

## Markets at Risk

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Welcome to our first publication of the *ProfitScore IQ* newsletter. We plan to publish this newsletter during the first and third week of every month starting in July. The actual publication dates will vary based on our receipt of benchmark performance data, but plan on receiving this newsletter in your inbox during those weeks.

This newsletter will be free for friends and clients of ProfitScore Capital Management, Inc. The topics will vary from week to week, but we will always update you on what we are thinking long and short term about the markets and the performance of our four portfolios. We have a lot to cover, so let's dig in.

### **My Job Is To Worry**

As your portfolio manager, my job is to worry, so I do that a lot. Before I tell you about some of the things on my economic radar screen, let me stress that it is my job to worry and not yours. Your account is being managed by me and my team of very talented absolute return money managers. It is actively managed to produce consistent absolute returns regardless of what is going on in the market.

And, it looks like I am not the only one worried these days. A bearish market call was sent over the wires last Monday night by Morgan Stanley's top analyst. With their large footprint, this almost certainly contributed to the markets' sell off last week. Here is a summary of what Morgan had to say:

### *Morgan Stanley issues "full house sell signal"*

*Morgan Stanley has issued a "full house sell signal" as of Monday, saying three of its leading indicators - bond yields, Institute for Supply Management new orders, as well as valuation and risk - showed it was time to sell. "Such a full house sell signal across these three indicators is rare, and has occurred only five times since 1980," said analyst Teun Draaisma in a European strategy research report. "Equities have always been down in the next 6 months, on average by 15%. Previous occasions include September, 1987 and April, 2002. We prefer to be on the right side of those odds." Draaisma also said that cautious sentiment can negate a valuation sell signal.*

It is interesting that a "perma bull" like Morgan issued this warning. Could the last bear market and their loss of assets have made Wall Street honest again? I doubt it very much. From a sentiment counterpoint, short interest on the NYSE was twice previous record levels before the sell off

began last week. My guess is that Morgan "front ran" the information, hoping to capitalize on everyone bailing out on their news so they could make money on their shorts. I guess we shall see. Even if they are correct and last week's action was a shot across the markets' bow, you could place a reliable bet that some of Morgan's money front ran their press release.

To Morgan's credit, there are a lot of imbalances out there right now, but then again there is usually always something to get excited about. The dollar just recently bounced off an all time low. If you travel to Europe, you will not believe how worthless the dollar has become. On the positive side, a falling dollar helps multi-nationals, whose exports are more competitive overseas. The downside is that when a dollar buys less overseas, it's difficult to keep inflation low. Unless China continues to give away their products, you will soon see higher prices at your local Wal Mart.

Another interesting development to keep in mind is food inflation. There has never been a problem with inflation when food OR energy has increased in price. Conversely, there has never been a period of low inflation when food AND energy have both increased in price. Since difficult economic periods are almost always caused by something the government has done, have you given any thought to the ramifications of ethanol and the potential of unintended consequences?

I am sure you have heard that the price of land in Iowa and other corn producing states is up about 3 fold with the ethanol buzz. Ethanol subsidy is at best a bad idea, and using current technology it will not work for many reasons, but it is currently politically correct. [Cause] Because of the subsidy, corn is soaring in price. Farmers want to plant corn and not other crops to benefit from rising prices. [Effect] This has caused food prices to inflate. The cost of tortillas is up significantly in Mexico. Since poorer countries pay a much higher percentage of their income for food, higher food prices are a major cause of world wide inflation. I don't know about the gas prices where you live, but regular unleaded gas in Boise, Idaho, is \$3.43 per gallon. Ouch!!!

The reason the government is subsidizing ethanol is to lower energy prices. The unintended consequences of rising inflation and a falling dollar will accomplish this through reduced world wide oil demand caused by economies that are in a tail spin due to rising inflation. The smoking gun is almost always the government, so that is what I look for when searching for cracks in the economic dam.

The equity markets were plenty volatile last week, but on a relative basis, the long end of the yield curve made them look tame. Long term interest rates appear to be making a structural change and are now poised to go much higher. Pimco's bond God, Bill Gross, came out last week and said he was wrong in his projections. He now sees the range of long term rates reaching 6.5% versus the 5.5% he estimated earlier. On a percentage basis, he is raising his estimate by a whopping 18.1%. For relatively calm interest rates, that is significant change and may put the death nail into already difficult real estate markets.

### **If Two Heads Are Better Than One, What About 13?**

If you did my job and traveled to many of the top investment management conferences that were attended by some of the best absolute return money managers in the country, you would more than likely have come to the same conclusion that we have; and that conclusion is that the whole is greater than the sum of its parts. You would have come up with the great idea to manage individual accounts for individual investors by incorporating the same kinds of strategies that institutional investors have enjoyed for decades. All you would have needed to pull this off was a technology partner to make it happen and then your phone rings and it is your new technology partner on the line.

A lot of research, a few lumps on my head and hundreds of hours of work have gotten us from point A to point Z. It wasn't always easy, but in the end, I think we have literally changed the way money will be managed in the future for individually managed accounts.

Depending on the portfolio of your choosing, your account is being managed by between 4 to 13 managers. On average, the more volatile the asset class, the more managers we have involved. Fixed income has the fewest and arguably some of the most talented managers, while equity managers make up the largest number of specialists. As I mentioned in an earlier update, we are not sitting on our hands at ProfitScore. We are very involved in the day-to-day management of your accounts and run this entire multi-manager process with an iron fist. If a manager does something that is out of the ordinary, it sticks out like a sore thumb in the multiple reports I receive every day. In addition to managing some of the strategies ourselves, each manager's individual performance is monitored on a trade by trade basis. Our hedge fund experience is the foundation of the risk management infrastructure that we use today to manage your ProfitScore account.

### **What's A Fair Benchmark?**

As you might have noticed on the month end performance reports, we have changed the benchmark indexes we use. In order to properly gauge our success, we needed to provide you with other absolute return benchmarks that more closely resemble the style of management that we are conducting inside our 4 portfolios. Although more common today, all of these absolute return benchmarks are found in the hedge fund universe.

Today, there are currently over 8,000 diverse hedge funds managing around \$2 trillion dollars, so there are many sources that publish meaningful hedge fund index data. We have attempted to use the most recognizable indexes for each investment category that resembles one of our 4 portfolios.

For your reference, we also include a standard benchmark index that is commonplace in the investment industry. The most common index for equity portfolios is the S&P 500, and it is also listed for three of the portfolios that have equity exposure. It has been provided for your reference only and we do not consider it to be a benchmark for our equity portfolios. Hedge fund benchmarks raise the bar for our performance because they tend to make money in most market environments with relatively low volatility. Our portfolios are not exact replicas of any of the hedge fund indexes but should give you a better gauge to monitor our success moving forward.

### **Performance versus Our Benchmark Index**

Our performance for May was almost a complete opposite of April's. Our most aggressive portfolio, The Expedition, led the way both in overall performance and against its benchmark, while our fixed income portfolio, Income Builder, lost 4 basis points for the month. Our other two portfolios, The Guardian and Harmony Plus, had a good month and continue to produce consistent low volatility absolute returns. For a detailed analysis of our performance, please click on the links provided below:

[http://www.profitsscore.com/income\\_builder.pdf](http://www.profitsscore.com/income_builder.pdf)

[http://www.profitsscore.com/harmony\\_plus.pdf](http://www.profitsscore.com/harmony_plus.pdf)

[http://www.profitsscore.com/the\\_guardian.pdf](http://www.profitsscore.com/the_guardian.pdf)

[http://www.profitsscore.com/the\\_expedition.pdf](http://www.profitsscore.com/the_expedition.pdf)

### **Current Portfolio Holdings**

As our clients have learned by logging into their accounts and looking at their portfolios, our investment positions change everyday and can sometimes change twice a day. Some of our traders trade daily, some weekly and some monthly, but when you aggregate all this activity into one account, some change almost always occurs on a daily basis. In other words, any portfolio's composition today can be completely different tomorrow. All of our portfolios are invested across one or more of the three pillars of strength highlighted below. Each pillar is comprised of several different strategies that are similar in design and investment category. To enhance the consistency of performance, all investment strategies produce uncorrelated investment returns.

#### Index Advantage

Our cumulative long/short index allocations have ranged from flat, to net short to net long last week. It was a very volatile week in the equity markets, and our traders adjusted rapidly to changing market conditions and held up fairly well in a difficult week. For a relative comparison, our equity exposure produces about 1/3 of the S&P 500. As of close of business Tuesday, our long/short exposure was net long going into Wednesday.

#### Strategic Balance

Our rotational strategies were our bright lights last month but have lagged so far in June. The extreme interest volatility made it difficult for interest rate sensitive sectors, and this has caught some of our traders off guard. Being short oil and precious metals helped soften our underperformance to interest rate sensitive positions. Due to the oversold nature of some of these sectors, we do expect a bounce as positions regress back towards their mean.

### Income Advantage

As we mentioned earlier, the long end of the yield curve got a wake up call. After last week's gut wrenching volatility, the inverted yield curve is now about flat. Ten year plus bonds appear to be heading into a bearish phase as global inflation raises its ugly head. It is our opinion that significant, multi-year changes are currently underway in long term bonds. Central bankers across the globe have stepped in to raise rates in an attempt to slow down global inflation. Our high yield exposure has gone from net long to neutral. Our long exposure to the dollar proved to be correct as it anticipated this increase in rates. Our long/short bets on bonds were about half correct as our traders attempt to adjust to the unsettled fixed income environment. If rates increase to the top of Bill Gross's range, there is still 24% more downside to longer term bonds as the long end of the interest rate yield curve pushes higher.

### **What Is On Deck For ProfitScore?**

I started out in this industry as a sub-advisor to other money management firms. My practice grew to include individually managed accounts and later a hedge fund. Today our multi-manager portfolios incorporate many of the ideas I learned along the way and culminates in a management style that will change the way money will be managed inside individually managed accounts.

Our fastest way to grow our assets under management appears to be through wholesale distribution channels. Thanks to early success in this channel, I am focusing the firm's attention on this market opportunity. We recently landed a large institutional client who has hired us to manage his firm's assets within our multi-manager portfolios. We are having back door conversations with two large annuity firms who want to offer our portfolios on their annuity platforms. I met with another gentleman in Atlanta on Thursday who feels there is a real need for our product in the hedge fund space. In the last 30 days, institutional clients have been contacting us, so it appears word has gotten out about our unique alternative to hedge funds.

Our branch offices in Portland, Bend, and Phoenix are ramping up as we grow our firm's direct customer base. In the last eight months we have hired and trained five people, implemented a web based CRM system, developed new marketing material, implemented a new phone system, moved our offices, hired 13 investment managers, changed custodians, and as of today, published this new newsletter. We have done more in less than a year than most firms in our industry accomplish in five years. You might say we have had a lot on our plate. One of the last things I have on our list is to update our website. With a little luck, this should be completed within 45 days.

Thanks for your trust, support and friendship during our metamorphosis. Your account will soon be rewarded for your patience. If I don't talk to you in the meantime, please look for our next edition of this newsletter around the 5<sup>th</sup> of July.

Most respectfully,

John M. McClure  
President & CEO

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