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Three Last Minute Year-End Tips

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As Kenny Loggins wrote, "Make no mistake where you are. This is it."

The last day of the last week of the last month of the last quarter of the year. 2015 will soon be in the books and it will go down as a year where the stock market was down a little and the bond market was down more while commodities were down huge.

As I sit here in rainy Vermont finishing up my final newsletter of the year, here are three tips which you may able to take advantage of.

1 - To lower your tax bill, consider making that final charitable contribution.

2 - Don't forget to take those required minimum IRA distributions if you are over 70 1/2 or have an inherited IRA.

3 - Harvest tax losses by selling losers and buying similar but not the exact same investments.

I am sure I will write this another few or so times, but I have really enjoyed writing this newsletter and interacting with so many people this year. Wishing you and your families a very
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Happy, Healthy, Safe and Prosperous New Year!

Third Avenue Travesty... Major High Yield Bottom Part I

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After peaking way back in 2014 and declining ever since, the high yield (junk) bond market has finally made national news over the past few weeks with the very high profile blow up of the Third Avenue Focused Credit Fund (TAFCF). This was not some fly by night little fund or fund family. It's a small, mainstream mutual fund family and the fund itself had more than $3 billion in assets in 2014. Last week, after massive withdrawals, the fund announced it was closing and that shareholders could not redeem their shares for cash anytime soon. Third Avenue was going to conduct an "orderly" liquidation. Good luck with that!

Over the past 20 years, my peers and I have often discussed this is exact scenario. What happens when there is a mass exodus in an illiquid asset class like junk bonds? If Third Avenue was a closed end fund (CEF) or exchange traded fund (ETF), sellers would simply drive the price lower and lower until sufficient buyers came in, presumably when the share price of the CEF or ETF was significantly below the value of the underlying assets in the fund. In other words, the CEF or ETF would trade at a discount to the net asset value of the fund.

In Third Avenue's case, it is an open ended fund that issues more and more shares to meet investor demand. When redemptions swell, the manager chooses what to sell and when. And it's unlikely that securities are sold on a pro rata basis. As TAFCF's assets collapsed, my sense is that the fund manager sold most or all of the bonds that were easier to sell, i.e., liquid, hoping that he could stem the tide and high yield bonds would stabilize or even bounce. When the liquidations never ceased, the fund was probably left with the true crap of crap instead of the well diversified portfolio it had weeks, months or quarters earlier. In other words, at the detriment of the shareholders who stuck by the fund, they were left with illiquid garbage.

This raises a whole series of questions regarding the fund manager's and fund company's fiduciary responsibility to its shareholders. Clearly, they had absolutely no plan for a mass exodus, like disaster planning for many firms in my space. How could they allow the fund manager to sell the better quality bonds and turn the fund into a heap of crap? How could they penalize investors like this? While I am sure they will hide behind the nonsensical legalese of the prospectus, this is a travesty!

Real Volatility on the Increase

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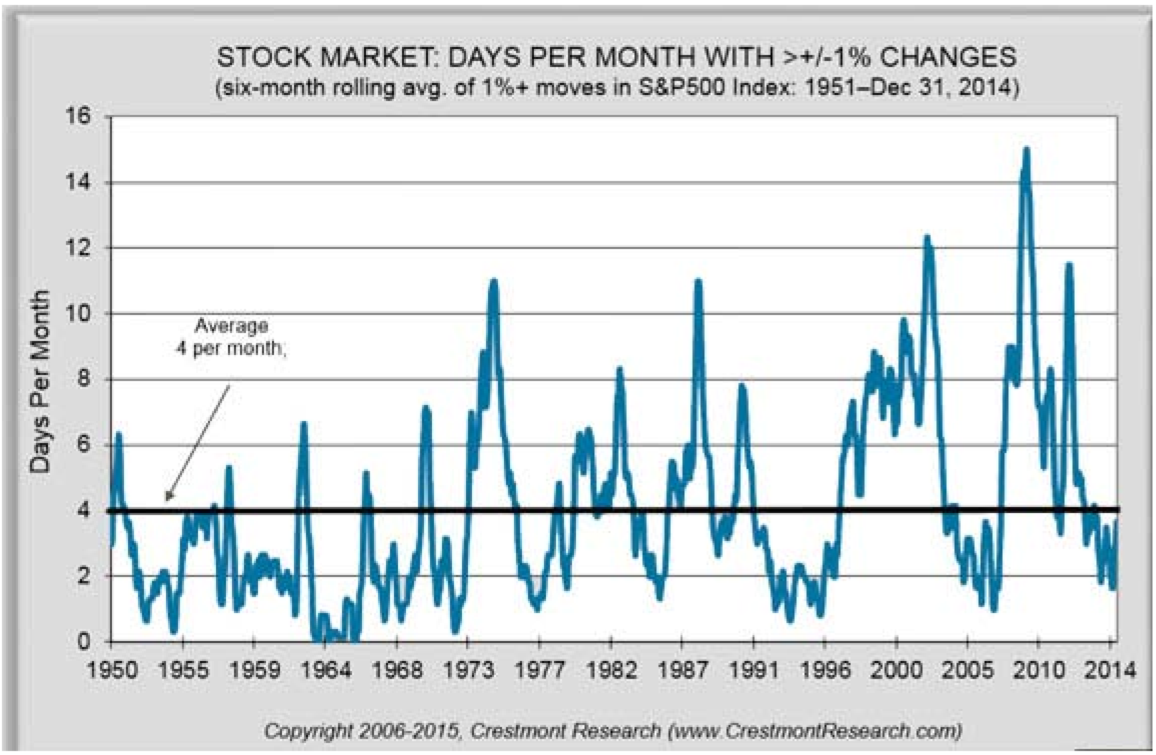
"Volatility is not the enemy of the long-term investor. That investor's response to volatility is."

- Josh Brown

If financial markets were truly efficient or truly random, there might be more rationale to a buy-and-hold approach. But every time investors begin to get complacent and venture a little further out on the risk curve, moving away from the concept of managing risk, the market provides a sharp reminder that risk matters. Late summer of 2015 was one of those reminders, but was it really a surprise? In January 2015, Ed Easterling of Crestmont Research maintained that "If history is again a guide, a surge to high volatility may not be far away."

Easterling's work, along with that of a number of mathematicians and technical analysts, have found in the market, patterns that rhyme. They are never an exact repeat of the past, but the similarity is there. "Markets have memories," said mathematician Benoit Mandelbrot. But the news seems to come as a surprise to the financial media each time market volatility takes off.

Volatility is the up-and-down movement of the market. As this chart from Crestmont Research shows, the S&P 500 (and other market indices as well) has historically moved from periods of low volatility to periods of high volatility. High volatility periods tend to be times of greater risk in the market. These are times when investors are more prone to emotional decisions, when hair-trigger computer programs can launch market moves and when negative news tends to carry more clout than the positive.



The chart above from Crestmont Research shows the pattern of low volatility periods followed by high volatility years.

When volatility falls below the historical average of four 1% moves in a year, high volatility may well be on the horizon. It's just a question of how soon, how much and how long.... 2015 is above trend, but clearly expanding of late. The increased volatility should continue in 2016 as short-term interest rates are likely to rise further.

How I Can Best Protect My Investments as the Markets Tank

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The following is an article I wrote for Crains Wealth.

Investors don't plan to fail. They fail to plan.

Markets typically pullback every month. Most pullbacks are nothing more than innocuous 3% to 5% dips - short bouts of weakness followed by new highs. Every quarter or so, the shallow pullback deepens to a 6% to 9% drop. Occasionally, full-fledged corrections of 10% or more
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take hold. Every four to five years, a bear market hits that lops at least 20% off of the major stock-market indices.

When investors think about protecting their investments, they usually don't worry about the small pullback, and many don't really care about the deeper one. It's the steep declines of 10% or more that tend to test the mettle of the average investor. I know from my own client base that I rarely hear from anyone who is concerned until they see a stock-market decline, usually one that exceeds 10%, make headline news.

Before the stock market begins to decline, investors need to have a set of plans designed to remove emotion from the decision-making process. Whatever that process is, it absolutely cannot be a subjective decision, since countless studies have shown that emotion-based investing fails in all market environments. Don't wait until the stock market is in full decline before establishing the plan!

In my firm, we use time-tested, sophisticated, quantitative and technical models to determine risk/reward ratios, allocations, position sizing and our overall exposure to various markets. However, it doesn't have to be that complex.

Simple systems include selling a certain percentage of a position when it declines by a predetermined amount from a peak. Others use the 50-day, 100-day or 200-day moving average to generate buy and sell signals. Momentum investing 101 has guidelines for buying or selling securities after the return over a certain period becomes positive or negative, in essence betting on the continuance of an established market trend. Dow Theory involves watching the industrials and transports make new highs or breach secondary low points to determine how to navigate the investing environment.

After the investing plan is created there are a several methods to protect investments once the situation has been triggered.

The first is the easiest and simplest; securities are sold to raise cash. The small downside is that it becomes a taxable event, but in my business, tax considerations are secondary to opportunistic capital preservation.

Another way to preserve your investments is to hedge. That means once your plan triggers to take defensive action you buy a mutual fund or exchange traded fund (ETF) that goes up when a given market index or sector goes down.

A more complex and sophisticated method to protect a portfolio from decline is to buy put options or sell call options against the position. In this advanced case, the purchase of put options is preferred if volatility is low or if he anticipated decline is substantial. Selling call options may be a better choice if volatility is high or if the forecast weakness is on the more mild side.

Finally, good old fashioned, non-correlated asset diversification may be helpful.

In a modern-day equity portfolio, a Treasury bond mutual fund or ETF will often rise when stocks decline. Additionally, the Japanese Yen typically behaves in a similarly contrarian way and can be purchased through the CurrencyShares Japanese Yen ETF (FXY). During other periods over the past 40 years, commodities and real estate investment trusts (REITs) have sometimes been non-correlated to equities, but that hasn't been the case during this bull market.

The most important takeaway is to create a comprehensive plan in advance and stick to it, no matter how stressful market conditions become.

Upcoming Appearances

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CNBC's Worldwide Exchange - January 13th 5:30 AM

You can view most of the past segments by clicking below.

Media Appearances

(http://www.investfortomorrow.com/InMedia.asp)

Investment Quotes/Adages To Live By

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"The only easy day was yesterday."

- The U.S. Marines

"When in doubt, get out!"

"If it's obvious, it's obviously wrong."
-Joe Granville

"It's ok to be wrong, but it's not ok to stay wrong."

"This time is different."

"The markets require the patience of a dozen men."
-Robert Rhea

"Luck is the residue of effort."

"The most bullish thing a market can do is go up in the face of bad news."

"The most bearish thing a market can do is go down in the face of good news."

"The market can stay irrational longer than you can stay solvent."
-John Maynard Keynes

"Government is best which governs least" - Thomas Jefferson

Inflation is the one form of taxation that can be imposed without legislation.
-Milton Friedman

"You cannot legislate the poor into freedom by legislating the wealthy out of freedom. What one person receives without working for, another person must work for without receiving. The government cannot give to anybody anything that the government does not first take from somebody else. When half of the people get the idea that they do not have to work because the other half is going to take care of them, and when the other half gets the idea that it does no good to work because somebody else is going to get what they work for,that my dear friend, is about the end of any nation. You cannot multiply wealth by dividing it." - Dr. Adrian Rogers, 1984

"Bear markets seem to be divided into three phases: the first being the abandonment of hopes upon which the final uprush of the preceding bull market was predicted; the second, the reflection of decreased earnings power and reduction of dividends, and the third representing distressed liquidation of securities which must be sold to meet living expenses. Each of these phases seems to be divided by a secondary reaction which is often erroneously assumed to be the beginning of a bull market."
- Robert Rhea

"Free enterprise is a rough and competitive game. Nobody too big to fail. Nobody too small to succeed. It is a hell of a lot better than government control." - Ronald Reagan via Dan Kennedy

"A government big enough to give you everything you want is big enough to take everything you have." - Gerald Ford via Dan Kennedy

"The problem with socialism is that, sooner or later, you run out of other people's money." - Margaret Thatcher

"Diversification alone is no longer sufficient to temper risk... You need something more to manage risk well."
- Mohamed El-Erian

"A little bit at a time adds up to a lot in no time"

To Your Financial Success,

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