Critical Math Advisors
Quarterly Newsletter

July 2011

EXCHANGE TRADED FUNDS (ETFs)

Exchange Traded Funds were created to replicate a stock market index, such as the S&P 500. A significant difference between them and mutual funds is that ETFs, much like an individual stock, can be traded all day long, whereas most mutual funds trade once per day at the market close. The ETFs that we use in our models are all highly liquid and represent either equity indices or bonds.

Since a modest start in 1990, the number of ETFs has jumped to more than 2,700, and many have become very specialized and complicated. An advanced version of ETFs is known as Exchange Traded Products or ETPs. These investments are comprised of Exchange Traded Notes and Exchange Traded Vehicles. They are very often linked to illiquid asset classes, and are often used by hedge funds to speculate on those asset classes. We consider them inappropriate for our strategies and do not use them at all.

In addition to ETFs being used to track an index, they have also been created to provide exposure to other asset classes; for example, gold. As reported in Wealth Daily, citing International Monetary Fund (IMF) Financial Statistics, only the central banks in the United States, France, Germany, Italy and the IMF own more gold bullion than the largest gold ETF. Central banks have their own agendas regarding ownership of gold, but a gold ETF reflects the interests of gold investors. If investors' appetites for gold should sour and this ETF should be forced to sell bullion, it could have a profound negative effect on the price of gold.

When it comes to trading ETFs, there's an interesting aspect that's not often discussed. When stocks, bonds and other financial instruments are traded, a seller delivers the securities to a buyer and the trade is then "settled," generally within 1-3 days. Most of these trades are now done electronically, but if a seller does not deliver the security on time, it is designated "fails to deliver." As reported in "The Economist," last year, ETFs accounted for 9% of trading volume in America's equity markets, but nearly two-thirds of the value of all fails. It is interesting to note that when the "flash crash" occurred in May 2010, roughly two-thirds of the trades that had to be cancelled were ETFs. As ETFs become more complex and more sophisticated, they threaten the orderly process of settling the $7.5 trillion of security transactions each day.

Asset Management through Adaptive Allocation

A MULTI-STRATEGY and ACTIVELY-MANAGED APPROACH to INVESTING

which seeks to adapt to any given market environment, reducing market exposure when risk is deemed high and investing aggressively when risk is considered low.

ECONOMY VERSUS INVESTING

Conventional wisdom might suggest that faster economic growth should result in higher equity returns. However, recent studies have found this scenario not to be so. Looking at the American stock market over the last 40 years, there is actually a negative relationship between changes in growth forecasts and equity returns. The 2010 study conducted by London Business School academics, titled "Credit Suisse Global Investment Returns Yearbook," looked at 5-year GDP growth rates of 83 countries from 1972-2009. The study found that investing each year in the countries with the highest economic growth over the previous 5 years earned significantly less than investing in the lowest growth countries. After all, if investing were as simple as following economic growth, wouldn't we all be doing it?

EUROPE

There has been much discussion lately about the solvency of Greece. Many experts cannot identify a scenario wherein Greece does not default. Since Greece is such a tiny part of Europe, people have asked why it matters at all to the international community. The answer is contagion. If Greece defaults, might Ireland or Portugal follow soon after? If those two default, might Italy and Spain be in trouble?

We should mention that default does not necessarily mean that the country in question can't honor its obligations. According to rating agencies like Standard and Poors, Moodys and Fitch, they might define default as an arrangement that requires debt holders, such as banks and other countries, to absorb losses in addition to the country in question. Bond yields in Greece, Portugal and Ireland suggest that investors generally believe that the risk of further intervention is extremely high, and that some form of default is likely.

BONDS

For some time, some pundits have been predicting a decline of significance in the bond market. Many experts have said that interest rates must rise, causing bond prices to drop, but that has not happened yet. If, however, interest rates do rise, Treasuries could significantly fall in value. Bloomberg.com reported that David Zervos, the global head of fixed income strategies at Jefferies Group Inc., the most bearish of the 20 primary dealers, expects the yield on the 10-year Treasury note to hit 4.25% by year-end. If he's right, 10-year note investors will lose close to 7%. This loss would be significant because many Treasury bond investors think of that asset class as being safe. It is important to realize that longer term Treasuries are extremely interest rate sensitive, and the return on these bonds and notes will decline as interest rates rise.

CHINA

China has its own domestic and international agenda. While encouraging consumption at home, it is also attempting to curb what some are calling a bubble in real estate, as evidenced by multiple interest rate increases. On the world stage, China is attempting to solidify its relationship with Europe by taking on debt of the weaker southern nations. The long-term result of this strategy is unknown, but it appears to be politically obvious, as Europe goes hat in hand to Beijing, while the China/U.S. relationship is more distant and fraught with suspicion on both sides.

As Chinese interest rates rise, and the expanding middle class clamors for higher pay and benefits, inflation is likely to increase. As Chinese goods become more expensive, that inflation gets exported to the U.S. The Federal Reserve would like a bit more inflation, but, of course, nothing of the runaway variety. With wages stagnant, and the jobs market in the U.S. limping along, serious inflation does not appear to be in the cards at this time.

There has been much talk about China becoming the number one economy in the world. Here are some interesting statistics. As noted by A. Gary Shilling on Bloomberg.com, in 2009, China's Gross Domestic Product (GDP) was $4.9 trillion vs. the U.S. at $14.3 trillion. Since China has 1.3 billion people, as opposed to something over 300 million in the United States, the GDP per capita in China is $3,709 vs. $46,405 in the U.S. To close this gap, China's GDP would need to grow around 10% per year for 30 years. We think that to be highly unlikely.

We must not forget, not withstanding China's "economic miracle," they are nevertheless a communist country, based on centralized planning. A good example of this planning is the massive Three Gorges Dam completed in 2006. It has been said that the communist government ignored warnings that the dam would silt up the reservoir basin and cause enormous problems in so doing. As had been the case in a previous dam project, some experts believe that serious problems have already been attributed to Three Gorges. The point here is that absolute power, with no checks and balances, can cause enormous unintended consequences.

Investment Strategy Positions as of June 30, 2011

(Subject to Change without Notice)

RUSSELL 2000 INDEX (IN OR CASH)	**CASH**	**HIGH YIELD CORPORATE BONDS** (IN OR CASH)	**CASH**	**INFLATION PROTECTED BONDS** (IN OR CASH)	**IN**
S&P 500 INDEX (IN OR CASH)	**IN**	**HIGH YIELD MUNICIPAL BONDS** (IN OR CASH)	**IN**	**FOREIGN BONDS ($ US HEDGED)** (IN OR CASH)	**IN**
STOCKS (NUMBER OF HOLDINGS)	**5**	**CONVERTIBLE BONDS** (IN OR CASH)	**IN**	**REAL ESTATE INV. TRUSTS** (IN OR CASH)	**IN**

How to Contact Critical Math Advisors

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Historical performance results for investment indices and/or categories have been provided for general comparison purposes only, and generally do not reflect the deduction of transaction and/or custodial charges, the deduction of an investment management fee, nor the impact of taxes, the incurrence of which would have the effect of decreasing historical performance results. It should not be assumed that our performance corresponds directly to any comparative indices.

The S&P 500 Index is an unmanaged composite of 500 large capitalization companies. This index is widely used by professional investors as a performance benchmark for large-cap stocks. You cannot invest directly into an index. An ETF is a type of investment company whose investment objective is to achieve the same return as a particular market index.

Our performance results reflect the reinvestment of dividends, and are net of applicable transaction fees, Critical Math Advisors LLC's investment management fee, and any other related account expenses. It does not reflect the impact of taxes on non-qualified accounts. Current performance information may be obtained on the web at www.unusualfund.com or by calling 1-888-653-9331.

In preparing this report, CMA has relied upon information provided by sources deemed to be reliable and is available upon request. Sources include Gemini Fund Services, Morningstar, Bloomberg, Yahoo and The Economist. The data herein is not guaranteed.

Critical Math Advisors is moving !!!

Our new location as of July 28, 2011:

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