



Looking ahead to 2009 (part 3)

Will you want to own stocks in 2009?

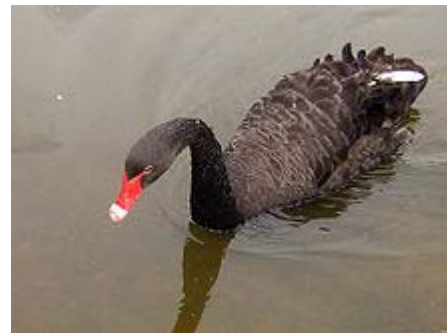
December 31, 2008

We are closing out the toughest year for global stock markets since 1931. Both the S&P 500 and the DJIA completely collapsed that year and were down over 50%.

Here is the bad news. Both the DJIA and the S&P 500 were down again in 1932. If history repeats itself, or even “rhymes”, that would imply that 2009 will be another bad year for stocks.

Before going on I want to mention once more that I have often wondered what it would be like to manage money through times like this. The truth is that I never imagined it would happen. The events of the 1930's were supposed to be “once in a lifetime”. They were the “Black Swan”.

If you are not familiar with the Black Swan theory “it refers to a large-impact, hard-to-predict, and rare event that is beyond the realm of normal expectations. The Black Swan theory refers only to events of large consequence and their dominant role in history. The term **black swan** comes from the commonplace Western cultural assumption that 'All [swans](#) are [white](#)'. In that context, a [black swan](#) was a [metaphor](#) for something that could not exist.” **Nassim Nicholas Taleb, The Black Swan, 2007**



So twice in my parent's lifetime a “once in a lifetime” Black Swan has appeared. For the record they are both still alive and living in Florida. They are safe this time from the Black Swan. It was not so easy for them the first time. This go-around is yours and mine to contend with. How it will end is still unknown.

How it will end is not even the question to focus on right now. The question of the moment is “how will we get through it”?

We have learned a lot in 2008 that will help us in 2009

The first piece of good news is the statement above. Let me be as absolutely clear and candid as I can about what we learned. Some of these things may surprise you. Some may seem self evident and you may ask yourself why didn't they know that before? To get the answer to that question please re-read the definition of Black Swan theory. Pay close attention to the part that reads “**a large-impact, hard-to-predict, and rare event that is beyond the realm of normal expectations.**” And remember that “[a black swan](#) was a [metaphor](#) for something that could not exist.”

We have learned:

- ✦ No one, including us, understood the gravity of the situation. As we reread all the very high cost and normally high value research we subscribe to we can find NO ONE who was coming close understanding the gravity of the situation until Hank Paulson started making noise about something called “TARP” in September of 2008. That is when the alarm bells officially went off.
- ✦ Now that we do understand the gravity of the situation we can be much more realistic about expectations for 2009 and beyond.

- ✚ Trying to “bottom fish” in the stock market, during a bear market, rarely works. Stocks that look “dirt cheap” tend to get cheaper. You can’t “average down” in a bear market. In other words if you try to buy GE at \$18 because it is DIRT CHEAP, with the intent of buying more if it goes to \$17, you are making a big mistake. Because it is ultimately likely to go to \$15 or lower—which it did! And, you will get stopped out, which we did.
- ✚ Calling bottoms is a fool’s errand.
- ✚ The only stocks you can buy in a bear market are ones that get bona fide actionable technical “buy signals” using the combination of moving average crossovers and relative strength indicators that we now call the “5T signal”. We have learned this signal works with overwhelming accuracy. The only trouble is that it has taken us most of the year to completely develop and understand this technique.

It should not come as a surprise to anyone that we would use “once in a lifetime” conditions to work on new techniques to deal with them. I would hope that our clients would expect us to learn and adapt.

If any client reading this would like a more precise definition of this trading signal we are happy to provide it to you. We are not disclosing it in this general publication.

- ✚ No other “buy” signal that we traditionally used in other market conditions has held up to the ferocity of this bear market.
- ✚ At this point traditional “fundamental analysis” is helpful only to separate quality companies from those that aren’t. But buying the company with the best fundamentals hardly guarantees a profitable trade. It makes the most sense to use fundamental analysis to make your “watch list” for companies you would like to own once they get the 5T Signal. Buying them before the signal, in anticipation of the signal, is an invitation to lose money.
- ✚ There is the “buy” side of the market, also called the “long side”. There is also the “short side” of the market which involves selling stocks in advance of them falling to profit from the fall. This should have been the easiest trade of 2008, but it wasn’t. It is almost impossible to trade a market in which the rules are literally being rewritten on a daily basis. Shorting the market into the face of all the intervention from the FED and the Treasury was costly.
- ✚ It might be possible for a reader to simply leap to the conclusion that K&A (5T) simply doesn’t know how to sell short.

I can dispel that myth for you with two sets of data. The first table on the next page includes a list of the top 25 performing “long/short” equity mutual funds for 2008, year to date. This is a class of mutual funds in which there is a total of 140 funds. Of the top 25 only ONE has a positive rate of return for the year. Most have **WORSE** performance than ALL of the K&A (5T) models.

The second table is the worst performing 25 funds from the group of 140. Their numbers are abysmal for the year. They are FAR, FAR and AWAY below all the K&A (5T) models.

These are funds that were shorting stocks and going long stocks in 2008 and couldn’t produce positive returns (with one exception). Clearly it has been a punishing year for the both sides of the long/short equation.

Data Provided by Lipper	
Search Funds:	
Top 25 Funds out of 140	
Fund Name	Year to Date
	Return
Fusion Gbl Long/Short	3.00%
Dover L/S Sector;Inst	-0.40%
Dover L/S Sector;Inv	-0.80%
Nakoma Abs Return	-4.30%
Caldwell&Orkin:Mkt Op	-5.10%
Highland:Eqty Oppty;Z	-10.70%
Highland:Eqty Oppty;A	-11.30%
Highland:Eqty Oppty;C	-12.00%
Arrow Alt Sols;A	-12.20%
Arrow Alt Sols;C	-12.90%
Aberdeen:Equity L-S;I	-13.70%
Aberdeen:Equity L-S;A	-13.90%
Aberdeen:Equity L-S;R	-14.30%
Aberdeen:Equity L-S;B	-14.50%
Aberdeen:Equity L-S;C	-14.60%
Palantir Fund	-19.80%
Rock Canyon:Top Flight	-20.30%
Schwab Cap:Hdg Eq;Sel	-21.00%
Schwab Cap:Hdg Eq;Inv	-21.20%
Wasatch:1st Srce Long/Sh	-21.50%
SSgA:Direct Cre Eq	-22.90%
Robeco Bost:LS Eq;I	-23.00%
Robeco Bost:LS Eq;Inv	-23.20%
Dunham:Monthly Distr;A	-24.00%
Dunham:Monthly Distr;C	-24.60%
Bottom 25 Funds out of 140	
DWS Dscpld L/S Gro;A	-40.60%
Aberdeen:Hedged Core;B	-40.80%
Aberdeen:Hedged Core;C	-40.80%
MainStay 130/30 Gro;I	-40.80%
ICON:Long/Short;I	-40.90%
ICON:Long/Short;Z	-40.90%
DWS Dscpld L/S Gro;C	-41.00%
ICON:Long/Short;A	-41.00%

MainStay 130/30 Gro;A	-41.10%
DWS Dscpld L/S Val;S	-41.40%
DWS Dscpld L/S Val;I	-41.40%
MainStay 130/30 Gro;C	-41.50%
ICON:Long/Short;C	-41.50%
DWS Dscpld L/S Val;A	-41.60%
DWS Dscpld L/S Val;C	-42.00%
Dreyfus 130/30 Gro;I	-44.40%
MainStay 130/30 In;I	-44.60%
Dreyfus 130/30 Gro;A	-44.60%
MainStay 130/30 In;A	-44.70%
Dreyfus 130/30 Gro;T	-44.70%
Dreyfus 130/30 Gro;C	-45.00%
MainStay 130/30 In;C	-45.10%
Baron Partners Fund	-48.00%
RidgeWorth:IE 130/30;I	-53.80%
Ralph Parks:Cycl Eqty	-69.30%

What will 2009 bring?

U.S. stock markets will start 2009 on technical sell signals. They have been that way for months. But most of the U.S. stock market averages are VERY CLOSE to getting new buy signals using our proprietary 5T Signal. Some foreign markets, including China, have already moved to buy signals.

These are some of the indicators that were making us think there could be a significant "Santa Claus" rally. Many averages are already on early MACD or Stochastic buy signals. That is another reason we were encouraged about the "Santa Claus" rally.

At this point we will wait for confirmation of the 5T Signal before adding any index longs, or additional stocks to any of the models. Stocks that are currently in the models are on 5T Signals with the exception of Coke (KO). KO has been teetering on and off the signal for the past several days. If the market advances into the New Year, KO will get a firm signal back on January 2nd or January 5th. If the market rolls over it will clearly lose the signal and we will sell it.

In 2009 we intend to hold only equities that are ON the 5T Proprietary Buy Signal. All other traditional technical analysis will be used only to anticipate our signal, which tends to come a little later than some of the more traditional signals. But we do not intend to buy ahead of our signal. That frankly is a mistake we made several times in 2008 and there is no need to repeat it in 2009.

We are not making any predictions about what levels the market will end 2009. That is frankly stupid at this point given the enormity and gravity of the current economic crisis.

However it is critically important to remember 2009 is not 1932!

The markets were reeling then from lack of stimulus by the Fed, the White House and Congress. For example the money supply in the U.S. contracted by 33% from 1929 to 1933. Banks failed in droves and there was no Federal intervention. As money supply contracted, what might have been a short term cyclical problem was turned into a long term secular depression.

Like it or not the reaction of our government and FED is entirely different this time. Our Fed, and White House and Congress are POURING HUGE stimulus into the U.S. economy. Our money supply is exploding upward. The FED has injected over \$2 Trillion in stimulus and there are now forecasts that it could go to \$8 Trillion before this is over. TARP has spent \$350 Billion and the White House is now asking for \$350 Billion more. President-Elect Obama is said to be crafting a second "TARP" for another \$700 Billion to \$1 Trillion. Governments around the world are throwing billions more at their domestic problems.

None of us know the outcome of all of this, but it is much more likely that we will see "reflation" than continuing "deflation". That is one of the reasons that gold (GLD) is behaving so well. It actually broke out of its "lower highs and lower lows" trend today. GLD is now solidly poised to move up.

We are very inclined to think that people should be looking back to 2002-2003, and not 1932, to see how 2009 might look. Check out the chart below.



This is the S&P 500 (SPX) from 1996 through the present. A few things are clear. The market topped in 2007 at almost precisely the same place it topped in 2000. It has tumbled almost the same amount in late 2007 and 2008 as it did from the top in 2000 to the final bottom in 2003.

We have pointed this out before in other charts. While the tumble has been much quicker, we suspect the healing will take just as long as it did last time. In other words we believe the most likely scenario is that the market experiences what may look like a surprising large rally in 2009, only to be followed by what appears to be a very scary sell off, that takes us right back to the former lows.

Whether that happens or not is almost irrelevant. What is important to remember is that markets that have suffered this much damage can't heal in a day, a week, a month, or even a quarter. It **WILL** take time.

During that time we will want to own stocks that are on our buy signal, and not own the ones that aren't. It is really just that simple. We need to be very precise in this in order to make money in equities in 2009.

We also know this, buying stocks in 2009, is probably more about making HUGE amounts of money in 2010 and 2011 as the global economy stabilizes and starts to grow again. But if you want to be making that money you will have to be buying in 2009.

A few good things to say about the models

We have talked to lots of new prospective clients this year, and we have taken in more new clients from September through December of this year than we often do in a year or two. Why are people migrating to K&A (5T) even though our models are down for 2008?

First and foremost, **Hatteras, Halifax, Mendocino, The New World and Fresnel** are quite profitable since their inception dates. That is not the experience of many investors who have spent the past decade away from K&A (5T). We have interviewed lots of people who are underwater for the past five to ten years, or more, as a result of the devastation of 2008.

Second, we have adapted to these markets and many other managers or advisors have not. We see statements on accounts that are down 30 to 60% this year, and there have been **NO CHANGES** in the accounts. We think this is simply negligent on the part of the managers or advisors who are working with these accounts.

Third, we have identified concrete strategies for 2009 which we firmly believe will produce positive investment results for our clients. We have made our case, in writing, and our clients are agreeing with us, voting with their dollars.

We thank you again for your friendship, trust and loyalty. We are looking forward to working with you in 2009.



All the best, PK

Paul Krsek
MANAGING MEMBER & CHIEF INVESTMENT OFFICER
5T Wealth Management, LLC
702 Trancas Street, Suite 200
Napa, California 94558



(707) 603-2672 Office
(707) 486-7333 Cell
(707) 224-2521 Fax
paul@kaassets.com
www.kaassets.com

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K&A manages accounts with various histories and investment objectives. Various accounts may be managed differently from time to time.

Krsek makes frequent reference to the model portfolios called Hatteras, Mendocino, Halifax, Bonavista, Fresnel and The New World. During 2005 Paul Krsek was appointed Chief Investment Officer of K&A, and as such is responsible to make all trading and management decisions for all client accounts which are being managed according to a specific portfolio model. A description of each of our models can be found on our website at <http://www.kaassets.com/choices.htm>.

Not all accounts managed by K&A are "modeled" accounts. We strongly urge our clients to understand which model, if any, are being used to manage their accounts.

As of July 3, 2007 Lee O'Dwyer joined K&A as a portfolio manager. Paul Krsek and Lee O'Dwyer frequently discuss investment ideas, model portfolio strategies and the investment policies of K&A. But when it comes to the implementation of those policies Krsek is primarily responsible to manage the accounts that fit into each model portfolio description. He generally makes all final

investment and trading decisions relative to those accounts that are considered to be "modeled." However, in Krsek's absence O'Dwyer does have the authority to trade all client accounts. He has been actively trading accounts in the various models since joining K&A.

From time to time K&A receives requests from clients to purchase securities that are not included in the model portfolio to which they are assigned. Effective May 24, 2006 K&A has encouraged clients to hold such securities in a separate account for the client. Because K&A is a "fee only" registered investment advisor" it charges its normal management fee for monitoring such securities in the separate accounts in which they are held.

K&A makes every effort to exclude securities that are 'requested by the client' from the modeled portfolio accounts.

The investment objectives of various accounts and models may be substantially different from one another. Therefore topics or investments mentioned in E-Ellumination may or may not apply to specific managed accounts and/or models.

Trades or adjustments to accounts mentioned in ELLUMINATION may or may not happen in every account managed by portfolio managers at K&A.

If you are not satisfied with the investment results in your account it is your responsibility to inform Krsek or Andreae and to discuss possible changes that can be made to the account to accommodate and satisfy your needs.

The assets held in managed accounts at K&A Asset Management, LLC may include stocks, bonds, cash, commodities, foreign exchange or mutual funds or exchange traded funds (ETF's), money market accounts or limited partnerships that represent the same. They are subject to market fluctuation and the potential for losses. The assets are not insured. The value and income produced by these investment products may fluctuate, so that an investor may get back less than they initially invested.

The portfolio managers at K&A Asset Management, LLC do not guarantee results.

Past performance should not be considered an indicator of potential future performance. If you do not consider yourself suitable, either emotionally or financially, to experience volatility and/or losses in financial markets, you should not invest.

From time to time Krsek lists the simple annual returns of the six model accounts in this newsletter. These accounts are "models" and do not represent the actual results accruing to individual accounts. Simple annual return does not represent "time weighted return" as reported individually to clients in their quarterly reports prepared using Centerpiece.

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Sincerely,

Paul Krsek
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