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**Choice Research Quarterly**

**4Q2008**

Each quarter we issue research describing current intermediate term market trends, followed by a discussion of various fund management including risk control techniques we employ and the manner in which they may come into play during those trends. This research is intended to complement our regular Monthly Commentary, included with our monthly results update.

A summary table of contents is shown below. **If you have any comments please feel free to email CAI at [info@choicealternative.com](mailto:info@choicealternative.com) or telephone +1 (212) 248-2733 x701.**

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## Choice Research Quarterly, 4Q2008

### Stocks have lost \$25.6 Trillion since October 2007

The past few months have experienced some of the largest bankruptcies, failures, and bailouts of financial institutions in history. According to Bloomberg News, for the period October 2007-2008, the values of stocks worldwide have fallen -41%, or \$25.9 trillion. On an individual country basis, the US has lost by far the most at nearly \$7 trillion. China ranks second at -\$1.77 trillion, followed by the UK (-\$1.72 trillion), Japan (-\$1.54 trillion), and Hong Kong (-\$1.47 trillion).

Following through from September's demise, during October, equity indices in the U.S. and around the world collapsed in the manner of a cascading waterfall. At its low, the Dow Jones Industrial Index dropped -27.36% and ended the month down -14.06%; the S&P 500 in October dropped -28.00% and ended down -16.94% – it was the S&P 500's worst month in 21 years, while the MSCI World Index dropped -29.89% and ended the month down -19.05%. In terms of alternative investments, the Hedge Fund Research US Global Hedge Fund Index fund lost -9.26% (following a drop of -6.90% in September) and some of the largest and *previously* respected hedge fund firms (*i.e.* names such as Maverick Capital, T Boone Pickens' BP Capital, and the Citadel Investment Group) suffered massive losses in October following the deluge encountered in September.

Market conditions are much more dangerous in this bear market than during the last, Dot-Com led bear of 2000 to early 2003. This is due to the speed with which the indices are dropping; right now the S&P 500 Index has dropped an amount similar to the Dot-Com crash, *but in a little over a third of the time.* Additionally, as we will discuss later, daily volatility is significantly higher than during the Dot-Com bear market. If we recall, losses during 2000-2003 arose essentially from the correction of a mania in the technology sector. Today losses radiate from the very heart of the global credit and the financial system (poor lending standards and risk control), exacerbated by deflation in the housing market, and a resultant deepening economic recession with global implications. In short, the carnage in this bear environment is much wider and occurring with greater speed.

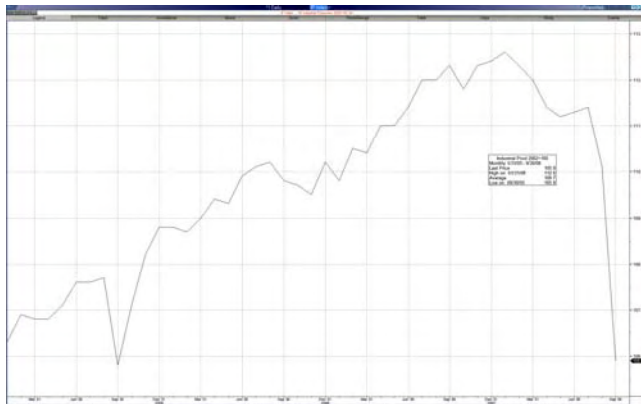




### Economic Headwinds

Our growing concern for the past year has been a loss of faith in the US financial system and its knock-on effect for the world’s financial system and the economy. This fear exploded into market consciousness in October. At the same time, the odds of a major economic dislocation – such as a protracted worldwide recession – have increased during the past few months, putting further stress on the global system. In the US, the investment banking sector collapsed forcing mergers (Bear Stearns, Merrill Lynch, and Wachovia) and bankruptcy (Lehman Brothers). The final two bulge bracket firms (Morgan Stanley and Goldman Sachs) ultimately became commercial banks as events drew back the veil on questions regarding the financial services model. In addition, the world’s largest insurance company (AIG) became insolvent, forcing a US Treasury lead bail out.

Mass insolvency would have a devastating economic impact on credit and lending – the lynchpin of commerce and economic expansion. In such an environment, the repayment of debt becomes difficult to impossible not just for the overleveraged, but even those households built on cash flow, when a light disturbance occurs, as credit is still extremely tight and unforgiving. Now, according to *Ned Davis Research, Inc.* American domestic debt is 356.5% of Gross Domestic Product. To put this into perspective, reversion to the mean is 150%, and that does not allow any room for undershoot.



Although the US financial system is still in distress, the recent moves by central authorities – providing liquidity and various debt guarantees to the private sector funded by the general pool of tax receipts (depicted in the cartoon to the below right). However, other major

economic problems have arisen. As a next step, the current US government and newly-elected Obama administration are exploring various stimulus options to reignite the economy. However, a deeper economic slump around the globe and in international trade has begun to accelerate as evidenced by a shocking collapse in output over the months of August and September (graph in the above left shows US Industrial Production), and this threatens to overwhelm the incoming Obama administration as it struggles to restore confidence in America.





Note the Baltic Dry Goods Index (“BDIY”) chart to the right. This index is based on professional assessments made by a panel of international ship broking companies to provide an assessment of the price of moving major raw materials by sea. Simply stated, the BDIY provides both a rare window into the highly opaque and diffuse shipping market and an accurate barometer of the volume of global trade – devoid of political and other agenda rhetoric or concerns. As the chart depicts, the demand for global shipping has collapsed.

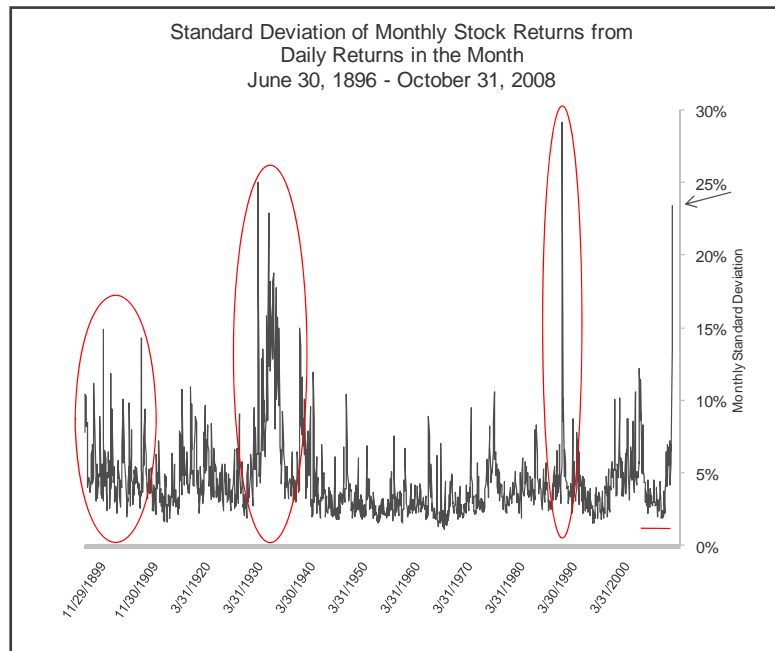


*The 90% fall in the value of the BDIY indicates a slowdown in real demand for bulk commodities and more importantly, a near collapse in the global trading system because of the inability of importers and exporters, particularly those based in the emerging world, to obtain trade finance.*

**Will recent stock price volatility continue?**

October 2008 was one of the most volatile months on record since the Dow was first published in May 1896. As a look back historically, we searched for all days with a 4% move up or down in the Dow. CAI research reveals that October 2008 had eight of these types of movements in any trading day, edging out the prior records recorded in November 1929 and June 1932's of seven (the Great Depression period's secular bear market). CAI expects this type of volatility to continue for at least the next several years.

As we discussed in the CAI 1Q2008 Research, published in February 2008, current volatility (as measured by the standard deviation of monthly stock returns from daily returns back to 1896), is not yet out of line with certain prior market cycles. In fact, although hard to stomach, volatility has been higher and more protracted in periods such as in the late 1800's into the early turn of the last century, and also during the 1930's.



Therefore, we have taken this into account in building the



portfolio and controlling risk. We believe the prudent investor should prepare for the swings that define such activity in other analogues of uncertain times (e.g. turn of the century United Kingdom losing its hegemony grip, along with credit contractions, gold standard implications and panic, and the 1930s Great Depression and World War II period).

Two other important observations emerge from the chart on the prior page: 1) how quiet the market was between March '04 – May '08 (straight red line extended over a four year and two month period) and 2) the degree to which recent volatility has significantly exceeded that experienced by investors who are younger than, say, 40 years old. Unlike the 1987 spike, it's hard to escape the conclusion when studying history and analytical data, that even when things "normalize", intermediate term markets will carry significantly higher volatility (risk premium) than they have during more recent market cycles.

**Are we approaching sentiment levels consistent anywhere near a market bottom?**



We are quite cognizant that bad times by definition always look worst at the bottom. Most measures of sentiment that we track are becoming deeply overdone. We noted the emotionally bearish "More Pain" *Barron's* magazine cover on October 25, 2008 to the left. However, the following week's "Still Bullish" October 31, 2008 issue seems to ironically neutralize overly bearish sentiment.



In addition to other important CAI indicators, when compared to all previous sharp selloffs since August 2007, sentiment remains surprisingly complacent given the severity of the recent declines. Therefore, although the market could work off current over-sold levels, the likelihood of a major secular bottom being reached is not confirmed by our research and analysis.

Mass media coverage, similar to the *Barron's* covers, tends to coincide with declining markets, not actual market bottoms. At **market bottoms**, investors tend to be wrung-out and worn-out, and media prognosticators are in no hurry to make another batch of incorrect predictions that will make them look like foolish to their viewers and readers.



Given the combination of all our indicators, and the wide and loose whipsaw environment uncertainty is producing as of this writing, our system keeps us in oversized T-bill positions with little risk exposure. Suffice it to say, that authority involvement in the markets is not promoting orderly price discovery at this juncture, while credit markets are barely thawed. CAI avoided short or long side whiplash in the rocketing rally of October 28<sup>th</sup> and subsequent fade, and prepares for a lower risk set up with a bearish posture.

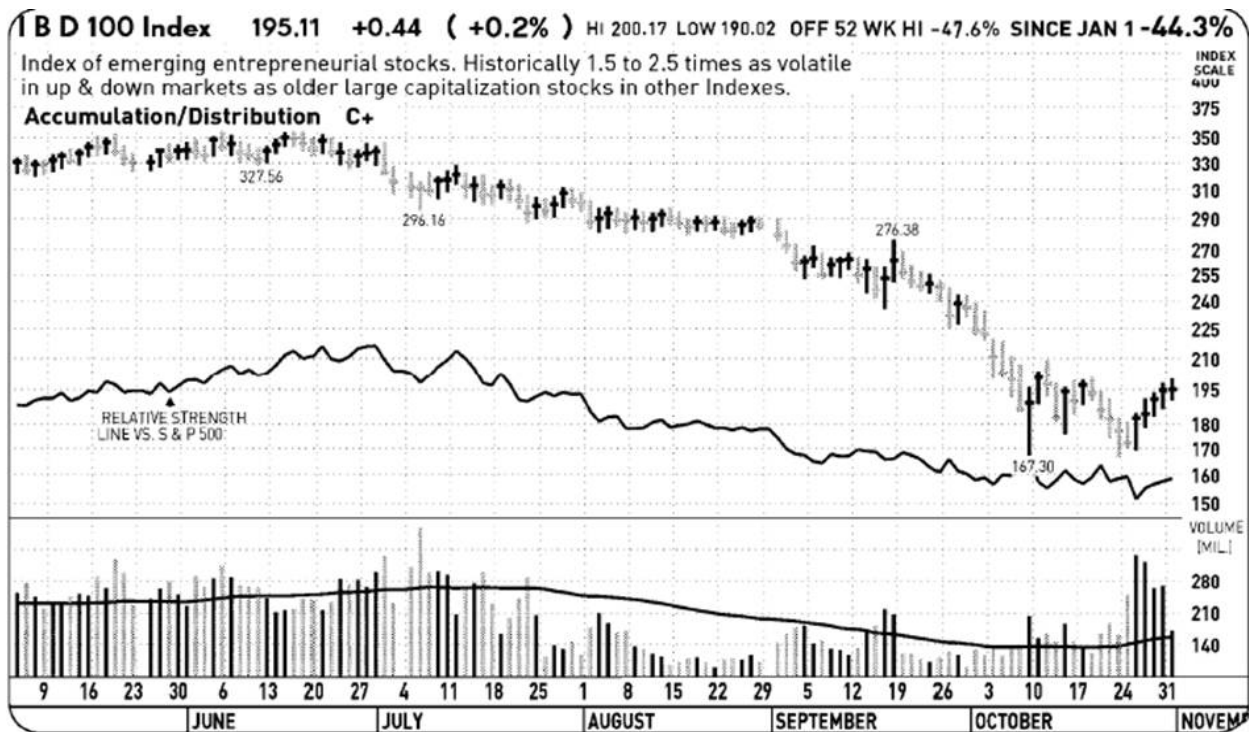
As we will discuss later, individual long-side equity investment candidates are non-existent at this juncture according to CAI's quantitative models and research, another characteristic supporting a mere oversold condition in an evolving secular bear market as opposed to an inflection bottom being reached at this juncture. While we absolutely respect the potential for bullish upside movements in this market, as indicated by the chart to the right, the primary trend appears decidedly down. Hence, we look to position with the larger down trend at lower risk entry points. For now, that seems to be a function of time to digest the current downside price action.





One would hope that there are always superior growth stocks performing, right?

A measure of growth stock performance is the Investor's Business Daily 100 Index ("IBD 100"), a proprietary list of the 100 top-ranked companies published every Monday in Investor's Business Daily ("IBD") newspaper. The IBD 100 ranks growth stocks based on superior earnings, strong price performance, and leadership within their respective industries. A laggard performer since January 1, 2008, the IBD 100 is now down -44.3%, year-to-date, and demonstrates relative weakness when compared to the S&P 500.



Indeed, during the past few months, including before and during the recent spike rallies, CAI's long system's internals and quantitative models generated zero individual equity "Buy" signals. Yes, that is none!

Fund Management continually contrasts sentiment with our proprietary quantitative screening models, a universe of 5000+ potential growth equities to determine possible buying candidates versus market sentiment and action. Despite the 10% rally on October 28, 2008, CAI quantitative models reveal only one stock issue meeting these growth criteria. That is 1 out of 5000+.

In this instance, when liquidity screens and CAI's reward/risk metrics were applied, the stock price action was so volatile that our protective stop placement – a fundamental tool by which we define position risk – would have to be so wide to filter volatility from



actual trend change, that the potential reward/risk metrics did not justify taking any position.

To contrast, typically at the beginning of major, sustained up trends (e.g. February/March of 2003), or large market rallies, or rebounds from selloffs, have large numbers of growth stocks breaking out into one year, multiyear, or all-time new high ground. This type of action displays market internal strength necessary for a newly developing bull market to emerge. Furthermore, this bottoming action tends to portend a strong and multi-month (6 months and often longer) tradable up trend in the major averages. As the "foot soldiers," if you will, carry the upside load and re-instill investor confidence, the market then "climbs the wall of worry" (e.g. contrary and positive price action in the face of seemingly bad corporate and headline news). This is true of practically all major bull runs in history that CAI studied with data points back to 1800. None of these positive long side bottoming out characteristics are currently present, yet.

While we expect the market will have sustainable oversold rallies, wringing out an excess of bearish sentiment, the lack of early leaders is a primary level bearish signal currently within CAI's system cautioning against any aggressive long side positioning, and postures the Fund for careful shorting.

So, what about the recent vertical rallies in stocks?

Much excitement in the media is generated by sharp reversal rallies. Indeed, the near vertical rallies in the Dow Jones Industrial Average on October 13th and 28th were two of its largest one day gains, ranking fifth and sixth on the list, since the Dow was first published on May 26, 1896.

While market commentators have been almost giddy over these fast and steep movements, it's important to note that 13 out of 20 or 65% of the best 20 days on record occurred during secular bear markets (depicted in bold and italic in the chart to the right).

Therefore, such rallies are usually nothing more than panicked short covering, followed soon thereafter by renewed downward pressure, as the excitement and emotion generally expends itself. The rallies of this just past 10/13 and 10/28, have not appeared to be no different.

Given all of the above, you might ask: "With the major market averages down 30% or more, and many hedge funds down 10% to 50%, how is CAI avoiding similarly steep losses?"

Table with 3 columns: Rank, Date, and Percentage. Title: Dow Jones Industrial Average Best 20 Performing Days from 05/26/1896 - 10/31/2008. Rows 1-20 showing dates and percentages, with rows 9-13 in bold and italic.



## **CAI's Methodology: A Look under the Hood**

If you've been reading our Monthly and Quarterly Commentaries, you have a pretty good idea of how we think and the investment and risk control processes we implement at CAI. Our basic investment tenets do not change, regardless of the market's condition. Specifically, these tenets are:

- » **Superior risk control**
  - Apply Patented risk based systems
  - Stop-loss based sizing of securities and portfolio positioning on entry
  - Trailing stop-loss based Entry/Exit techniques
- » **Capital preservation**
  - Use of the above techniques plus the broad use of low risk instruments
  - Thorough counterparty risk management processes and procedures
- » **Identifying, Testing and Following Investable Trends, Bull or Bear**
  - Pattern recognition models and trailing stop-loss entry/exit techniques
  - Seeking outsized growth potential in intermediate term trends (weeks to months)
- » **Scale In & Out**
  - Ride winning positions, cut losers and build on strength of Fund II's equity curve
  - Manage overall position and aggregated portfolio risk exposure

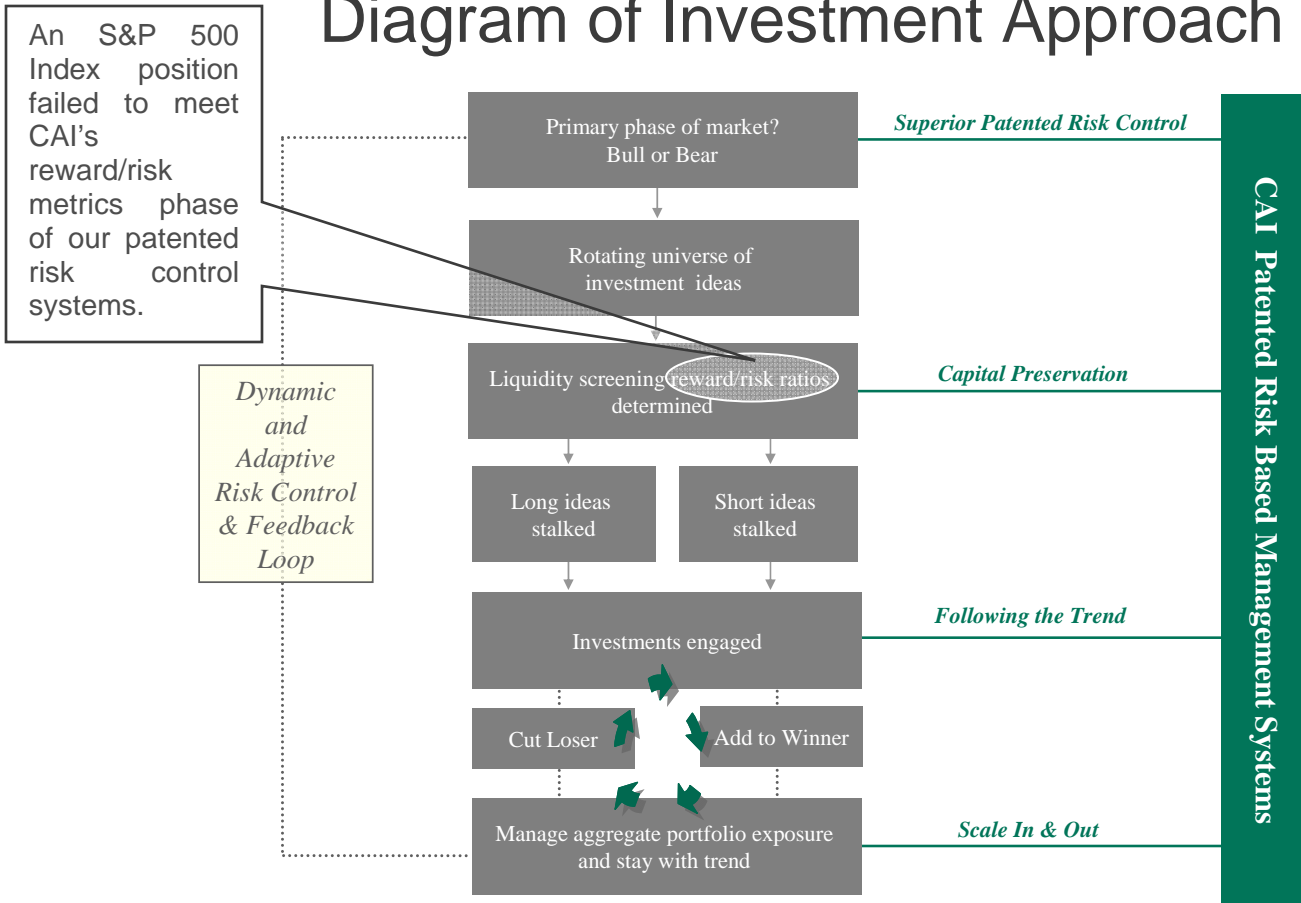
In this quarterly piece, we'd like to show you an actual example of our investment process with a description of a position considered, and then rejected by tests we apply prior to engagement. We believe that a look at this process helps provide an illustrative example of our investment process.

### **S&P 500 Index "Trapdoor" Non-Trade of October 28, 2008**

On October 27, 2008, the S&P 500 Index was in the process of a vicious five-day, -13% loss. The speed and severity of this loss had the qualities of "too much, too fast," which carries with it the possibility that a capitulation bottom could be forming. Other quantitative models continued to monitor the markets while Fund Management researched and applied rules it utilizes prior to engaging a position. On the next page we provide you with CAI's "Diagram of Investment Process". Note that a position in the S&P 500 Index failed at the third phase in our analytical structure where CAI's patented risk control systems force strict adherence to reward/risk ratio metrics prior to engaging any position (highlighted with a shaded oval and a call out box on the diagram on the next page). Additionally, our patented risk based management system aggregates such risk control consideration across our total portfolio.



# Diagram of Investment Approach



As a result of CAI's patented risk based management systems and Fund Management's careful work, system intelligence rejected taking on a position due to an unacceptable reward/risk metrics, although we felt like a short covering spike could come at any time.

By October 28<sup>th</sup>, a short covering panic did indeed move the S&P 500 Index up over 10% leading many media talking heads to predict that the bottom was in place and that it was time to jump back in on the long side of market with both feet. As discussed, CAI's research and metrics continued to rule against this position. Here are further relevant rules applied by our system:

- 1) Quantitative screening for growth stock leadership: There were no growth stocks demonstrating leadership in the market as determined by our quantitative models, and growth stocks continue to demonstrate laggard relative performance. Indeed, CAI quantitative models revealed only **one** growth stock making a new yearly high, and that was due to a buyout. Otherwise, no stocks in our universe were making multiyear or all time highs.
- 2) Volatility was still at an extreme: Market bottoms are usually accompanied by a period of decreasing or tightening volatility, whereas current volatility continues to reach extreme levels. On October 27<sup>th</sup> with a little over a half hour left in the S&P



500 Index Future's pit session, the Index dropped -5.4% in 26 minutes – creating a trapdoor for unsuspecting investors. We cannot stress how substantive such a level of volatility is in and of itself. Volatility then undulated 3 more times (up and down) in whipsaw fashion on the open and until 2PM on October 28<sup>th</sup> before rallying into a close of +10% on the day.



- 3) Credit analysis: CAI's ongoing credit research and analysis continues to indicate weakening balance sheets and probable resultant downside surprises in the capital structures of companies and poor earnings prospects given an evolving economic recession.
- 4) Credit market dislocation: Moreover credit markets remain under stress, some badly enough that they are putting the banking system of entire nations at risk. October witnessed Iceland's financial collapse, and many other nations face possibly a similar fate.
- 5) Primary stock prices are in a downtrend: Primary price trends are down, which usually lead to downside, rather than upside, surprises.
- 6) Absence of capitulation: Our systems have yet indicated true capitulatory washout sentiment – at times the market has been heavily oversold, but no climactic washout event has come to fruition.



Note among others the previously referenced “Still Bullish” contrarian *Barron’s* magazine cover on October 31<sup>st</sup> and other proprietary CAI sentiment indicators, which have not reflected market bottom type analytical readings at this juncture.



7) CAI Indicators remain non-confirming:

a. With CAI’s quantitative stock models still bearish, and the secular trend pointing down, our research seems to indicate an oversold S&P 500 Index move up at best, with moves running counter to the primary trend and serving only to reduce but not eliminate pent-up and extreme bearish sentiment. Our models continue to indicate that the larger trend is more powerful than potential counter trend rally, and that this is a *vastly* more dangerous market environment than the bear market of 2001-2003. Whereas the Dot-Com bubble of 2000 was technology basically working off a valuation mania and a very shallow recession, this bear market is one of systemic risk in the financial sector, housing deflation, and a deep recession, global in proportion.

b. CAI’s quantitative models indicate “trap door market” vulnerability still acutely sensitive to negative headlines and corporate surprises. The market is not “climbing the wall of worry”, it is still attempting to discount in lock step as news hits the wires whereas at bottoms prices tends to act contrary to news.

c. Despite being oversold and at an acute awareness for a “crash or panic”, the market’s daily volatility is still very high. (Procedurally, this level of volatility demands very wide placement of stop orders; doing so lowers trade reward/risk ratios and *per se* many possible trades do not conform to CAI’s risk control metrics which CAI operate on a minimum of 3 to 1 reward/risk metrics).



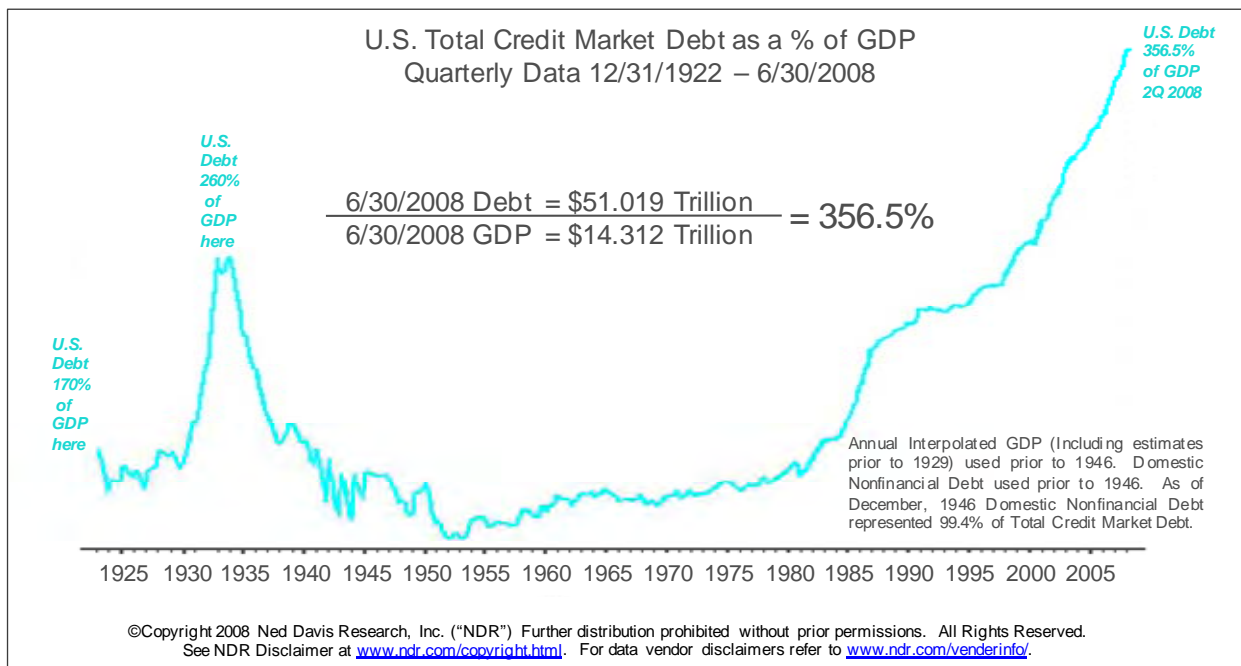
To state this graphically, a 3 to 1 reward/risk metrics for a long position in the S&P 500 Index dictated a 46% up move projection, which would not only have to violate significant secular downtrend momentum, it would represent a less probable V-type bottom and then market up in straight line fashion.



**So, what now?**

Is the worst of the bear market over? In our opinion: No.

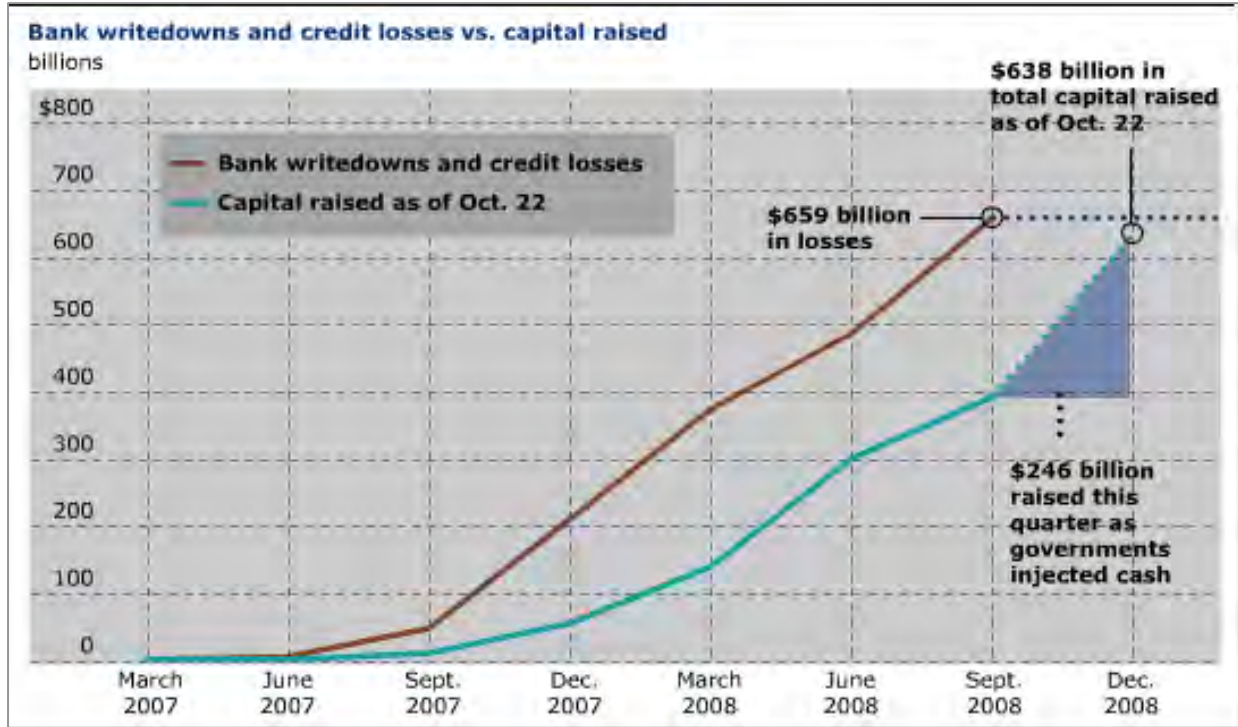
Aggressive action by U.S. authorities seems to be gaining some traction in the financial and liquidity stress elements CAI analytics monitor – LIBOR rates are receding, credit spreads are beginning to narrow, and the US dollar is gaining in strength.



However, as the chart above provided by *Ned Davis Research, Inc.* indicates, the current difficulties are a result of two decades of overconsumption and borrowing which ultimately culminated with poor bank lending standards and risk control. Until a great deal of credit forgiveness and deleveraging is achieved, the economy and the equity markets will continue to face large headwinds.



The chart below supplied by Bloomberg, seems to support this thesis. It displays bank write-downs/credit losses in red and capital raised in blue as of October 22, 2008. The chart shows that bank write-downs and losses are still ahead of actual capital raised. *These two lines must meet before banks can begin to consider themselves sufficiently capitalized, and thus on their way back to normal functioning.*



Additionally, the U.S. consumer is on the ropes. Lack of credit, declining home values, and eight consecutive months of job losses have combined to generate the lowest Consumer Confidence reading since monthly records began in 1967.





## Conclusion

As depicted in the cartoon above, in the coming months, we expect continued intervention by government authorities in the markets and economy, such as tax policy, liquidity injections to different sectors, stimulus packages, and so forth. Some of these initiatives will be successful, some will not. As the market washes out, growth stock will stabilize and show new signs of relative strength near multi-year or all time highs, and our system is ready to pounce on the opportunity. In the meantime, to employ assets, the Strategy focuses on risk control, and macro opportunities that are evolving given the larger down trend in stocks.