

**BigPictureTrading**  
macro . technical . options

# MACRO MASTERS

Tutorial 5  
Modules 22-25



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## Module 22

### Building your Own Portfolio




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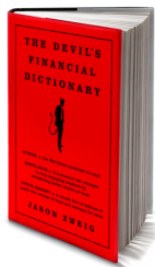
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### Cynical Reality of the Markets



**CLIENTS, n.** Also known, on Wall Street, as muppets, flunkies, chumps, suckers, marks, targets, victims or “vics,” dupes, baby seals, sheep, lambs, guppies, geese, pigeons, and ducks (as in “When the ducks quack, feed’em”).




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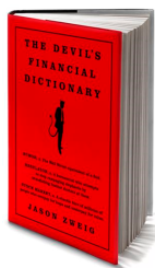
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### Cynical Reality of the Markets



**STOCKBROKER, n.** ...Reputed to have disappeared, they have been renamed FINANCIAL ADVISORS by the brokerage firms employing them and now typically charge a mere 1 percent every year for the rest of their clients' lives. Often, such “financial advisors” are forbidden from providing a broad range of financial advice, are under limited obligation to put their clients' interests ahead of their own, and blindly follow the recommendations of their employer regardless of their clients circumstances.




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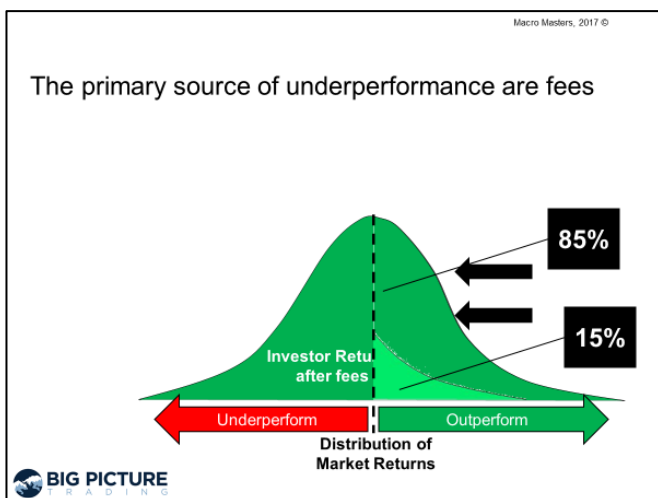
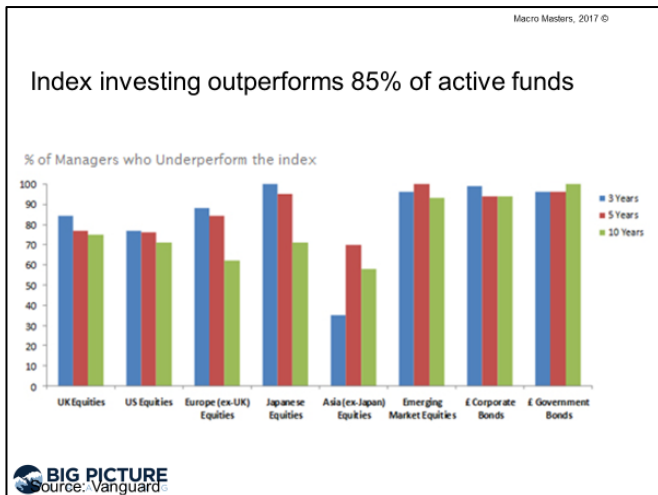
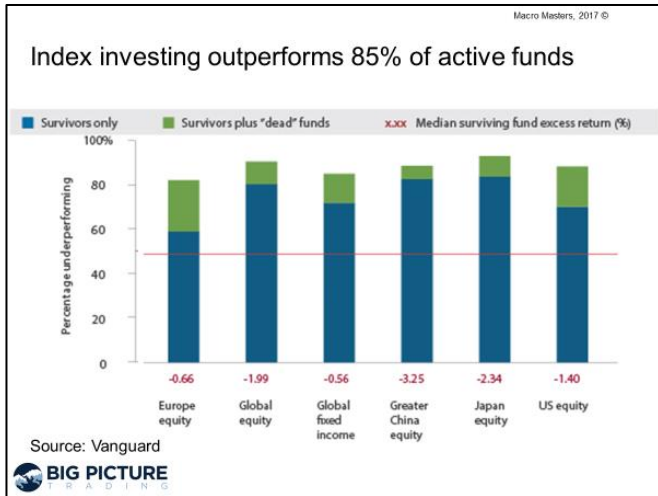
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- Assume the only difference between the performance is the fee
- Investor starts with \$200,000.00 in a retirement account
- Will continue to contribute \$20,000.00 every year
- Tax sheltered compounding

Period	Period investment	Total investment	Period interest	Total interest	Total value
0	\$200,000.00				\$200,000.00
1	\$200,000.00	\$220,000.00	\$10,000.00	\$10,000.00	\$330,000.00
2	\$200,000.00	\$240,000.00	\$11,500.00	\$21,500.00	\$261,500.00
3	\$200,000.00	\$260,000.00	\$13,075.00	\$34,575.00	\$294,575.00
4	\$200,000.00	\$280,000.00	\$14,728.75	\$49,303.75	\$329,303.75
5	\$200,000.00	\$300,000.00	\$16,478.13	\$65,781.88	\$365,781.88
6	\$200,000.00	\$320,000.00	\$18,285.45	\$84,057.38	\$400,057.38
7	\$200,000.00	\$340,000.00	\$20,202.87	\$104,260.25	\$444,260.25
8	\$200,000.00	\$360,000.00	\$22,213.01	\$126,473.27	\$486,473.27
9	\$200,000.00	\$380,000.00	\$24,323.66	\$150,796.93	\$530,796.93
10	\$200,000.00	\$400,000.00	\$26,539.85	\$177,336.78	\$577,336.78
11	\$200,000.00	\$420,000.00	\$28,861.11	\$206,203.89	\$626,203.89
12	\$200,000.00	\$440,000.00	\$31,310.18	\$237,513.80	\$677,513.80
13	\$200,000.00	\$460,000.00	\$33,875.69	\$271,389.49	\$731,389.49
14	\$200,000.00	\$480,000.00	\$36,569.47	\$307,958.96	\$787,958.96
15	\$200,000.00	\$500,000.00	\$39,397.95	\$347,356.91	\$847,356.91
16	\$200,000.00	\$520,000.00	\$42,367.85	\$389,724.75	\$909,724.75
17	\$200,000.00	\$540,000.00	\$45,484.24	\$435,210.19	\$975,210.19
18	\$200,000.00	\$560,000.00	\$48,760.55	\$483,971.54	\$1,043,971.54
19	\$200,000.00	\$580,000.00	\$52,198.58	\$536,170.12	\$1,116,170.12
20	\$200,000.00	\$600,000.00	\$55,808.51	\$591,978.62	\$1,191,978.62
21	\$200,000.00	\$620,000.00	\$59,598.93	\$651,577.55	\$1,271,577.55
22	\$200,000.00	\$640,000.00	\$63,578.88	\$715,156.43	\$1,355,156.43
23	\$200,000.00	\$660,000.00	\$67,745.71	\$782,902.15	\$1,442,902.15
24	\$200,000.00	\$680,000.00	\$72,145.71	\$855,059.97	\$1,535,059.97
25	\$200,000.00	\$700,000.00	\$76,753.00	\$931,812.96	\$1,631,812.96

**\$1,431,812**

**\$1,631,812**

## Investor Averages 7.00% Return

Period	Period investment	Total investment	Period interest	Total interest	Total value
0	\$200,000.00				\$200,000.00
1	\$20,000.00	\$220,000.00	\$14,000.00	\$14,000.00	\$234,000.00
2	\$20,000.00	\$240,000.00	\$16,380.00	\$30,380.00	\$270,380.00
3	\$20,000.00	\$260,000.00	\$18,926.60	\$49,306.60	\$309,306.60
4	\$20,000.00	\$280,000.00	\$21,651.46	\$70,958.06	\$350,958.06
5	\$20,000.00	\$300,000.00	\$24,667.06	\$95,625.13	\$395,625.13
6	\$20,000.00	\$320,000.00	\$27,686.76	\$123,211.89	\$443,211.89
7	\$20,000.00	\$340,000.00	\$31,024.83	\$154,236.72	\$494,236.72
8	\$20,000.00	\$360,000.00	\$34,596.57	\$188,833.29	\$548,833.29
9	\$20,000.00	\$380,000.00	\$38,418.33	\$227,251.62	\$607,251.62
10	\$20,000.00	\$400,000.00	\$42,507.61	\$269,759.23	\$669,759.23
11	\$20,000.00	\$420,000.00	\$46,883.15	\$316,642.38	\$736,642.38
12	\$20,000.00	\$440,000.00	\$51,564.97	\$368,207.34	\$808,207.34
13	\$20,000.00	\$460,000.00	\$56,574.51	\$424,781.86	\$884,781.86
14	\$20,000.00	\$480,000.00	\$61,934.73	\$486,716.59	\$966,716.59
15	\$20,000.00	\$500,000.00	\$67,670.16	\$554,386.75	\$1,054,386.75
16	\$20,000.00	\$520,000.00	\$73,807.07	\$628,193.82	\$1,148,193.82
17	\$20,000.00	\$540,000.00	\$80,373.57	\$708,567.39	\$1,248,567.39
18	\$20,000.00	\$560,000.00	\$87,399.72	\$795,967.11	\$1,355,967.11
19	\$20,000.00	\$580,000.00	\$94,917.70	\$890,884.80	\$1,470,884.80
20	\$20,000.00	\$600,000.00	\$102,961.94	\$993,846.74	\$1,593,846.74
21	\$20,000.00	\$620,000.00	\$111,569.27	\$1,105,416.01	\$1,725,416.01
22	\$20,000.00	\$640,000.00	\$120,779.12	\$1,226,195.13	\$1,866,195.13
23	\$20,000.00	\$660,000.00	\$130,633.66	\$1,356,828.79	\$2,016,828.79
24	\$20,000.00	\$680,000.00	\$141,178.02	\$1,498,006.81	\$2,178,006.81
25	\$20,000.00	\$700,000.00	\$152,460.48	\$1,650,467.28	\$2,350,467.28

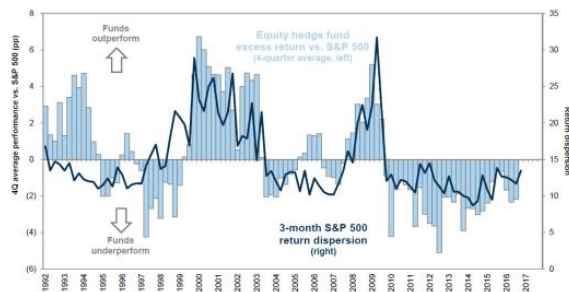
\$200,000

\$2,150,467

\$2,350,467

## Stock-pickers struggle when dispersion is low

3-month return dispersion and equity hedge fund excess return vs. S&amp;P 500



BIG PICTURE

## Portfolio Theory

BIG PICTURE

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## Does Price Discount Everything?

- Efficient Market Hypothesis (EMH) suggests share prices adjust to all new publicly available information and changing economic conditions
- This supports the idea that all known information is priced into the markets
- Supply and demand, investor sentiment and expected future valuations are already being considered




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## Flaws in Efficient Markets

- The mark to market structure is vulnerable to supply/demand imbalances caused by the psychological herding of investors
- Negative sentiment drives further weakness which validates further negative sentiment
- Positive sentiment drives further strength which validates further positive sentiment
- This creates substantial and extended trends that drive markets materially above and below their mean price




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## Top Down Investing

- Top down investing focuses on the big picture
- Analyzing the economy for the sectors and industries that will do the best
- Individual companies are then further analyzed within the targeted sectors




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## Top Down Investing

- There is more active application of options to the top down approach
- When identifying economic conditions that are favorable, you seek to identify sectors that would have a high correlation to the markets




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## Modern Portfolio Theory

- Theory that it is possible to construct an optimal portfolio offering the maximum possible expected return for a given level of risk
- This requires Security Valuation, Asset Allocation, Optimization and Performance Measurement




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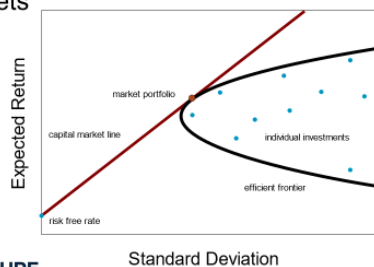
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## Modern Portfolio Theory

Asset Allocation broken down:

- Diversification to remove unsystematic risk
- Optimizing the best risk adjusted returns of assets




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## Beta

- Beta is a measure of the volatility, or systematic risk of a stock in comparison to the market as a whole
- It also measures the variance of the stock to the movement of the markets




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## Alpha

- Measure of performance on a risk adjusted basis
- Anyone can double returns by doubling risk
- Increasing returns without adding risk is termed "Creating Alpha"




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## Diversification

- Seeking a basket of uncorrelated assets
- Owning multiple stocks in a sector only removes company specific risk, but not market risk
- Utilizing risk management and hedging reduces the need for diversification




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# Sharpe Ratio - Performance

- Excess return per unit of risk
- Can be on an investment or on a trading strategy
- The higher the Sharpe Ratio the better

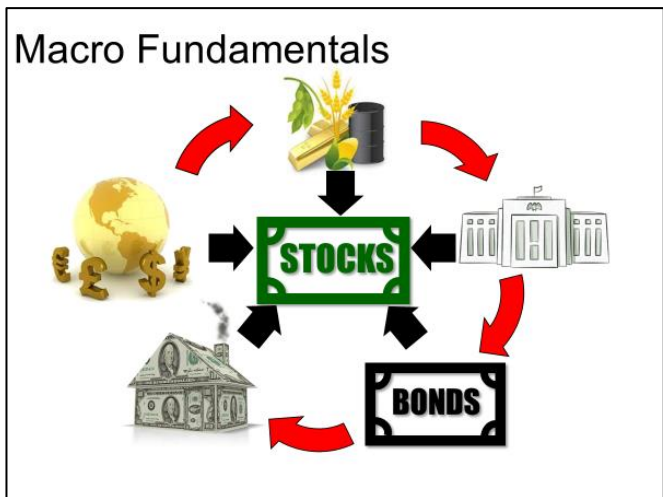
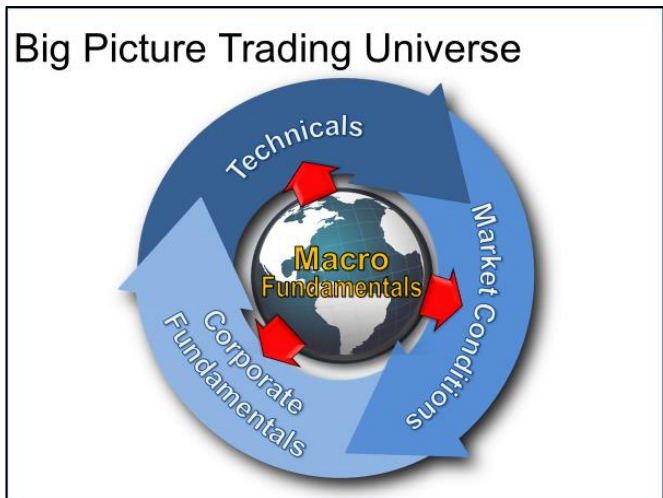
$$= \frac{(\text{Return} - \text{Risk Free Rate})}{\text{Standard Deviation}}$$
The logo for Big Picture Trading, featuring a stylized globe icon to the left of the text "BIG PICTURE" in a bold, sans-serif font, with "TRADING" in a smaller font below it.

# Developing a Methodology

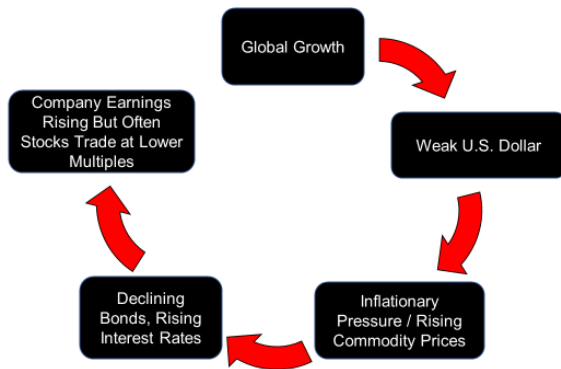
1. Macro economic assessment
2. Develop a thesis on the market and identify the sectors that would allow you beta participation
3. Find the stocks that have the best relative strength within a sector
4. Technically observe if the price behavior is confirming your thesis
5. Develop options strategy to create asymmetrical risk/reward



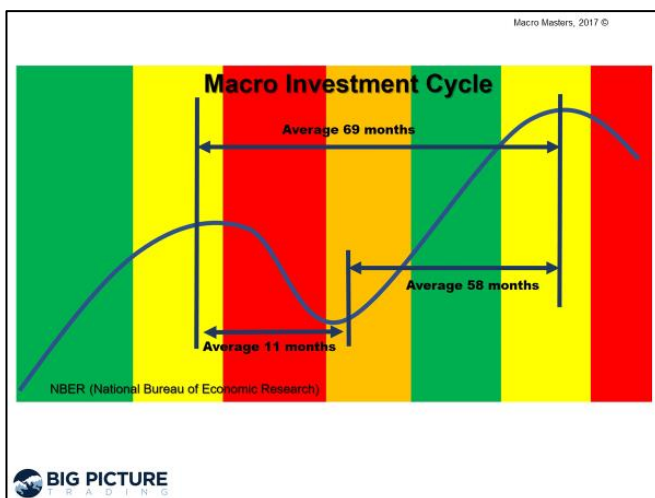
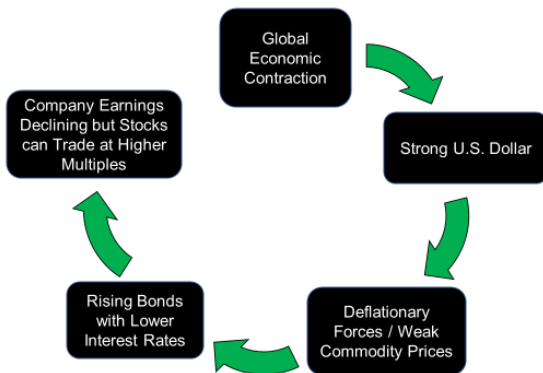
**BIG PICTURE**  
TRADING



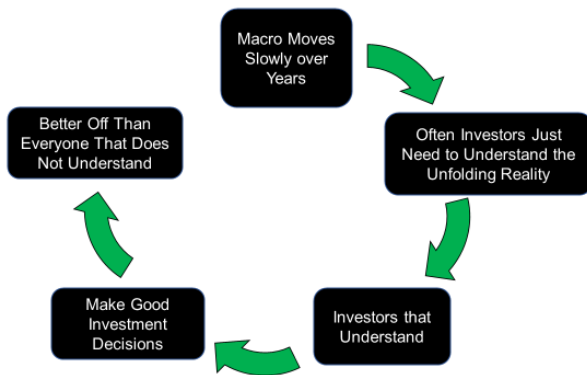
## U.S. Dollar Cycle



## U.S. Dollar Cycle



# The Macro Investor or Trader

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## The Macro Investor or Trader

- Recognize the underlying macro fundamental drivers in play
- Assess the liquidity flow of the trends using technical analysis
- Utilize options to build asymmetry in your positions
- Have willingness to move or hedge your currency exposure



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## Module 24 Equity Analysis

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## Market Earnings Cycle

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## Stock Market Drivers

1. Growth in top line revenues and earnings
2. Growth in margins
3. Growth in multiples

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## Revenues and Earnings

Growth in top line revenues and earnings:

- Brand new product or market
- Stealing market share from competitors
- Inflationary price rises

Earnings Per Share	Earnings Multiple P/E	Perceived Value of Stock
\$10.00	10	\$100.00
\$11.00 	10	\$110.00
\$12.00 	10	\$120.00



## Growth in Margins

No Growth, but increasing profits:

- Cutting costs
- Innovation and productivity

Earnings Per Share	Earnings Multiple	Perceived Value of Stock
\$5.00	15	\$75.00
\$5.50 	15	\$82.50
\$5.75 	15	\$86.25



## Growth in Multiples

What the market is prepared to pay for:

- Discounting all future growth and earnings
- This discounts interest rates

Earnings Per Share	Earnings Multiple	Perceived Value of Stock
\$1.25	15	\$18.75
\$1.25	17 	\$21.25
\$1.25	20 	\$25.00

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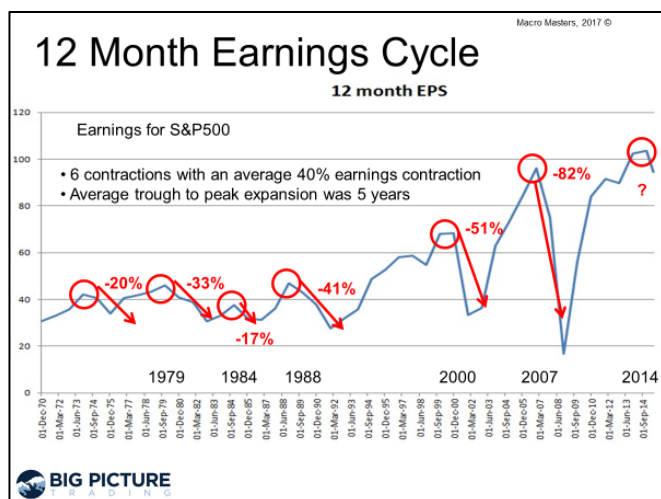
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## Earnings Contraction

When a companies earnings contracts:

- The stock becomes more expensive, even if the stock stays the same in price

Earnings Per Share	Stock Price	P/E Price Earnings
\$10.00	\$100.00	10.00
\$7.50 	\$100.00 	15.00 
\$5.00 	\$100.00 	20.00 

## Multiple Contraction

When a companies earnings contracts:

- The stock may decline based to maintain the same multiple

Earnings Per Share	Stock Price	P/E Price Earnings
\$10.00	\$100.00	10.00
\$7.50 ↓	\$75.00 ↓	10.00 ➡
\$5.00 ↓	\$50.00 ↓	10.00 ➡

## Multiple and Earnings Contraction

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When a companies earnings contracts:

- The stock price may decline and uncertainty may drive a lower multiple

Earnings Per Share	P/E Price Earnings	Stock Price
\$10.00	20.00	\$200.00 (0.0%)
\$7.50 ↓	15.00 ↓	\$112.50 (-44%) ↓
\$5.00 ↓	10.00 ↓	\$ 50.00 (-75%) ↓



## Additional Metrics for Valuations

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- Price to Sales
- Price to Book
- Enterprise Value to Sales
- Enterprise Value to EBITDA
- Enterprise Value to Free Cash Flow

**Book Value:** value of assets on company's books

**Enterprise Value:** theoretical takeover value of the company – market cap + debt + minority interest + preferred – cash

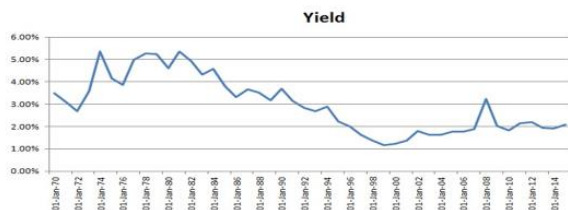
**EBITDA:** Earnings before interest, tax, depreciation and amortization



## Dividends

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- Dividends and dividend yields are discounted like bonds and real estate income cap rates



## Contribution of Dividends to Returns

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S&P 500 Total Return: Price and Dividend Contribution

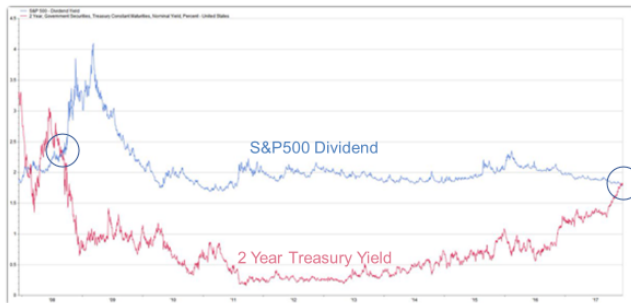
	Total Return	Price Appreciation	Income Return	As a Share of Total Return	
				Price App.	Div. Income
1930's	0.1%	(5.3%)	5.7%	na	na
1940's	8.9%	3.0%	5.7%	33.6%	64.5%
1950's	18.9%	13.6%	4.7%	72.0%	24.7%
1960's	7.7%	4.4%	3.1%	57.2%	41.0%
1970's	5.8%	1.6%	4.1%	27.8%	71.1%
1980's	17.2%	12.6%	4.1%	73.2%	23.8%
1990's	18.0%	15.3%	2.3%	85.1%	12.9%
2000's	(0.9%)	(2.7%)	1.8%	na	na
2012	16.0%	13.4%	2.3%	83.8%	14.3%
2003-2012	7.1%	4.9%	2.0%	69.7%	28.9%
1930-2012	9.3%	5.2%	3.9%	56.0%	41.8%



## Dividend Yield vs 2 year Treasury Yield

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Comparative measure, often as a risk adjusted return on investment



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# Company Share Buybacks




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## Understanding Share Buybacks



- Company ABC is trading at \$100.00 a share
- The company has 1,000,000 shares outstanding
- Market Cap \$100,000,000
- \$10,000,000 in earnings
- Earnings per share: \$10.00
- P/E Ratio of 10 (\$100.00/\$10.00)




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## Understanding Share Buybacks



Company ABC



- Company borrows \$5,000,000
- Buys 50,000 shares back from the markets




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## Understanding Share Buybacks



- ABC is trading at \$100.00 a share
- The company has 950,000 shares outstanding
- Market Cap \$95,000,000
- \$10,000,000 in earnings
- Earnings per share \$10.50
- P/E Ratio of 9.52




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## Understanding Share Buybacks



- Company is now cheaper at the P/E Ratio of 9.52
- Market trades the stock up to \$10.50
- At \$10.50 the shares are back up to a P/E Ratio of 10.00
- Shareholders make profit without the stock actually growing its earnings




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## Module 25

### Asset Class and Sector Rotation




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### Cyclical vs. Defensive Stocks

- Cyclical stocks are highly correlated to the economic cycle
- Generally cyclical stocks have a higher beta
- Defensive names have far more inelastic to the economic cycle
- Generally defensive names have a lower beta




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### Cyclical Sectors

1. Consumer Discretionary
2. Financials
3. Industrials
4. Information Technology
5. Basic Materials




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## Defensive Sectors

1. Consumer Staples
2. Energy
3. Healthcare
4. Telecommunications
5. Utilities
6. Conglomerates



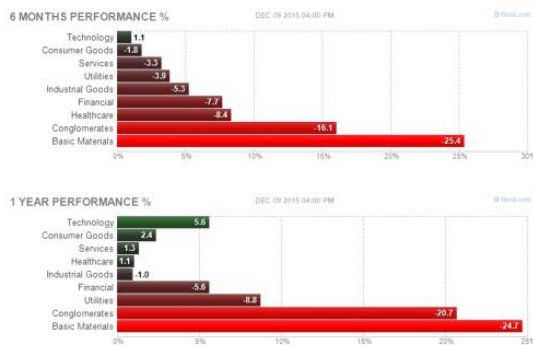
## Financial Visualization Resource

[www.finviz.com](http://www.finviz.com)



## Financial Visualization Resource

[www.finviz.com](http://www.finviz.com)



# Financial Visualization Resource

[www.finviz.com](http://www.finviz.com)

## Using the filters

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My Portfolio	Order	Market Cap	Class	Signal	Home (all stocks)	Tickers	Filters
Exchange	Any	Index	Any	Technical	Any	Country	Any
Market Cap	Any	NYSE	Any	Forward P/E	Any	P/E	Any
P/B	Any	Price/Cash	Any	Price/Free Cash Flow	Any	EPS growth	Any
EPS growth	Any	EPS growth	Any	Sales growth	Any	EPS growth	Any
EPS growth	Any	EPS growth	Any	Sales growth	Any	EPS growth	Any
Dividend Yield	Any	Return on Assets	Any	Return on Equity	Any	Return on Investment	Any
Quick Ratio	Any	LT Debt/Equity	Any	Debt/Equity	Any	Gross Margin	Any
Net Profit Margin	Any	Current Ratio	Any	Inventory	Any	Operating Margin	Any
Financial	Any	Fixed Asset	Any	Capitalization	Any	Operating Margin	Any
Performance	Any	Performance 2	Any	Volatility	Any	Operating Margin	Any
30 Day Simple Moving	Any	10 Day Simple Moving	Any	30 Day Simple Moving	Any	Operating Margin	Any
Average	Any	50 Day High/Low	Any	50 Day High/Low	Any	Operating Margin	Any
Beta	Any	Average True Range	Any	Average Volume	Any	Operating Margin	Any
Price	Any	Target Price	Any	EPS Date	Any	Operating Margin	Any

BIG PICTURE TRADING

## Comparing Low/High Beta

SPHB – Powershares S&P500 High Beta ETF

### Top 10 holdings:

Chesapeake Energy Corp	CHK	Beta 2.48
Freeport-McMoRan Inc	FCX	Beta 3.22
Williams Companies Inc	WMB	Beta 1.82
Transocean Ltd	RIG	Beta 1.66
Micron Technology Inc	MU	Beta 2.17
Marathon Oil Corp	MRO	Beta 2.80
Devon Energy Corp	DVN	Beta 2.61
Western Digital Corp	WDC	Beta 1.19
United Rentals Inc	URI	Beta 2.94
Murphy Oil Corp	MUR	Beta 2.61

BIG PICTURE TRADING

## Comparing Low/High Beta

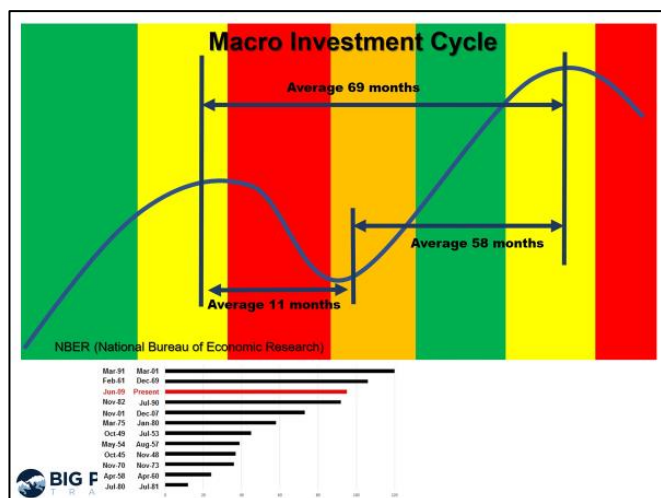
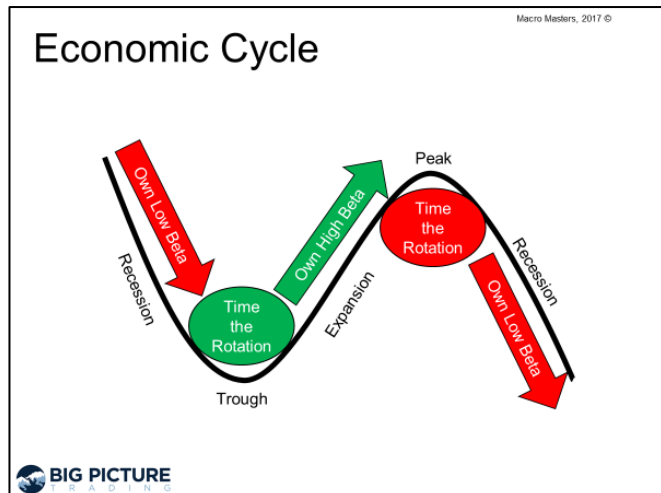
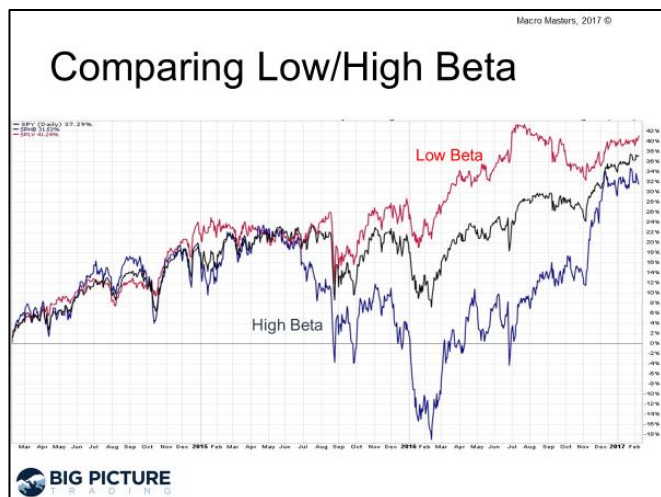
SPLV – Powershares S&P500 Low Volatility ETF

### Top 10 holdings:

AT&T Inc	T	Beta 0.39
PepsiCo Inc	PEP	Beta 0.63
Republic Services Inc	RSG	Beta 0.57
Allstate Corp	ALL	Beta 0.95
Procter & Gamble Co	PG	Beta 0.51
Altria Group Inc	MO	Beta 0.46
Waste Management Inc	WM	Beta 0.56
McDonald's Corp	MCD	Beta 0.73
Johnson & Johnson	JNJ	Beta 0.64
United Parcel Service Inc	UPS	Beta 0.90

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## Long/Short Investment Strategy

- Commonly utilized by hedge funds and progressive asset managers
- Combining two correlated assets anticipating a particular investment to relatively outperform the other
- Long the anticipated higher alpha asset
- Short the anticipated underperforming asset
- Allows one to hedge out systematic risks while profiting from relative outperformance



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## Module 26

# Currency Impact on Investing

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## Impact of Currency on Stocks

- Significant currency moves have material affect on the performance of stocks
- When the majority of investors believe in constant dollars, they are deceived by performance

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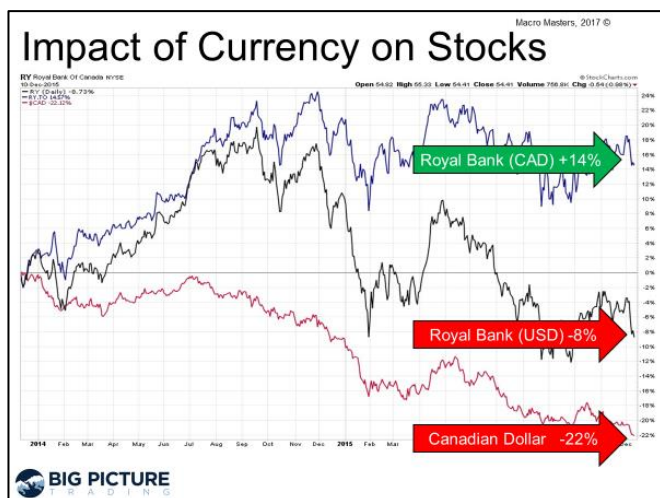
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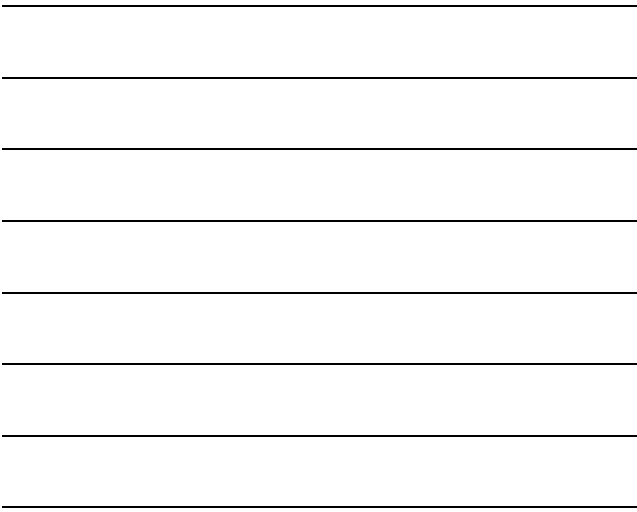
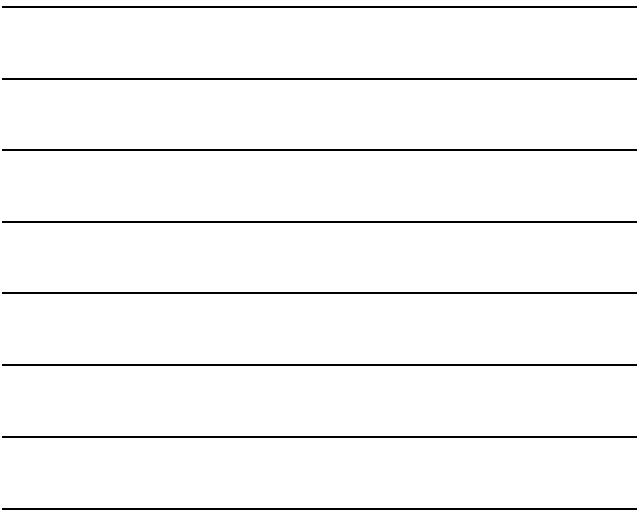
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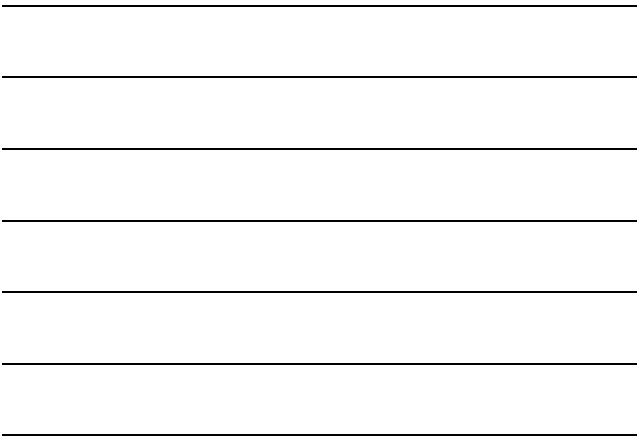
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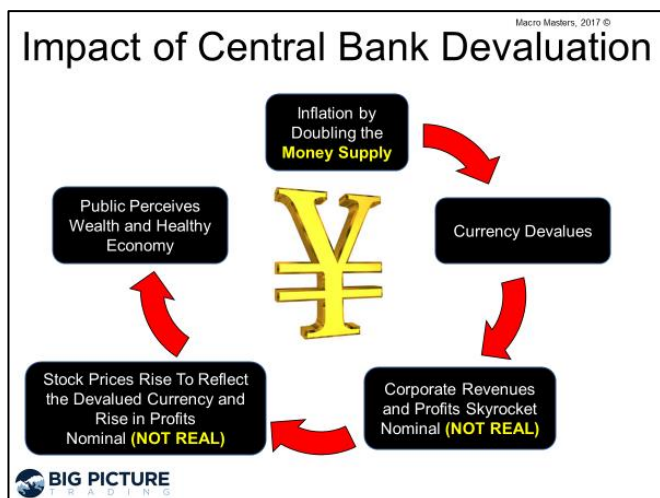
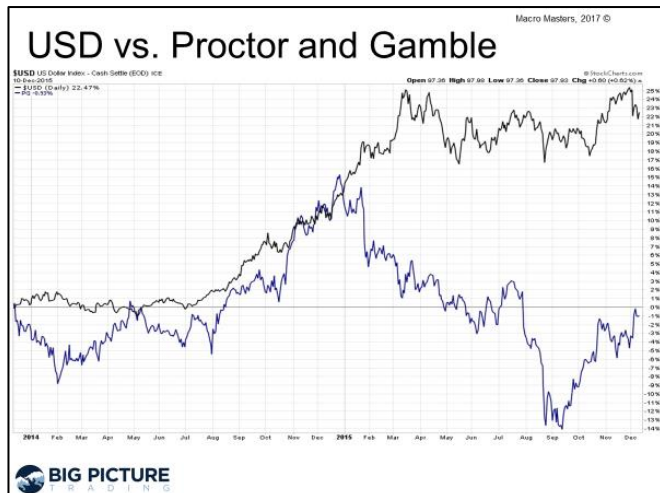
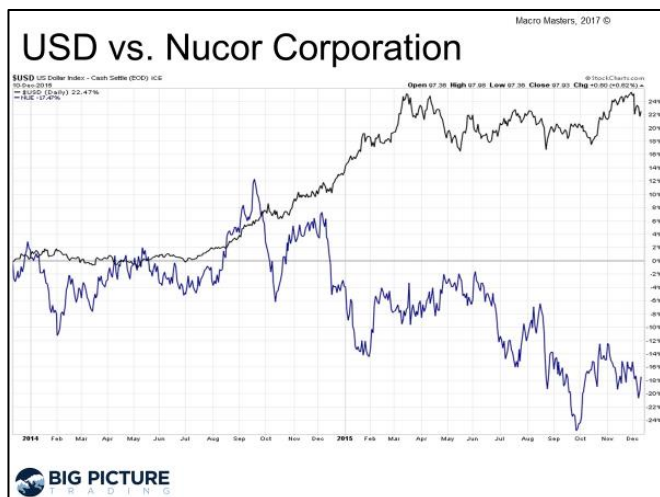
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- Most stock traders do not realize that they are currency traders by default
- International conglomerates are currency sensitive
- Commodity stocks are currency sensitive



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## Way to Trade It

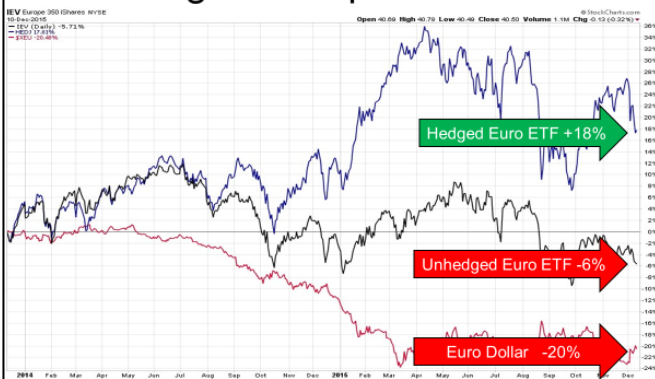
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- Invest in the stock markets on a currency hedged basis
- If you know which Central Banks are implementing currency destructive policies, you know their stock markets will benefit if you can hedge the currency loss



## Euro Hedged Comparison

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## Currency Impact on Performance

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European Fund  
Manager



European High Beta  
Hedge Fund  
Management Fee  
2% / 20%

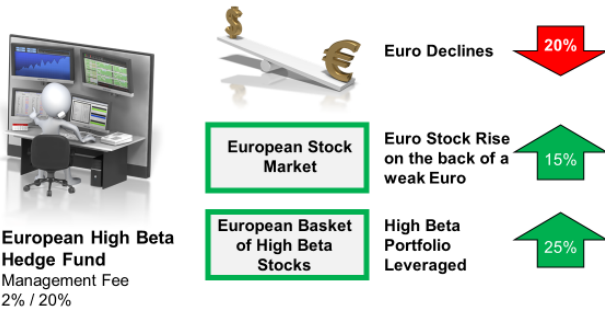


Investors



## Currency Impact on Performance

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## Currency Impact on Performance

Average investor content as brokerage account shows at 25% rise in value



Look at your account, you are up 25%. Now my fee is 2% + 20% of your profits



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## Was there anything impressive?



- Took double the risk to create the returns
- No real alpha with a poor Sharpe ratio (underperformed on a risk adjusted basis)
- Clients made relatively little return on a currency adjusted basis
- The decline in the Euro was the biggest precipitating contributor to the performance

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## Designing Portfolio

1. What is the primary bias for the USD?
2. What stage of the business cycle are we in?




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## Bullish US Dollar / Late Cycle

Generalization:

1. Overweight US dollars and cash
2. Underweight commodities
3. Defensive low beta over cyclical
4. Overweight international markets with currency hedges
5. Underweight corporate and high yield bonds
6. Overweight longer duration government bonds




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## Bearish US Dollar / Early Cycle

Generalization:

1. Underweight US dollars and low cash levels
2. Overweight commodities
3. Overweight cyclical high beta over defensive
4. Equal weight international markets (no currency hedge)
5. Underweight long duration government bonds
6. Overweight corporate and high yield bonds




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# Big Picture Investment Considerations




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## Summary

1. Credit and business cycles matter
2. Liquidity matters for short-term asset pricing
3. There are always strategic times to be overweight and underweight different asset classes
4. It is always about your risk adjusted return




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## Realities of the System

- Mature stage of debt super cycle where the massive inexhaustible debts are a drag on global growth
- Central bank intervention into capital markets (asset price manipulation is a new reality)
- At some point the global economies will be forced to address the paradox with some form of financial reset




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## The System

- The inextinguishable debt continuously extracts money supply from the system forcing structurally low rates (negative real interest rates)
- The system only works with continuous inflation
- If money supply (debt) is not continuously created, deflation is a certainty
- Everything is exponential, which over a long enough period guarantees a culmination point



## Critical Thinking

- Know the rules of the game
- Accept the unfolding reality over opinions
- Critically think through the best risk adjusted way to benefit from the markets
- Use options to make asymmetrical trades to manage risk

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