Welcome to the **Manhattan Beach Capital Newsletter**. I plan to send these following the 3rd Friday of each month. I plan to use this monthly letter to provide an update on the performance of the fund, and to share a little market education that typically doesn't make it into the regular headlines. I'll keep future newsletters to 1 page, but this first one has an *extended details* section, because there have been some very, very interesting things taking place over these last few months.

(I plan to send this newsletter after the 3rd Friday because my primary investment strategy uses options, and the regular options expiration schedule is the 3rd Friday of each month. It's a logical time to take accounting of performance.)

Fund Performance:

Period Ending:	11/21/2011				
Month	**Oct 11**	**Nov 11**	**Dec 11**	**Jan 12**	**YTD**
Closed	7.6%	4.6%	-	-	**12.4%**
Open	-	-	4.2%	5% target	

Closed represents final performance from trades or partial value of open trades which has become irreversible gain. *Open* indicates expected return for trades expiring in the future month.

Fund Review

October was a generous month for stocks, followed by a shaky but level November. The October rally enabled the portfolio to close out both months for a handsome 12.4% gain. The sideways staggering for November worked well for the trades I had open, but didn't offer opportunity for a full distribution like October did. In addition, stocks have climbed quickly, and have a long way to potentially fall. Thus, I've chosen to err on the side of safety when opening new trades in the current environment.

Market Review

The last three months have seen the highest daily volatility since the 1930's, while losing all the year's gains over a week in August, and then running them back up in October. The August drop was triggered by the US Credit downgrade alongside concerns of entering a recession. The October rally was fueled by traders who don't see a recession on the horizon, and better than expected corporate earnings. Then Greece came needing a bailout, leaving private investors with a 50% loss on bonds while the European Central Bank doesn't have to take any loss. And just when Greece looked contained, Italian and Spanish bond yields started running to 7%, the level at which they're generally considered unsustainable. And so the market has flipped and flopped sideways for November.

Market Outlook

While the US appears to be avoiding recession with meager growth (giving a case for buying safe dividend stocks), uncertainty in Europe will continue to dominate market movement. The likely recession across Europe will certainly hurt US growth in 2012, and if the financial turmoil that could come out of Italy and Spain triggers, that could lead to a global recession, bringing the market back to 2008 lows. But if disaster is averted, buyers could quickly move back into stocks. Thus, volatility. The market is poised to rally back up, but it's climbing on a shaky foundation.

Fund Strategy

Given the expected volatility in the market, and the very real potential for a major crash, my trading strategy will be weighted heavily toward safety. Until we get either the crash or convincing stability in Europe, I am going to target only 5% gains each month, and ensure that the portfolio is always safely positioned to survive/thrive in a major crash.

Extended Details

There's a lot more going on than what I've written below, but I've tried to touch on the major components that have moved the market over the last few months.

Market Review - Detailed

These last few months have seen the highest market volatility since the 1930's, as measured by days that the S&P 500 moved more than 2%. This volatility was initiated back in August with the downgrade on US Government debt from AAA, along with growing concerns about entering another recession. The ironic outcome of the downgrade is that while US Govt debt was downgraded, US debt is exactly what everybody fled to buy for safety. Investors fled to safety in the US Treasury because they feared a quick market decline (which happened). The US debt that ended up hurt by the downgrade wasn't the federal government debt, but the state and local government debt. Investors still believe the US federal government can tax its way out of the hole, or continue printing money to carry the debt. The state and local governments on the other hand, had less of a safety net to bail them out. Investors sold the risky US debt that might need bailing out, and bought the safe US debt.

Through September, competing opinions on whether we're headed for a recession or continued slow growth battered stocks up and down. Eventually, the Fed stepped in with "Operation Twist" to reduce bond yields, making stocks look more attractive. The tide turned on October 4th when the Dow Jones pierced its low for the year, looking to dive another 10%, and then rallied nearly 4% in the last 49 minutes of the day! Somebody was buying, and buying hard!

Earnings season started in October and kept the momentum going, with 71% of S&P 500 companies beating expectations. (Although, expectations had been greatly reduced in the months prior. Also note that earnings have been carried largely by international sales, on a devalued dollar, which makes numbers higher back home.) The scary thing in this rally is that it was on unusually thin volume. The prices kept moving up, but there was very little money driving it up.

October topped over with the best rally since late 2009, then began staggering up and down while Greece took center stage with its unsustainable debt, and political inability to make cuts while its citizens were rioting in the streets. Eventually, a deal was reached where private creditors agreed to take a "voluntary" 50% loss on their Greek bonds (Although a few weeks later, it appears only 70%-80% of private creditors are actually willing to accept this negotiated deal. The European Central Bank would take no losses on the bonds it has purchased from Greece.) So Greece has left the headlines, but is still far from resolved.

The stock market couldn't rise higher with the concerns in Greece, but Greece wasn't enough to make stocks fall – after all, Germany has enough fire power to bail out Greece, and has an interest in keeping the Euro together.

Enter Italy. Greece is a straw that won't break the Euro Camel's back. Italy on the other hand, the 3rd largest Euro economy, is a big marble pillar. An Italian default will crush the camel flat, never mind breaking its back. Greece is Too Big to Fail. Italy is Too Big to Bail Out. It was almost 2 weeks ago when yields on Italy's 10 year bonds rose over 7% (Now Italy has to borrow money at 7% instead of, say 3%, to finance its spending.) 7% is the level at which Portugal, Ireland, and Greece needed a bail-out. Italy has had two bond auctions since then, and the only major buyer of their bonds has been the ECB (European Central Bank – the equivalent of the US Federal Reserve), barely keeping rates below 7%. Now Spain's

bond yields are taking little hops over 7%, and European leaders are openly mentioning a “two speed Europe” separating the strong economies from the weak economies. With this turmoil, France’s bonds are on the rise to 3.6%. Not yet worrisome, but not a sign of comfort.

In a nutshell, Europe is a mess in every way you measure it.

It’s important to recognize that the current European debt crisis is different from the US debt crisis in 2008. The 2008 crisis was one of *liquidity* (having enough cash for short-term transactions) whereas the current Euro crisis is one of *solvency* (being able to pay for your consumption). Europe has addressed the liquidity related issues with their banks, so we shouldn’t see a Lehman type failure. However, Greece and the other PIIGS are simply insolvent – it’s like they’re borrowing 10 euros at an interest rate of 1 euro a year, but only producing .7 euros a year. They can’t afford to pay the interest for what they’re borrowing.

Market Outlook - Detailed

Now looking ahead to what the markets might do.
(Please keep in mind, I consider myself a rookie at all of this, and I spend most of my time programming instead of researching economic dynamics. So I’m offering my best estimate, but there are certainly pieces missing and factors not fully considered.)

On the 1 year term: European growth is meager at best, and it seems most experts have them pegged for a recession. This will negatively affect exports from the US and China. China can still grow on its own internal consumption, but the US is barely hanging onto meager growth. If Europe stays healthy (I’m not sure how), the US should keep limping along. But if (when?) Europe enters a recession, it’ll change the growth prospects in the US, and weigh on the markets.

On the positive side, stocks are historically cheap, and the US doesn’t have recession indicators flashing. The markets have already partially priced in the risk over there in Europe. So if you think we’re going to continue with slow growth, it’s a great time to buy. Warren Buffet has plowed more money into stocks this last quarter than any in his history. He’s telling people every day that he thinks we’ll be just fine. But keep in mind that most of Buffet’s major investments from 2008 and 2009 are still underwater.

Over the next few months: It seems that news from Europe will continue to dominate the markets. Good news in the US (like unemployment project to fall to a mere 8.7% by the end of 2012), is totally overshadowed by small spikes in Italian and Spanish bond yields. Political leaders will continue to say whatever it takes to reassure the markets, but credibility is already stretched thin. The ECB can buy ultra-risky bonds, but they can’t print money in the way the US Fed does (Disclaimer: I don’t understand the differences between the Fed and ECB, but that’s what I’ve read). The EFSF (European Financial Stability Fund) created to backstop Greece and the other PIIGS (Portugul, Ireland, Italy, Greece, Spain) isn’t materializing the money they intended, but even if they did, there’s no way it can backstop Italy or Spain.

Bottom line, I think the Euro zone (and Euro currency) is near the brink of a forced major restructuring. When Italy or Spain finally falls over the edge, a lot of people are going to lose a lot of money. There will be a lot of fear in the markets, which will make them drop like 2008. I can’t tell if that’s going to happen this week, next week, next month, or maybe not until March 2012. The only way that won’t happen is if Italy and Spain are both successful at simultaneously cutting their spending, and fostering economic growth (a very difficult thing to do, even for healthy countries).

At every sign that Italy and Spain are turning around, the market has a bunch of Bulls ready to buy in on these cheap stocks. The market could make a good rally if we have no bad news for a month, like October. However, at every negative headline, buyers are going to disappear, and we'll see a sharp drop. This fear and optimism will make the markets continue to be highly volatile until we see a steady conclusion to the Euro Zone sovereign debt crisis – either Europe becomes steadily healthy (bringing rallying markets), or they crash and restructure.

(For the record, there's a whole lot about inflation, currency valuation, housing markets, consumer spending, emerging markets, and (of course) congressional super-committee decisions, that I haven't included in this analysis. Either way, I think the Euro situation is the dominant factor by a long shot.)

Fund Strategy, Extended Details (If you're interested)

If you're interested in a little more of what causes performance in the fund to go up and down, then read on. I won't get too detailed, but will give you a sense of why October was so strong, November was pretty mild, and December and January are expected to be more mild.

Currently, most of my trades are open for a period of 7-9 weeks. I start constructing and entering trades the day that new options are available two months out, and add to the portfolio over the next couple weeks as the market moves up or down. This enables me to build a portfolio with trades distributed for safety, and giving increased profit potential in certain pockets.

I only enter trades which have a back-tested profitable outcome of 96% or higher. That sounds like incredibly high probability for gain, but the "1 in 20" chance of loss certainly can happen in the market. August was a "1 in 20" month for the market dropping, posting two daily drops on the Dow Jones top 10. Then October was a "1 in 20" month for the market rallying. My expectation for "normal" months will be a modest 5%-7% profit.

Risk and protection considered, the nature of my trades highly favor volatile market declines (like August). These periods of rapid decline can be dangerous if my portfolio is over-exposed to a specific sector, but become highly profitable when I have it safely balanced. The greater safety I build into my trades against a market drop, the lower my gains on a regular basis, but the greater profit will come if/when the market takes a nose dive. So the up-side of lower returns in the next few months is greater safety in the portfolio, along with higher potential for gains if we get a serious decline.

Just for Kicks

"Quitting my day job, and starting Manhattan Beach Capital."

It's not often that the infamous Murphy shows up in my life to take a good laugh introducing misfortune, but in the case of launching Manhattan Beach Capital, Murphy had a party. It's an entertaining story.

I devised a way to construct these "very low risk trades" back in March 2011, but had to mostly leave it on the shelf until we finished Propulsion Checkouts on Dragon C2. I ran some small trial trades in the markets which had mixed outcomes, but validated the underlying concept (I'll spare the details, but Murphy first showed up here, twice). When we finished Dragon in mid-June, I took a 2 week vacation to focus purely on programming a tool to construct and test these trades. That went well, and it was clear

that this strategy could very easily replace earnings from my dream job that I'd had at SpaceX for the last 3 years. I gave SpaceX my notice for a temporary leave, and entered a few trades in late July 2011.

My models had been built from data covering the last 18 months of market movement. That had a decent distribution of market behavior, and 2008 was recent enough that another large crash seemed very, very unlikely. I felt like I was in safe territory.

My 2nd to last day at SpaceX was August 4th. The markets had been sliding for the last 2 weeks, and tipped over the waterfall that day. The Dow Jones posted its **8th largest daily loss** to that day, falling 4.3%. I checked my trades against my models, and they were within 0.2%! I felt great!

On my first workday away from SpaceX, the Dow Jones set another record, posting a 5.5% loss for the day, **the 6th largest drop** in history! Again, I checked my trades against my models, and they were within 0.4%! I was starting to feel nervous, but overall I saw this as a very strong validation because it held beyond the data my model had been built from.

That's when Murphy came out swinging. The next day brought a **top ten gain** on the Dow, bouncing 4%. Following that was **another top ten drop**, losing 4.6%. Then it posted the **11th highest jump** at 3.95%. Those three days threw my model into a pit of angry tigers, turning the trades from very safe gains, into some ugly losses. Seeing what this monster volatility was doing to my trades, I decided to exit before it got any worse (and they certainly would have gone worse had I stayed in). I exited with a very disgruntling 12% loss.

On top of that, my brokerage increased my margin required by 46% on the first day of the fall, then by another 36% after that! That was enough to force me to exit a couple trades which otherwise were very comfortable 3% gains, turning them into 5% losses! Grrr!!!

All said and done, I quit my day job, and immediately got hammered with a 17% loss! Since then, I've developed my tools to back-test every trade through 10 years of historical data (and changed the construction to turn volatility in my favor). I've now verified that, had I entered those trades in any other of the last 24 months, they would've been profitable. Any other month! And I made my move on the 1 in 24 that they couldn't handle!!!

So my introduction to the world of trading left me bruised and battered, but still standing, and stronger for it. But I still can't help laughing at the precise convergence of timing.

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