Lindisfarne Investments, LLC

An island of safety in a sea of risk

Market Update
February 15, 2013

The art of investing has few rules when you get right down to it. If you are investing important money, that is money that would impact your life styles and goals if you were to lose it, there are really only three main rules.

1. First and foremost, pay attention to risk. If the market is too risky, don't invest. Wait until the odds are in your favor. If the particular investment is too risky, find another.
2. Second, buy things that are in favor. That is, things that are going up in price. A good company is not always a good stock.
3. Remove your emotions from your investment decisions.

There are several ways to monitor risk. One you have seen many times before in these reports, R/r. Our R/r indicator is the current Return divided by the current risk for a market, a sector or a security of interest.

Another way to monitor risk is best described as a circuit breaker. Just like the electrical panel in your house where a circuit breaker will trip when there in an electrical danger thereby cutting off the power to the offending area, a market circuit breaker does the same with the market. Lindisfarne Investments also uses this type of circuit breaker in its market analysis. If the breaker has "tripped", we will not make investments in that market or security until the conditions are safe once again. Typical items that compose a market circuit breaker include things like new market highs and lows and/or advancing issues and declining issues and bond yield trends.

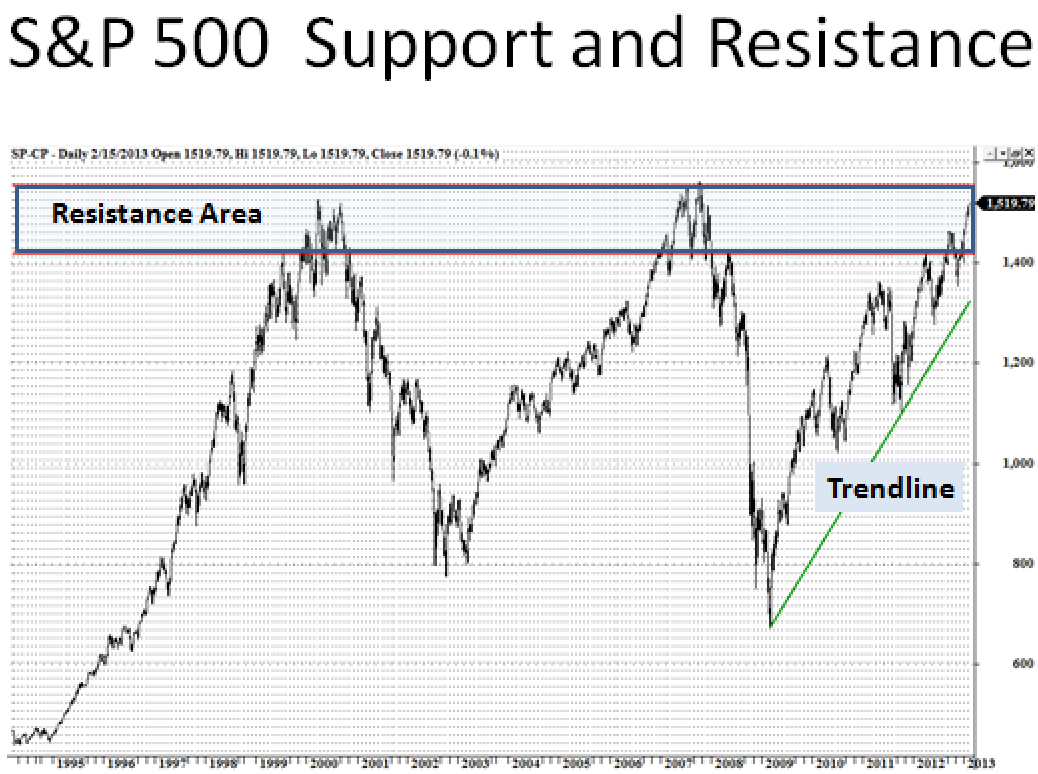
2012 was a risky year. The circuit breaker for investing in equities was "tripped" for more than half the year. So, for most of the year, we were invested in the bond-portion of the market. Here, the risk was low and the returns were consistent.

But now, the equity circuit breaker is reset. We have moved our asset based accounts back into a split between bonds and equities.

We are near all time highs and in the area that we had previously identified as a major resistance zone, see below. The top of this resistance area is marked by the market highs in 2000 and 2007. The question remains as to what the market will do at this resistance. There are three possibilities.

1. The market will continue higher as though the top of the resistance wasn't there. Once it was beyond, it might then pull back to the top of the area before continuing higher.
2. It might move sideways as a way to catch its breath.
3. It might go down as it has the last two times it was here.

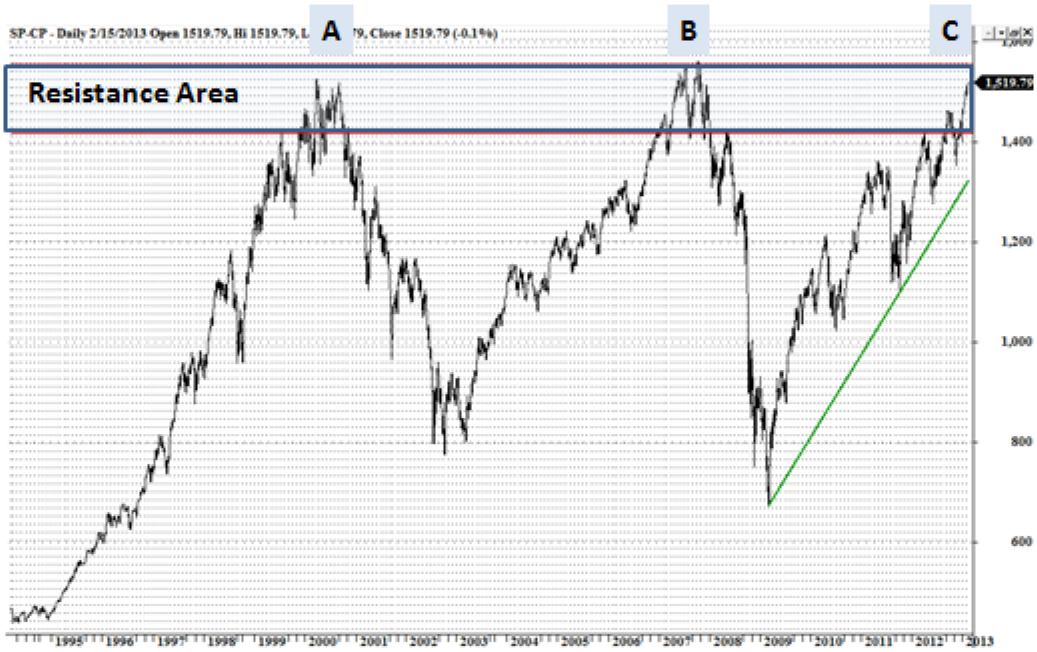
Let's take these one at a time.



First: the market continues higher.

The resistance was formed in 2000 at the point marked "A". There is an old market saying that at resistance, "You fade the first time you test the resistance" (Point "B"). That would have been a great trade to take. But the saying continues, "You go with the movement at the second test of resistance" (Point "C") -- which is now.

Previous Highs



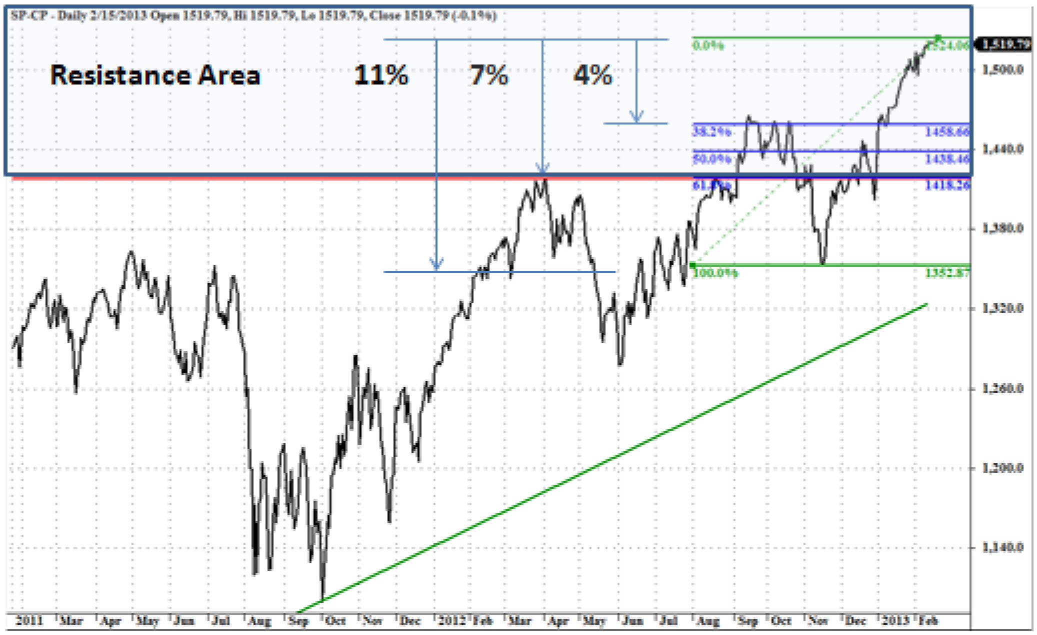
Of course, the second possibility can occur, the market can move sideways to relieve the buying pressure that has been present. In 2000, we stayed in the resistance area for a year and in 2007, we stayed 1 ½ years. One thing that might keep us here now is the jockeying in Washington about the sequestering of the budget (due in several weeks), disagreement about the debt ceiling (May), delay over passing a new budget, etc. These are all issues that will be resolved, but the negatives of the 24 hour news cycle and the uncertainty of what the resolution will be can put the brakes on further market advances, at least for a while.

The third possibility of a pullback or downtrend starting from this area can be either mild or dramatic. On the mild front, the following chart shows a Fibonacci set of lines from the previous low in November until today. The 38%, 50%, 62% and 100% levels are typical levels that a pullback would normally go to without invalidating the current uptrend.

As you can see on the next chart, a 4% pullback takes us to the 38% level. Coincidently, this is a support area formed by the market high in September and October of 2012. A 7% pullback takes us to the 62% Fibonacci level and the support formed by the high in March of 2012. An 11% pullback (100% Fib level) takes us to the low in November 2012 but also to the highs formed in the spring of 2011.

The most talked about pullback level that is mentioned in the financial news is a 6% to 10% pullback, letting the market “rest” before it goes higher. This type of pullback can take anywhere up to 6 months before it reaches support.

Fibonacci Pullbacks



However, the dramatic pullback is one that turns into a major downtrend, just like in 2000 and 2007. Here, the market could revisit the lows of 2002 and 2009 which were at the 800 and 700 price areas respectively. This would correspond to losses of between 47% and 54%.

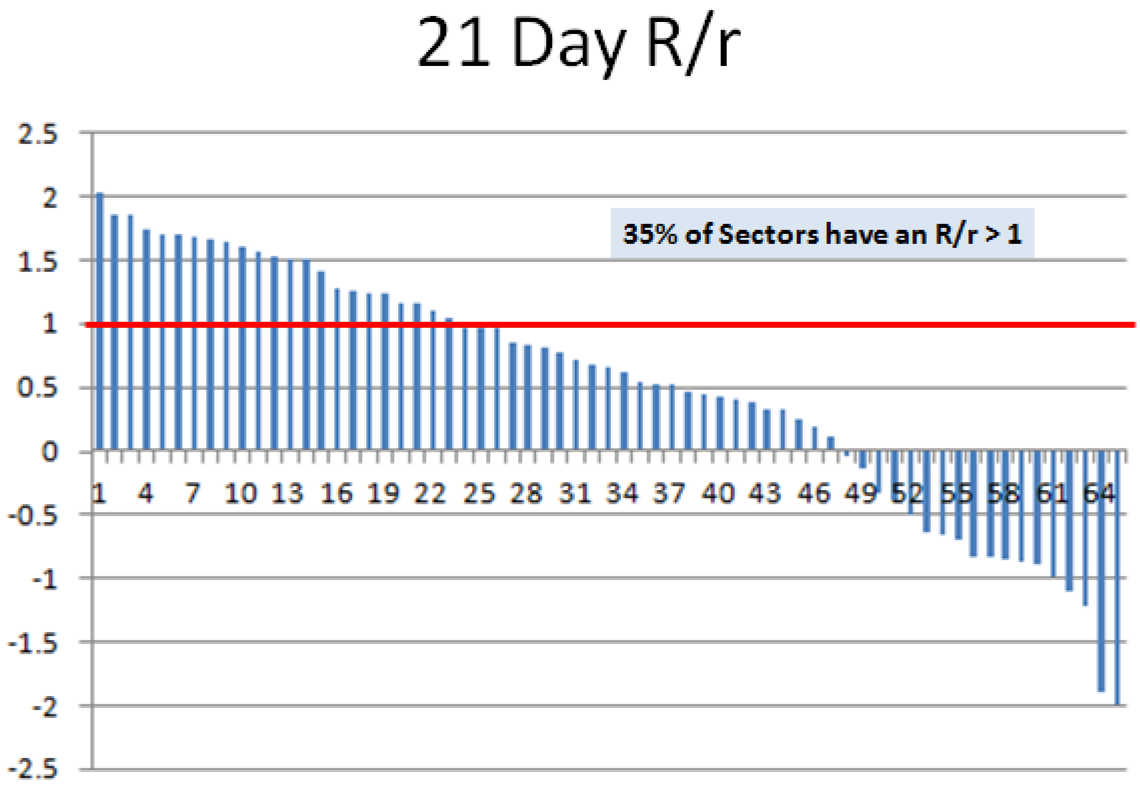
What could cause this type of bear market? The simple answer is the bursting of another bubble like the tech market in 2000 and the financial crisis of 2007. What could this be? Some possibilities are: the collapse of some major European banks, a regional conflict between China and Japan that could grow to pull in more nations, a currency devaluation war, a meltdown of our underfunded pension systems at the corporate and state levels, etc.

I feel that the probability of this type of pullback is very slight. The governments and central banks of the world have shown us over the last several years that they are willing to do whatever is necessary to maintain the structure of the financial industry and the liquidity of the markets. I do not believe that they will suddenly abandon that posture. The results would be too disastrous.

At Lindisfarne Investments, we have moved to a balanced asset mix between bond/income funds and equity funds. However, we have done so with funds that range from no-fee to inexpensive-to-sell and are using tight stops. In a moderate pullback, the strength of our holdings should moderate any downdraft. If not, then we will retreat from equities and if bonds are appropriate, move back to a further commitment in that asset class.

Meantime, if you wish to be invested, the following sectors are the least risky or have the largest gains over the last 21 days.

As you can see in the next graph, a number of sectors pass our R/r greater than 1.0 test. In fact, 35% are acceptable. Conclusion: the current advance has reasonable participation.



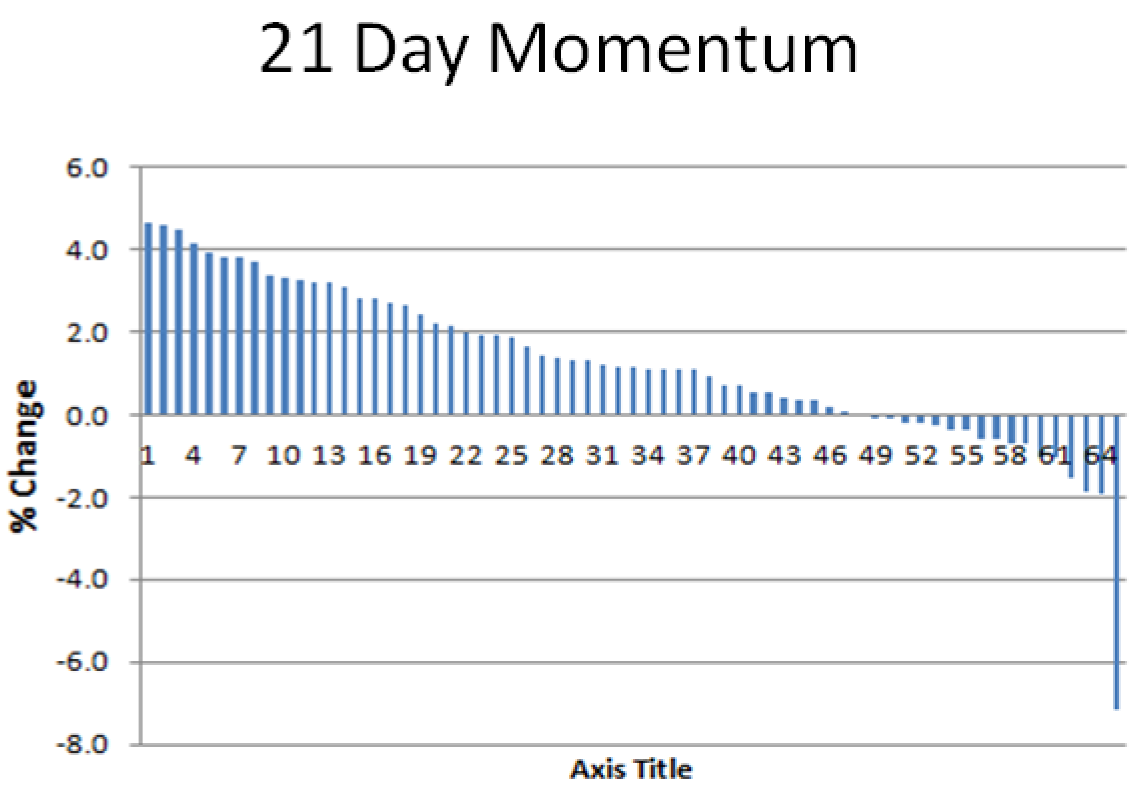
Lindisfarne Investments, LLC
320 Kenmore Drive, Bay Village, OH 44140
(440) 623-0775 www.lindisfarneinvestments.com

The top twenty sectors with the highest R/r are shown below:

Top Twenty Sectors for 21 day R/r

	Family Name	R/r
1	Mid Cap	2.0
2	Small Cap	1.9
3	Social Responsibility	1.9
4	Financial	1.8
5	Unique Style	1.7
6	Value	1.7
7	Consumer	1.7
8	Cyclical Sectors	1.7
9	Russell 2000	1.7
10	Income	1.6
11	Floating Rate Income Securities	1.6
12	Non Traditional	1.5
13	Growth	1.5
14	Quantitative Style	1.5
15	S&P 500	1.4
16	Micro Cap	1.3
17	Big Cap	1.3
18	Tax Managed Growth	1.2
19	Health	1.2
20	Floating Rate Bank Loans	1.2

From a momentum (or gain) standpoint, the next chart shows that most sector have shown a positive return over the same time period.



Remember, that even though there have been market gains in this time period, our circuit breakers have kept us out of the equities since the market risk was still viewed as too high. Just because the market is going up doesn't mean that it isn't risky.

Rule #1 implores us to avoid these riskier times in the market. It encourages us to make the market "prove itself" before we risk our monies. But as we stated, we are now in a risk-on period.

And the top 20 sectors from a momentum standpoint are shown next:

Top Twenty Sectors for 21d Momentum % Change

	Family Name	MOM
1	Russell 2000	4.6
2	Small Cap	4.6
3	Mid Cap	4.5
4	Social Responsibility	4.1
5	Financial	3.9
6	Value	3.8
7	Cyclical Sectors	3.8
8	Micro Cap	3.7
9	Growth	3.4
10	Consumer	3.3
11	Income	3.2
12	S&P 500	3.2
13	Quantitative Style	3.2
14	Health	3.1
15	Tax Managed Growth	2.8
16	Big Cap	2.8
17	Unique Style	2.7
18	High Tech	2.6
19	Western Pacific	2.4
20	Japan	2.2

Just because we have identified the best performing sectors from an R/r or Momentum standpoint, we need to go further. Starting with a list of non-load funds for a sector of interest, we look for the best performing R/r or Momentum funds within a given sector.

Having found funds of interest for several sectors, the next step is to see how they work together from a portfolio standpoint. Does the combination show a degree of non-correlation whereby a weak moment in one fund is offset by a strong showing in another.

Only now are we ready to invest.

If you are invested with your non-Lindisfarne monies, be vigilant. Our current market, economic and political conditions can dramatically change what happens in the near term. Actively managing your money is more important than ever.

That what we do for you at Lindisfarne Investments. We manage by the rules stated earlier. We watch the risk first, identify the sectors that are moving, select from within the sectors, review the overall portfolio combination and then invest as un-emotionally as we can.

Please feel free to pass this update on to anyone that you think might be interested in it. If they wish to be on the mailing list or would like more information about the services of Lindisfarne Investments, we can be contacted by phone at (440) 623-0775 or by email at bill@lindisfarneinvestments.com .