September 1, 2012

*Exceptional Bear’s* unique contribution to the Wave Principle -

*The ability to predict Catastrophic Events*

Asset Class Investing – *the right way & the wrong way*

Hedge Funds are an implosion of wealth-destruction waiting to happen. Even as Hedge Fund investment returns have fallen below those of the broader indices, since 2010 they have garnered $150bn in new funds from investors. *What’s the draw, you ask?* Well in 2008, when most investors lost tons of money, at least the 38% the market plunged that year, Hedge funds on average managed to lose only 19%. What investors are looking for now is long-term survival, mainly through the lower volatility promised by hedge funds.

Risk Neutral a 50% losing investment

The prevailing “risk neutral” strategy, which balances equal amounts of long and short positions, remains a 50% loser in all but Markets which remain in a narrow “trading range”. In a big rally, just as in a plunge, 50% “wrong way” investments drag down overall returns.

Volatility is a product of the *Bear Market*

Volatility is solely the product of the *Market’s relative position* in the *Boom-Bust Cycle*, and therefore not something any hedge fund can control, and even fewer forecast. So the notion of diversifying away volatility is entirely foolish and precisely the wrong approach. By promising fewer losses, coupled with nominal returns, “come hell or high water”, Hedge Funds are forfeiting what little edge they might have had, to placate antsy investors. Nevertheless, in the short-run, this appeasing of investors, heads off a rush of assets walking out the door, and a drastic reduction in income from client fees.
When a hedge fund, which has been in business for 30 years, lays claim to the ultimate “capital preservation”, it is a prime example of false security, based on the notion of managed risk. In fact, the risk of Mandelbrot’s “Noah event” is incalculable, and highly underestimated under the current paradigm. The recent losses at JP Morgan’s London commodities subsidiary is but a tremor, which normally precedes and warns of major earthquake; a minor fractal of just such a “Noah event” of cataclysmic proportions. Nevertheless as the Market is going on its 12th year of lean or sub-par returns, investors continue to expect no more than the Biblical “Joseph event” of “seven lean years”. That analogy has long ceased to make any sense, and hints precisely of the degree of trend up-shift which Exceptional Bear identified last year. Obviously the 30-year data-sample cited above is far too small, to take into account an event which occurs once every 70+ years in an invariably recurring cycle, since the dawn of mankind, once the last generation’s experience is not longer assumed to have any value “this time”. Although there have been near catastrophes since, these were all on a lower Cycle degree of trend, the last Supercycle Bear Market culminated in the 1929-1932 Crash. This time is no different, a Crash of unfathomable dimensions, will culminate this Bear Market as well.

The Predictability of Noah Events – our contribution to the Wave Principle

Our unique contribution to the Wave Principle is the identification of precise market patterns which precede the cataclysmic events of which Mandelbrot warned. These can now be forecast to recur with amazing accuracy. Mandelbrot’s “Noah’s event” is always preceded by a “gearing up” two degrees in Magnitude, which I have labeled the Supercycle Transition, for the current highest degree, at which its effects are most devastating. In the paper Elliott Wave: the Missing Piece, available to all subscribers, I pinpoint the occurrence of these gearings, shortly before a dramatic shift of two degrees in trend, both Bullish and Bearish. In every instance, these gearings reverse the wave count back to Primary degree upon completion, which serves as the basic building block of Supercycle Degree.

One crucial aspect, which has escaped every single Elliott practitioner since Ralph Nelson himself, is the application of the inverse guideline or pattern grouping, as required by Mandelbrot’s law of fractals. While no one complains of the tremendous prosperity erupting from the Great Bull Market of 1984 - 2000, it too was preceded and followed by a Supercycle Transition.
Perhaps the primary reason why a Market Tsunami is never expected, is that such a gargantuan leap in magnitude is made, through two consecutive gearings in the degree of trend, which serve to compound the devastation, every bit as much as the incredible wealth creation of the corresponding Bull Market of the same degree, in a much abbreviated time span.

In the big picture, Bear Markets complete their devastation in about 20% of the time required to create that wealth. Within the entire Supercycle Wave (III) from 1932 to 2000, only the final segment between 1984 and 1997 inclusive actually operated at Supercycle degree …this was where dramatic elongation and gearing reached its zenith. Similarly, although the Big Bear began officially in 2000, only the culminating tip of its C Wave will be of comparable degree. Diag IIs always serve as an introduction, which presages the long Bearish tumble, and therefore they are the prelude to wave 1.

To further illustrate, each 3rd corrective, or “c” wave is often one degree of trend higher than wave a and explains why the price territory traveled so often equals 1.618% of wave a. When two degrees of trend are simultaneously leap-frogged in the Supercycle Transition, the elongation of the C wave often extends 2.618 to 3.618 times the length of wave a.

In the inverse “bullish fractal”, the same relationship between waves a and c plays out as a microcosm of the larger Bear Market, and thus provides a preview for those who can see. This means that once this b plunge simulates a “crash” to the naïve, the real Crash will only occur after Market Euphoria has dulled our senses and better judgment even worse than March 2000. Only then when its least expected the “Real Mother of all Crashes” still 3-5 years away, will finally cause the ultimate devastation, just as 1930 was perceived as the recovery from the 1929 Crash, only to be followed by two years of incessant plunging, at a slower pace.

Why are hedge funds so lost, regardless of niche? Because these managers fail to see the big picture. When the Market plunges, well over 90% of all stocks plummet. Trying to identify the few that will remain afloat is a losing game.

The 80/20 Rule of Investing

The application of the Pareto Principle, otherwise known as the 80/20 Rule to investments, won Sharp and Markowitz the Nobel Prize. They simply re-applied a familiar concept to a new field. Regardless of endeavor or field, 80% of results derive from just 20% of inputs, while the remaining 20% of “returns” are sourced in 80% of the effort expended. More often than not,
these ratios occur in an even more severe 90/10 distribution, regardless of the details. The obvious deduction is to focus on that 20% and by extension, the top 20% of the 20%, and eliminate the rest.

It's not the longs that “made” hedge fund performance in 2008, but the shorts, from our perspective, these are synonymous to “inverse funds”. “Value investing” will simply not work in a “Correction” of this magnitude. “Value investing” like “buy & hold“, is uniquely a “Bull Market strategy”. Unfortunately the tide has turned - we are NOW in a long-term Bear Market. To put this in perspective, John Paulson, who is credited with making more money than anyone in the industry by betting “short” against sub-prime mortgages in 2007, then turned around and lost more than anyone else with his bet on a US Recovery….remember the “green shoots”? Bet on a recovery anytime soon, and you too will likely have your head handed to you.

Optimal Bear Market Investing

The best possible strategy then is one with a perspective of the larger investment cycle – the Big Picture, which invests consistent with the larger trend. Unfortunately only an expert Elliott analyst can fit the bill. As Robert Prechter is quoted “less than one in a million practitioners can interpret Elliott well”, ironically he’s not one of them. Just as most analysts have mistakenly diced and compartmentalized this Bear Market into multiple bull/bear cycles, which are mere fractals of the larger whole.

The Big Picture

This is the Big Picture weekly S&P. As you see, the two fractal structures began with a highly bullish Diag II, in the a wave, to indicate the beginning of a long correction, which is subsequently played out in the c wave. Sandwiched in between this repeating fractal, a gearing-up, interpreted as “noise”, has occurred, so that the second instance will unexpectedly dwarf the first.

This is a major reversal in process, culminating in a plunge to at least the area of S&P 950, and could potentially match the 2009 low, near 675. As in the previous instance, the plunge is wave b of an a-b-c “upside correction”, where b is a counter-trend “head fake”. The entire a-b-c comprises wave 4 of the final Diag II in a series of three. Although the pattern is essentially the same as in 2007-2010, the big difference is Degree of Trend, which will manifest as a Spike
in both volatility and trajectory. You will note the second instance is labeled as A-B-C to reflect the higher degree of trend.

Below you see a close-up of the B wave in its infancy. A Diag > indicates a terminal move, so the smaller structures pointing up, are once again fractals of the larger, more ominous Diag > pointing down.
Below, even with this alternate count, as an extremely large (a)-(b) downside transition beginning in April, the pattern indicates a severe downward wave B plunge.
Major Reversal confirmed by Failure

A failure or a “truncated 5th wave” means the 5th wave has failed to exceed the price of the 3rd wave in the same series. What’s more, it signifies an ending by exhaustion, to compound both the effect of the Diag > seen above, and the violence of the reversal ahead. As you see below in the 15-min chart, after the failure the wave pattern decidedly plunged in “5” waves, and was followed by a Diag > in wave (ii), where it indicates the end of the upside correction. Next a “gap down” wave (iii) should make this reversal very plain on Tuesday, after the Labor Day Holiday.

As you see below rather than the exception, inverse fractals of a lower degree often occur immediately after the larger structure, or even as an integral part of it.
Timer Digest S&P

SPXU Inverse S&P 500; UPRO long S&P 500

**full pos SPXU** average cost 47.5; **Sell**

1/2 SPXU limit 52

Timer Digest Bonds

**TMF 20-yr. long Bond;** TMV 20-yr inverse bond

**CASH** sold TMF at 79.62 (average cost 75.55 for 5.4% gain)

**Buy ½ pos TMV limit 47.5**
Pension

**CASH** sold TMF average price 79.66 (cost 74.69 for 6.65% gain)

*Buy 1/3 pos TMV limit 47.5*

Traders

**CASH** sold TMF at 79.62 (average cost 75.55 for 5.4% gain)

*Buy 1/2pos TMV limit 47.5*

continued
35% DRV Inverse Real Estate; DRN Real Estate “One Fund” Strategy

**Pension**

1/3 pos DRV average cost 25.29

Buy 1/3 pos DRV limit 22

**Traders**

½ pos DRV average cost 25.29

Buy ½ pos DRV limit 22
35% EDZ Inverse Emerging Markets; EDC Emerging Markets

Pension

1/3 pos EDZ cost 13.89; Sold 1/3 EDZ at 13.38

Sell 1/3 EDZ limit 14.30; CXL 16.20

Buy 1/3 EDZ limit 13.15

Traders

1/2 pos EDZ cost 13.89; Sold 1/2 EDZ at 13.38

Sell 1/2 EDZ limit 14.30; CXL 16.20

Buy 1/2 EDZ limit 13.15
30% FAZ Inverse Financials; FAS Financials

**Pension**

2/3 pos FAZ cost 25.61

Sell 1/3 FAZ limit 25.75; CXL 26.5

**Trader**

Full pos FAZ cost 25.77

Sell ½ FAZ limit 25.75; CXL 26.5
Alternate position long (VIX) TVIX, inverse (VIX), XIV

Full pos TVIX average cost 5.135;

Sell 1/2 TVIX limit 7.25

Below you see gold just beginning to climb concurrent with the drop in stocks. A high near 1900 is highly likely and could be exceeded.
To view the long-term public charts, where you can view the full long-term charts shown magnified above, click: [http://stockcharts.com/public/1317031/tenpp](http://stockcharts.com/public/1317031/tenpp) if you are a subscriber to stockcharts, I would appreciate your vote, voting now is or subscribers to stockcharts only, and found at the top of the first page, at the right comer.

Best regards,

Eduardo Mirahyes

*Exceptional Bear*

"Opportunistically timed investments that maximize wealth"