



Artemis
FINANCIAL ADVISORS LLC

Market Outlook & Strategy

Second Quarter of 2012

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Executive Summary

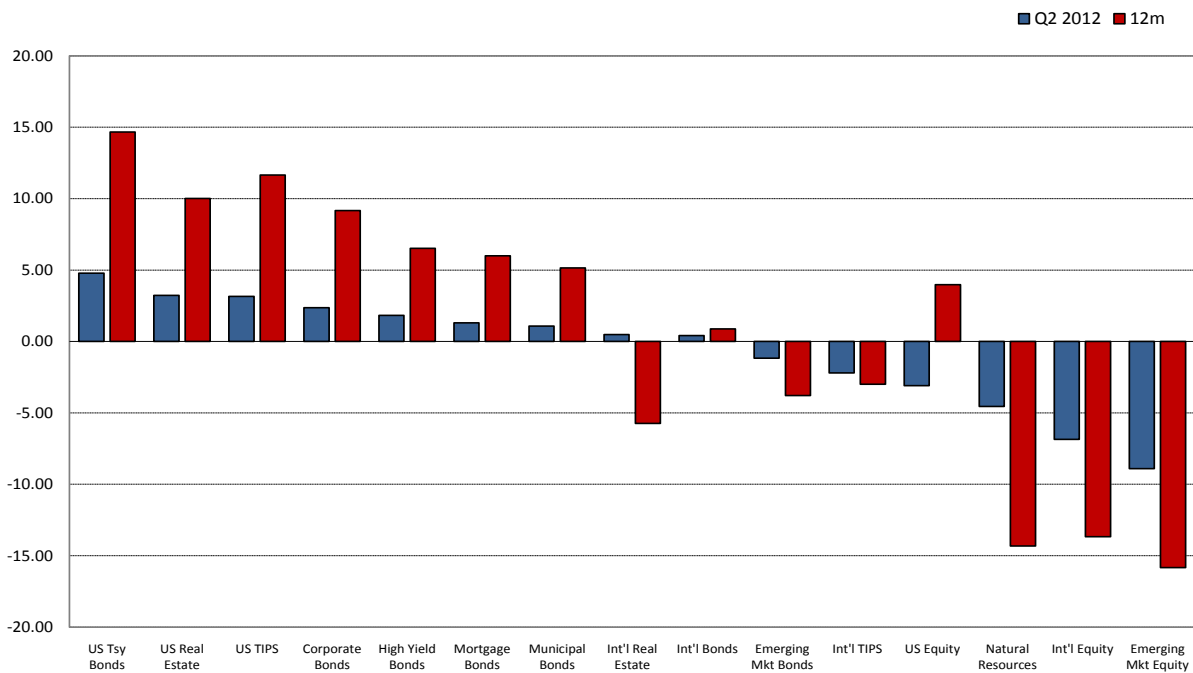
- **Global equity markets disappointed in Q2** due to sluggish global growth, disappointing economic data from the U.S., and a resurgence of European financial turmoil. As such, we again saw a flight to safety that boosted returns in the very safest segments of the fixed-income universe.
- This mid-year pullback is similar to what we experienced in 2010 and 2011, but so far **the pullback has been more muted**, perhaps because not all economic statistics have been negative. In the U.S., auto sales continued to rise, the housing market showed signs of life, and lower oil prices gave consumers more to spend. Importantly, central banks around the world took a more aggressive easing stance during the quarter.
- The current investment climate is prompting many to seek **new approaches to mitigate downside risk in their portfolios**. We devote this issue to discussing the topic of “tail risk” insurance – protection against sudden, severe, and unexpected portfolio declines, such as occurred in the fall 2008 and August 2011.
- In our view, **such tail risks are still with us**, including the possible break-up of the Eurozone, the pending “fiscal cliff” in the U.S., and various other unpredictable geopolitical risks (e.g., Iran).
- We believe that the **cost of insuring against those risks is sufficiently low to warrant inclusion in our client portfolios**, and we will be implementing a defensive strategy over the next month. Our selected strategy is described in detail in the pages that follow.
- We are also in the process of making several other changes to our investment strategy, including **closing out our already very underweight position in Europe**. While many believe that Europe is a “good buy,” we think the region is more likely destined to follow Japan’s path of slow-motion financial decay. We do not hold the same view for emerging markets but are not yet ready to increase our position in this asset class.



Markets in Review

Global equity markets disappointed in Q2: Debt and growth issues dominated the headlines and caused a muted version of the “risk off” trade to return to prominence (Figure 1). In Europe, Greece was again the main culprit, due to elevated debt levels, rising yields, social unrest, and two elections. Spain and Italy also saw their borrowing costs fluctuate, mostly moving higher overall, during the quarter.

Figure 1: Asset Class Performance in Q1 2012 (percentage points)



In the U.S. the first quarter ended with a surprisingly disappointing jobs report. This turned out to be a harbinger of further disappointments. For example, ISM Manufacturing PMI fell to 49.7, which signals contraction, and ended the quarter at its lowest level since 2009. Additionally, only 77,000 jobs were added during April and 69,000 in May.



The news from emerging markets was not much better. In China, we saw a continued overhang of excess supply in property markets and rising inventories across the manufacturing sector. Brazil, Russia, and other commodity-exporting countries also suffered due to the sharp pullback in commodity prices and slowing export demand.

As has now become typical in a “risk off” cycle, fixed-income markets benefited as investors sought safety. Fixed-income returns outside the U.S. were less favorable. Low international returns (in dollar terms) were partly attributable to U.S. dollar appreciation, but the European crisis was the overriding factor that hurt.

On a more positive note, the pullback in U.S. equities in Q2 was more muted than the sell-offs that occurred in 2010 and 2011, perhaps because not all the economic statistics were negative. Auto sales continued their healthy climb upward, and even housing showed small but meaningful signs of improvement. Moreover, declining commodity prices gave consumers more to spend. Internationally, central banks took a more aggressive easing stance during the quarter, although it appears more may be needed.

The investment climate remains highly uncertain as we enter the second half of 2012. Europe remains very volatile, and longer-term solvency issues are nowhere near to being resolved. While the situation is healthier in the U.S., the country faces the prospect of a “fiscal cliff” in 2013 if policymakers don’t act. Finally, while the emerging economies are generally in decent structural shape, recent events demonstrate that they are far from immune to slowing growth in developed markets.

Special Topic: Cutting-Edge Portfolio Risk Management

Ever since the financial crash of 2008, investors have been seeking new ways to mitigate downside risk in their portfolios. Investors were particularly discouraged by the failure of standard tools of risk management, such as diversification, during this period, and much has been written as to why such tools did not work. Since this time, we have seen a proliferation of new products and approaches to help protect portfolios from sudden, severe, and unexpected declines, such as occurred in 2008 and again in August of last year.

This is a topic Artemis Financial Advisors has been studying for some time now, and we are pleased to say that we will be implementing a new strategy to help protect our clients’ portfolios if such events unfold. In this section, we summarize the criteria we utilized to select the optimal strategy, explain how the strategy works, and describe how we will be implementing the strategy very soon.



The type of risk management we are referring to is often called “tail risk hedging.” It refers to the extreme occurrences that are found in the “tails” of the probability distribution. The tails are the events that represent very low likelihood of occurrence, but a very severe impact. In our view, such tail risks are still with us, including the possible breakup of the Eurozone, the pending “fiscal cliff” in the U.S., and a variety of other unpredictable geopolitical risks (e.g., Iran).

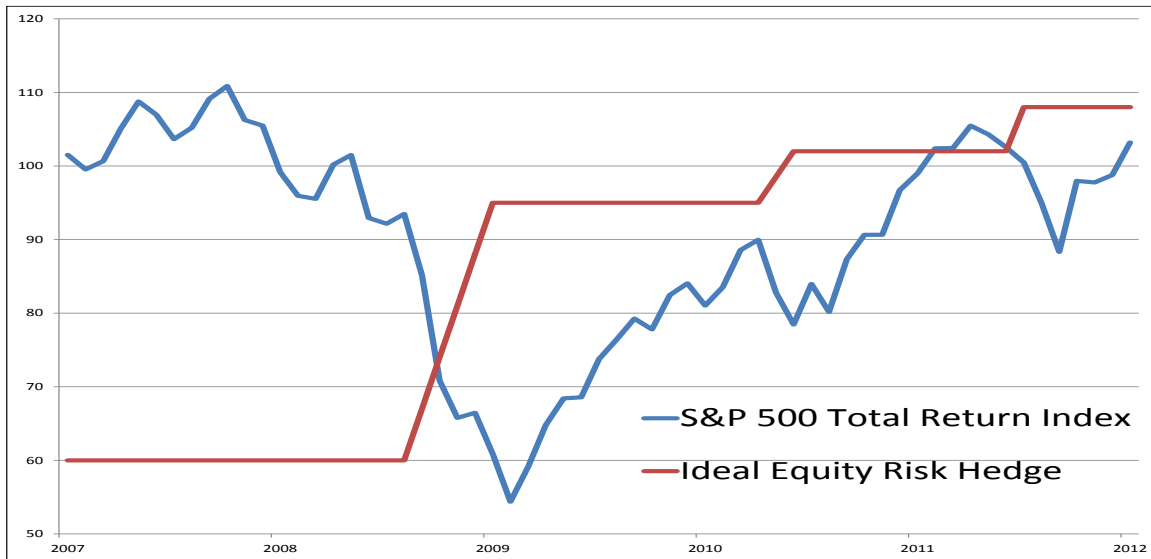
Our review of the literature revealed a wide variety of new “tail risk” products, each with its own characteristics and underlying market perspective. We began our search by defining the key criteria that an ideal tail risk hedge had to satisfy.¹ These are:

1. **Buy and hold** – Many of the available strategies are designed to be utilized for very short periods of time, and they work terrifically if you know exactly when to deploy them and when to stop. This is very difficult to do on a consistent basis, and so we wanted strategies that would act as long-term hedges instead.
2. **Effective** – We wanted a strategy that would work by appreciating substantially during market stress, thereby offsetting a meaningful proportion of the decline. Likewise, we wanted a strategy that wouldn’t give back all of its gains during the inevitable market recoveries. Figure 2 stylistically shows what such an ideal hedge might look like – flat during normal markets, then appreciating substantially when the market is in free fall, and maintaining the elevated level when the market has started to recover and thereafter.
3. **Operationally efficient and minimally disruptive to our client portfolios.** We did not want to upset the strategic and dynamic asset allocation strategies we deploy to mitigate risk in normal markets or during slow, protracted declines.

¹ We gratefully acknowledge adopting many of the criteria utilized by Brinton Eaton Wealth Management in its search.



Figure 2: The Ideal Tail Risk Hedge



Source: Bloomberg, Brinton Eaton Wealth Management

4. **Transparent** – We wanted our strategy to be reasonably simple to understand and rules-based (in contrast to strategies driven by manager discretion), consistent with our “no black box” investment philosophy
5. **Liquid** – While we are looking for a buy-and-hold product, we wanted a strategy that had daily liquidity and no early redemption penalty
6. **Low cost (both direct and indirect)** – Cost is always a factor.

These criteria led us to reject most traditional risk-hedging techniques, as well as many of the newer strategies. For example, the most common technique to protect portfolios during times of extreme stress is to “go to cash.” As many have learned the hard way, this is one of the most expensive ways to mitigate risk because it relies on the investor knowing both when to get out of the market and when to get back in. Unfortunately, investors who try to time the market this way typically incur huge opportunity costs (lost profits when the market rebounds). In addition, the strategy violates our desire for a long-term hedge.

A common strategy employed by more sophisticated investment managers entails the use of put options, but they surrender their appreciation dollar-for-dollar when markets eventually recover. They can also be quite expensive and operationally cumbersome to implement across many portfolios.



The mutual fund industry has been active in the tail risk hedging space through the development of so-called “black swan” funds. While we did not look under the hood of all of these funds, what we typically saw was expensive and hard to understand.

Even the insurance industry has entered the fray with ever more complex variable annuities that provide guaranteed minimum benefits under any market circumstance. Once again, the problems with these products are their high costs and the limits they place on appreciation when markets are more normal. Like many of the black swan liquid alternative funds (a.k.a. hedge funds in a mutual fund format), they are also often impossibly complex to understand.

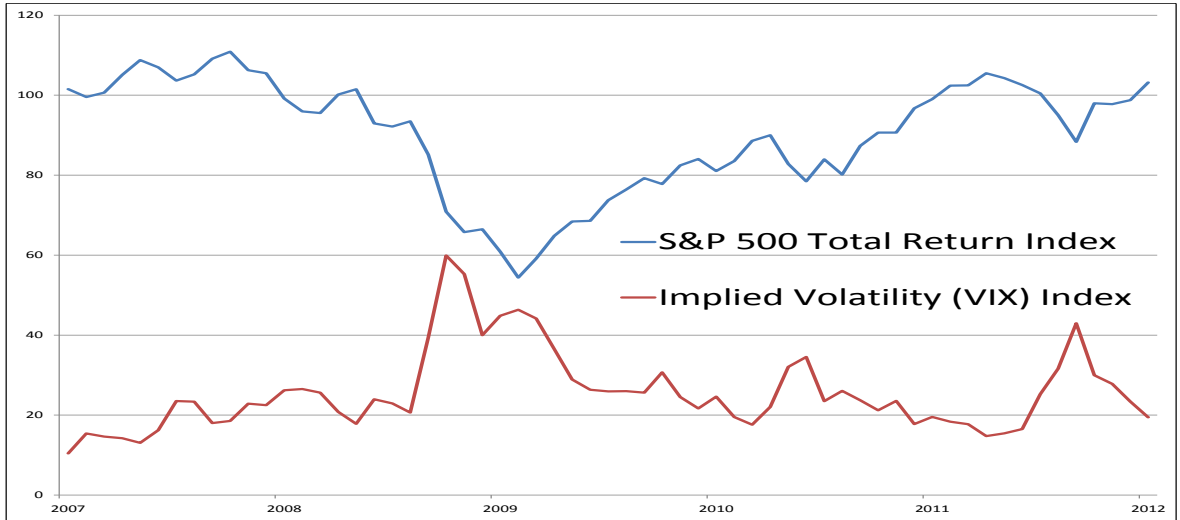
The most promising strategies we came across exploit volatility spikes in the market. In other words, they take advantage of the market’s volatility during sudden downturns to mitigate the impact of the decline. Designing a strategy that will consistently perform well when the market swoons requires an asset that reliably exhibits negative correlation to the market *precisely during times of market stress*. As it turns out, using the market’s own volatility fits this description very closely.

The most common measure of the market’s own volatility is the VIX Index, more commonly known as the “fear index.” This index is designed to measure the market’s expectations of volatility in large-company U.S. stocks over the next 30-day period. The VIX Index is calculated from the prices of a weighted blend of call and put options on the S&P 500 Index. The strong negative correlation between the VIX Index and the S&P Index is demonstrated in Figures 3 and 4 on the next page.

While the VIX Index is not an investable index, there exist two tradable products that track it: S&P VIX Short-Term Futures Index and the S&P VIX Mid-Term Futures Index. These products model the excess return of holding rolling long positions in VIX futures contracts of varying lengths of time before maturity. One might logically deduce then that an effective hedge might be as simple as “going long on volatility,” i.e., purchasing one of these index-based products when anticipating a strong market correction.

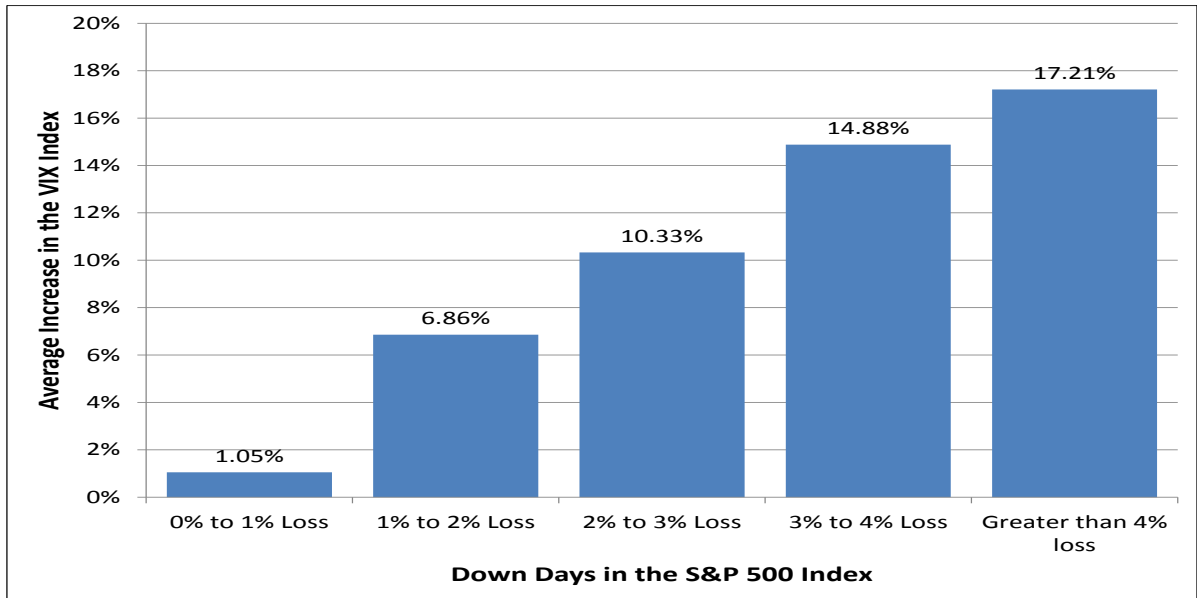


Figure 3: S&P 500 Total Return Index vs. Implied Volatility (VIX) Index



Source: Bloomberg

Figure 4: Non-investable VIX Index: Negative correlation during bear days

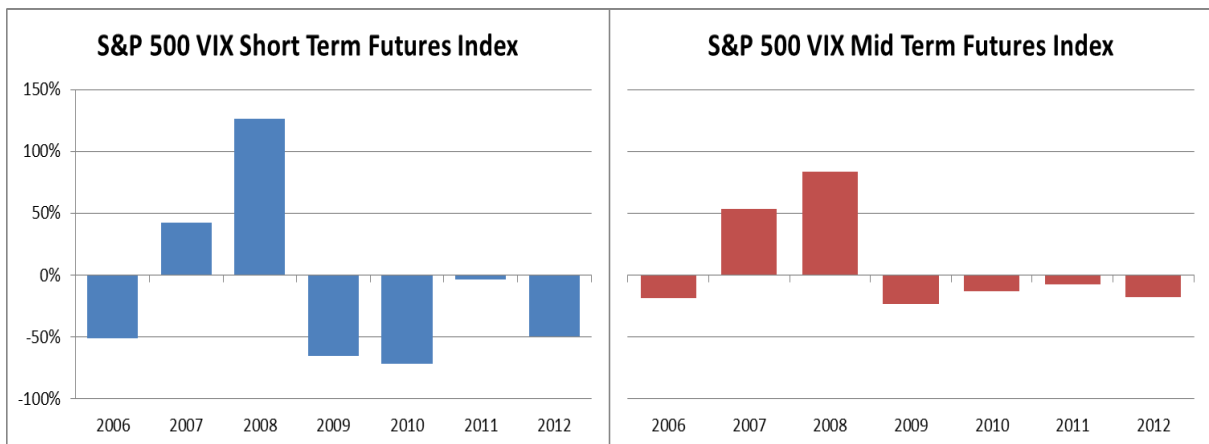


Source: Barclay's Capital Analysis, 1/1990-4/2010



The problem with this strategy is that the market for VIX futures contracts is more often in “contango,” which means that the prices of later-maturing futures contracts are often higher than the nearer-term expiring contracts. When this happens, the cost of the replacement contract will be more expensive than the expiring one, and so the investor incurs what is called “negative carry.” Long-term investors who buy and hold VIX futures contracts can, therefore, suffer very high costs of carry, especially when markets are calm and rising. Figure 5 shows the annual returns associated with the S&P VIX Short-Term Futures Index and the S&P VIX Mid-Term Futures Index. The large negative returns in both indexes in 2009 and 2010 reflect the high cost of carry in bull markets.

Figure 5: Annual Returns of S&P 500 VIX Short- and Medium-Term Futures Indexes



Source: Bloomberg, Standard & Poors. Data: 12/2005-6/2012

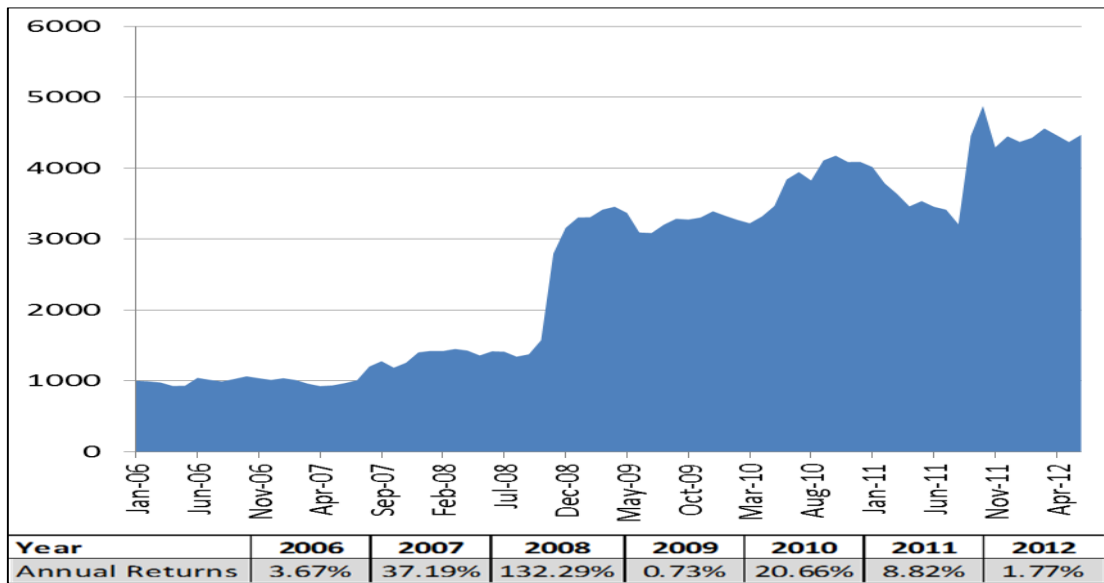
One of the most promising volatility-based strategies is a dynamic approach that seeks to mitigate the often high cost of investing directly in volatility in VIX futures markets. This strategy allocates daily between the S&P VIX Short-Term Futures Index and the S&P VIX Mid-Term Futures Index (sometimes being short the Short-term Index), based on how much the market is in contango. The strategy’s goal is to attack the high cost of carry while also reacting positively to overall increases in market volatility. It does so according to pre-set rules, not a manager’s hunch about the market.

The strategy appears to work nicely, as shown in Figure 6. The blended index (which the strategy tracks, less a fee) appreciated substantially during the fourth quarter of 2008 and again in the summer of 2011 (the U.S. debt ceiling crisis). Data at the bottom of Figure 6



shows that the strategy achieved a positive return in all years, well in excess of cash returns during recent years.²

Figure 6: S&P 500 Dynamic VIX Futures Index



Source: Barclay's Capital Analysis – 2012 data thru May only

Implementation

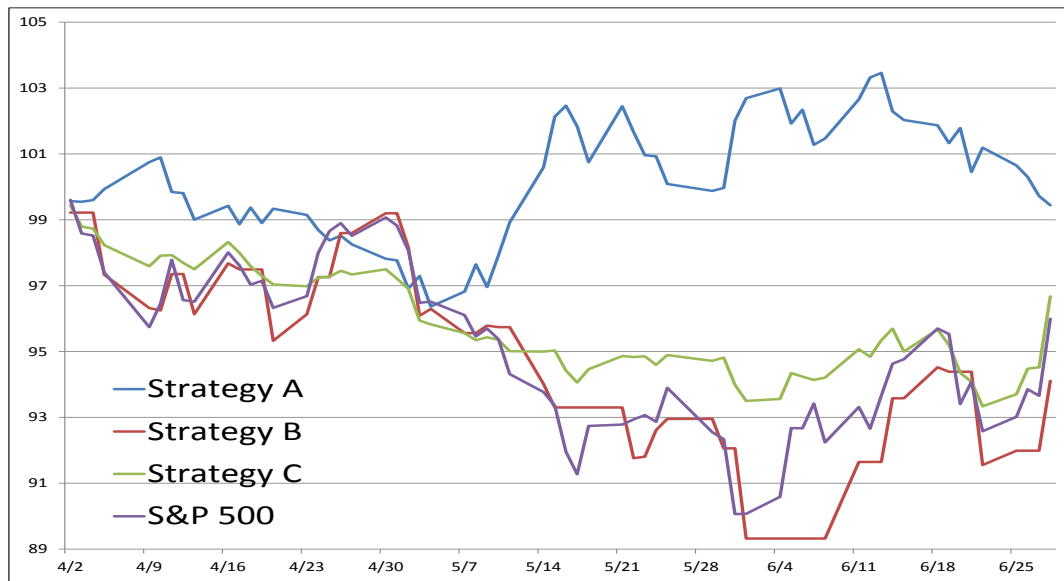
It is important to recognize that one is not purchasing any equity per-se with this strategy, so it is not an equity-replacement strategy. There are several other new strategies (which like our strategy are also exchange-traded products) that attempt to reduce volatility by either dynamically allocating between stocks and bonds, or between stocks and volatility, based on explicit market signals. We rejected these two approaches (although they and a few others remain on our watch list) because we did not want to upset the overall equity allocation and the small-company, and value-oriented equity tilts we already have in our client portfolios, which are the lynchpins of our long-term strategy. Moreover, a recent look at how the strategy we have selected (Strategy A) performed recently during the selloff in

² These are back-tested results, not actual results, because the strategy was not commercially available until the fall of 2011. However, because the strategy tracks this index (less a fee), and is 100% rules-based, the actual strategy would have performed as shown had it been available during the entire period shown.



May versus these others (Strategies B and C), suggests that ours is doing a better job (Figure 7).³

Figure 7: Comparative Performance of Several Tail Risk Strategies – Spring 2012



Source: Bloomberg

We view our selected strategy as a partial substitute for holding very safe investments whose primary purpose is to stabilize client portfolios in times of stress. Hence, the strategy will be funded either from current cash holdings or from one or more of the safer segments of fixed-income holdings in our clients' portfolios. The hedge will be sized in proportion to the amount of equity in a given portfolio. While we have not completed all testing, we anticipate that the allocation will be about 5% to 10% of total equity.

³ Many of our clients also hold an allocation to an equity index fund that tracks high dividend-paying large-company stocks. This index is less volatile than the S&P 500. For clients who have less need for current income, we may replace a part of this allocation with a mutual fund that holds a fixed allocation to the S&P 500 and a direct investment in volatility (via a swap agreement which does not require capital). This will reduce the amount of cash or high-quality fixed income we need to devote to the strategy directly.



Key Risks

This strategy, like all strategies, is not risk-free. A good example is the first half of 2011, when the underlying index lost value (see Figure 6 again) due to curve flattening. Another example when the strategy might not perform well is if there is a change in VIX (volatility) that occurs more quickly than the strategy can adjust its exposure, which only happens at the close of each trading date. A good example might have been the September 2001 terrorist attacks. Lastly, the strategy is currently only available with counter-party risk, so investors take on the credit risk of the sponsoring bank. Nevertheless, we believe the benefits of the strategy outweigh the risks, especially for the small amounts we will be purchasing.

Bottom Line

Our role at Artemis is to help our clients manage the risks associated with participating in the markets. We believe this new strategy will be an effective complement to diversification and to dynamic asset allocation, our other core risk mitigation techniques. We also believe it will help us to take risks when we believe such risks will be adequately compensated over time and, in so doing, enhance our clients' long-term returns.

Artemis Portfolio Strategy

While the above-described strategy is the biggest change we are making to our client portfolios, we anticipate making several others in the very near term. First, we are in the final stages of testing a promising new approach to investing in commodities, one which appears to have much better risk/return characteristics than our current strategy of investing in a broad basket of commodities. We hope to make our final product selection in the next few weeks and will be writing in detail about this strategy.

We have also decided to close out our already very underweight position in Europe and Asia (developed markets). While many believe that Europe is currently a "good buy" given its low trailing P/E multiple relative to U.S. equity, we no longer believe Europe is poised to turn the corner. We fear that the region may well be destined to follow the slow motion financial decay path experienced in Japan, whose stock market has yet to recover from its peak in 1990. We will be monitoring this decision closely and will re-enter Europe when we see sustained progress.



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We have still not fully eliminated our modestly underweight position in emerging market equities, as we remain concerned about slowing growth in some of the largest emerging market economies, especially China. Indeed, China continues to display broad-based weakness across exports, industrial production, real estate, and autos. Authorities have eased some monetary policy measures, but lending and money supply growth remain tepid, underscoring continued risks to the outlook. For us, the key signal to start to overweight emerging stocks is when Chinese shares begin to take off. We remain confident, however, in the longer-term emerging market growth story.

On the fixed-income front, we favor U.S. high-yield bonds, and, increasingly, U.S. and real estate income, and we have recently modestly increased our clients' exposure in these areas.