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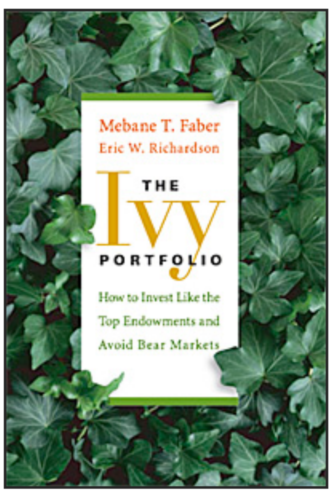

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Politics and Profit

Two Positive Tailwinds for Stocks

Any trading system that uncovers alpha must have a justification for why the strategy works. If you cannot explain why the inefficiency exists then you are likely just data mining and exposing your portfolio to unintended risks with uncertain outcomes. Ray Dalio, Founder of the world's largest hedge fund Bridgewater Associates states

"Because I believe that all criteria for investing (that is, good betting strategies) should have a logic that isn't time specific, I believe that the alpha generators that make up the ultimate alpha generator should be timeless and universal. By that I mean that they should have worked over very long time horizons and in all countries' markets."

There are countless strategies, indicators, and systems that are mentioned in the popular press with such catchy names as The January Indicator, Dogs of the Dow, Elliot Wave theory, Dow Theory, Sell in May and Go Away, and The Fed Model. As a responsible investor that is risking hard earned cash when investing, it is of utmost importance to validate any indicator or system of investing (and yes I include buy and hold based on Modern Portfolio Theory here too!). Even with reams of supporting data it is vital to step back, employ some common sense, and ask why a tendency (because some are just that, tendencies) may work.

The Presidential Cycle

Two such anomalies are setting up for a favorable year end and start to 2011. The first is what is known as the Presidential Cycle. This theory goes that equity returns during the third and fourth years of a President's term are more favorable than the first two years. The fundamental justification is that the President tries to force any difficult legislation into law during the first two years of his presidency. Historically the President's political party loses power in the midterm elections (as we saw this past November). After the first two years, the task of re-election takes hold and the President is consumed with securing a second term of office or campaigning for his party's potential replacement. The data bear out that monetary and fiscal policy have historically been easiest during these periods as the President moves the machinery of the Federal Government in order to promote economic growth and lower unemployment.

The historical data support this theory – -there are even studies that go back to the early 1800s (although data are a bit spotty pre-1900). Median returns have been 5% in Year 1, 5% in Year 2, 22% in Year 3 and 11% in Year 4 since 1927. Since World War II the S&P 500 has not had a down Year 3 at all with gains averaging 18% per annum. The fourth quarter of Year 2 (the one we are in now ending December 31, 2010) is the best performing quarter followed by Q1 and Q2 of Year 3 (January - June 2011). Can you be certain that Year 3 will be positive? No, as evidenced by the awful 1931 bear that lost 44%. Some critics of this approach argue that the recent stimulus of the past two years front loaded and distorted any potential ramp in 2011 and 2012. But there are reasons to believe that more often than not it will be.

The January Effect

A second market bias is the large outperformance of small cap stocks in January. Historically small caps outperformed large caps in 80% of all Januaries by 3 percentage points per year (small caps being defined as the bottom 30% of stocks market cap weighted). So-called microcaps (the smallest of the small caps) historically produce even better results. The fundamental reason for this tendency is tax sensitive investors (mostly individual retail investors) sell small caps to lock in year-end tax losses, and then reinvest their portfolio in the New Year. An academic paper by Haug and Hirshey called "The January Effect", examines this property all the way back to 1800 with supporting results.

Some analysts have argued that the January Effect has moved into December as investors look to front run this tendency. This is a classic example of traders adjusting to market inefficiencies and an example of their behavior having a direct influence on market inefficiencies.

Combining the Two

What about combining of these two factors, The January Effect in small caps and the Presidential Cycle? Historically across the 48 months in the four year cycle the January of Year 3 is the single biggest outperformer with median returns since 1927 of nearly 8% a month for small caps. Does this mean that January is guaranteed to be great? Again, nothing is guaranteed - Year 3 Januaries have varied from 27% to down 10%. While many of these tendencies are just that, investors can view them as head or tailwinds that could give bulls and bears pause. The easiest method to take advantage of this effect is to go long a small or microcap ETF (IWC, PZI) or mutual fund (BRSIX). For a more market neutral approach, go long a microcap ETF and short a large cap ETF (VTI, SPY).

Research has also shown that screening for small caps down significantly from their highs in mid-

December respond the best to the January Effect. Derivatives such as options could also be used to gain cheap exposure while limiting downside losses. For a list of stocks that passed our screens on December 14th here is a link to the post.

Best Regards,

Mebane Faber

What I'm Reading

Investment Related

- Time to Get Long Munis for a Trade? *(World Beta)*
- Real Time Hedge Fund Tracking Results. *(World Beta)*
- Montier's new must read: "In Defense of the Old Always". I read everything from GMO so a bit surprised I didn't also see this: Momentum – A Contrarian Case for Following the Herd. *(GMO)*
- A Contrarian's Guide to Football Betting. *(WSJ)*
- Top hedge fund stories 2010. *(AR)*
- Another must read, Howard Mark's "All That Glitters". *(Oaktree)*
- Finally added Thaler's Nudge blog to the blogroll. Interesting post on The Charity Deduction. *(Nudge)*
- You need to be different and make concentrated bets if you're an active manager, and Morningstar has a way to find the closet indexers. *(Morningstar)*
- A fun read about inflation. *(Slate)*
- A nice piece from the NY Times on activist funds and ValueAct specifically. Following their picks on a quarterly basis on AlphaClone would've beaten the market by over 15% a year since 2002. *(NYTimes)*
- Interesting piece in The New Yorker by Cassidy What Good is Wall St? There is a particularly interesting section on Woolley and his Centre for the Study of Capital Market Dysfunctionality. Linked is a speech he gave and his 10 point manifesto for investing. *(New Yorker)*
- We already have one blog reader that has won the NAAIM prize for best paper, let's get another! Deadline is March 2011 and the prize is $10k. *(NAAIM)*
- I have long believed there is an opportunity for online education surrounding investing and personal finance. A few different sites have investing/finance as a component of their offerings (like Sympoz and MIT Open Course) but I have yet to see the "Rosetta Stone" of

investing education.

- I actually didn't know FQ took over a mutual fund as sub until a reader left a comment on the blog. Here is an older PDF "Balancing Betas". Managers FQ Global Essentials Fund (MMAVX). *(First Quadrant)*
- Great post on just how little people understand about investing. Wow. From the Dorsey Wright folks:

"If interest rates rise, what will typically happen to bond prices?

18% - They will rise

28% - They will fall

5% -They will stay the same

10% - There is no relationship between bond prices and the interest rate

37% - Don't know

2% - Prefer not to say

Diversions

- Ebert's top movies of the year. *(Sun Times)*
- Chances are that you've been to a restaurant and had your food cooked by the sous vide method of cooking. Since Cuisinart hasn't put out a cheap model yet (and the SousVide Supreme is still about $300) I tried some steak and chicken through the budget "beer cooler and thermometer method". Great results! Even Thomas Keller has a cookbook dedicated to the subject – Under Pressure: Cooking Sous Vide.
- Although that pales in comparison to former MSFT CIO (CTO?) Myhrvold's 2400 page, $500 (and $1mm production cost) Modernist Cuisine: The Art and Science of Cooking.
- While I have yet to book a hotel on Jetsetter, it is a weekly drop by for some killer deals on some of the top hotels in the world.

Upcoming Events & Travel

Below are events where Cambria will be speaking or attending:

AlphaMetrix Conference	Jan 26-28	Miami, FL
MTA Conference	Jan 29	Charlotte, NC
Private Event	Jan 30	Raleigh, NC
TD Ameritrade Conference	Feb 2-5	San Diego, CA
Index Universe ETF Conference	Feb 6-8	Hollywood, FL
AAII Silicon Valley	Feb 19	Sunnyvale, CA
R Finance	Apr 29-30	Chicago, IL
NAAIM	May 2-4	San Diego, CA
ETF Investing	May 16-18	New York, NY

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