The Starboard Side Report

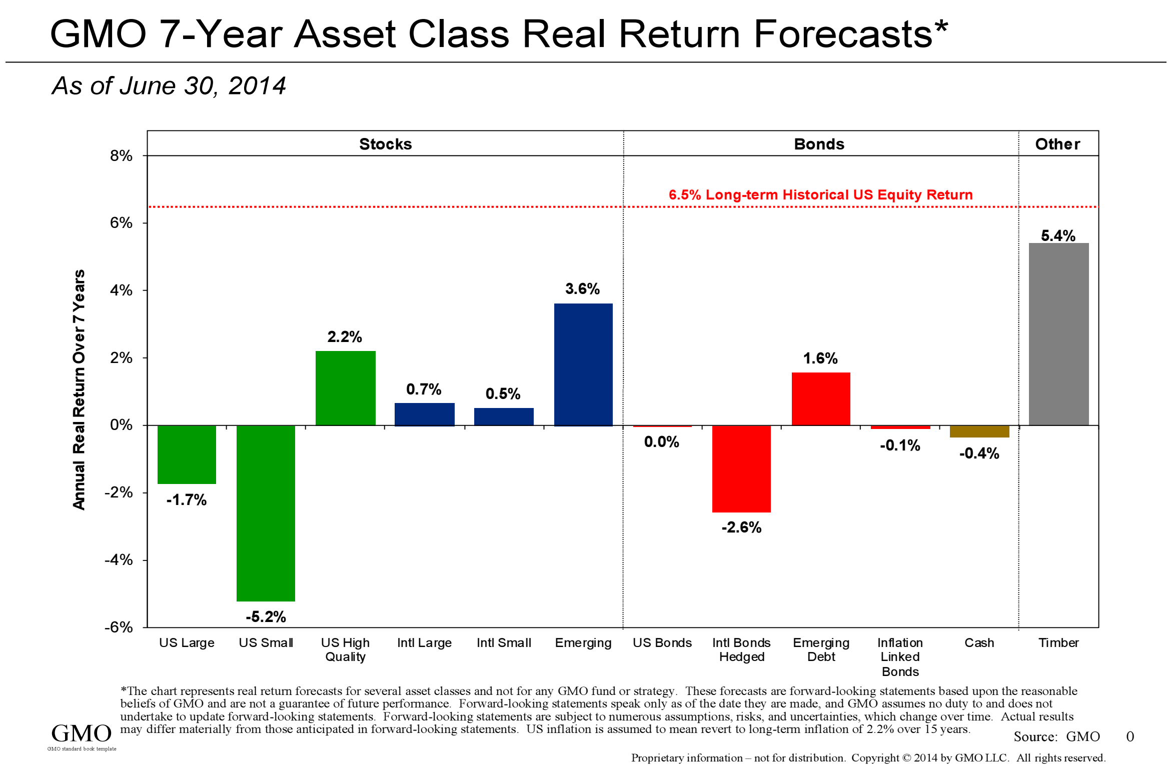
The week ending August 22, 2014

Chart of the Week

The Short Russell 2000 ETF (RWM) chart above is the primary security that we have used for hedging the market. It has an inverse relationship to the Russell 2000 Small Cap index; *think small cap stocks down, this Short ETF up.* Performance wise, we have been struggling with this holding for some time now. However, this chart depiction appears to be on the threshold of a change to the upside. When it makes the change, it usually does so with a great deal of volatility. I have often talked about the 50 day moving average vs. the 200 day. For instance, last week we saw how gold recently started to trade 50 above the 200, and as long as it maintains this direction, gold will rise. The same can be viewed on the chart above in an opposite direction regarding the relationship of 50 below 200 creating continued downside for RWM. That appears to be changing based on how the prices of the averages are squeezing together, which indicates a breakthrough of the 50 above the 200. The 50 day is at 16.48 with the 200 at 16.91; not far apart. Another reason to believe that the upward movement will occur in this holding is illustrated above on the p-volume trading above the average (green over black lines). This is an indication that institutional investors have been strong buyers of RWM since January. When positive volume occurs with sideways price movement, it is what is known as a divergence (demand that has not yet shown up in the price movement).

Viewing charts to make an analysis of a security or markets is known as technical analysis and using economic data to arrive at an opinion is known as fundamental analysis. For the past two years, the chart above has disagreed with the fundamental analysis performed by GMO, as seen in the graph below. Their research, which we strongly agree with, has suggested that US small cap stocks will create a negative annualized return of minus 5.2% for the next 7 years. Two years ago, GMO's number was in the minus 2% area and we used that same opinion to buy a US small cap hedge to protect against market risk. Short term, we should have paid more attention to the chart. However, if the fundamentals are correct, that will balance out over time once the small cap decline starts. In order to have a minus 5.2% decline annually for the next seven years, at some point small cap stocks are going to have to crash because of their lofty levels. We expect that this RWM position would then add account value to your holdings for several years to come, making the past two years worth the pain. A mentor of mine gave me advice many years ago. He said market analysis is like playing a piano; you to have both hands on it to make good music. His metaphor related to technical and fundamental analysis; you must use both or your decision process will be out of tune. It's not time to rock and roll yet, but the lyrics and the beat are sure coming together.

Please note below the second green column.



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