of devaluation. The ECB by contrast is sitting idly by and allowing deflation to become endemic. The money supply is only growing comparatively slowly when compared to the US and what may

occur in Japan. The pound is caught in the middle of the global money flow and will likely wilt against the euro. A move above 1.60 is required to negate this hypothesis.

POUND/EURO



COMMODITIES.

- **CRB hits two year high as gold, oil and food drive up dollar prices**
- **Gold may correct in the next few weeks.**
- **Oil price is unsustainable on fundamentals but.....**
- **Coffee may be getting back into form**
- **Cotton racks up the profits.**
- **Wheat is all chaff.**

CRB INDEX



The US commodity index has had a major bull run over the past 12 months. This has been driven

in parts by the dollars' demise, Mid East tension and the rise in gold. This rise is possibly an early warning that the Fed in its eagerness to offset deflation may print too many dollars and recreate inflation instead.

A move below \$230 would suggest prices were stalling.

Gold has probably run too far too quickly. With the various sentiment indicies registering 16 consecutive days of bullish extremes we are very wary of a "surprise" sell off. Traders could short gold with a stop at 365 and a target of 325.

GOLD (weekly)



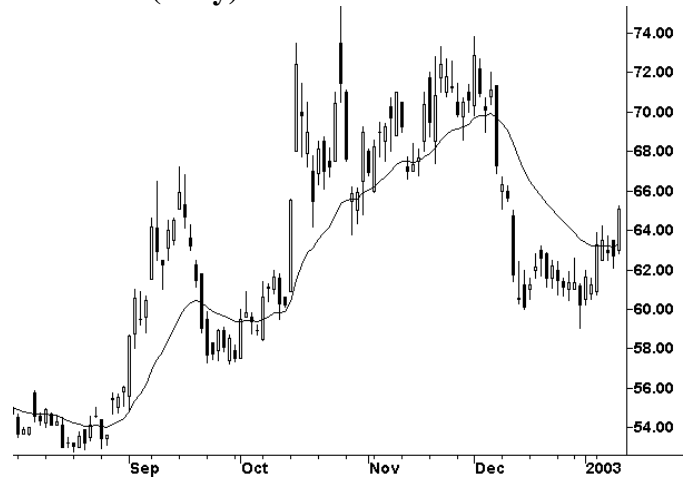
Oil appears to be backing away from recent highs yet again. With OPEC promising to produce more oil the price is only being suspended at current levels due to "war premium." If and when the war on Iraq begins or is finally called off then prices will hit either \$50 or \$15!

OIL (NYMEX daily)



Coffee an old favourite over the past few months looks like it may be capable of re-awakening yet again. The move above \$64 suggests a strong move onwards to the 68 region. A move below 62 would negate this trade.

COFFEE (daily)



Cotton has been a profitable position over the past few months with our original mention at \$29. The price currently looks likely to consolidate and we would take profits or place a stop at \$50.

COTTON (weekly)



Wheat has finally lost all its backwardation and slipped into contango confirming the dismal picture painted by the recent slide back toward the multiyear trading range of \$3.00. Support may be found at this level but we suspect that the technical damage caused by the recent declines will take some time to work off. However, unless the price declines below \$3.00 and stays there then we would expect a gradual strengthening of price over time.

WHEAT (monthly)



FINALLY a little trading educashun!

UNDERSTANDING TRADING TACTICS

We reproduce an interesting experiment that highlights a very pertinent point. The KEY to successful investing is not just about “getting the markets right” but also about sound trading strategies.

How often have we all predicted a certain move correctly and yet still lost money? We have many times and will no doubt continue to do so.

Followers of our “Break-out” portfolio (currently ahead over 43% since Oct 2000) will be aware of our strict 10% trailing stop approach. This kind of trading discipline has been far more crucial in making the gains than stock selection.

Many investors simply do not understand strict risk reward analysis of various investment strategies and as such suffer disastrous losses via either not cutting losses short or by over trading individual positions. They also fail to appreciate the impact of losses and the returns needed to restore the *status quo*.

The Gambler's Fallacy and the Drawdown Impact

"The Gambler's Fallacy" and "The Drawdown Impact." By understanding these two simple ideas - and remembering them in the heat of battle - you'll go a long way toward improving your chances for investment success.

How Many Lost It All... Even Though the Odds Were Stacked in Their Favour!

To illustrate the importance of these two concepts, IITM's Mr Van Tharp had an audience of investment advisers play a trading simulation game. Van simulates 50 trades by pulling a marble out of a bag 50 times. Each marble represents either a winning or losing investment. You simply bet on whether he's going to pull out a winner or a loser before he pulls it out. Sixty percent of the marbles are winners, so if everyone were to simply bet the same amount on every trade, they'd each come out a winner.

But everyone doesn't come out a winner.

Quite the contrary, only a third of the people in the room are winners. Amazingly, of the other two-thirds that lost money, half of them **lost it all** - in a game they were basically guaranteed to make a profit.

Additionally, even though everyone started with the same amount of money, no two individuals in the room ended with the same amount of money (except those that went bankrupt). This all goes to show that the question, "*How much to invest?*" may be every bit as important as the more popular question, "*What should I invest in?*"

There were two special marbles in the bag to keep things interesting. One was a 10x winner - meaning if you bet £5,000 out of the initial (imaginary) £100,000 you were given to start with, you'd make 10 times your money on that bet, for a profit of £50,000. There was also a 5x loser in the bag. So if you bet £5,000 when Van pulled the 5x loser, you'd lose £25,000.

Ignore the "Gambler's Fallacy" at Your Own Risk.

So let's consider the Gambler's Fallacy. This one is simple. Yet nearly every “mug punter” falls for it. And most investors fall for it too. It's our toss of a coin analogy on the front page. If heads came up 10 times in a row it is still 50/50 that heads will result in the next coin toss. So do not invest via the law of averages.

This same idea - that each individual outcome is unique - applies to investors as well as players of

Van's marble game... "My last three bets were wrong, therefore chances are I'll be right on this one." This thinking is the Gambler's Fallacy. And if you ignore the Gambler's Fallacy in your investing or trading, chances are, you could end up broke, just like a handful of the players of Van's game.

After all, in Van's game you were practically guaranteed to win. But what are your guarantees in the stock market? There are none.

Why Drawdowns Are So Important

The next thing is the "*Drawdown Impact*." How did a third of players go broke in a game they were guaranteed to win? They didn't understand the impact of "*drawdowns*." Let's say that, after a streak of losers, you had £50,000 left out of your original £100,000. And let's say you wanted to lay down a big bet to try and catch up with the rest of the crowd - say £10,000? You may not realize it, but due to the rules of the game, you run the risk of getting wiped out. Let's say that Van pulls the one 5x loser marble out of the bag...poof, you're wiped out instantly. If you don't fully understand what you have at risk, you can (and eventually will) get clobbered.

As you know, we recommend limiting your downside risk to 10 to 25% depending on the volatility of the stock on any given investment. This means that if the investment does fall that much, you "only" have to earn upto 33% to get back to where you started. I say "only" because if you're willing to have a 50% drawdown, you've got to earn 100% to get back to where you started. And if you have no limit, and one of your investments falls 90%, it has to rise 900% to get you back to where you started. That is the impact of drawdowns.

If you limit your drawdowns on your investments to 25% per investment, you at least have a fighting chance of getting that money back. If you allow larger drawdowns, you're going to be a loser over the long run. No doubt about it.

So when you're in the heated emotions of the game of investing, and you want to get back what's gone, remember the *Gambler's Fallacy* and the *Drawdown Impact*. Remembering these will save you from making a seriously bad decision. And by

doing this, chances are your investments will outperform everyone you know.

IITM's Van Tharp wrote a very good book detailing many of the specific things that you could do to improve your investing. It's called, *Trade Your Way to Financial Freedom*. Dollar for dollar, it's probably the best introduction to what Van and IITM do. [Click Here](#) to order it from Amazon.

If you have any questions or comments about this month's letter please do not hesitate to e-mail us at Barmac.

May we apologise for the late delivery of this months letter. Next issue will be targeted for first week of Feb.

May we wish you all a very prosperous and healthy New Year

REGARDS

Andy McCarthy

Andy Bartles.