

Sector Performance

The first quarter of 2008 is finally over! The first three months were very tough for investors. The credit crunch that began last summer finally came to a head during the first quarter. The rapid de-leveraging resulted in the implosion of quite a few hedge funds, and a 100+ year old investment bank. Equities were not immune (they at least were liquid and had some value), and the result was a very poor start to the year for the major stock market benchmarks.

When we look at the market indicators today we see a difficult market ahead, but one in which there are many options, and plenty of opportunity. Our indicators are positive and have attractive field position. As it stands today we have a green light with respect to the equity markets and recognizing that is the first step toward sound risk management. It doesn't make the market in front of us easy, there are still risks, but we have a solid game plan presently being executed.

What risks? Alan Greenspan is now convinced the US economy is in recession according to an interview last week. It is still an election year, which causes a high degree of uncertainty with that November date looming, and possible indications of the Fed cutting rates yet again, and the early rounds of another earnings season on Wall Street kicking off as well. There are plenty of things that could derail this market, but 36 out of 40 sectors are showing buying opportunities. Our short-term indicators also remain on buy signals and are yet to reach overbought levels. In short, we are in wealth accumulation mode and the most important thing we can do is simply make sure our actions are consistent with that risk status.

There will always be those investors out there who want to wait until everything lines up to put money to work in the market. They want to open up the Wall Street journal and see the headline, "All Roses", at the top of the front page. They want to see a US economy that looks like someone put rocket fuel in the gas tank and all heads of state in the Middle East joining for one big group hug. The problem is that, first of all, that isn't going to happen and, second, if it did it would probably represent a top in the market rather than anything approximating a bottom. Low risk opportunities in equities are typically not met with "all roses," but rather something more similar to what we see

today. A tough situation, but one yielding many potential plays that offer expected positive outcomes (Dorsey Wright & Associates).

To reach these positive outcomes a solid plan and strong market analysis is needed. We focus on sector analysis and invest the portfolio in specific sectors through ETFs (exchange traded funds). Just the other week an article published in *The New York Times* was brought to our attention. The article was written by Mark Hulbert, "Picking the Forest or the Trees." In the article, Hulbert writes that,

"...a manager's success in emphasizing sectors in a portfolio is a better forecaster of performance than his ability to pick individual stocks."

This, in and of itself is not a terribly profound statement, but this type of thinking would certainly fly in the face of conventional wisdom in an industry that puts the vast majority of emphasis on individual stock selection as opposed to sector selection. There have been numerous studies done in order to determine whether the risk associated with buying stocks is related to the individual stock, sector, or overall market. The findings in the studies were very similar in all of the cases, and one study in particular that was published by Benjamin King and discussed in *Investor Business Daily* in 1994 found that only 20% of the price movement of a given stock is directly attributable to the company itself. Therefore, about 80% of the price movement is attributable to the overall market and sector. However, most people spend 80% of their resources towards researching the company itself and only 20% of resources are spent evaluating the overall market and sector. The bottom line here is that even if you are dead right on the stock, and bought it for all the right reasons, if it is in a poor sector that you are more than likely fighting a losing battle, or at least an uphill battle.

Another study was done with four hypothetical investors that shows the true importance of sector rotation. In this look back at the markets, we have four investors, each of whom has a different series of outcomes based upon how he invests. The image below will show you the results and presents a very strong case for the use of sector rotation in the portfolio. The first investor is who we'll term, "the buy and holder." He just buys the S&P 500 and rides it up and rides it down, making no movements at all in the portfolio.

Our second investor is only invested during those months that the S&P 500 has an up month. So for instance, in 2006, there was only one down month (May, down 3.09%) so he would have had the returns of the S&P 500 for each month except May. Or said another way, he was able to perfectly time the market. Our last two investors were sector investors. The third investor was smart enough to know every year what the best performing sector was for the year was going to be and invested 100% in that sector. The fourth investor was an unfortunate fellow who perhaps was following the sage advice of magazine covers but he bought the worst performing sector every year.

As you might imagine, each of investors had dramatically different results from their initial investment of \$10,000 in 1990. Mr. Buy and Hold currently shows a portfolio value of \$41,550. Mr. Perfect Market Timer has a portfolio value of \$606,503. Mr. Perfect Sector Timer though has seen his portfolio swell to just under \$7,000,000 while Mr. Poor Sector Timer's portfolio is now only \$229! So that is the answer. It is that easy, right? All you have to do is invest in the best performing sector each

year and simply walk away. Unfortunately, it is not that easy, nor are we advocating that we try to pick the absolute best performing sector and put all your eggs in one basket. Rather, this is a powerful illustration of just how important incorporating a sector rotation plan can be into the overall portfolio strategy. It is also an eye opener that the magnitude of buying the best sectors is even greater than that of being able to perfectly time the overall market.

The best tool that we have found in order to exploit the benefits of sector rotation is relative strength. Relative strength is just a means of comparing one thing to another, we use it to determine what sectors have the greatest likelihood of out performance. In sports, these comparisons abound to the point of justifying elaborate ranking systems and endless debate. There are tennis rankings, World Golf Rankings, and even handicaps for the amateurs.

There are BCS standings for College Football, Passer Ratings for the Pros, with the goal of all of these comparisons being essentially the same – determine who is the best or the strongest of all potential candidates. As players and teams compete, winning and losing events, the rankings evolve and incorporate more data. In the investing world, our ranking system works in a very similar fashion (Dorsey Wright & Associates).

Rest assured that we are taking all the necessary actions to manage your accounts, and keep your portfolio inline with your investment goals. By letting relative strength

guide us into and out of the right sectors of the market in a logical, systematic way, our portfolios are outperforming the market year-to-date. In fact, as most of you may know, the average account is actually positive for the year compared to a negative and volatile market. If you have any specific concerns you would like to address, we are always here to discuss them with you.

Hypothetical Performance of 4 Different Investors				
Year End	Buy & Hold Strategy	Perfect Market Timing	Buying the Best Performing Sector	Buying the Worst Performing Sector
Beginning	\$ 10,000	\$ 10,000	\$ 10,000	\$ 10,000
1990	\$ 9,344	\$ 12,253	\$ 11,271	\$ 5,499
1991	\$ 11,802	\$ 17,334	\$ 18,135	\$ 5,550
1992	\$ 12,329	\$ 19,694	\$ 22,435	\$ 4,676
1993	\$ 13,199	\$ 22,256	\$ 27,604	\$ 4,334
1994	\$ 12,996	\$ 26,028	\$ 33,864	\$ 3,567
1995	\$ 17,429	\$ 35,092	\$ 51,487	\$ 3,978
1996	\$ 20,960	\$ 45,198	\$ 69,935	\$ 3,859
1997	\$ 27,460	\$ 67,962	\$ 105,078	\$ 4,215
1998	\$ 34,783	\$ 103,921	\$ 282,008	\$ 3,151
1999	\$ 41,575	\$ 140,880	\$ 753,836	\$ 2,605
2000	\$ 37,359	\$ 168,486	\$ 1,176,587	\$ 885
2001	\$ 32,487	\$ 208,068	\$ 1,315,424	\$ 404
2002	\$ 24,896	\$ 248,911	\$ 1,363,173	\$ 248
2003	\$ 31,463	\$ 333,023	\$ 2,058,938	\$ 266
2004	\$ 34,293	\$ 388,507	\$ 2,726,652	\$ 270
2005	\$ 35,322	\$ 440,290	\$ 3,656,168	\$ 260
2006	\$ 40,133	\$ 516,329	\$ 5,002,734	\$ 278
2007	\$ 41,550	\$ 606,503	\$ 6,745,687	\$ 229

Source: Sector performance based upon Dow Jones sectors

Thank you for your business and support,

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