BRIGHTVIEW
CAPITAL MANAGEMENT

THE ADAPTIVE INVESTOR

This article is part of a series written by Michael Kerris at BrightView Capital Management with the goal of educating investors about investing in a more sophisticated risk-averse way.

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S&P 500 at 2102.44

A Time To Avoid Losing Money

There are times in the stock market that it makes sense to try and make money. And then there are times that it makes more sense to try and not lose money—to preserve capital. I think we are in the second environment.

A market can do two things. It can trend or consolidate. A trend can be a bullish or bearish. For example, from October 2007 till March 2009 the U.S. stock market (ie., S&P 500) trended down and resulted in a bear market. And then from March 2009 till February of this year, the market trended up. This has been a bull market. Since late February, however, the market has stopped trending and has been consolidating. In fact, the market has had only a 4.6% trading range since mid-February, which is among the narrowest ever for a span this long.

A tight range-bound consolidating market will eventually lead to a market breakout. The question is in which direction will it break out? We are still in a bull market and inertia dictates that the easiest path is still up. Perhaps this is why other than the permabears, just about every Wall Street investment bank believes that this consolidation will ultimately take the market higher. Again, just like The Force in Star Wars, inertia is a powerful force. So odds may be that they are right. Most dips in trends turn out to be buying opportunities. And that is one of the foundations for the Adaptive Strategy that we successfully use at BrightView Capital Management.

Unfortunately, however, nothing lasts forever. Bullish trends do eventually come to an end, and lead to new bearish trends. And as for Wall Street economists and market forecasters, let's remember that these were the same people that recently missed predicting the 2000-2002 and 2007-2009 bear markets. And we must also realize that the market tends to fool as many people as often as it can. I'm also hesitant to trust those that are financially incentivized to keep talking the market higher. And then there is always the variable of what unknown events may happen that can adversely impact the market, particularly when it has become so fragile.

We are not predicting that the market is about to drop. It may or it may not, and its too unwieldy to be predictable. Instead of trying to predict, we try to actively listen to what the

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market is saying and position ourselves accordingly. Ultimately we do not have a preference if the market climbs or falls as we can attempt to profit in either direction.

We are warning people to take their investments and their mindset off of auto-pilot and to start weighing not only the potential rewards that the market is presenting but also the potential risks. The roads have fogged over and it is no longer prudent to drive at normal highway speed. There may or may not be a hazard ahead, and we need to slow down to allow ample distance to break if necessary.

We first voiced a concern about the market in a January 15th research piece that we published (available at www.BrightViewCm.com). We called attention to how uncharacteristically weak the market was acting. We stated that the market would likely recover as it takes many months for a bull market top to exhaust itself and become a bear market. It takes many failed rallies, with weakening efforts that result in lower highs and lower lows. All of these bruised bullish attempts help to introduce concern and fear into investor psychology which leads to an end of buying the dips and a start to selling the rallies. October 2014 was the first sign of weakness. Now fast-forward to today. We may now be 10 months into a market toping process. Similar to the approximately 10 months that it took in 2000, or the approximately nine months that it took in 2008, before those markets collapsed.

During the last several months, we have been sharing with our investors an increasing number of factors that give us concern about the increased risk of a market sell-off. There are many warning signs, both fundamental and technical. Some include:

Fundamentally

- Stock valuations and expectations are high. This increases the chance for disappointment.
- The growth of emerging market economies, including China, have slowed.
- Europe's growth is also weak.
- China's stock market has been very unstable.
- The U.S. dollar continues to strengthen making American goods less competitive, and sales and earnings comparisons more challenging.
- Emerging market currencies have been weakening.
- Commodity prices have been weakening.
- In particular, oil prices have fallen precipitously hurting energy companies and their stocks. The majority of the stocks in the energy sector have already fallen more than 20% and are in a bear market.
- The high-yield bond market has been selling off. This often serves as a warning sign for what to expect for stocks.
- The Federal Reserve is on the verge of a cycle to raise interest rates, as overdue as we believe it is.
- We are seven years into an economic recovery and bull market. This is the third longest bull market in history.
- The stock market is up 18 percent annualized in the last three years and 13 percent in the last five years, both of which are way above the long-term average. The market is due for some mean reversion.

- Money continues to pour out of the U.S. stock market.
- Investor sentiment continues to weaken.

Technically

- The S&P 500 is up two percent for the year and flat for the last six months. The market continues to trade in an extremely tight range (2044 to 2134). There has not been a five percent pullback in the S&P since December.
- The S&P's Bollinger Bands, which measure the level of volatility, continue to tighten. The two other periods where volatility was this narrow was in 1966, which was the end of a bull market and in 1994. Both periods were followed by elevated volatility.
- To gain perspective, it's often helpful to use monthly and weekly bar charts instead of daily. The market's monthly chart is starting to curve down with lower highs and lows, and with many long upper candlestick tails—indicating that higher prices are being rejected.
- The internals of the market continue to be weaker than the market averages would otherwise indicate. The S&P 500 is market-capitalization weighted giving greater weight to companies with greater market value. Without mega-cap leadership from stocks like Facebook (FB), Netflix (NFLX), and Google (GOOG), the market would be fairing worse.
- The number of stocks making new one, three, six and 12-month lows far outpaces the number of stocks making new highs. And this is occurring on each of the major exchanges (the New York Stock Exchange, American Stock Exchange, NASDAQ) and for ETFs.
- A growing list of stocks are trading below their respective 200 day moving averages, suggesting a long-term shift in trend. The first time or two that a stock or index falls to its 200 day moving average it tends to bounce off aggressively. The more times it comes in contact with it, the less repulsion force it offers till eventually it loses most of its ability to keep averages above it. Ironically, once below the moving average, instead of acting as support it can begin to act as resistance.
- Specifically, from December 2012 till September 2014, the S&P stayed well above its 200 day moving average. Since then, with increasing frequency, the market has fallen to and below it several times.
- The Dow Jones Industrial Average and the Russell 2000 (small cap index) are already trading below their 200 day moving averages.
- Last week, the Dow Jones Industrial Average's 50 day moving average crossed below its 200 day moving average ("the Death Cross") further suggesting a shift in trend.
- The Dow Jones Transportation Average has fallen significantly causing a negative Dow Theory signal. The transportation sector is often a leading indicator for the stock market.

With these and other factors, we think it is just too hard for the market to rally. The market can continue to consolidate within this tight trading range for months to come, but we believe that the greatest risk of a market fall is during the next couple to few weeks.

Most people follow a fully-invested long-only buy and hold strategy. A strategy like that works in many environments, but not at the start of a bear market. Investors who bought

and held at the top of the 2000 market took seven-and-a half years to break even. Those who bought at the top of the 2007 market took six years to break even. And this assumes an investor was not among the many that ultimately capitulated somewhere near the bottom of the 50% sell-offs.

Its clear we would not currently advise being fully-invested with a long-only strategy. Also with the market still technically in a bull market, it may still be too early to be outright bearish with a stock shorting strategy. While the market remains range-bound, there may still be some money to be made for the agile investor that can alternate between longs and shorts. But, for the average investor, at least some of their portfolio should now be in cash. BrightView has been opportunistically reducing its market exposure. Cash provides an investor the ability to calmly act from a position of confidence instead of fearfully needing to react.

Additional inflection points where long-positions should be cashed out are if the market breaks below its 200 day moving average (currently at around 2077), breaks below its July lows (at 2044), and/or breaks its long-term trend line (currently around 2030). If the market falls below any of these levels it can attract additional selling which can accelerate the sell off. This is another reason to close some long positions now and raise cash.

Alternatively, if several of the issues that we raised start to resolve themselves, and the market begins to firm up, and breaks above the May 20th high of 2134, it may be time to add to long positions.

The stock market can provide a wonderful return, but its times like this that the best return is achieved by not losing money.

We at BrightView Capital Management believe that there is an important place for hedge fund investments in everyone's portfolio to hedge against risk and volatility, and to potentially make a positive absolute return through a full stock market cycle. Investors should also consider the possible additional gains from long term compounding at higher rates of return. When investing in a hedge fund, it is important to find one with a strategy that matches your investment objectives, and with a manager you believe in.

We welcome your feedback as we strive to make hedge fund investing more accessible.

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