Welcome to the May 2011 newsletter of Aleph Investments. This month, I have three main short topics for discussion:

- Dispersion of client results.
- Completion of The Impossible Dream 2 project.
- Housekeeping items

Dispersion of Client Results

One of my goals as a portfolio manager is to keep performance similar among all of the portfolios of the same type. When I set up an equity portfolio, I look at my portfolio, which is the biggest portfolio by a factor of 4.7 to the next largest portfolio. I compare the cash of the new portfolio to the net liquidation value of my portfolio, take a ratio, and apply that ratio to my stock positions, giving me the number of shares to buy of each for the new account.

But the market nuances on the day I assemble the portfolio make a difference, particularly in the level of cash held by the new account. If the market is rising, there will be proportionately less cash in the new portfolio by some amount, and vice-versa if the market is falling. Also, for a few of the companies in the portfolio, I don't want to rush a trade and get a bad execution. I'm happy to say that not only are the commissions low at Interactive Brokers, but the executions relative to my past experience have been excellent.

The following table summarizes results for my "long only" clients and me over the last four complete months.

Date	Feb-11	Mar-11	Apr-11	May-11
Std deviation	0.00%	0.01%	0.03%	0.10%
Average	2.78%	-0.44%	1.48%	-2.11%
Max	2.79%	-0.42%	1.56%	-1.94%
Min	2.78%	-0.46%	1.47%	-2.23%
Count	3	5	8	11

In general, the degree of dispersion across accounts is low, and I hope to keep it that way. A greater concern for me is generating better returns versus the market. Not only is my money on the line here, but yours is also, and I want to see get better results than over the last four months.

Impossible Dream 2

Two newsletters ago, I had described a bond management strategy that I thought was promising, but didn't do well enough to be usable. I have a usable one now, with one problem. Like the credit cycle, it delivers returns in a lumpy manner. Most people want smooth positive returns all the time when they invest in bonds.

Unfortunately the amount of opportunity in the market is not constant. Sometimes yields are lower than the risks, and caution is warranted. Most valuation-oriented investors exit to preserve capital. Here's the trouble: often that condition can persist for some time, which leaves extra returns on the table. So when should an investor decide to adopt a more conservative posture?

One simple rule is to hold investments that are the furthest above, or the least below their 200-day moving averages. As the bull phase of the credit cycle gives way to the bear phase of the credit cycle, using a criterion like that creates a changing of the guard as the rule exchanges risky investments for safer investments. This same rule works well at the time that the bear phase of the credit cycle gives way to the bull phase of the credit cycle, changing from safer investments for risky investments.

In order to test this theory, I made a list of all of the Bond Exchange-Traded Funds and Closed-end Funds [CEFs] out there. I ranked them by liquidity, and imposed three constraints: volume traded of over $1 million per day, and no CEFs with high premiums to net asset value. As a result, many of PIMCO's best performing funds were disqualified, because I believe eventually investors will panic and lose a lot. I have the same issue with floating rate loan funds. Third, CEFs had to have good historical results in their asset subclass. Unlike stocks, superior bond performance tends to persist.

From that, I chose 33 funds that represent the fixed income universe pretty fully.

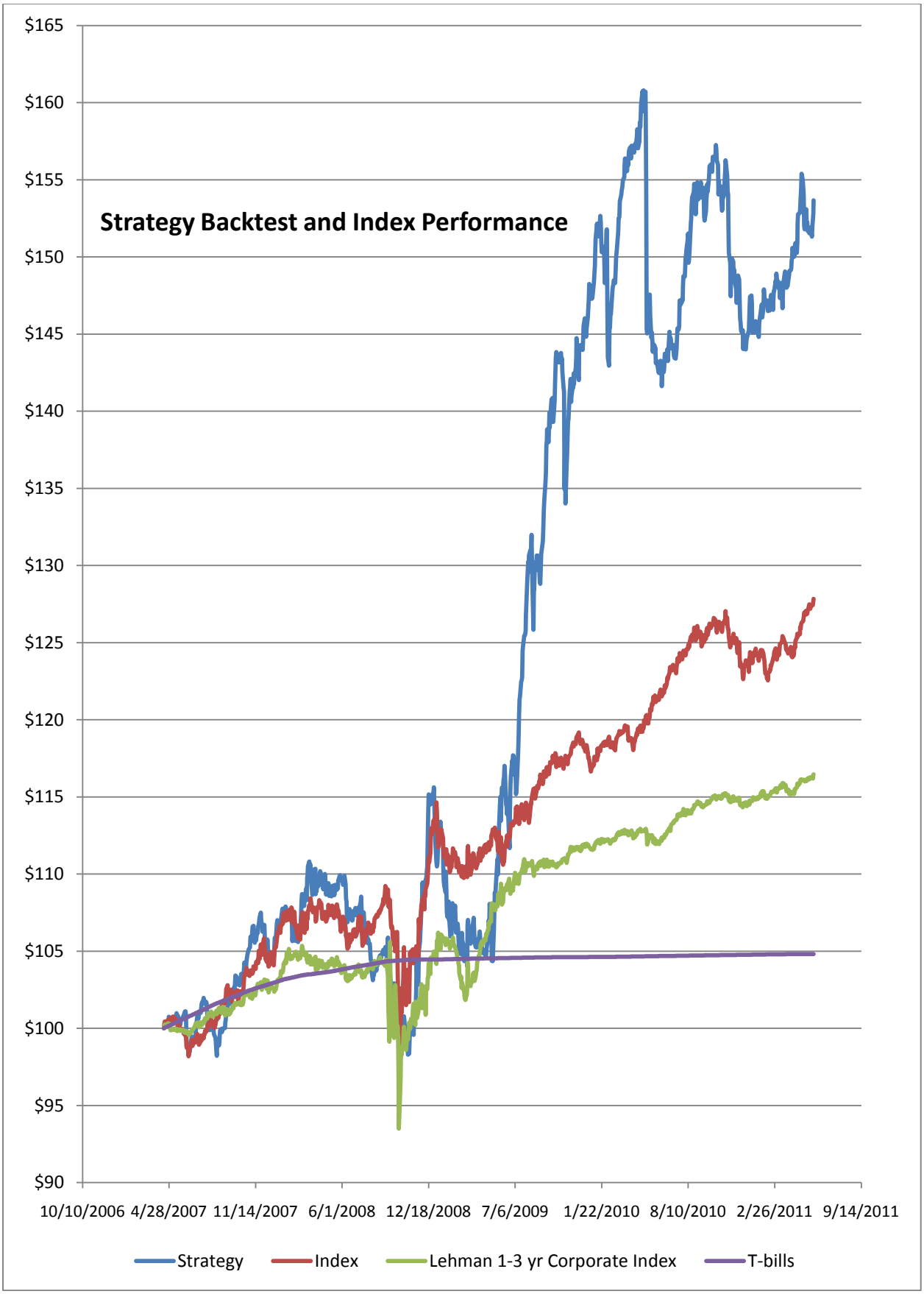
- Maturity: Short, Intermediate, and Long
- Credit: Everything from Treasury quality to junk bonds and preferred stock
- Currency: Domestic and Foreign
- Country types: US, Developed, and Emerging Markets
- Inflation-protected, and not-protected

My list will change as I find more securities that meet my criteria. Given the growth in ETFs, there will likely be more new funds to come.

The simple rule for this portfolio is own the top 10 funds on the list in terms of momentum using the current price versus its 200-day moving average as a measure. For this backtest, I ran it from April 13th, 2007 to May 27th, 2011. The ending date was when I started this project. The starting date was 200 days after Rydex launched its CurrencyShares exchange traded products. I wanted those for diversification purposes.

What kind of results would this strategy have generated against passive benchmarks?

	Strategy	Lehman Aggregate Index	Lehman 1-3 yr Corporate Index	T-bills
Annualized Return	11.01%	6.15%	3.78%	1.15%
Partial Year 2007	5.84%	5.25%	2.53%	3.00%
2008	8.21%	7.90%	2.25%	1.42%
2009	28.62%	2.97%	6.42%	0.16%
2010	0.07%	6.37%	2.87%	0.14%
Partial Year 2011	4.24%	2.77%	1.49%	0.04%
Worst 365 days	-6.55%	-6.97%	-7.92%	0.12%
Standard Deviation	10.24%	7.16%	6.77%	0.09%
Probability of loss over 365 days	26%	2%	11%	0%


Strategy Backtest and Index Performance
$165
$160
$155
$150
$145
$140
$135
$130
$125
$120
$115
$110
$105
$100
$95
$90
10/10/2006
4/28/2007
11/14/2007
6/1/2008
12/18/2008
7/6/2009
1/22/2010
8/10/2010
2/26/2011
9/14/2011
Strategy
Index
Lehman 1-3 yr Corporate Index
T-bills

Note: the Lehman (or Barclays) Aggregate is the most common benchmark that broad investment grade managers compete against. It did particularly well because Treasuries were rallying. The Lehman 1-3 year Corporate Index is an index of short corporate bonds with little maturity risk, and not much credit risk.

In general, following one simple rule that I specified in advance of running my analysis, the strategy keeps pace with other strategies from the end of the boom through the bust phase of the cycle, and makes very good returns through the bull phase of the cycle (which is when the most returns can be made with the least risk). The strategy adapts to what is working best in the market.

Risk Factors

1) Backtest – This is only a backtest. With any backtested strategy, when it gets applied in real-time with real money, almost never does as well as the test. But valid strategies often do half as well, and this one has some decent theory behind it.

2) Flash Crash – If you will notice, the strategy performed horribly in May 2010. That was due to the Flash Crash, when many ETFs fell sharply because of the loss of liquidity. Any ETF/CEF that fell sharply would likely drop out of the portfolio, because this strategy is momentum driven.

During a Flash Crash, I would temporarily suspend the momentum rule, because if the loss is just due to trading dynamics, and not fundamentals, all of the funds bounced back in days. Then when markets normalize, I would reinstate the rule, and I would drop the Flash Crash era from my database.

The results here follow the mechanics of the model, with no human intervention. At a Flash Crash, I would take over.

3) Breakdown of the Credit Cycle – It is possible if enough market actors begin to anticipate the credit cycle, as with any strategy, the strategy will not work as well, or may cease to work at all. I don't find that likely because most fixed income investors either face yield mandates or structural mandates, and can't be very flexible in their decisions.

4) Unconstrained Strategies – There are unconstrained strategies, and this is one of them. Unconstrained strategies offer a lot of potential for good and bad performance, because they are free to invest anywhere in the bond arena.

5) Federal Reserve Loosening – This strategy has only been tested during a period where the Fed was loosening. It will behave differently when the Fed is tightening. It may not work as well. The idea is that it would adapt, and invest in shorter-term securities, but who can tell what will happen then? The Fed itself could become choppy and unpredictable if raising rates makes a big change in economic activity, which could make this strategy work less well.

6) JP Morgan credit risk – The Rydex CurrencyShares funds are undiversified, investing in loans to JP Morgan's London subsidiary. They are very useful for diversification, but if JP Morgan or its London subsidiary gets into trouble, the funds may face losses, and so might this strategy.

7) Active management – actively managed bond funds often hit cold spells. Even bond ETFs have replication issues, leading to underperformance.

8) Trading Frictions, Commissions, and Fees – The results of the backtest are prior to trading frictions, IB commissions, and Aleph's fees (presently 0.3%/yr).

9) And there may be more risks that I can't think of. ETFs are subject to many games in creation and liquidation.

Where would the strategy be investing as of June 13th? Equally in:

1. Rydex CurrencyShares Swiss Franc Trust – FXF
2. Vanguard Extended Duration Treasury Index ETF – EDV
3. John Hancock Preferred Income Fund II – HPF
4. John Hancock Preferred Income Fund – HPI
5. Morgan Stanley Emerging Markets Domestic Debt Fund – EDD
6. Western Asset Emerging Markets Income Fund – EMD
7. SPDR DB International Government Inflation-Protected Bond Fund – WIP
8. Rydex CurrencyShares Euro Trust – FXE
9. Aberdeen Asia-Pacific Income Fund – FAX
10. Rydex CurrencyShares Australian Dollar Trust – FXA

That's 50% Developed Markets Foreign Bonds, 20% Emerging Markets Bonds, 20% US Preferred Stock, and 10% Long US Treasury Bonds. Again, this is an unconstrained portfolio; it will follow market trends.

My Actions

I will be investing in this strategy starting later in June, and I will not publishing this strategy. I think it offers a lot of potential to deal with the multiple risks of inflation, dollar depreciation, credit risk, and deflation.

Housekeeping items

1) For clients that want to save on their taxes, I have one thing that I recommend you should do at Interactive Brokers. Go to Account Management:

https://www.interactivebrokers.com/sso/Login

and after logging in choose **Report Management**, and then click on Tax Basis Declaration. Choose Maximize Losses, then click Continue. This setting will give you the lowest taxes overall in most scenarios. If you don't take this action, the default at Interactive Brokers is first-in, first-out, i.e., securities are sold in the order in which they were bought. For more definiteness, consult your tax advisor.

2) I may have to formalize this at some point, but if you want to:

- Switch your percentage allocation within the bond and stock strategies, or
- Ask me to use the switching model to trade between stocks and bonds on your behalf, as described in last month's newsletter, or (Current signal is invest in the bond strategy.)

- Change hedging in taxable accounts.

Just e-mail me, and I will make the changes.

3) If you want direct billing, rather than deduction from your account, just e-mail me, and I will add you to the list for direct billing.

4) IB e-mailed you on this, but I would just want to point you to their semi-annual disclosures:

http://www.interactivebrokers.com/en/accounts/legalDocuments/semiAnnualDisclosures.php

Many of them may not be relevant to you. Those that I think you *might* want to glance at are 3, 7, 21, 23-26, 27-29, 34, and 35.

5) If you want to set up an additional account, say, to have separate accounts for stocks and bonds, follow the instructions in the attached file, "Create Additional Account."

6) I will not be able to do this forever as my client load grows, but if you have a small question regarding some other financial problem that you have, I would be happy to try to help you. If it is a common enough problem, I might write a blog post about it.

7) Finally, if you have friends that might need my services, please refer them to me. My firm has been growing at a reasonable rate, but in order for me to be able support my family long-term, I need about 4 times more external assets than I have now. Advertising is complex for Investment Advisors; word of mouth is often the most effective. So if you run across people dissatisfied with their current relationship that you think I could help, let me know.

Thanks for your business, and here's to better future performance.