

**June 2009**  
**Ryan Krueger**

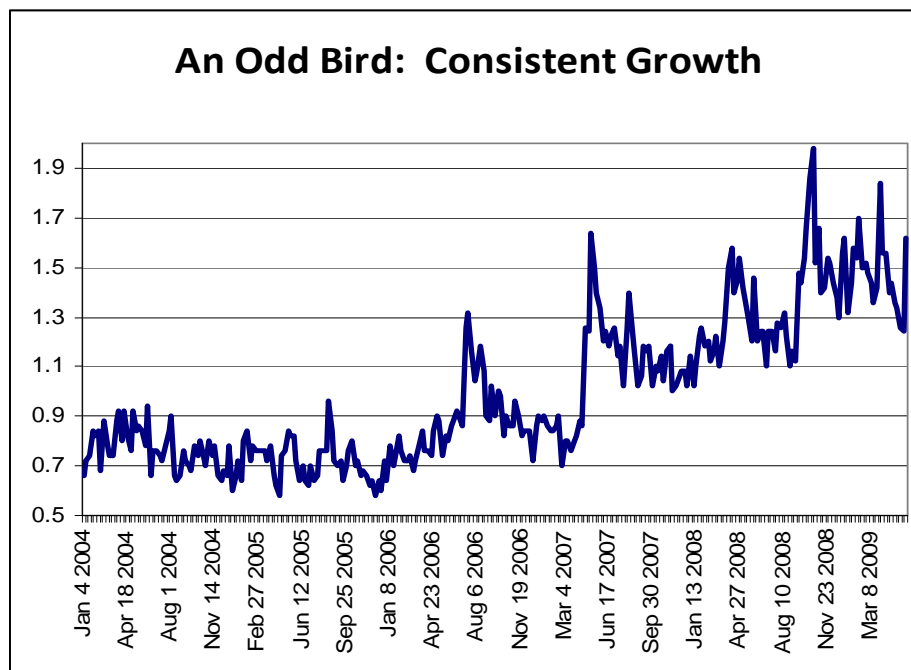
**Inliers**

I listened to really smart bond guys that love stocks in here. I heard from some of the sharpest stock guys that love cash in here. I was told anecdotally about some of the most conservative investors who are all of the sudden looking to get into anything at all in here. And that was just yesterday.

Bears have pressed short interest higher right in the middle of a 12-week (and counting) streak of net fund inflows from the Bulls. The battle lines are drawn. Yet the most anxious of all appear to be the record crowds in cash, worried that's being turned into trash. So where do we go from here? Even bloggers, a group not short of opinions, have suddenly lost their keyboards with that answer. Birinyi & Associates keeps track of the top investment blogs' sentiment. The "neutral" among them have hovered around 20% for most of the 12 months. In the last two months, confusion rallied "neutral" all the way up to 55%.

Perhaps the most fascinating, of all the different opinions and data points recently is the one I found where many bulls and bears are correlated for the first time that I have ever seen. More on that in just a moment...

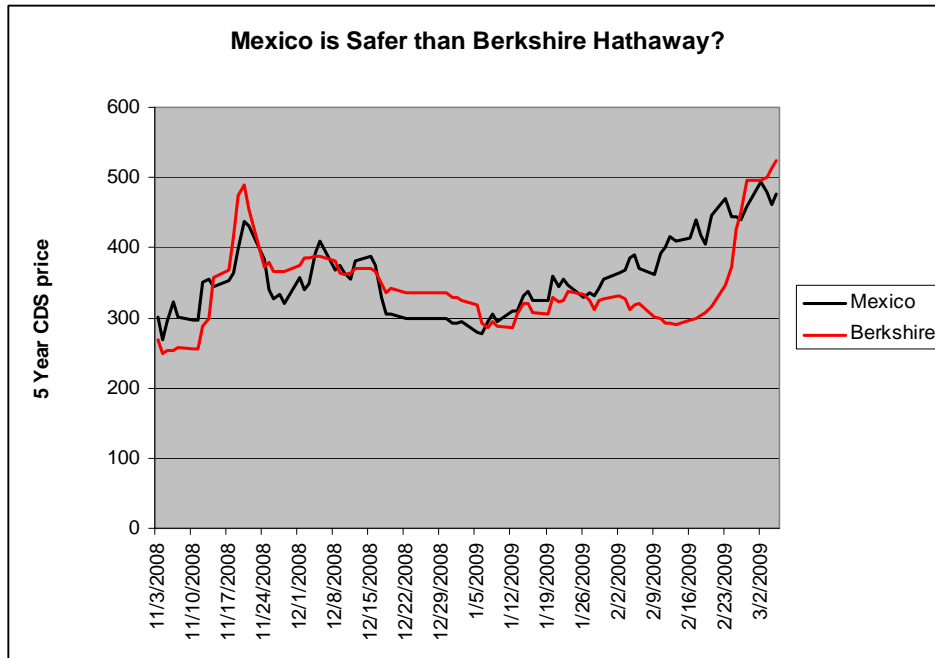
But first, I think most investors are looking for something – ANYTHING – that is consistent in a world without solid five-year growth like pictured in the chart below.



What is it? A group of completely transparent managers accountable for their own results while delivering a product with world-class accuracy that takes only seconds to manufacture. Too unusual to possibly be true? Well, they used to be. You are looking at a chart I made of the number of Google searches for "Black Swan."

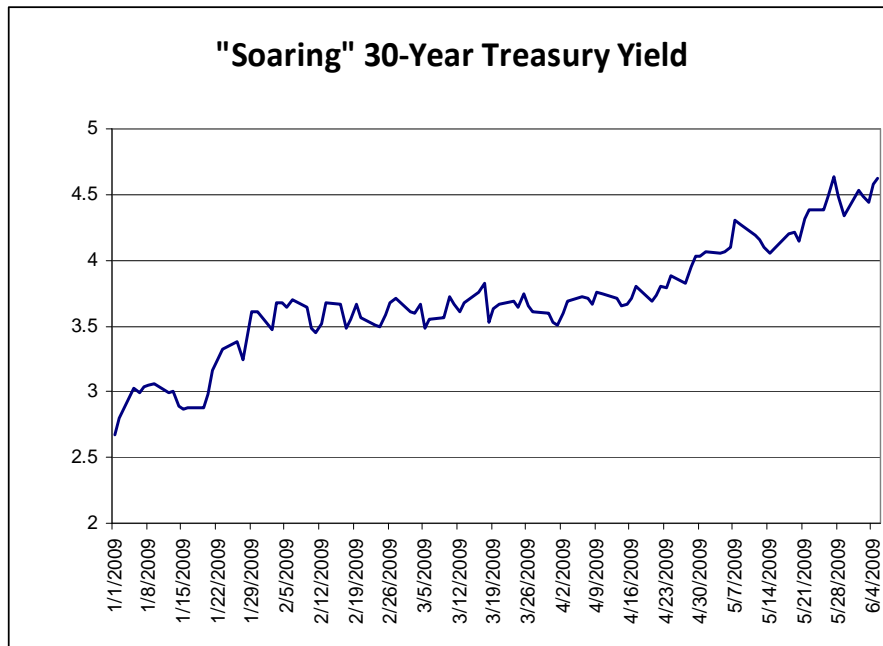
For several centuries it was common knowledge that all swans were white. Then a black one was found in Australia and more recently the term has become a brokerage-household name wondering what other unknowns lurk. Is it possible a different risk is now present if Black Swans have become over-exposed? There are now about 13 million Google matches for Black Swan and around 1 million for White Swan (remember the ones we previously only knew to search for). Has the overwhelming favorite of what you will actually see next been priced with steep underdog odds in stocks like swans?

If there was one chart to mark this time that stands out most from our book of hundreds we draw each month (or else we'd never believe most of this stuff actually happened), it would be this one I shared with our partners in March 2009.

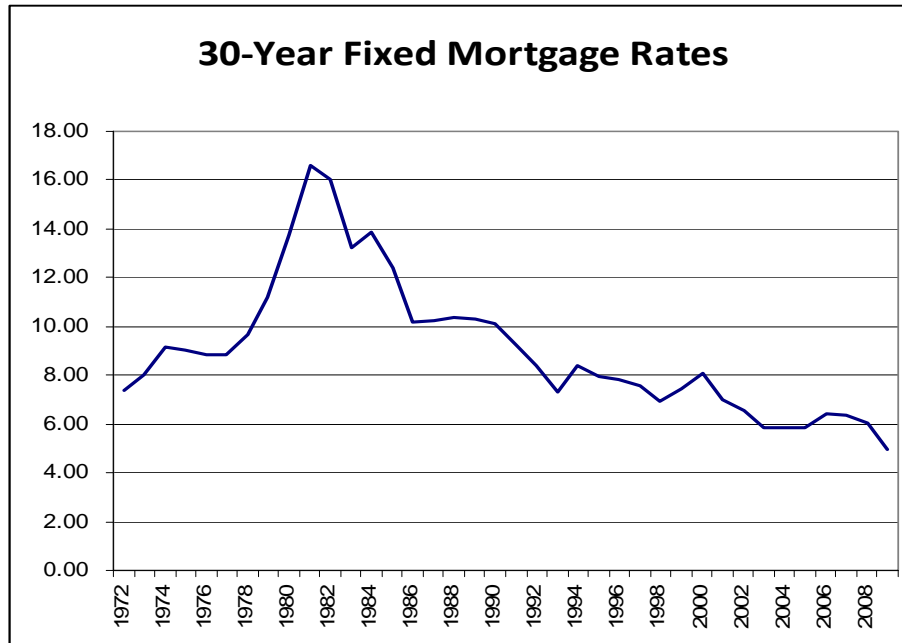


You are looking at the prices on two different Credit Default Swaps – pricing the odds at Wall Street betting parlors on whose debt was most likely to default: Mexico or Berkshire Hathaway. I am not sure how many Black Swans are in Omaha, but as you can see here, odds and risk were so out of whack recently that Berkshire was laying the points to Mexico in a contest of who was most likely to go belly-up.

So what's the trade? I will share one of Curbstone's answers to that question, but first some much needed context for a market that feels divorced from anybody with a lens wider than a day or week. Every movement is now described as soaring, flying, plunging or collapsing isn't it? The most recent breathless launch of Treasury Yields offer many reported examples.

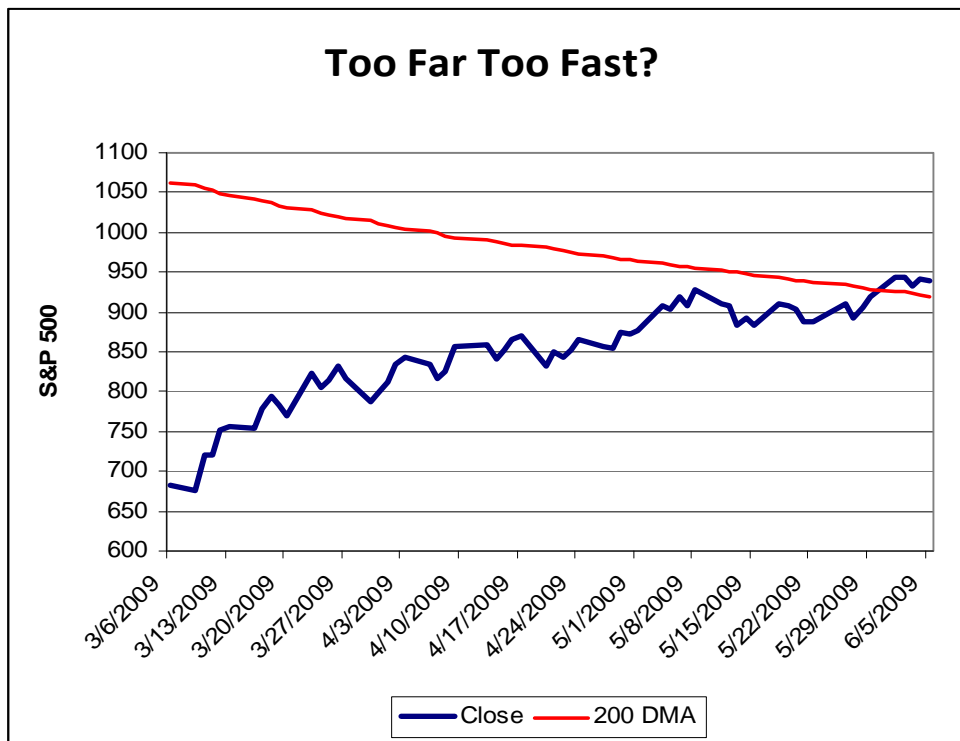


Above is the 2009 move on the 30-Year Treasury yield. Making the leap from this uncharted flight (I'm getting the hang of this Swan hyperbole), are a lot of fears that this is another reason for stocks to revisit lows because it's the last thing a fragile consumer can handle. I know more consumers who will need a fixed mortgage this year than will trade Long Bond futures, so what matters more – that chart above or this one below? That “soaring” looks a lot differently in the context of the past four decades.



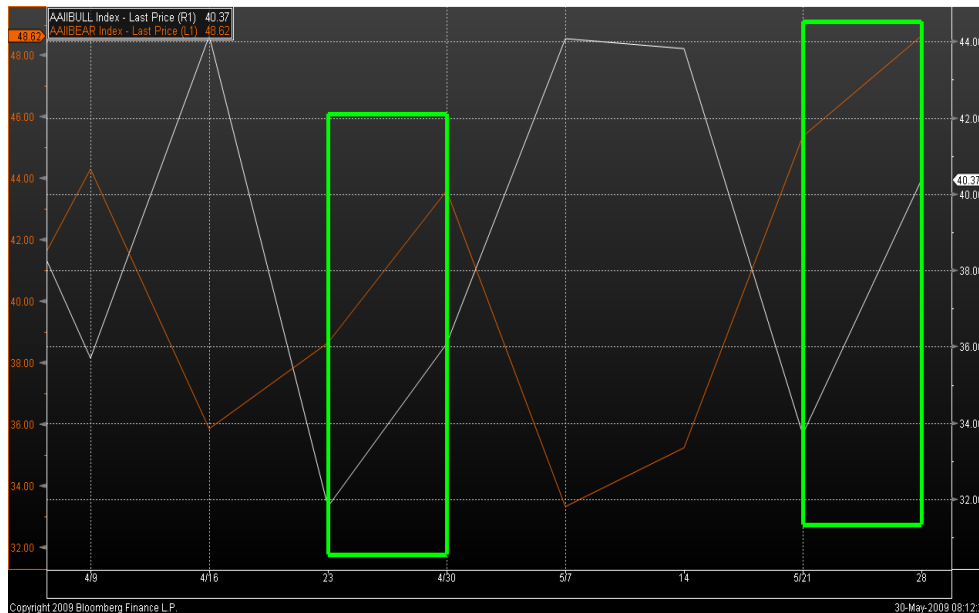
Widen the lens even more and you will find this grounded fact. Using the benchmark 10-Year Note (remember they stopped selling the 30-Year for a while, since everybody is a trader now) you will find that since 1962 yields have been higher than they are now only about 99% of the time.

So is something else going on here, to explain why small ticks in short times somehow get described as parabolic moves? If you dismiss that flimsy question (perhaps correctly), I wonder if a major clue has not been discarded, that might help solve the following most profitable stock market riddle of all time. What can it do that will surprise the most number of people? The always un-crowded possibility follows in a moment. It may or may not be the right answer but I think the odds are priced very nicely. With blinds filled by Swan Hunters, I can think of only one move that would surprise them. There is one bird's wings that are more difficult to see – a hummingbird – which (hint) also happens to be the only bird capable of flying forward and backward.



The question on Bull's and Bear's minds is whether we have come too far to fast. Again let's climb onto an uncrowded perch to use a wider lens. The S&P 500 broke more than this well reported 200-day Moving Average last week. It also broke all other records in history, with the exception of only one, for how long we spent underneath that 200-day moving average: 523 days.

So how are both camps playing it? Here's that fascinating agreement I promised.

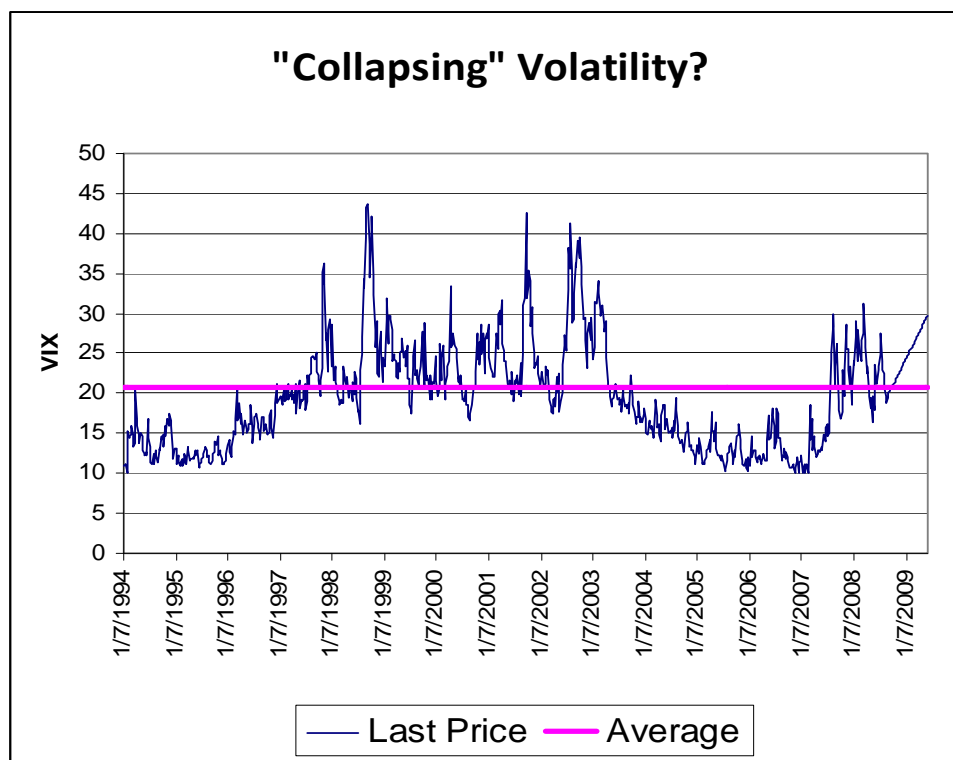


I overlaid the AAI Bullish and Bearish Sentiment readings. Naturally, throughout time one is falling when the other is rising. Many seasoned investors like to draw conclusions around which side of the boat is getting too crowded and then sell that consensus. I drew these green lines instead showing something remarkable – Bullish and Bearish sentiment

have been rising together. Each group now conditioned to look for outlying Swans to the upside and downside. “Outliers” by Malcolm Gladwell did not spend 28 weeks atop the New York Times bestseller list by accident.

One of the strategies Curbstone has been employing could then best be described as “Inliers.” If bulls and bears are both pressing their bets, we would like to deal cards to each group, especially when they become more convinced. We have been sellers of Volatility, and continue to be. As an example, we might take half a position in a stock and sell a put below the market for the other half. We choose to use zero leverage so we hold cash against the put sold. At the same time we sell a call above the market against the shares we originally purchased. Again using no leverage, our call is also covered. We are happy to acquire our full position if we are put the shares lower. We are happy to be called away higher. But instead of thinking directionally as all of the confusing data above has led investors in a variety of ways to do, we are preparing for a third possibility that seems the most un-crowded of all: What if not much happens for a change?

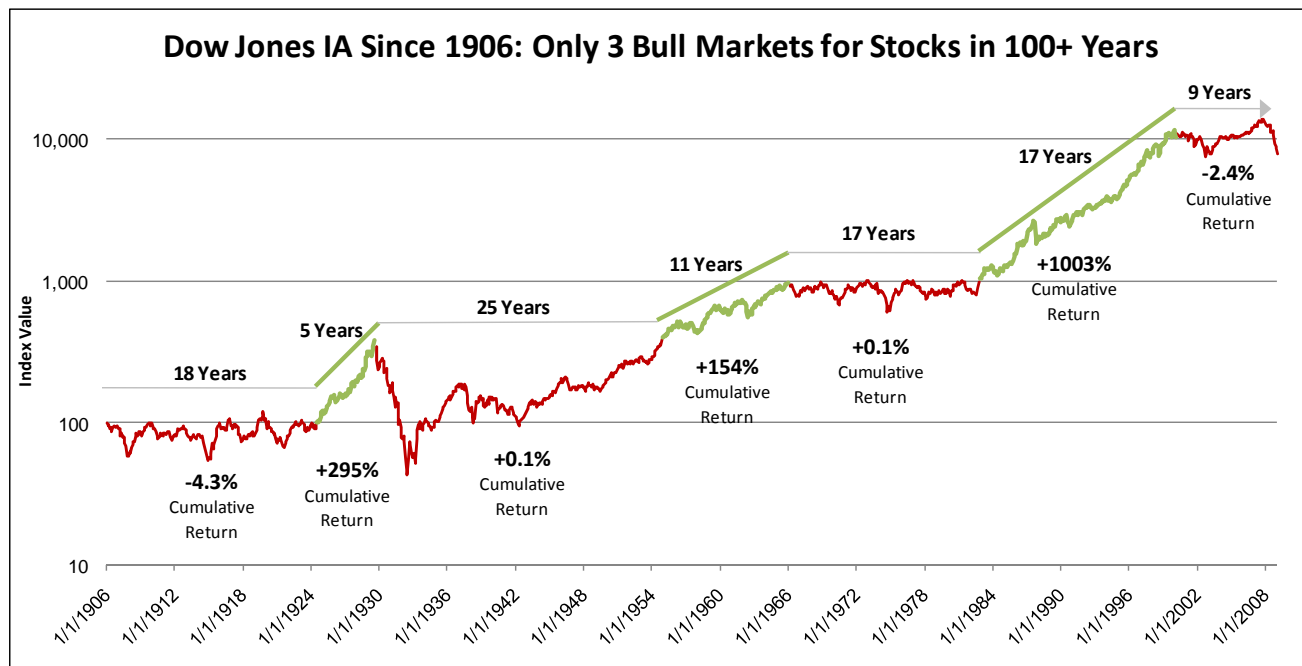
You are told volatility has collapsed. If you’ve made it this far you are automatically downgrading every report of ‘soaring’ or ‘collapsing’ or anything bird related.



Here is the widely reported VIX to measure the S&P’s volatility. It looks a lot different if you take out the soaring levels last year and the collapse this year. We smoothed that into the straight line you see at the end to show where we are today. We still used all of that data to come up with the average since 1994 which is 20.65. Volatility prices are not low at all, in fact they are close to 50% higher than average. At Curbstone, we do not care much about the VIX to begin with, because we do not sell overall market options, we select individual equities where volatility will always be rising and falling separately.

We think there is a better than average chance that one prediction you do not often hear comes true – that the most bullish and bearish among us can both be wrong. In that case and simple example above, both puts and calls we sell can expire worthless, the option writer pocketing both premiums.

The mother of all Inliers hides from most in plain sight. Stocks spend more time doing nothing than you are likely ever to hear from people hired to do something with them.



Like the secret he found to becoming a great Canadian hockey player (be born in the right month), Gladwell might point out that successful investing over the last 100 years came down to an account being born in one of only three periods.

Out of greed, fear, frustration, or all three – Bulls and Bears might be overpaying for the chance of outliers, when the odds favor Inliers.

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