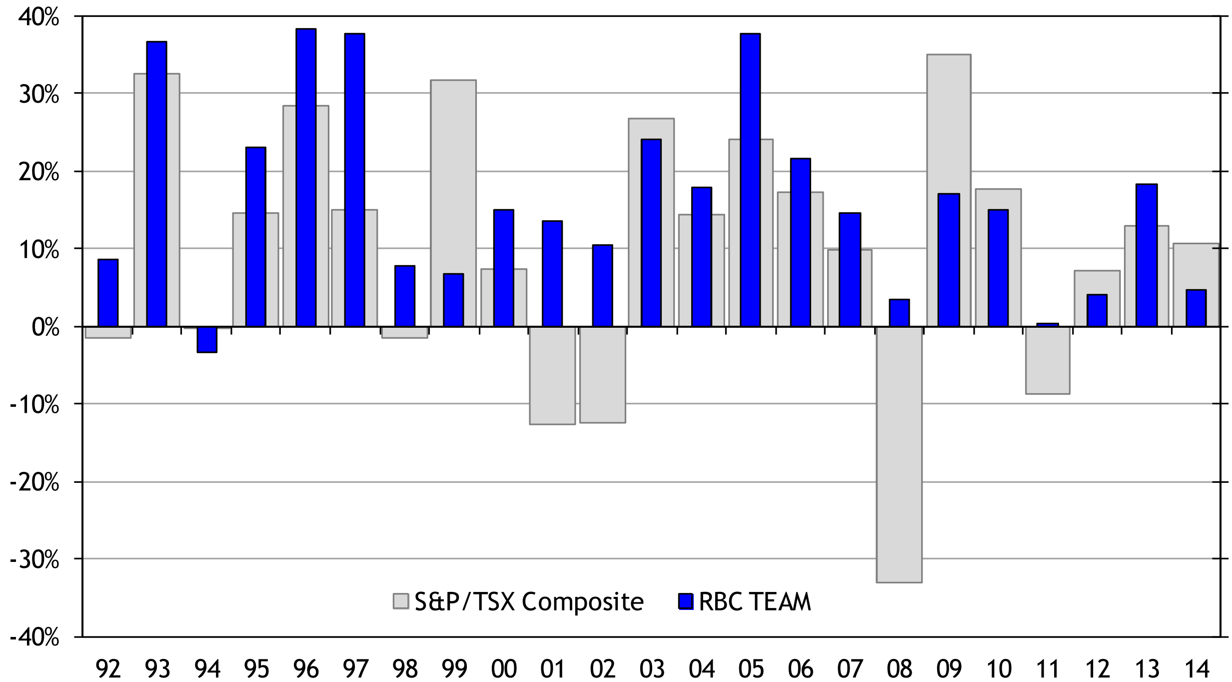
February 9th 2015

"Won2One" with Nick Foglietta

Tactical Equity Income Model Portfolio Record



Tactical Equity Income Model Present Conditions:

TEAM Model Asset Allocation: **50%** Equities/ **50%** Fixed Income
S&P/TSX 60 Closing Value: 15,083
TSX 200 Day Moving Ave: 14,847
% Above/Below 200 Day Moving Ave: **1.59%**
Levels for change: 100% stocks - **TSX 15,590** and 100% fixed income – **TSX 14,105**

<u>*Weekly Quote*</u>

"I'ma make a deal with the bad wolf so the bad wolf won't bite no more!"

Aaron Bruno, lead singer Awolnation – song "*Hollow Moon*"

…Maybe a quote the Greek Prime Minister could have used…

Greeks and Game Theory

You have to hand it to the Greeks…they have made the political landscape of Europe infinitely more interesting this year.

When the world is full of leaders who have exactly the same vision of what "the solutions" are to our problems, all the fun is taken out of following the "game". Moves become too predictable…and just in case someone wasn't sure what that predictable move was going to be, the leaders "unintentionally float" the idea in the media to get a reaction before they announce it…just to make sure there are no surprises. All in all…BORING!

But now we have a Greek government that is not playing this game. What happens next is much less predictable when the leaders at the meeting table are not all reading from the same hymnal!

The European establishment has nobody but themselves to blame. If you oppress a people long enough with hollow promises of help but, at the same time, hold them hostage while they wait…you will reap the whirlwind.

Let me describe one of the lead characters in this drama. Yanis Varoufakis is the 53 year old Greek Finance Minister. His formal training is in math and stats and he has been an on-campus academic for a good part of his working life. Nothing really earth-shattering so far, but when you dig a bit deeper he gets really interesting.

First, this guy does not wear a tie. Second, his main mode of transportation is his motorcycle…and he is a true enthusiast. Yanis describes himself as a "libertarian Marxist" and yet, is exceptionally well balanced in his understanding of political process.

Yanis also has an incredible habit of quoting “rock song lyrics” to answer questions he wants to dodge…how can you not like this guy?

His books include *The New Keynesian Macroeconomics (1992), Rational Conflict (1991),* and the co-authored effort, *Game Theory – A Critical Introduction (1995)*. (He has gone on to write 4 more books on game theory.)

You really need to consider those three titles mentioned above. I believe the offer an outstanding clue as to what we can expect from the German-Greek negotiations that will go right down to the March 1st wire…IMHO. Sit back and enjoy the show. It should be very interesting and, I suspect, “market moving” too!

From here, I want to take a little detour into “Game Theory”. Game theory has been on my mind a lot lately. The incredible moves in financial markets in both directions have had many investors looking for answers that just are not to be found. The swings are quite “oversized” and “irrational” on many days.

The one fact I keep coming back to is with **no nominal return available on fixed income investments (see last week’s comment) large investors have been forced into “speculating”.** But when they speculate in an asset class they are like a herd of rampaging elephants…using huge amounts of money in their trades!

So when the rest of us view the markets from a historical perspective, the crazy volatility simply appears to be **irreconcilable** and **unwarranted.**

Let’s apply some “game theory” to this situation.

When people decide to play a game the objective of each player is to win. Winning is to be achieved within a set of established rules that each player agrees to adhere to. The game begins and goes down a designed path.

As the game progresses, some players succeed and some fail. This is the game state of Nash Equilibrium and is acceptable to the players because it is expected. The sudden changes in fate are what make the game fun!

But what if at some point a player starts to cheat? *At first, nobody notices. A little later the players realize something is not working quite right…the* ***rules do not appear to be controlling the flow of play anymore****. At this point maybe another player decides to cheat as well. Now the rules appear to be even more distant from the outcomes the players in the game are experiencing.*

Finally, everybody starts to cheat. The players have no choice if they want to continue to play. The rules are no longer relevant and chaos ensues.

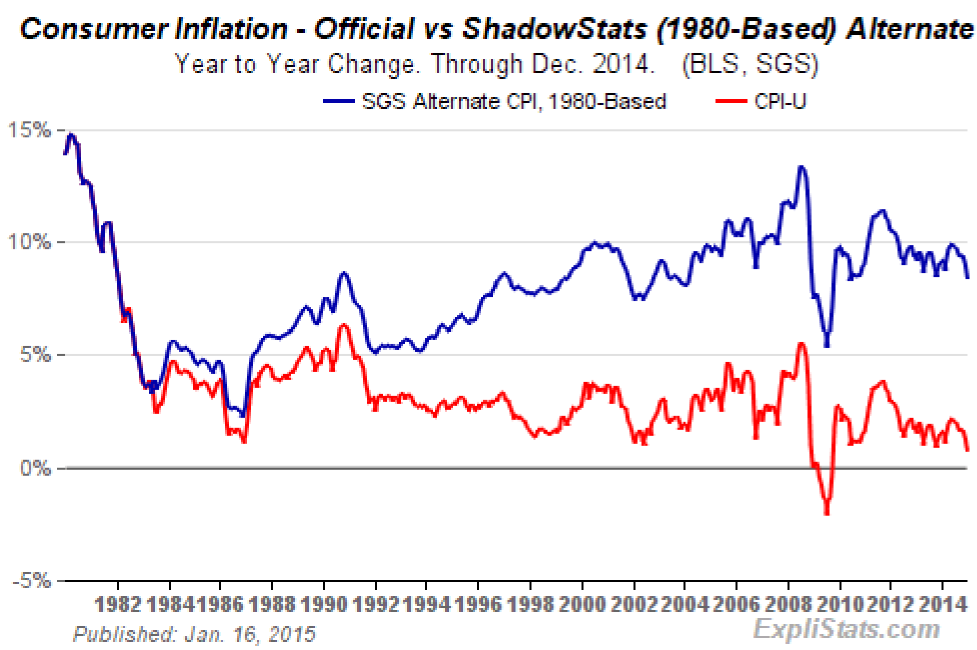
The scenario above describes what has transpired in the fixed income markets since 2008. Bond yields have traditionally have had a close tie to the long term inflation rate.

(Bond investors have always expected to earn a yield in the range of 1% above the inflation rate.) The “cheating” in this area started a long time ago.

Governments figured out if they “understated” inflation a whole bunch of good things happen for them:

- Interest rates stayed lower
- Pension increases and wage settlements stayed lower
- Stock prices would command higher P/E multiples and go higher

In short, governments figured out that lying about inflation was a “very good thing” and, in the short term, did only a little damage to everybody else.



But in the long term, this “cheating” has had huge repercussions. In the chart above, John Williams from Shadowstats.com shows us just how nasty this “understatement” has been.

I consider the “cheating” being done since 1980 being the “single player cheating” in my game theory example. But in 2008, the Central Bankers around the world to “cheating” to a new level! The global Central Bank cheating surge is the equivalent to “multiple players are cheating” in the game theory example…and in many ways financial chaos in terms of historical comparisons has been the result.

Bottom line:

The financial landscape of today is not the same as any time before in our lifetimes. **Bank survival** and **asset price inflation** are the only two objectives that are non-negotiable when our political and/or financial leaders meet.

Navigating these less rational investment conditions has always been the vision behind the TEAM Model philosophy. **The goal of trying to take advantage of longer term uptrends in asset markets and avoid long term downtrends is sensible and worth pursuing.**

The biggest "push-back" I have experienced from clients using TEAM is that they do not like the fact that it takes **an entire month to shift its asset mix**.

(Note - Our "back-tested" data to 1986 showed there was no statistical significance to using a "MONTHLY" portfolio shift interval versus a "BI-WEEKLY" or "WEEKLY". Over the long term the "right" choices balanced out the "wrong" choices in each case.)

There is an old saying that "the customer is always right". Since there is no single correct template for the TEAM discipline…my goal is to make it right for you!

Therefore, to offer a solution to this push-back, I am launching a **new version of the TEAM strategy that will run off of a THREE BUSINESS DAY tactical change algorithm**.

I already have a small number of these portfolios up and running on the "short cycle" strategy. I will also be contacting a number of you who I believe suit this strategy well.

To be clear, **the original TEAM Models do not change**. The one month window has actually worked out very well a number of times in the past 3 years keeping TEAM from being "whipsawed" on its positions. But I do want to give investors a choice between the long and short cycle.

If you would like to learn more about the "Short Cycle Tactical Equity Allocation Model (TEAM) Portfolio" please touch base with me and we can discuss this idea and how it pertains to your personal financial goals.

About the author: Nick Foglietta is a Vice President, Investment Advisor at RBC Wealth Management in Nanaimo, B.C., Canada. He has been managing money since 1988.