Sentiment Update—Behavioral Clues?

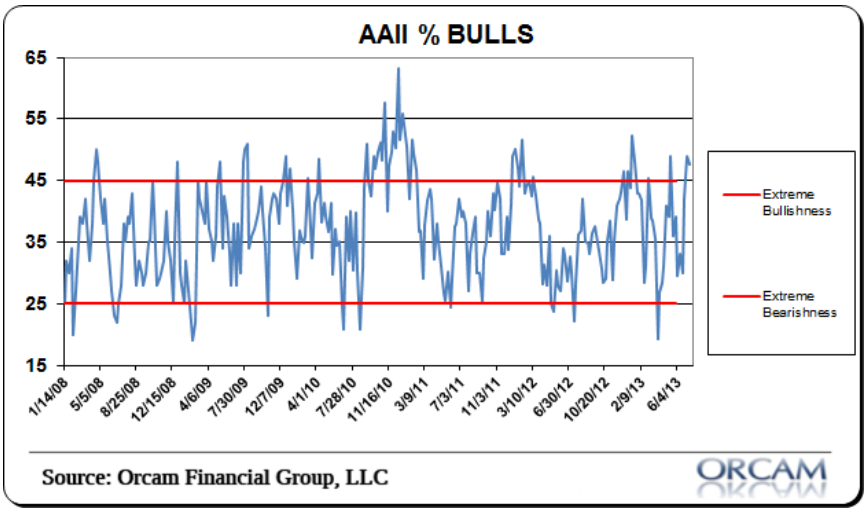
Cullen O. Roche
Founder
Orcam Financial Group, LLC
cullenroche@orcamgroup.com

It might seem like the world makes no sense these days. Governments are printing money like crazy (or at least everyone thinks so) yet interest rates are low. Corporate profits are slowing yet the stock market can't go down. The Fed says it's likely to "taper" and the stock market barely budges. Investors are being whiplashed around like they don't have a clue what's going on. And maybe they don't. But that doesn't mean we can't glance into the current sentiment of the markets to see where we're at.

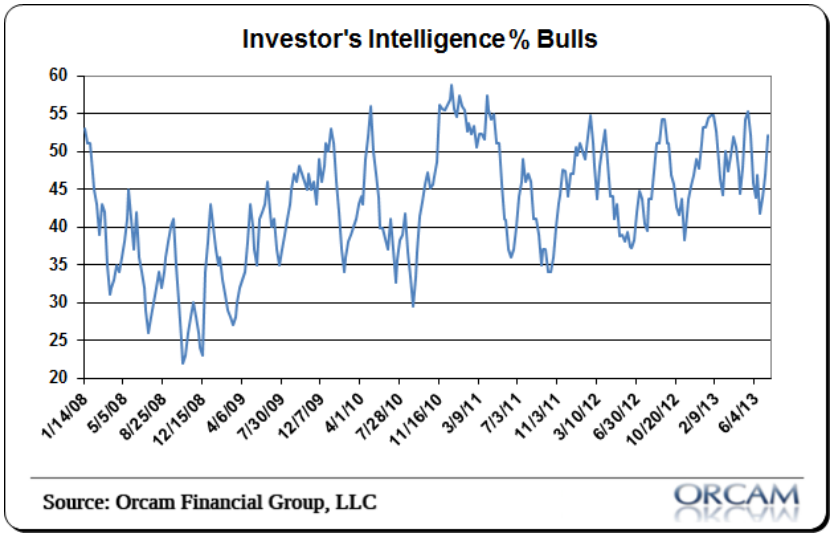
Long story short— Stay bullish, but don't get overly aggressive….

Sentiment Indicator Update

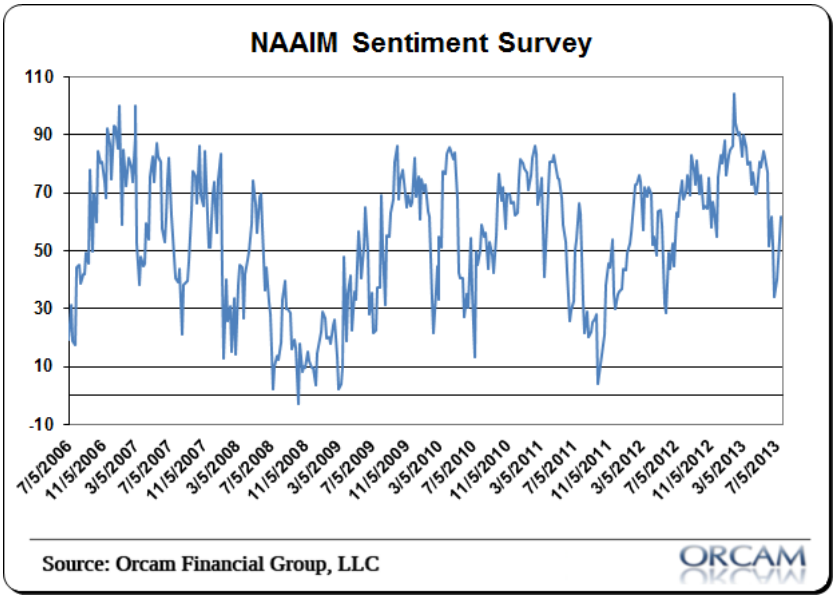
Retail investors are a notoriously contrarian sign. And if the current AAII sentiment reading is saying anything it's telling us that retail investors are overly bullish. The latest reading of 48 puts us in an unusual territory that tends to make for vulnerable sentiment.



The institutional money is telling a more mixed story. The Investor's Intelligence Survey showed 52.1% bullishness as of last week. That's only a modestly high reading in the last few years and nothing to be terribly alarmed about.



The NAAIM survey is showing a similar trend. We're well off the lows seen in early July following the S&P's brief dip, but also not at any level that's terribly worrisome.



The more interesting chart, to me, is the Volatility Index or the "Fear Index". It's not easy to gauge market sentiment using the VIX, but there are times when it reaches extreme levels where it becomes a rather useful metric.

First, I'd note that the VIX, at 12.66, is still historically high. The index trouched on a secular basis at levels close to 10 during the early 90's and the 2003-07 bull markets. So I think the VIX is telling us two stories here. First, there's a lot of euphoria that could still be priced into the secular story. I think that meshes with my general overall bullish view of equities here. But the recent readings are down almost 50% from the June highs and a sign that complacency has swept back into the market in a rapid pace.

I think the approach at present remains a cautiously bullish approach. I think it's absolutely fascinating to see how a very simple 60/20/20 portfolio has done this. That is, if you'd implemented a 60% equity position, 20% Lehman Bond Aggregate with a 20% cash position (T-bills) you'd be up 11.8% YTD with a standard deviation of 5 and a Sharpe Ratio of 2.11. And that's with a 20% cash hedge on your portfolio through the entire year during a time when the Lehman Aggregate has vastly underperformed. That's a hell of a good result on a risk adjusted basis. And it assumes you ignored any "risk on" reading from the QD metric this year.

Long story short—stay predominantly bullish, but don't go getting all crazy. A cautiously bullish approach has worked extremely well this year.

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