BLUE WATER'S Market Perspective

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We welcome back all of our long-term readers, and in addition we extend a warm welcome to those who are new readers. Here is the Table of Contents for this issue:

We hope that this issue's offering will prove useful to a wide range of investors and will help explain more completely our opinions on what should be done under current market and economic conditions. For new readers, please note that each issue going forward will feature a special topic for more detailed examination, plus a bi-monthly economic and market review. There will only be room for a brief discussion of each topic, so even the busiest reader ought to be able to glean something from this report with a minor time commitment. Please feel free to send us an e-mail or call with questions, comments or suggestions.

Also, please visit our revised and updated website at www.bluewatercapitaladvisors.com, and our blog at http://bluewatercapital.wordpress.com.

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Economic Commentary:

No Man is an Island

By Kevin M. Wilson

The Cyprus Disaster Produces a Situation Worthy of the Poets

Our title for this section is based on a quotation from John Donne (1572-1631). "No man is an island, entire of itself...any man's death diminishes me, because I am involved in mankind; and therefore never send to know for whom the bell tolls; it tolls for thee." The near-destruction of the Cypriot financial system by the "bail-in" that was imposed on them by the ECB, the IMF, and the EU is a seminal event that will be looked back on as a major turning point in the European economic crisis. Perhaps this sounds over the top a bit, given the fact that Cyprus is such a small economy in the scheme of things. But some very scary precedents were set, and many observers think that we will all be forced to live with the consequences. The foundation of modern retail banking, the deposit guarantee by government (i.e., the equivalent of our FDIC) was almost violated by the EU under their bail-in proposal, but this dangerous idea was fortunately voted down by the Cypriot government. Instead, small depositors were spared after first being scared, and only large

Continued on page 2

No Man is an Island (Continued)

depositors saw losses (“haircuts”) to their bank assets. The EU’s near-confiscation of all depositors’ assets was part of their attempt to keep Cyprus in the Euro-zone at any cost. This was wrong on so many counts it’s hard to know where to start.

To begin with, the entire economic system that is capitalism is based on faith in the system, or confidence. In advanced capitalist economies, people know: 1) that they have property rights; 2) that the common currency may safely be used for local transactions; and 3) that fractional reserve banking is more or less safe because the government backs up both the banks and their smaller customers’ deposits. As a result of the Cyprus crisis, all three principles are now in question, and not just in Cyprus, but everywhere in the Euro-zone. To support the really insupportable Euro, Germany and others insisted that the Cypriots undertake a “bail-in” involving the closing of some large local banks with 100% losses for bondholders, shareholders, and large depositors. There is no reason to worry about the losses to shareholders and bondholders, since they knew they were taking risk, but larger depositors of course did not know they were directly underwriting bank risk. The surviving large Cypriot banks were re-structured using the proceeds derived from confiscating a substantial share of larger depositors’ assets for accounts holding above about $130,000 (100,000 Euro’s). The “haircut” such depositors were subjected to was initially supposed to be around 40%, but this estimate has risen to as high as 60% in some cases, and even this amount is subject to revision. A complicating factor is that the EU has no system-wide equivalent to our FDIC, but rather relies on a tacit agreement by (sometimes insolvent) local governments to protect smaller depositors.

In part the increase in the “haircut” for deposits is due to administrative uncertainty, and in part it is due to incompetence. Believe it or not, just before the bank holiday for all Cypriots was declared, billions of Euros were withdrawn in time to beat the bank closure, indicating that some people probably received inside information. In addition, bank branches in London and elsewhere weren’t actually closed for several days after the Cypriot national bank holiday started, giving numerous wealthy foreigners an easy way out. As a result of these two mistakes, the assets on deposit available for confiscation shrank substantially, leaving those who didn’t cheat holding the bag on the “haircut,” whose proportions had to grow to cover the lost deposits. Thus were foreign interests favored and local interests ignored, at least for a few days. Still, the government claims that foreign accounts have borne 70% of the loss so far. The impact of all this on the local economy is nevertheless severe, with hundreds of small businesses already closed as a result.

To add insult to injury, various EU officials have re-iterated since the Cyprus bank holiday that this confiscation process may have wide application in other European trouble spots, and legislation is moving through the EU system to make such an outcome more likely. The precedent has therefore been set, and henceforth the preservation of the Euro may be accompanied by “bail-ins” in the form of outright confiscations, rather than bail-outs involving bonds bought at public expense. The good news is that the public may pay a lower direct cost for “saving” the system, and bank shareholders and bondholders may pay substantially more, as they should have all along. The bad news is that savers and depositors throughout Europe have had a scare, and now they know that politicians are willing to sacrifice the basic principles of capitalism to “kick the can.” Next time a “bail-in” is attempted in Europe (and we know there will be another), there may be a bank run as a result of this precedent.

Global Economic Slowdown Deepens

Goldman Sachs has recently reported that the global economy has entered a cyclical “slowdown” phase over the last few months. In a cyclical “slowdown,” growth momentum typically falls and GDP growth is subdued. Stock markets can still go up even under these conditions, but returns have historically tended to be somewhat tamer under these conditions, and volatility higher. So far the most seriously impacted areas are in Europe, including Greece, Spain, Cyprus, Portugal, France, and Italy, but parts of Asia and South America have also slowed. For example, Spanish unemployment has recently surpassed 28%, a level matching that seen in the Great Depression. Manufacturing production, export volumes, and real GDP have fallen throughout Europe, and weakness has also been transmitted into many Asian and Latin American developing economies.

U.S. economic data have become weaker of late, with many measures nearing or actually within recession territory. Durable goods orders (refrigerators, etc.) have been declining, various regional manufacturing indices have declined sharply, the housing recovery appears to have stalled, retail sales have slowed, productivity growth has declined, unit labor costs have risen, inflation has recently turned negative, and industrial production has stalled. All of this may so far be characterized as a mid-cycle slowdown, but because several of the above measures have reached typical recession levels, a U.S. recession can’t be ruled out. Indeed, the YOY change in real GDP is only 1.9%, a level normally associated with the onset of recession. Even the jobs recovery may be questioned now because the monthly non-farm payroll reports on job growth have declined over the last few months.

Attempts by the Federal Reserve to stimulate the economy with low interest rates and bond purchases have only had a minor impact on the economy in spite of heroic efforts. This is in sharp contrast to the effects on stocks. The problem, as it has been all along, is that people and institutions

Continued on page 3

No Man is an Island (Continued)

have been deleveraging, and so there has been less demand for debt in recent years. Household spending has also been reduced, corporate spending has been in decline for quite some time, and government's attempts to offset private sector spending with public sector spending have slowly wound down. Now there are new hurdles for corporations and consumers due to the federal budget sequester, the impending start of "ObamaCare," and the new, higher payroll taxes on workers. These will have a lagged but important negative effect on spending. On the other hand, falling petroleum product prices have given a boost to the economy that partially offsets the higher tax rates. It is possible that we avoid what looks to be a world recession, and even lead the way out with our characteristic economic resiliency. However, it is too early to tell if that will be the case again this time.

Market Commentary:
Earnings Season Impact

By Dheenu V. Sivalingam and Kevin M. Wilson

General Market Action and Its Drivers

With markets in a surprisingly strong uptrend, weakness has been quickly bought and sell-offs in the major indexes have all been quickly reversed before they reached even the 3% level of losses. One has to look at this type of market as a market which goes up much easier than it goes down, and this is a very real reflection of the relative conviction of the bulls and bears in the market. When something finally breaks that pattern, it will not be proof that the trend is over, but it will be a strong warning to sit up and pay attention. We still see a clear and strong intermediate term picture, and also a very cloudy longer term picture, but there is great value in understanding the message of the market from a shorter term perspective. Should the market at some point roll over into a period of months or quarters of weakness, it will be wise to reduce equity exposure and have relatively underweight long positions in case these market conditions degrade even further. But for now, the rally continues regardless of weak economic data and poor earnings and revenue data, driven by P/E multiple expansion (i.e., investors are willing to pay ever higher prices for the same earnings. What is interesting is that individual stocks that miss expected earnings and revenue targets have been severely punished, while the failures of the market as a whole, and the declines of many important economic factors, have been ignored.

Alcoa's earnings report has long marked the unofficial beginning of the earnings season, since Alcoa is by tradition the first Dow component to report each quarter. Recent Bloomberg surveys are suggesting that analysts as a group are expecting a contraction in earnings for the broad index of S&P 500 companies. We have seen this coming for a while as a lot of commodity related company earnings expectations have been slashed dramatically, and other sectors like technology and healthcare haven't seen meaningful increases recently either. In the last few weeks we observed an extension of the sell-off in the precious metals markets, apparently surprising many holding long positions in Gold and Silver. Momentum accelerated to the downside, and the longer-term uptrend is now decisively broken. One can view this current structure in Gold as a technical indicator called a bear flag, most likely setting up another down-leg for the metals. Though many support levels have certainly been broken through already, there also appears to be a good deal of stubborn bullish sentiment from the long time gold longs. Of course, gold in the long term does appear to be a good hedge against any currency devaluation, but in the short term the most likely trend is down for now.

Japanese stocks continue to soar in response to recent government policy initiatives, especially the de facto depreciation of the Japanese yen. The Bank of Japan is using massive levels of quantitative easing (QE) to boost inflation rates and monetize their government deficits. This has reversed many years of yen appreciation relative to other currencies. Recently, volatility in the US Dollar/Japanese Yen currency exchange rate has continued to expand, which is typical for a maturing trend. Though these price movements will challenge many shorter-term traders, the longer term picture is still strongly bearish for the yen and bullish for Japanese equities. We currently hold the moderately bullish view that the yen will fall to at least the level of 125 yen per dollar. We hold exposure to this area indirectly through stock ETF's that buy the Japanese stock market and short the Japanese yen.

In the coming days we will likely see a return to a focus on global earnings and revenues, and most likely the hopes for strong global growth are going to be questioned in the near term. While the recent political drama in Italy continues to be the focus of risk narratives for Europe, economic indicators for France and Spain show no signs of positive intermediate-term prospects.The latest chapter in Europe's poor economic performance is the deterioration in both manufacturing orders and consumer confidence, among major economies such as Germany, Italy and France, and in the Euro zone as a whole. The general economic picture for the Euro zone in March and April continued to decline as conditions throughout Europe continued to worsen. This may eventually have spill-over effects on U.S. markets.

Wealth Management Commentary:

The (Golden) Canary in the Coal Mine?

By Ted A. Pavlovich and Kevin M. Wilson

The recent crash in gold has surprised many long term investors, and perhaps a good question might be: could this be a (golden) canary in a coal mine for equities? It has often been observed that stocks follow commodities when major trends change.[1] Gold really took a big hit on Friday, April 12 and Monday, April 15, dropping $217 per ounce (13.85%) in just these two trading sessions. Basically, the liquidity came out of the gold market, and the bad news and selling pressure were met with very little buying interest in gold as a paper asset; this caused a collapse in gold prices. Gold had already fallen before the April 12 drop by about $356 per ounce (18.53%) from its peak at $1,921.15 per ounce on September 6, 2011, so the decline was substantial even before the crash. One interesting thing about the gold collapse on April 15 was that as the day went on, it became fairly predictable that other asset classes were going to be sold to cover margin calls.[2] Margin calls occur when traders borrow money to leverage their bets, and falling prices force them to add more cash to offset the losses sustained by their collateral. The cash is always due at the end of the day, so there is little time to think. That need for quick liquidity put some real downward pressure on equities, as people sought to raise cash by selling stocks.

The pricing behavior of gold recently is consistent with the notion of an impending equity correction. The last three major equity sell-offs (i.e., the 1972, 2000, and 2007 bear markets) were lead in each case by a drop in gold prices, followed by declines in other commodity prices. So something "Big" may be going on in the markets. One theory suggests that the change has been caused by the market giving up on the notion that high inflation is coming. If this is so, and if inflation is going to remain low, or even change over to disinflation, the Federal Reserve may find itself in a heap of trouble. If we find ourselves looking at actual deflation instead, the equity markets could be in for a significant correction. The Federal Reserve would be forced to pull another rabbit out of its hat to address this possibility of deflation, meaning even more quantitative easing might be required (QE4++?). The fundamentals underneath gold over the long term are as strong as they were at any time in the past, especially given the possibility of the Federal Reserve printing paper money all the way through 2016 (a possibility under certain conditions). Gold and gold mining stocks, over the long term, are a way to play this macro-trend. However, the sector is likely to continue to be under heavy pressure for a while yet. Corrections and sell-offs create occasional crises which in turn can create opportunities. We at Blue Water Capital look at the recent gold correction as a buoy marker that is warning us of approaching danger on one side, and opportunity on the other. We will use this warning along with other danger signs to navigate our way through these troubled waters. ■

Special Topic:
Strategic vs. Tactical Asset Allocation Strategies

By Kevin M. Wilson

Theory and Practice

One of the best ways to reduce the risk in a portfolio is to reduce the level of correlation between various portfolio assets and the market, as measured by a parameter called the correlation coefficient (r^2). A correlation coefficient (r^2) of 1.00 indicates perfectly matched changes in a security's (e.g., a stock's) returns when the market trend in general changes up or down, so that a 10% increase (decrease) in the market is matched by a 10% increase (decrease) in the stock. Similarly, a zero (0.00) r^2 value indicates no correlation between a stock and the market, while a negative correlation coefficient (r^2) indicates some degree of opposite movement of the security relative to the market. This is why, for example, bonds reduce the risk in a portfolio.[3] Bonds have at various times either a low or negative correlation to stocks, meaning they may "zig" when stocks "zag". This effectively reduces the volatility of a portfolio. The standard approach to controlling investment risk involves using asset allocation models to develop a mixture of asset classes (e.g., bonds, U.S. stocks, foreign stocks, etc.) in a diversified portfolio that produces the expected return with as little risk as possible.

When constructing a diversified portfolio, it is important to implement "strategic" asset allocation to help achieve investment objectives, and then "tactically" alter the sector and position concentrations as market conditions dictate. The strategic asset allocation has generally started out as a mathematically derived black box ("mean-variance optimization" or MVO) model utilizing historical asset class data, statistics, portfolio optimization algorithms, and other back-testing methodologies. The commonly used MVO models rely on Modern Portfolio Theory (MPT) entirely. MPT assumes that for the general markets, over long time periods, the past is a good indicator of future average risk premiums, average market returns for asset classes, and average correlations between asset classes. MPT also assumes that markets efficiently price in new information (meaning all information is freely available and all stocks are therefore always accurately priced), and that risk and reward are correlated in a linear fashion (the more risk you take, the more reward you get). Both the historic asset bubbles of the late 1990's and mid-2000's, and the ensuing market meltdowns make it obvious that there are indeed long stretches of time during which the assumption of efficient markets is simply not valid. In an efficient market, neither the bubbles nor the meltdowns could have occurred.

Some of these assumptions are still probably fine for very long-term (at least 50 years) strategic asset allocation, but they do not reflect reality with respect to shorter-term market fluctuations. Indeed, one of the Nobel laureates for MPT, Eugene Fama, to his credit published data in 2002 that directly contradicted his original theory that risk ("beta") and reward are correlated in a linear fashion. This in effect undermined one of the major pillars of MPT. JPMorgan Asset Management has shown that the actual relationship observed between standard deviation ("risk") and total returns is the reciprocal of the predictions of Modern Portfolio Theory (MPT) over at least the last 20 years (that is, the higher the risk, the lower the reward). This suggests that there

Continued on page 6

BWCA Moderate Portfolio Back Test - Up Capture in a Bull Rally **CHART 1**

Strategic vs. Tactical Asset Allocation Strategies (Continued)

are serious problems with making tactical allocation decisions based on MPT alone. Thus, the commonly used MVO-based approach that assumes the validity of MPT should not be used in most circumstances for retail investors. This has not prevented hundreds of institutions from basing their entire approach to asset allocation for clients on modified MVO black box models, because of their mathematical rigor (if one ignores the assumptions), and because the only replacement methodologies are based on sound judgment and empirical methods rather than math.

Empirical Approach

What is the investor to do? William Bernstein[4] suggested that since MVO models can't predict the future, investors should simply evaluate three factors central to diversification and asset allocation: 1) one's tolerance for deviating from index returns on major asset classes; 2) the number of different asset classes one wishes to own; and 3) one's tolerance for overall risk.

There are various ways to deal with these questions, but our solution has evolved into an empirical methodology using back testing models. These allow us to use historical data much the same way that MVO models do, but without the MPT baggage that caused so much trouble for investors in recent market spasms. Our guiding principle is to first do no harm; therefore we think that minimizing market losses in major sell-offs is a priority for most investors. Our back testing methods have been applied not just to strategic and tactical asset allocations, but also to stock selection based on fundamentals, and trend following technical indicators. We will only discuss asset allocation back testing in this article, but will revisit these other subjects at another time.

We use three different back testing tools, each with its own advantages and disadvantages. Very specific allocations, such as those found in our current portfolios, can be back tested on either the Bloomberg or Morningstar™ professional analytical tools designed for that purpose. More generalized models for strategic and tactical allocations have been run using the analytical tool found at www.ETFreplay.com. We favor using Exchange Traded Funds (ETFs) to serve as proxies for market classes in our generalized back testing models. The models are by necessity over-simplified, and readers should note that back testing involves hypothetical results and does not represent actual results. Also, of course readers should remember that past performance is no indication of future returns. Limitations to the model results have been imposed by the lack of appropriate benchmark proxies for some periods and the arbitrary 10-year limit to many of the available back test models. Finally, so-called "tail risks," which are spectacular one-off events like 9/11, the 1987 market crash, or the 2010 Flash Crash, are by their nature unpredictable and therefore can't be modeled. Investors should view all results as tentative and use caution in interpreting these models.

We use three different scenarios as likely drivers of tactical or strategic allocations. These obvious but useful choices are 1) Bull Market; 2) Bear Market; and 3) Muddle-Through Case. In this report we will only discuss allocation back tests for these scenarios for a moderate investor, but we have also conducted research on allocations for both conservative and aggressive investors. Taking the Bull Market Case first (see Chart 1), we chose a mixture of ETFs that we thought would demonstrate up-capture (percentage of the cumulative positive move of the benchmark captured by the model portfolio) during an extended stock rally. The model runs from March of 2009 to the present, and uses as its benchmark an ETF that tracks high dividend stocks (there are no ETFs that would qualify as balanced moderate

Continued on page 7

CHART 2

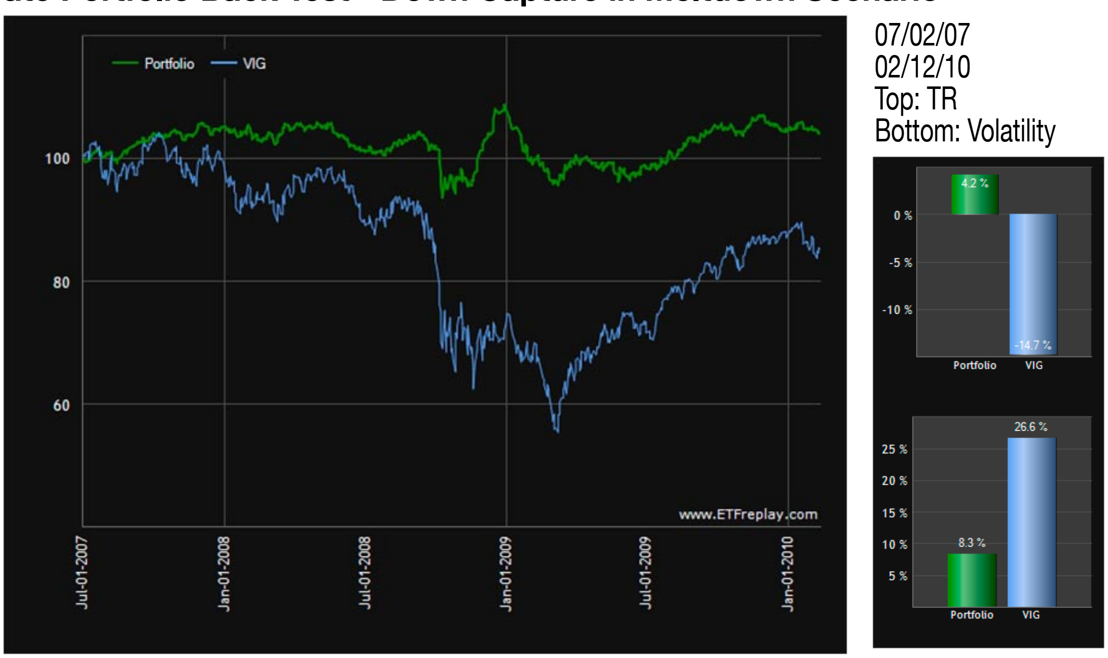
BWCA Moderate Portfolio Back Test - Down Capture in Meltdown Scenario

Benchmark: VIG

Composition:
Stocks: 35%
Bonds: 50%
Cash: 15%

Max. Draw:
BWCA: -13%
VIG: -47%

07/02/07
02/12/10
Top: TR
Bottom: Volatility



Strategic vs. Tactical Asset Allocation Strategies (Continued)

portfolios for the full time period in question, so we used a 100% stock portfolio that is income oriented instead). The allocations in this BWCA back test model are 75% stocks, 14% bonds, and 11% cash. The Bull Market Case model results indicate that under the assumptions given here, our moderate allocation would have underperformed a 100% stock portfolio, but would still have produced a hypothetical return of 122% over 4 years. The maximum drawdown (paper loss) in that time would have been about 13% for the model, compared to 17% for the benchmark, and the volatility (standard deviation) of the model would have been a bit lower (14%) than that of the benchmark (17%). Up capture for the Bull Case allocation would have been about 84%.

Taking the Bear Market (Meltdown) Case next (see Chart 2), we used a mixture of ETFs that we thought would demonstrate down-capture (percentage of the cumulative negative move of the benchmark captured by the model portfolio) during an extended stock sell-off. The model runs from July of 2007 to February of 2010, and uses the same benchmark as before. The allocations in this BWCA back test model are 35% stocks, 50% bonds, and 15% cash. The Bear Market (Meltdown) Case model results indicate that under the assumptions given here, our moderately defensive allocation would have outperformed a 100% stock portfolio, and would have produced a positive hypothetical return of 4.2% over the 2 ½ years studied, compared to a 15% loss for the benchmark. The maximum drawdown (paper loss) in that time would have been about 13% for the model, compared to 47% for the benchmark, and the volatility (standard deviation) of the model would have been much lower (8%) than that of the benchmark (27%). Down capture for the Bear (Meltdown) Case allocation would have been about 28%.

Taking the Full Cycle (Muddle-Through) case last (see Chart 3), we used a mixture of ETFs that we thought would demonstrate up capture (percentage of the cumulative positive move of the benchmark captured by the model portfolio) for a moderate allocation (neither bullish nor bearish) during the full market cycle, from the peak in 2007 until now. The model runs from July of 2007 to May of 2013, and uses the same benchmark as before. The allocations in this BWCA back test model are 45% stocks, 40% bonds, and 15% cash. The Full Cycle Case model results indicate that under the assumptions given here, our moderate allocation would have nearly matched a 100% stock portfolio, and would have produced a positive hypothetical return of 35% over the 5 years and 5 months studied, compared to a 36% gain for the benchmark. The maximum drawdown (paper loss) in that time would have been about 18% for the model, compared to 47% for the benchmark, and the volatility (standard deviation) of the model would have been much lower (8%) than that of the benchmark (21%). Up capture for the Full Cycle Case allocation hypothetically would have been about 97%, and down capture only about 38%.

These results suggest that tactical allocation shifts based on back tested empirical models could be quite effective in cutting risk, at little cost to the reward ultimately received. Bloomberg and Morningstar™ results for similar model portfolios using more sophisticated and complex portfolio components confirm this result. Of course the key is getting the timing right for allocation shifts from one model to the next, but we will save that discussion for another day. We therefore conclude that, assuming one can recognize the appropriate times to tactically re-allocate, investors can reduce their risk by positioning their portfolio allocations to fit the general market environment, and investors appear to be taking unnecessary risks in pursuing buy and hold strategies over the full market cycle.

CHART 3

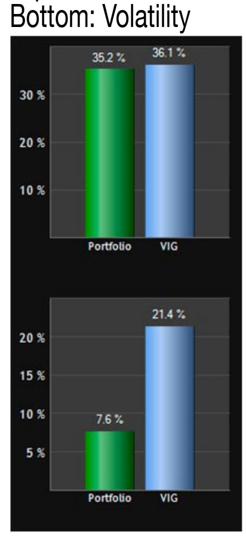
BWCA Moderate Portfolio Back Test: Up Capture - Full Cycle

Benchmark: VIG

Composition:
Stocks: 45%
Bonds: 40%
Cash: 15%

Max. Draw:
BWCA: -18%
VIG: -47%

07/02/07
05/12/13
Top: TR
Bottom: Volatility



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We encourage you to share our newsletter with business associates, friends and family. Let them know what we have done for you to preserve and grow your wealth. We would be glad to help your contacts benefit as well. We are not a “stay the course” or a “do nothing” type of firm. We are actively researching, analyzing, and managing risk every day. We do not take our fiduciary responsibilities lightly. We work hard on your behalf to anticipate economic trends and take action accordingly based on our assessment of risk and potential returns. We have made significant investments in our business to make sure we have the best information and people that are capable and intellectually equipped to make important and timely decisions managing your wealth.

Also, please visit our website at www.bluewatercapitaladvisors.com, and our blog at http://bluewatercapital.wordpress.com.

Please attend our next “Monthly Market Review” if you can; we’d love to see you, your relatives, and your friends there. The next scheduled meetings will be held at 5 pm - 6:30 pm on June 21, 2013 at our offices in the Medical Arts Bldg. (“Top of the MAB”); and on Sept. 19 at a Location TBD. We run meetings every month for ten months, but we don’t run the meetings in July or August due to vacations. If you can attend in June or some later time, please RSVP to Blue Water.

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Disclaimer

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