

SmartStops Market Risk Report - Week ending Friday, May 27, 2010

Market Risk: **Above Normal**

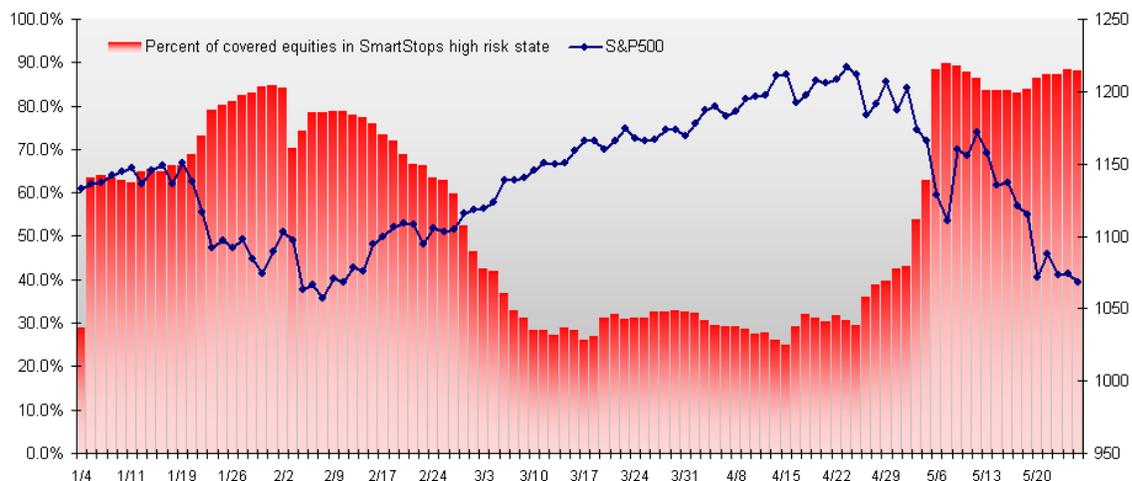
What Do I Do Now?

Wow, it has been a rough few weeks.

Investors are tired, frustrated, worried and generally not happy. The S&P 500 has dropped more than 10% since April 23 and is acting like a manic depressant with volatility ruling the day.

If you have been following the SmartStops risk signals, you are probably sitting on the sidelines in cash or fully hedged. The number of covered equities triggering their daily SmartStop risk alerts jumped from a mean average of 2.6% to 14.9% on April 27th and 31% on May 5th.

As of May 5th, before the "Fat Finger" day, SmartStops had placed over 60% of covered equities in the above normal risk state. This has since jumped even higher and currently stands at 88%.



So the question stands - what do I do now?

The old adage is, don't try to catch a falling knife. But at this point I am sitting on the sidelines and my entire target portfolio is a falling knife. Have we hit bottom? Is the market going to recover? Or is the European debt crisis and a slow down in China going to cause a double dip and bring the S&P back to 900? Nobody knows. But based on fundamental analysis and market research, we can identify equities that we believe will be good long term investments and that appear to be undervalued today. The question remains, will they be more undervalued tomorrow? To help limit my risk when entering volatile down markets like the one we have been experiencing, I like to use SmartStops exits and risk alerts.

I consider myself a value investor and get excited when I see equities go on sale. However, my Achilles' heel is that I often get too excited and enter early only to ride the investment down further before it recovers and moves up. While long term I may end up having made a good investment, I lament the opportunity cost of not having the cash to buy when the stock fell lower. The following process helps me maintain discipline, manage risk and capitalize on opportunities.

First, I identify my shopping list of 5 or so stocks that I believe are great long term investments and undervalued today based on their fundamentals and future business opportunities.

Second, if I feel the market may be turning and I am anxious about missing a possible move up, I step in without fear. I can do this because I am going to use stops to manage my downside risk. For this initial purchase, I like to use 50% of my total target investment amount.

Third, I enter the position into my SmartStops portfolio and use the SmartStops daily published short term exits and risk alerts to set my stops and alert me to signs of increased risk.

If the market remains stable and I do not receive any SmartStop risk alerts on my positions, I let this initial investment ride for a week or two before revisiting my buying decision and committing the remaining 50% of my capital.

If on the other hand an equity falls and triggers its SmartStop, I liquidate 50% of my initial investment in that position leaving only 25% of my investing capital at risk. I then watch the stock or ETF, hoping it indeed does go lower giving me a better entry point. If it does, I buy in at a lower price and repeat the process. If I get whipsawed and the stock immediately bounces up, I still benefit by having 25% of my funds invested and can now begin to invest my remaining capital for the long term. In this manner I step my way in and out if the equity continues to fall, limiting my losses and preserving my capital for use at a lower price.

The following Google example demonstrates the power of using stops to manage your risk as you enter into a down market searching for the bottom.

An investor may like Google as a long term investment believing there is real value anywhere below \$550 and they may want to allocate \$10,000 to this position. Using the process above, they may have experienced the following sequence of events these past few weeks.



We don't know what tomorrow brings, but we can take action as events unfold to manage our risk and capitalize on opportunities.

Have a great Memorial Day weekend.

Your SmartStops.net Team

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