



2011 Third Quarter Investment Outlook and Commentary

To Our Investors,

The third quarter was a rough one for investors as the Standard & Poor's downgrade of the United States and persistent fears of a European sovereign debt meltdown wreaked havoc on world financial markets. Investors experienced some of the most volatile market moves since the *annus horribilis* of 2008. Virtually all asset classes—with the exception of U.S. Treasuries—suffered losses. Even gold, which had been considered a “safe haven” asset for much of the past three years, saw a sharp correction. Though it is too early to say with certainty, it appears that the gold bubble may finally have burst.

Through the third quarter our actively-managed Tactical Portfolio returned (5.2%), losing less than the (8.7%) of the S&P 500 Total Return Index for the period.

Portfolio Review

SCM Strategic Allocations

Our returns for second quarter 2011 on the passive **Strategic Allocations** were the following:

Preservation of Capital	3.16%
Conservative Income	2.75%
Growth and Income	(1.99%)
Growth	(5.02%)
Aggressive	(8.35%)

All Sizemore Capital portfolios beat the S&P 500 for the year to date, though the Growth and Income, Growth, and Aggressive allocations still suffered losses. Bonds and dividend-paying stocks were the best performers, while European and emerging-market equities were the biggest drags on performance. For a description of recent changes made to the Strategic Allocations, please refer to the [Second Quarter 2011 Letter to Investors](#).

SCM Tactical ETF Portfolio

The SCM Tactical ETF Portfolio was positioned relatively conservatively at the start of the third quarter, but not quite conservatively enough to escape the wave of volatility. Even our conservative positions in dividend-focused stocks, health care, and international telecom saw significant declines, though less than the broader market. Our positions in emerging markets suffered the greatest losses for the period.

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On August 15, midway through the quarter, we made significant changes to the Tactical ETF Portfolio. In a memo distributed to private clients, we wrote:

It has been a rough summer for investors, but the Tactical ETF Portfolio has weathered the storm comparatively well. Our heavy allocation to steady dividend-paying stocks and to defensive sectors such as utilities, telecom, and health care took less damage than the overall market averages. During a panic-fueled rout—such as the one that followed Standard & Poor's downgrade of the United States from AAA to AA+—you win by not losing.

Though it is always difficult to remain calm when surrounded by hysteria, it is much easier when you understand your portfolio holdings and are comfortable with the prices paid. Investors need not be scared when they are holding quality, conservatively-financed companies at reasonable prices. Volatility—even violent volatility like we saw in August—can be viewed as a buying opportunity...

We have also initiated a short sell of gold via the **Proshares UltraShort Gold Fund (GLL)**. The price of gold soared during the run-up to the S&P downgrade announcement, as investors were truly desperate to get into something "safe." Gold rose from less than \$1,500 per ounce to over \$1,800 per ounce in a matter of weeks, and the most popular gold ETF, the Gold SPDR (GLD) came within a hair's breadth of eclipsing the S&P 500 SPDR (SPY) becoming the largest ETF in the world by assets under management.

In a volatile commodity like gold, there are numerous opportunities to make short-term tactical trades, both long and short. We believe this is one of those opportunities.

Now with the markets settling down to something resembling normal, we expect the price of gold to fall, at least in the short term. We have had a negative view of gold for nearly a year now, though we know from experience it can be financial suicide to bet against an asset bubble—whether it be in tech stocks, Miami condos, or gold. For this reason, we are going to keep a close eye on this trade. Should gold rise above its recent all-time highs, we will close out the short position. Gold may be in an irrational bubble, but that doesn't mean that the bubble has to burst today. On balance, we see downside of less than 10% and upside of 30% or more, making it a trade worth making.

Our optimism proved to be a little premature. After a brief respite, the volatility continued throughout August and much of September. Gold briefly rallied to new highs, prompting us to close our initial short position. We did, however, find a new opportunity to re-enter the short position. On August 26 we wrote,

Following our guidance of our August 15 memo, we closed our short position in gold via the Proshares UltraShort Gold Fund (GLL). On August 15, we wrote,

Should gold rise above its recent all-time highs, we will close out the short position... Should gold rise above its recent all-time highs, we will close out the short position. Gold may be in an irrational bubble, but that doesn't mean that the bubble has to burst today. On balance, we see downside of less than 10% and upside of 30% or more, making it a trade worth making.

Days after we closed the short position, gold surged to a new all-time high above \$1,900 per ounce and then immediately crashed in the biggest two-day sell-off since 1980. We have used this volatility to initiate a new short position. In order to avoid wash sale restrictions, we have opted to use the ETN DZZ rather than GLL. The two funds trade in virtual lockstep, making DZZ an acceptable substitute.

Our trading guidance remains the same. We are willing to put 10-15% of the position at risk, which translates to only 50-75 basis points of the entire portfolio. We believe that gains of 30% or more are likely, making this a trade worth making. Should gold prices again break into new all-time highs, we must simply conclude that this bubble has further to inflate and that this is not an appropriate time to bet against it.

Though it is too early to say, the gold bubble may have finally burst. As we enter the fourth quarter, our gold short position is the only portfolio position that is showing strength.

Looking Ahead

The remarkable thing about the volatility that has dominated the markets for the past several months is that none of the issues driving it are new. The U.S. economy remains sluggish, and its government continues to spend irresponsibly more than it takes in via taxes. Greece, which threatens to start a domino effect that could tear the European Union apart, was a basket case two years ago. It's still a basket case today. There is little new news here.

It is a mistake to read too deeply into the markets bends and twists because you're attempting to assign reason to the irrational. John Maynard Keynes, who made a fortune in the stock market, had a colorful way of describing it. In his *General Theory of Employment Interest and Money*, Keynes compared the stock market to a newspaper beauty contest in which readers are asked to choose the most beautiful girl from a selection of photos. The readers who picked the most *popular* face would win. Notice I said "popular" and not "beautiful."

As Keynes noted, "It is not a case of choosing those that, to the best of one's judgment, are really the prettiest, nor even those that average opinion genuinely thinks the prettiest. **We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be.** And there are some, I believe, who practice the fourth, fifth and higher degrees."

And here we are today. Investors today are not so much afraid of the economy or of a Greek default as they are afraid of how each other will *react*. No matter what I think the fundamental consequences of a Greek default would be, if I think the investor down the street will panic and sell, I sell first. This creates a cycle of self-fulfilling prophecy and adds significantly to the volatility that has been roiling the market.

This madness cannot last forever. Eventually, the volatility will play itself out. Perhaps Greece will finally default and the months and months of handwringing will finally be over. Or perhaps (less likely) growth picks up significantly in United States and eases the fears that we are returning to recession.

It is impossible to say, of course. But this is the nature of the investment game. Investing is an exercise in making decisions under conditions of uncertainty. And under these conditions, you have to filter out the hysteria and embrace your "[Inner Spock](#)."

Being as objective as we can be, we continue to see value in American and European multinationals with high and rising dividends. There is a core of solid bluechips that will survive and thrive under even the worst-case scenarios being described today. These are the companies that we are using as the core of our investment strategy.

In addition to this solid core, we continue to look for tactical trades as market conditions warrant. Our gold short, for example, has added value for us during a very difficult period in the market. We will continue to look for short-term trading opportunities as we navigate through this volatile period in market history.

Announcements

We would like to build on our announcement from last quarter. Our first two portfolios—tracking the Tactical ETF Portfolio and the Sizemore Investment Letter Portfolio—are now live on the Covestor platform (see <http://covestor.com/sizemore-capital>). A new portfolio mirroring the Strategic Growth Allocation will be launched early in the fourth quarter. Covestor allows investors will smaller portfolios to mirror the investment strategies of their managers, and this allows Sizemore Capital Management to reach new clients that we would ordinarily not be able to serve. We consider this an exciting new avenue for growth.

Here's to a strong finish for 2011.

Respectfully,



Charles Lewis Sizemore, CFA
Chief Investment Officer, Sizemore Capital Management, LLC