IR&M

Risk management research

Ineichen Research & Management ("IR&M") is an independent research firm focusing on investment themes related to absolute returns and risk management.

Change spotting

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Alexander Ineichen CFA, CAIA, FRM
+41 41 511 2497
ai@ineichen-rm.com
www.ineichen-rm.com

"Where one thing falls, another grows. Maybe not what was there before, but something new and wonderful all the same."
—Bambi's mother

"Intelligence is the ability to adapt to change."
—Stephen Hawkins

Executive summary

- On 3 May 2013 the first momentum monitor was launched as part of our risk management research. Herein some colour is added to this new risk management tool.
- Spotting change is important. There are essentially three approaches to change: 1. display complete ignorance, 2. having a wild guess as to what it means, or 3. measuring it in a systematic fashion with an applicable methodology and adapting to it.
- Momentum can be perceived as a philosophy. We recommend it as a risk management tool, rather than a philosophy. If risk is defined as "exposure to change," then one ought to spot the change.

Content

Change spotting

"When circumstances change, I change my view. What do you do?"
— John Maynard Keynes

"I'm always thinking about losing money as opposed to making money. Don't focus on making money; focus on protecting what you have."
—Paul Tudor Jones

Adding colour to momentum monitor

"The trend is your friend."
—Saying

On 3 May 2013 the first momentum monitor was launched as part of this risk management research effort. In this report, we add some colour to the logic behind both: "momentum" as well as "monitor".

The term "monitor" sounds actually quite boring. It really sounds like maintenance research; which, at one level, the momentum monitor is. The idea behind monitoring is twofold: observation as well as discipline. A monitor allows regularly observing as well as regularly revisiting large amounts of data in a systematic fashion. An investor only interested in Danish shares or US Treasuries for example can apply a tick-the-box approach by just quickly—within seconds—check whether anything has changed from one week to the next. This, we believe, is helpful for investors who are not close to the market as well as those investors who sit in front of a Bloomberg screen the whole day. For the former it is informative as well, ideally, a source for investment idea generation and/or risk warnings. For the latter, it is an opportunity to take one or two steps back and briefly have a broader view of the market than the view one gets by observing ticks the whole day. By being glued to the screens one can sometimes miss the forest for the trees, no?

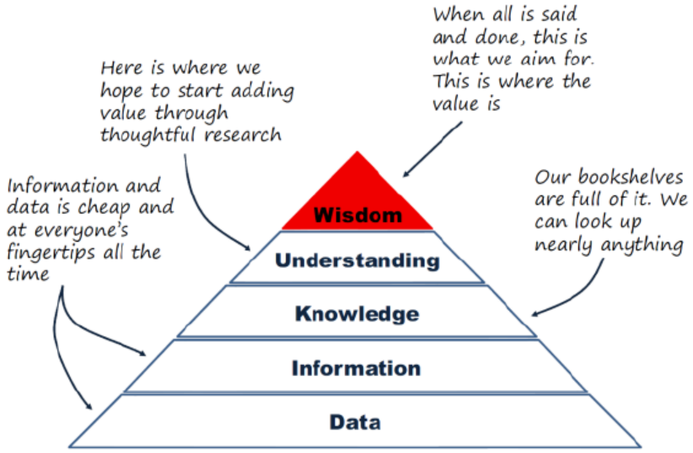
"Never have investors reached so high in price for so low a return. Never have investors stooped so low for so much risk."
—Bill Gross

The momentum monitor can add discipline to an investment process. For example in the momentum monitor from 17th May 2013 it was becoming apparent that momentum in bonds was in the process of reversing. (The quote from the bond king in the side text in relation to the lofty valuation of bonds was from 14th May.) Something had changed. Keynes' quote at the top of the page is the applied wisdom that goes with changing circumstances. Whether that requires hedging, rebalancing, taking profits, setting stop losses, directing new capital, etc. depends on many other factors idiosyncratic to the investor. The "signal" is systematic; essentially the opposite of someone's forecast. It therefore allows adding a certain element of discipline to the investment process. Furthermore, as mentioned in the May tutorial of the momentum monitor, large drawdowns and/or market mayhem more often than not occur when the price momentum is negative. The most extreme form of discipline related to trends derived from market prices is probably found in managed futures. There the trend, i.e., the price action is—simplifying a bit—the only input.

The term "momentum" has multiple associations. The most important one is the assumption or belief that there is such a thing as a trend. It's a bit the opposite of stochastic. If the investment world were entirely random, tomorrow's or next week's prices were a function of randomness; following a Brownian motion or any other stochastic motion. However, the ideas of Brownian motions and normal return distributions do not hold very well outside of the laboratory environment of the financial scientist.

"A fool with a tool is still a fool."
—Saying

The momentum monitor seeks to improve the investor's investment decisions. Seeking applicable wisdom is the goal of the whole research. Data and information is cheap and knowledge is something one can look up. Connecting the dots to understand what is going on and—ideally—applying some wisdom that has stood the test of time is the aim of this effort; hence our logo of the symbolised knowledge-pyramid.



Applied wisdom does not change from week to week. As a matter of fact, one could argue that wisdom is something that always applies. For example, Martin Zweig's "Don't fight the Fed" is probably always true. However, we are currently in a regime where it is most applicable. For the past months it was central banks' intervention that was the most important thing, with economic factors being somewhat delegated to the proverbial back burner.

Figure 1 shows the momentum monitor as of 7th July 2012; as it would have looked like around that time. Contrast this with the fundamentals. Figure 2 shows the second page of our regular risk management research update, dated 2nd July 2012. The technicals changed before the fundamentals. The fundamentals changed but changed much slower. The idea that markets are the ultimate leading indicator has merit. The following dialogue is quite telling:

Q:	Let's play a word association game. I'll say a word and you say whatever comes to mind: Technical analysis
Paul Tudor Jones:	Made well over half the money that I've made in my lifetime.
Q:	Fundamental Analysis
Paul Tudor Jones:	Made the rest.[2]

"I never use valuation to time the market. I use liquidity considerations and technical analysis for timing. Valuation only tells me how far the market can go once a catalyst enters the picture to change the market direction…The catalyst is liquidity, and hopefully my technical analysis will pick it up."
—Stanley Druckenmiller[1]

[1] Schwager, Jack (1992) "The New Market Wizards," New York: Harper Business.
[2] Marketfolley.com

Figure 1: Momentum monitor as of Friday 7 July 2012

IR&M momentum monitor 1/2	Medium-term					Long-term					50D MAV	
Week:	24	25	26	27	Chg.	24	25	26	27	Chg.	27	Chg.
Equities by region												
MSCI World	-7	-8	-9	1		18	19	-1	-2		↓	
Europe (STOXX 600)	-10	-11	1	2		19	-1	-2	-3		↑	
Eurozone (Euro STX 50)	-11	-12	-13	1		-4	-5	-6	-7		↓	
MSCI Emerging Markets	-10	-11	-12	-13		-2	-3	-4	-5		↓	
MSCI Asia Pacific ex Japan	-6	-7	-8	-9		-1	-2	-3	-4		↓	
Equities by country												
USA (S&P 500)	-6	-7	1	2		21	22	23	24		↓	
USA (Nasdaq)	-6	-7	1	2		20	21	22	23		↓	
USA (Dow Industrial)	-6	-7	1	2		26	27	28	29		↓	
USA (Dow Transport)	-6	-7	1	2		22	23	24	25		↓	
Canada (SPTSX 60)	-11	-12	-13	-14		-5	-6	-7	-8		↓	
Brazil (Bovespa)	-11	-12	-13	-14		-2	-3	-4	-5		↓	
Austria (ATX)	-11	-12	-13	-14		-2	-3	-4	-5		↓	
Belgium (Bel 20)	-10	-11	1	2		-1	-2	-3	-4		↑	
Denmark (OMX Copen 20)	-5	-6	1	2		20	21	22	23		↓	
Finland (OMX Helsinki)	-11	-12	-13	-14		-4	-5	-6	-7		↓	
France (CAC 40)	-11	-12	1	2		-3	-4	-5	-6		↑	
Germany (DAX 30)	-7	-8	-9	-10		17	18	19	-1		↓	
Greece (ASE Athens SE)	-12	-13	-14	1		-60	-61	-62	-63		↓	
Ireland (ISEQ)	-7	-8	-9	1		23	24	25	26		↓	
Italy (FTSE MIB)	-11	-12	-13	-14		-6	-7	-8	-9		↓	
Netherlands (AEX)	-11	-12	1	2		-3	-4	-5	-6		↑	
Norway (OBX)	-7	-8	-9	1		19	20	-1	-2		↓	
Portugal (PSI 20)	-12	-13	-14	-15		-55	-56	-57	-58		↓	
Spain (IBEX 35)	-16	-17	1	-1		-54	-55	-56	-57		↑	
Sweden (OMX 30)	-11	-12	1	2		19	-1	-2	-3		↓	
Switzerland (SMI)	-8	-9	1	2		21	22	-1	-2		↑	
Turkey (BIST National 100)	-7	1	2	3		15	16	17	18		↑	
UK (FTSE100)	-11	-12	1	2		-2	-3	-4	-5		↓	
Australia (S&P/ASX)	-5	-6	-7	-8		-1	-2	-3	-4		↓	
China (Shanghai SE)	-5	-6	-7	-8		-53	-54	-55	-56		↓	
Hong Kong (Hang Seng)	-6	-7	-8	1		16	17	-1	-2		↓	
India (Nifty)	-7	-8	1	2		-1	-2	-3	-4		↑	
Japan (Nikkei 225)	-8	-9	-10	1		15	-1	-2	-3		↓	
Singapore (STI)	-6	-7	-8	1		16	17	18	-1		↓	
South Korea (Kospi)	-5	-6	-7	-8		16	17	-1	-2		↓	
Taiwan (TWSE)	-9	-10	-11	-12		-1	-2	-3	-4		↓	
Equities by style												
USA (Large Growth)	-6	-7	-8	1		21	22	23	24		↓	
USA (Large Value)	-7	-8	1	2		20	21	22	23		↓	
USA (Small Growth)	-7	-8	1	2		20	21	22	23		↑	
USA (Small Value)	-7	-8	1	2		20	21	22	23		↑	

IR&M momentum monitor 2/2	Medium-term					Long-term					50D MAV	
Week:	24	25	26	27	Chg.	24	25	26	27	Chg.	27	Chg.
Bond futures												
US: Ultra Long Treasury	10	11	12	13		53	54	55	56		↑	
US: Long Treasury	10	11	12	13		4	5	6	7		↑	
US: 10Y Treasury	10	11	12	13		53	54	55	56		↑	
US: 5Y Note	10	11	12	13		53	54	55	56		↑	
US: 2Y Note	-1	-2	-3	-4		3	4	5	6		↓	
Canada: 10Y	7	8	9	10		3	4	5	6		↑	
Germany: Buxl (30Y)	12	13	-1	1		47	48	49	50		↑	
Germany: Bund (10Y)	11	-1	-2	1		50	51	52	53		↑	
Germany: Bobl (5Y)	10	11	12	13		48	49	50	51		↑	
Germany: Schatz (2Y)	12	-1	-2	1		46	47	48	49		↑	
UK: Long Gilt	10	11	12	13		-25	-26	-27	1		↑	
France: OAT	8	9	10	11		-149	-150	-151	-152		↑	
Italy: BTP	-10	-11	-12	-13		15	16	17	18		↓	
Spain: 10Y	-1	1	2	-1		-149	-150	-151	-152		↓	
Switzerland: Long Bond (8-13Y)	8	9	10	11		3	4	5	6		↑	
Japan: JGB 10Y	10	11	12	13		5	6	7	8		↑	
South Korea: 10Y	9	10	11	12		3	4	5	6		↑	
Australia: 10Y	11	12	13	14		54	55	56	57		↑	
Bond total return indices (USD unhedged)												
Barclays Global Aggregate	1	-1	1	2		19	20	21	22		↓	
Barclays Global Treasury	9	-1	1	2		3	4	5	6		↑	
Barclays Global HY	-5	1	2	3		20	21	22	23		↑	
Barclays World Inflation Linked	1	-1	-2	-3		96	97	98	99		↓	
Barclays US Aggregate	11	12	13	14		60	61	62	63		↑	
Barclays Pan-European Aggregate	27	28	29	30		52	53	54	55		↑	
Barclays Euro Aggregate	27	28	29	30		52	53	54	55		↑	
Barclays Asia Pacific Aggregate	2	3	4	5		61	62	63	64		↑	
Barclays Global Emerging Markets	1	2	3	4		28	29	30	31		↑	
Barclays US Corporate	35	36	37	38		148	149	150	151		↑	
Barclays US Corporate HY	-4	1	2	3		25	26	27	28		↑	
Barclays US MBS	69	70	71	72		68	69	70	71		↑	
Commodities												
Thomson Reuters/Jefferies CRB	-12	-13	-14	-15		-45	-46	-47	-48		↓	
Gold	-14	-15	-16	-17		-10	-11	-12	-13		↓	
Copper (Comex)	-10	-11	-12	-13		-2	-3	-4	-5		↓	
Oil (WTI)	-7	-8	-9	-10		-2	-3	-4	-5		↓	
Oil (Brent)	-9	-10	-11	-12		-2	-3	-4	-5		↓	
Miscellaneous												
Fed balance sheet	-15	1	-1	1		-6	-7	-8	-9		↓	
ECB balance sheet	53	54	55	56		48	49	50	51		↑	
BoJ balance sheet	5	6	7	8		95	96	97	98		↑	
BoE balance sheet	45	46	47	48		37	38	39	40		↑	

Source: IR&M, Bloomberg. Notes: Medium-term based on exponentially weighted average over 3 and 10 weeks. Long-term based on simply weighted average over 10 and 40 weeks. 50D MAV: 50-day simply weighted moving average. Chg.: Highlights change from Friday to Friday. Equity indices are price indices (except DAX). Index marked green: within 1% of (the then) all time closing high. Index marked red: recovered less than 25% from all-time-low.

- Technicals in equities were turning while fundamentals were not. The reason was liquidity, i.e., the Fed having another go at stimulating the economy.

Figure 2: Summary page from IR&M risk management research update 2nd July 2012

Risk Management Research – Q3 2012 Themes **Economy** Risk

Summary

The trends are in place and very little has changed.
Changes vs last update.

	Fundamentals						Remarks	Technicals		
	IR&M Models					Surprises**		Moving averages		
02 Jul 12	Percentile (2006-)	Change*** (22 Jun 12)	Rank	Direction*	Average (100-day)	Above average?			50D	200D	50D> 200D?
Global	58	-2.2		Falling	Falling	No	Negative	Declining.	Falling	Rising	No
US	67	-3.5	2	Falling	Falling	No	Negative	Declining.	Falling	Rising	Yes
Europe	47	-0.8	5	Falling	Falling	No	Negative	Declining.	Rising	Rising	No
Germany	55	-0.6	4	Falling	Falling	No	Negative	Declining.	Falling	Rising	Yes
France	43	-0.6	6	Falling	Falling	No	Negative	Declining.	Rising	Rising	No
Italy	41	-0.6	7	Falling	Falling	No	Negative	Declining.	Falling	Rising	No
UK	67	7.4	3	Rising	Rising	Yes	Negative	Sentiment indicators rising.	Falling	Rising	No
Switzerland	41	2.8	8	Falling	Rising	Yes	Positive	Safe harbour.	Falling	Rising	Yes
Japan	80	-1.8	1	Falling	Rising	No	Positive	At inflection point; surprising positively.	Falling	Rising	No
China	15	-1.2	9	Falling	Rising	Yes	Negative	Still at an inflection point.	Falling	Falling	No

Notes: * Direction: average last five days versus previous five-day average; ** Surprises are from Citigroup except Germany (which is our own). Surprises for France and Italy are for the Eurozone as a whole.
*** Change in percentile points relative to date shown in brackets.

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Source: IR&M

Momentum as risk measure

The main objective of this research effort is a focus on the downside. The second quote on page three by Paul Tudor Jones is very consistent with what this research is about. It is losses, especially large ones, that kill the rate at which capital compounds. It is the drawdown measure that is important, not volatility. Volatility by itself is a good thing. Equities are more volatile than bonds and outperform bonds most of the time. Volatility can be both good and bad while drawdowns are unambiguously bad. (Note that your author is old enough to have seen that even relative return managers—supposedly happy to hug an asset or liability benchmark at all times—are not indifferent to absolute losses. It's a regime-shift-kind-of-thing: when markets go up, benchmarking makes sense. During market mayhem, essentially when hell breaks loose, it doesn't. When faced with losses, committee-based-decision-making can result in abandoning the bull-market-embraced methodology at exactly the worst moment. Large absolute losses are an unambiguous negative, a game changer, a headache and widow maker, as well as a beliefs and career destroyer. They are to be avoided at nearly all cost.)

"The aim of the wise is not to secure pleasure, but to avoid pain."
—Aristotle

We believe the ideas behind the terms "momentum" or "trend-following" can help with risk management. CTAs and managed futures have a good enough track record and longevity for them to claim not being something esoteric or pseudo-scientific. The applicability of momentum as an idea might depend on the investor's definition of risk though. Herein it is embraced to avoid losses, which—as pointed out before—should interest all investors.

"It ain't over 'til it's over."
—Yogi Berra[1]

There is a difference between risk measurement and risk management.[2] Although the two are not entirely unrelated, the underlying skill set is different. Risk measurement can be narrowly defined and is probably to a large extent objective, whereas risk management is a much broader task and is subjective by definition.

Risk measurement is not synonymous with risk management

Risk management is at least as much a craft as it is a science. A craftsman needs a combination of skills, that is, a balance between outright knowledge and street smartness (tricks of the trade) to execute his job successfully. One could argue that this combination of skills goes far beyond, for example, econometric modelling of (historical) risk factors, or the abstract theorising under laboratory conditions. Risk—or, to use a more appropriate term, uncertainty—is about what you don't know, not about what you know.

"I am enough of an artist to draw freely upon my imagination. Imagination is more important than knowledge. Knowledge is limited."
—Albert Einstein

The risk management profession is potentially too much quant and too little thought. Quantitative analysis is a tool, not an ideology. (In the hedge funds space some the greatest success stories to date are quant while some of the most spectacular blow-ups were quant too.) Large banks employed many quant-savvy analysts in their risk management departments. (One reason was because the regulatory regime requires quantitative modelling, irrespective whether it makes

"I would rather be vaguely right, than precisely wrong."
—John Maynard Keynes

[1] Howard Marks, Memo to Oaktree Clients, 19 March 2012. In July 1973, when Berra's Mets trailed the Chicago Cubs by 9½ games in the National League East; the Mets rallied to win the division title on the final day of the season. This means a trend stops when it stops but not before.

[2] Robert Gumerlock, a former head of risk at Swiss Bank Corporation and O'Connor, on risk measurement: "When O'Connor set up in London at Big Bang, I built an option risk control system incorporating all the Greek letters – deltas, gammas, vegas, thetas and even some higher order ones as well (the delta of the gamma and the gamma of the vega). And I'll tell you that during the crash it was about as useful as a US theme park on the outskirts of Paris." From Alexander, Carol (1996) "The Handbook of Risk Management and Analysis," Chichester: John Wiley & Sons.

sense or not.) It turned out that not only where these quants not managing risk but measuring risk, they also were fooled by the idea that risk is something that one can measure down to three or four decimals. It's unfortunate but one cannot buy a biography of Steve Jobs, program a computer, and then expect the computer to run Apple. Most of the risk management literature is actually about risk measurement, not management.

There are many definitions for risk. Since the financial crisis we all know that it has very little to do with VaR (value at risk). The distinction between tracking risk, i.e., underperforming a benchmark and total risk, i.e., losing a lot of money, is important.[1] Warren Buffett's "definition" of risk in the side text is witty (as well as true, good advice, and relevant for both private as well as institutional investors). A good definition of risk is the following:

"Risk comes from not knowing what you're doing."
—Warren Buffett

> *Risk is defined as permanent impairment of mission.*[2]

This definition by an institutional consultant—who might or might not have an incentive to promote what institutional investors want to hear—is unambiguous and is applicable to nearly everything. Applying it to private individuals it means that slipping in the shower and braking ones' neck is a risk while being stung by a bee is not. (Assuming one is not lethally allergic, of course.) Applying the definition to a large universal bank means risk is defined as complete failure for the bank requiring a bail-out (because large banks don't "fail fail," they are too big) while exceeding the daily VaR by a couple of basis points is analogously equivalent to being stung by a bee.

"The punch you don't see is the one that gets you."
—Old boxing saying

Yet another definition that is applicable to the momentum monitor is the following:

> *Risk = exposure to change*

This definition[3] is very simple and unscientific but very powerful and has stood the test of time. Risk measurement deals with the objective part. The risk measurer either calculates bygone risk factors, simulates scenarios or stress tests portfolios based on knowledge available today according to an objective (and statistically robust) set of rules. Any assessment of risk is based on knowledge that is available today. Risk, however, has to do with what we do not know today.[4] More precisely, risk is exposure to unexpected change that could result in deviation of one's goals (such as meeting future liabilities, for example). By definition, we cannot measure what we do not know. We are free to assume any probability distribution, but that does not imply an objective assessment of risk. In other words, risk management is complex, primarily qualitative and interpretative in nature. Risk measurement, on the other hand, is more quantitative and rule-based, and has a rear mirror view by definition.

There are those who don't know – and those who don't know they don't know

[1] Your author first mentioned this distinction in Ineichen (2000) and repeated it ad nauseam ever since.
[2] "The wrong type of snow – Risk revisited," Towers Watson, February 2012.
[3] The source of this definition is from the education materials of Chicago-based options trading boutique O'Connor that joint ventured with your author's then-employer, Swiss Bank Corporation, in the late 1980s.
[4] John Kenneth Galbraith comes to mind: "We have two classes of forecasters: Those who don't know – and those who don't know they don't know."

The practical relevance of all this is that the momentum monitor can help with the risk management. It provides signals that can initiate a thought process. The momentum monitor is not the Holy Grail of finance, unfortunately. However, it is designed to quite literally point out change. And if risk is indeed "exposure to change" then pointing it out seems important and relevant. One example is the change in bonds. In the report, *A new dimension* from 19 April 2013, the main topic was *The cardinal question*. The cardinal question was and still is when bonds turn in earnest after a 30-year bull market. It never was an if-question. In the update from 22 March 2013 the following slide was included. Figure 3 measured positive momentum in US Treasuries combined with an economic indicator, in this case PMI that was favourable. (The more favourable the economy, the higher the probability of tightening, or, to use the modern vernacular, tapering-off.)

"Intelligence is the ability to adapt to change."
—Stephen Hawking

Figure 3: The cardinal question

Source: IR&M risk management update 22 March 2013

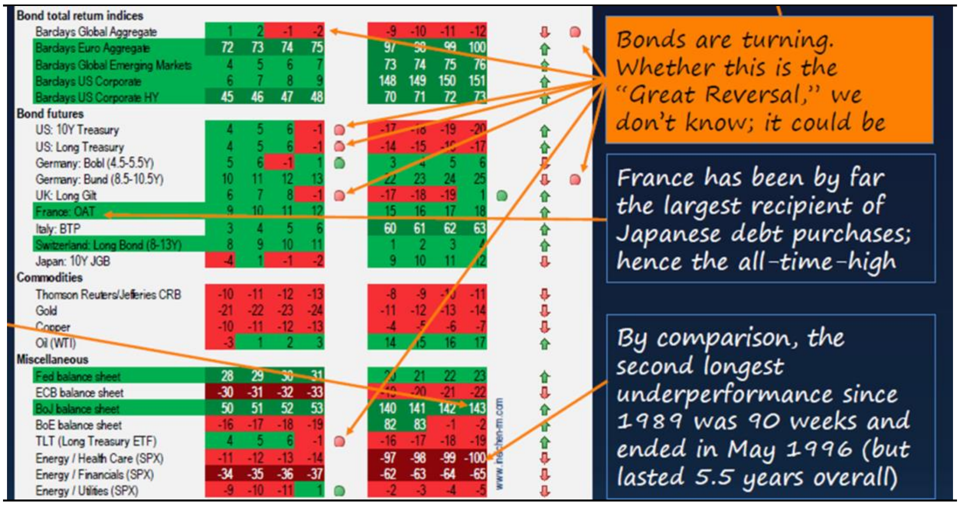
The rule shown in Figure 3 was a bit tongue in cheek as we were looking for a rule that "signalled" a rise in rates. The important thing is that it involves momentum. And the important thing about doing these momentum monitoring exercises is that it involves system; essentially a systematic approach to spotting change. The vertical lines in the slide above are facts, not someone's opinions. It is important to balance right-brain with left-brain thinking. There is a lot of behavioural finance that suggests one ought to prefer left-brain thinking. Trusting one's gut—an aphorism for right-brain thinking—also works in some cases. One just needs a really good gut. For committee-based investment decision making, however, one ought to focus on left-brain thinking rather than anything else. One disadvantage of the concept of momentum is that one never buys at the ultimate low or sells at the ultimate high which wasn't a problem for Mr Morgan's bottom line (side text). The low in US rates was in July 2012. However, the advantage is that the momentum monitor signals when the environment changes from headwind to tailwind or vice versa reasonably early and in a systematic fashion. This factual

"I'm not a market timer. I never bought at the lows or sold at the highs, but I was always in the game for the middle 60 per cent."
—J.P. Morgan (1837-1913)

knowledge should then help improve decision making. It can help with tactical asset allocation, position sizing, allocating new funds, hedging etc.

Figure 4 shows a screen shot from the momentum monitor from 17 May this year. The medium term trend in bonds had turned from positive to negative.

Figure 4: Screen shot from momentum monitor 17 May 2013



Source: IR&M
Note: See tutorial in appendix for a description of the various columns, colour coding and arrows.

There are two ideas that go with the momentum monitor:

Confucius *"Real knowledge is to know the extent of one's ignorance."*

Gartman *In a bull market you should be either flat, long or very long but not short. In a bear market you should be either flat, short or very short but not long.*[1]

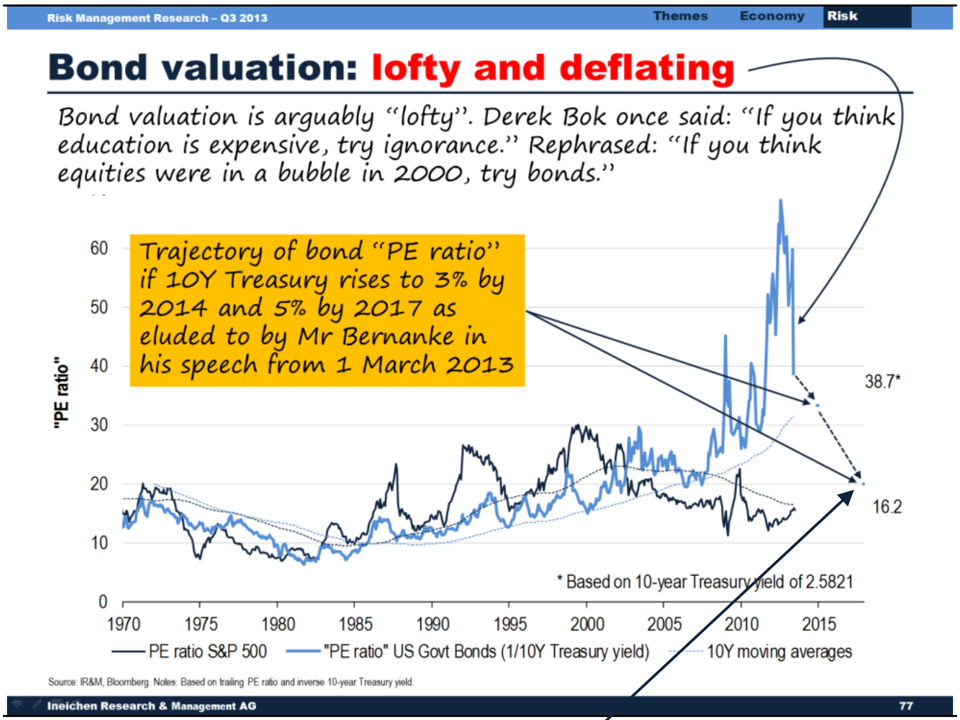
Confucius's quote is well known and has been repeated and rephrased by philosophers, economists, and investors alike. Applied to bonds and Figure 4 it means that back in May we know that something had changed or was the process of changing. If risk is really defined as exposure to change, then pointing out change is of course important. However, we still don't know how significant the change is. On 17th May we didn't know whether this change is the big one everyone has been talking about, i.e., the end of the 30-year bull market in bonds. At the time of writing, mid-September 2013, we knew, with the benefit of hindsight, that it signalled a major correction in bonds. However, in mid-September we still don't know the future trajectory of bonds. Figure 5 shows the trajectory of bond valuation if Mr Bernanke is right. On 1 March 2013 the Fed chief seer forecast 10-year rates to be at 4% by the end of 2014 and 4-5% by 2017. Note that Mr Bernanke's forecasting track record is arguably not spotless.

"We do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system."
—Ben Bernanke, 17 May 2007

Figure 5 shows equity and bond valuation, a slide that has appeared in the updates over the past months.

[1] This is not a quote that we copied verbatim. It's more a trading concept or investment approach/ideology than it is a literal quotation.

Figure 5: Equity and bond valuation in US



Source: IR&M, Bloomberg

- Equities are cheap relative to bonds when the data is presented in this fashion.
- A 5% yield implies a "P/E ratio" of 20x. (Or the equity P/E ratio of 16.2 implies an equities earnings yield of 6.2%, i.e., much higher than the yield in bonds.) If Mr Bernanke's prediction comes to fruition, bonds will deflate. Note that bonds could compound negatively in real terms in two different scenarios:
  1. low nominal rates - inflation +/- price stability < 0% real yield
  2. Higher nominal rates - inflation – losses from bonds < 0% real yield.

Mr Gartman regularly points out that in a bear market one ought to be short, very short or flat but not long. He adds an interesting twist to this idea: Fighting a trend is not only destructive for one's P&L; it also destroys what he calls "mental capital." For an absolute return investor losing money is unpleasant; it destroys one's financial as well as mental health. Seeing one's investment disappear is to be avoided therefore; hence the idea of managing risk. The relation to Confucius is that when a downtrend is in motion, we do not know how long and how bad it's going to get. The Confucian bit is that we ought to know what we don't know. In bonds or gold, then, it was better to be short, very short or flat but not long. Figure 6 applies this Confucius-Gartman-momentum logic to gold.

"There's a time to go long...there's a time to go short...and there's a time to go fishing."
—Jesse Livermore[1]

[1] Lefèvre (1994)

Figure 6: Gold futures (Nov 2012 – 12 Jul 2013)

Source: Bloomberg

- The medium term momentum switched from positive to negative in December 2012 and has been negative until quite recently. Applying the aforementioned logic means that one should have been short, very short or flat and shouldn't have been too courageous trying picking the bottom.
- A further aspect of this example is that "bad" news has a disproportionally negative impact in a "bad" market environment: essentially two negatives. (Bad news in a good market is cushioned by the bullish herd.) Negative outliers are more likely when momentum is negative. The 8.5 standard deviation shake-up in Gold in April is a case in point.

"Don't try to buy at the bottom and sell at the top. This can't be done — except by liars."
—Bernard Baruch (1870-1965)[1]

The momentum monitor also includes earnings momentum.

Earnings momentum

The sector breakdown of EPS momentum seems very consistent with the price momentum. Causality between fundamentals, earnings in this case, and price levels is a positive; especially given that the industrialised world is migrating to a planned economy with the central banks doing the planning.

Economic planning: "the process by which key economic decisions are made or influenced by central governments. "
—Britannica.com

Around the year 1997 there was an academic paper in one of the journals suggesting that sectors have become fundamentally more important in terms of performance attribution than countries. From a practical point of view both are important. Canada and Switzerland, for example and stating the obvious, are driven by both, local factors as well as what is going in energy and health care.

Stating the obvious, both country as well as sector specific factors matter

Figure 7 shows the sector weights of some of the main stock markets, with the last column showing the percentage of cyclicals. The earnings momentum monitor is relevant to investors who focus on one specific sector (a sector specialist for example) and those who focus on countries or geographic regions. For example the fact that earnings momentum was extremely negative in materials and energy is relevant for investors invested in, say, Canada and Germany, the former having the highest exposure, the latter the smallest. Consequently, Canada is up 1.1% year-to-date while Germany is up 17.8% (both in USD, as of 19 September 2013).

[1] Experience #4 (Baruch didn't want to call it a rule); from Baruch (1957), p 254.

Figure 7: Index/sector matrix (19 September 2013)

Sector weights, %	Consumer Discret.	Materials	Industrials	Financials	IT	Energy	Telecom	Utilities	Consumer Staples	Health Care	Cyclicals
USA: S&P 500	12	4	11	17	17	10	3	3	11	12	61
Canada: S&P/TSX Comp.	6	12	7	35	2	26	5	2	4	1	62
Europe: STOXX 600	11	6	16	22	4	9	6	3	11	12	59
UK: FTSE 100	7	10	7	21	1	16	8	4	17	8	47
Germany: DAX+MDAX	25	12	16	14	7	0	4	4	5	12	75
France: CAC 40	13	7	15	16	2	10	4	8	14	10	53
Italy: FTSEMIB	14	1	8	30	2	25	3	15	2	0	54
Spain: IBEX 35	12	1	10	37	3	7	14	12	2	2	64
Netherlands: AEX	6	11	11	23	10	16	1	0	22	0	61
Switzerland: SMI+SMIM	10	7	11	18	0	1	2	0	18	33	45
Sweden: OMX 30	11	1	35	22	10	1	5	0	4	10	80
Japan: Nikkei 225	22	7	21	19	8	1	9	2	7	5	76
Average	13	7	14	23	6	10	5	4	10	9	61

Source: IR&M, Bloomberg
Notes: Sorted by cyclicality, consumer discretionary most cyclical, health care least. Cyclicals (last column): sum of five most cyclical sectors. Light grey shade = sector > 10%, dark grey shade = sector > 20%.

Figure 8 shows a screen shot from the momentum monitor from 15 July 2013.

Figure 8: Screen shoot earnings momentum monitor 15 July 2013

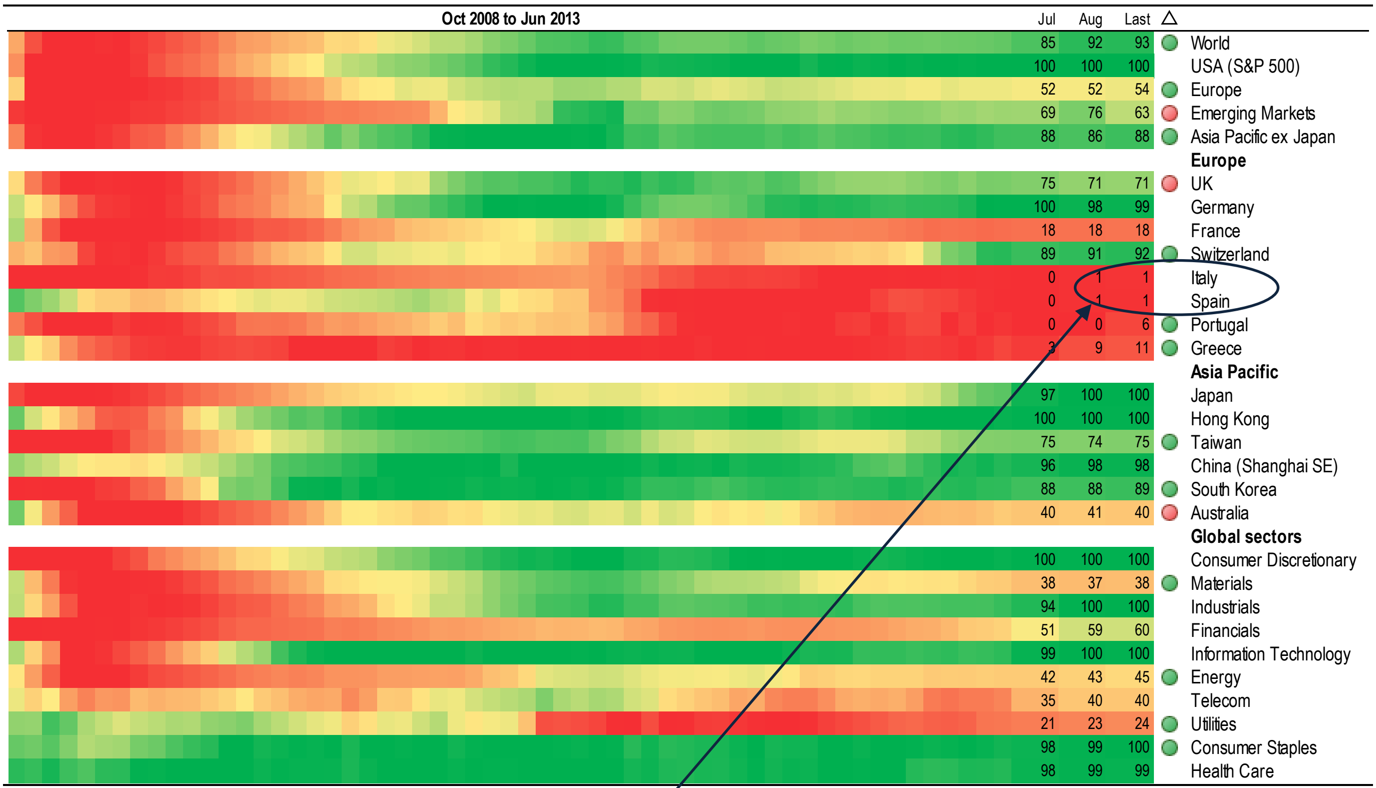
IR&M EPS momentum monitor 1/2	Medium-term					Long-term					50D MAV	
Week:	25	26	27	28	Chg.	25	26	27	28	Chg.	28	Chg.
Equities by region												
MSCI World	12	13	-1	-2		21	22	23	24		↓	
Europe (MSCI Europe)	-11	-12	-13	-14		-2	-3	-4	-5		↓	
Eurozone (Euro STX 50)	-17	-18	-19	-20		-6	-7	-8	-9		↓	
MSCI Emerging Markets	-6	-7	-8	-9		22	23	24	-1		↓	
MSCI Asia Pacific ex Japan	-6	-7	-8	-9		23	24	25	26		↓	
Americas												
USA (S&P 500)	-1	-2	1	2		25	26	27	28		↑	
USA (Nasdaq)	1	2	3	4		-2	-3	-4	1		↑	
USA (Dow Industrial)	-8	-9	1	2		25	26	27	28		↑	
USA (Dow Transport)	3	4	5	-1		27	28	29	30		↓	
Canada (SPTSX 60)	-15	-16	-17	-18		-2	-3	-4	-5		↓	
Brazil (Bovespa)	-11	-12	-13	-14		18	-1	-2	-3		↓	
Mexico (IPC)	-16	-17	-18	-19		-6	-7	-8	-9		↓	

Source: IR&M, Bloomberg

- Both price momentum as well as earnings momentum in Canada and Brazil had been negative for weeks. There is a saying that "no one rings a bell at the top." This is of course also true for the opposite; no one rings a bell at the bottom either. However, the momentum monitor will tell us when either price or earnings momentum (or both) have changed. If risk is indeed "exposure to change" then changing fortunes is obviously important.

Note that the earnings momentum only shows the momentum. For example the earnings momentum monitor section was early to point out that earnings momentum in Italy had turned. However, it didn't tell by how much. Figure 9 from our regular updates shows earnings in percentile terms over the past five years.

Figure 9: Earnings momentum (from 'More fragile than it looks, 13 September 2013)

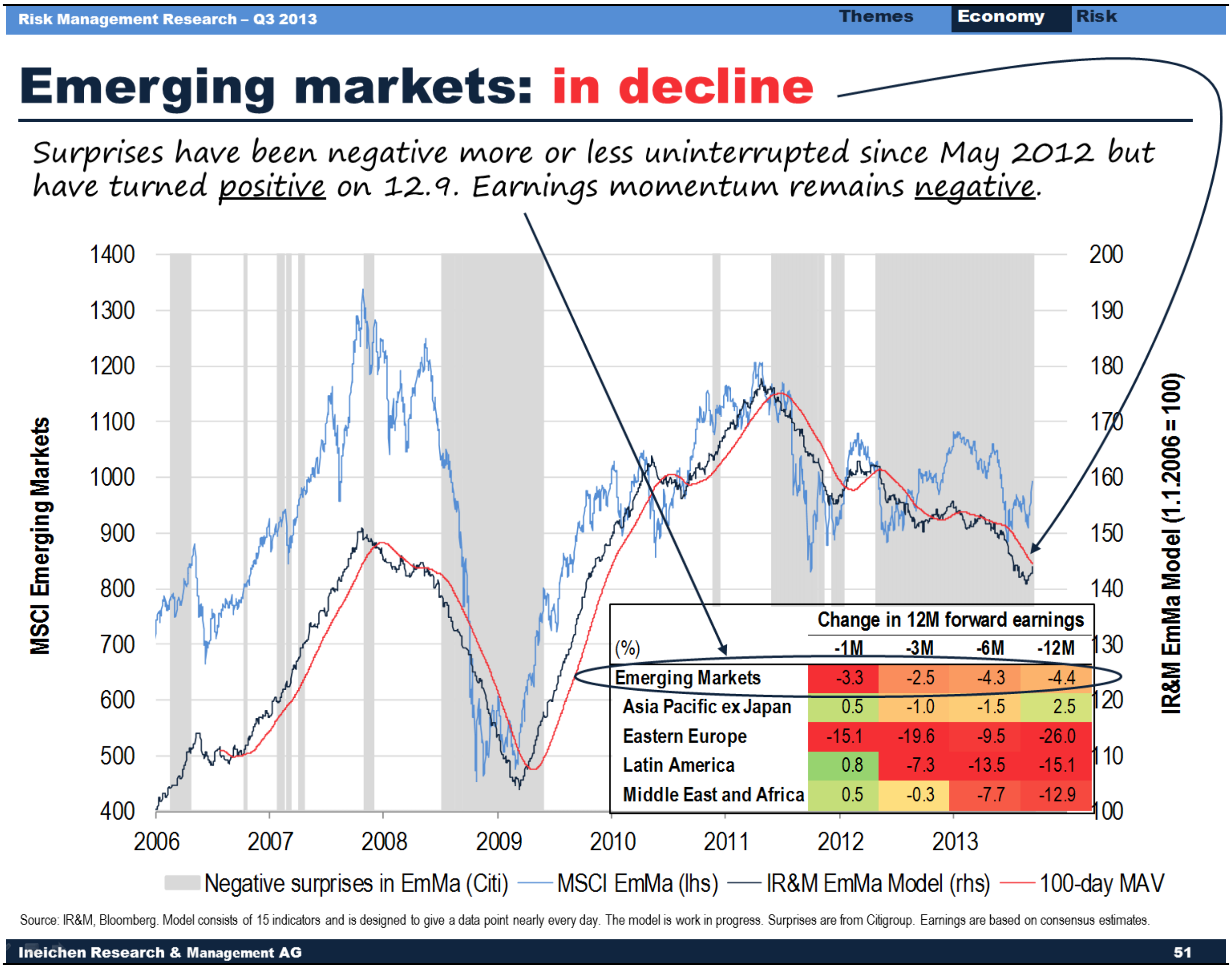


Source: IR&M, Bloomberg.
Notes: Based on 12-month consensus earnings estimates. Data is shown in percentile terms. 0=5-year low; 100=5-year high. Dots mark changes > 0.5 percentile points.

- Earnings momentum in for example Spain and Italy has picked up. However, it is still very low when compared to the past five years.

We see the momentum monitor is a tool and not necessarily a standalone publication. In terms of earnings it is important to contrast it with top-down and surprise factors. Figure 10 shows an example from a recent publication. It relates top down factors (our model), to surprises, as well as to changes in consensus earnings estimates.

Figure 10: IR&M EmMa model (from 'More fragile than it looks, 13 September 2013)



(%)	Change in 12M forward earnings -1M	-3M	-6M	-12M
Emerging Markets	-3.3	-2.5	-4.3	-4.4
Asia Pacific ex Japan	0.5	-1.0	-1.5	2.5
Eastern Europe	-15.1	-19.6	-9.5	-26.0
Latin America	0.8	-7.3	-13.5	-15.1
Middle East and Africa	0.5	-0.3	-7.7	-12.9

Source: IR&M

- The momentum price as well as earnings monitor have kept investors very cautious towards emerging markets. These momentum indicators have been pointing downwards long before market mayhem in Indonesia and India a couple of weeks ago.

The bottom line is simple.

Bottom line

Spotting change is important. There are essentially two approaches to change: having a guess or measuring it in a systematic fashion with an applicable methodology. The latter is robust, the former isn't.

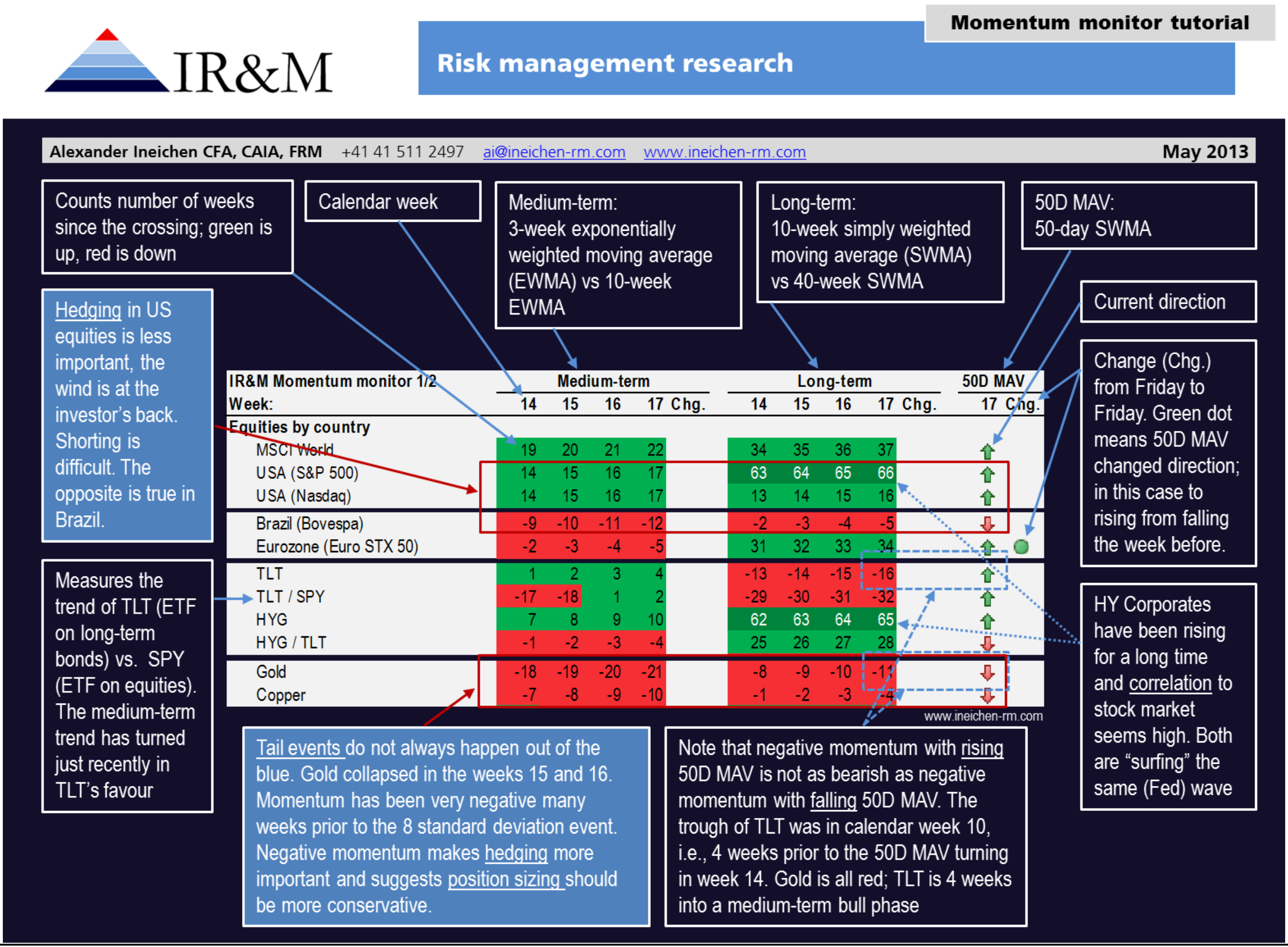
Momentum can be perceived as a philosophy. We herein recommend it as a risk management tool, rather than a philosophy. If risk is indeed exposure to change, then one ought to spot the change.

"Simplicity is the keynote of all true elegance."
—Coco Chanel

Appendix

Momentum monitor tuturial

Exhibit A: Momentum monitor tutorial as published with inaugural momentum monitor on 3 May 2013



Source: www.ineichen-rm.com

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Publications

Risk management research (subscription based)

More fragile than it looks	13 September 2013
Fragile growth	30 August 2013
In remembrance of caution	15 August 2013
Growth surprises, not taper timing	2 August 2013
Highly accommodative (Q3 2013 report)	17 July 2013
Tapering-off talk tapering off	1 July 2013
Mispriced bubbles	18 June 2013
All they know	3 June 2013
Pretty shocking	17 May 2013
No understanding – no assurance	3 May 2013
IR&M momentum monitor (inaugural issue and tutorial)	3 May 2013
A new dimension (Q2 2013 report)	19 April 2013
A bit of friction here and there	4 April 2013
As long as it takes	22 March 2013
Keep it coming	12 March 2013
The end of a system	1 March 2013
Great Unrecovery continues	22 February 2013
Showing mettle	15 February 2013
Currency wars	1 February 2013
Repressionomics (Q1 2013 report)	**18 January 2013**
Far from over	3 January 2013
Wriston's Law of Capital still at work	19 December 2012
A very long process	5 December 2012
In search of a real fix – obviously	22 November 2012
Socialising losses	7 November 2012
No risk (Q4 2012 report)	**26 October 2012**
No panacea	12 October 2012
No knowledge, no experience	1 October 2012
QE infinity	18 September 2012
Draghi put kicks in	7 September 2012
Enormously ineffective	27 August 2012
They want your money	16 August 2012
Whatever it takes	6 August 2012
No money	20 July 2012
Wriston's Law of Capital (Q3 2012 report)	**10 July 2012**
Pompous meddling continues	2 July 2012
Empty monetary bag of tricks	22 June 2012
Helping hand rather than an invisible one	15 June 2012
Fed recommends to hedge too	8 June 2012
Waiting for the next fix	1 June 2012
Hopium running low	25 May 2012
Euro area tearing itself apart	18 May 2012
PMIs make for horrid reading	7 May 2012
Just in the middle of the river	2 May 2012
Risky fragility	19 April 2012
What makes bears blush (Q2 2012 report)	**11 April 2012**
Conditionally well but subject to revision	4 April 2012
Not yet out of the woods	22 March 2012
Eerily unchanged	15 March 2012
Ltroveneous double liquidity whammy	2 March 2012
Bullish middle-game: an intermezzo?	17 February 2012
Shooting the economic lights out	3 February 2012
Confidence rally	27 January 2012
…	
Europe doubling down (inaugural report)	**3 October 2011**