GOLD & ENERGY ADVISOR

$19 BONUS ISSUE Special Bonus Issue

"These men warned about the Dow Crash before it happened!"

"Not only that, they regularly move in and out of the markets before big moves occur. The last 3 months alone, their stock trades are up over 34 percent, and their option trades are up over 330 percent.

"How do they do it? That's what this special issue is about!"

Geoff Garbacz

George Brandon

The subprime mortgage market melted down. The Dow plummeted by over 1,000 points. And the Fed has tried to rescue the market with a half-percent rate cut.

Of course, you knew all this already. The markets have been in utter chaos.

I'm sending you this special issue to introduce you to two men who saw this coming. In fact, I've wanted to interview them for reasons that have nothing to do with the subprime fiasco.

If you subscribe to my *21st Century Alert* service, you've seen my daily Morning Briefing, issued each weekday to keep you up-to-date on the markets. The Briefing is put together by Wall Street veteran Geoff Garbacz.

However, you might not realize that Geoff, along with his associates George Brandon and Michael Foley, also write *21st Century*'s The Madison Letter.

To describe The Madison Letter's track record as "impressive" would be an understatement. For example, in just the last three months alone, The Madison Letter's stock trades on names in the S&P 500 have made 34.3 percent. The Madison Letter's option trades are even better—up by a stunning 335.88 percent.

However, in my opinion, these numbers aren't even the most impressive part of the service. Geoff, George, and Mike have shown a remarkable ability to move in and out of the markets right before big shifts occur. Here are some examples from earlier this year.

On April 2nd, they recommended going long the S&P through their Madison Market Timing Indicator (launched April 1st). They got out 66 days later with a 6.79 percent profit (an annualized rate of 37.7 percent).

From June 7th to August 24th, they were short the market, and profited by 3.63 percent as it fell (an annualized rate of 16.99 percent).

Then they told Madison readers to go long on August 24th at 1462.34. *That same day*, the market jumped up by 1.16 percent.

And that's only their recommendations on the S&P. For the Dow Jones Industrial Average, they warned their readers to go short on July 16. In the following days, they wrote again and again about the nasty downturn ahead, even while the mainstream media was chirpy about the market's prospects.

You know what happened next. The Dow got pounded. Even during the rallies, when others were getting suckered back into the markets, Madison readers were warned to stay out.

The Dow sell signal was finally closed out in late July. Madison readers were spared some 700 points of the market's plunge. Those readers who not only exited their long positions but also went short were *very* happy indeed.

In this interview, I quizzed Geoff and George about their methods—how they make such profitable trades, and how they foretell the market's direction. I also asked their opinions on the recent Fed rate cut, as I think this will have a huge impact on the markets in multiple ways.

Enjoy!

J: Tell our readers about yourself and your partners.

Geoff: There are three of us involved in this: George, Mike Foley, and me.

George has 20 years of experience on Wall Street, and was a hedge fund principal/client relations manager. Mike also has over 20 years on Wall Street, and was a principal of a billion-dollar hedge fund. As for me, I've been on Wall Street for 21 years, and I'm the President and a principal in Quantitative Partners Inc.

We also have a secret weapon in my partner Jack Bahrenburg. Jack is a founder of Quantitative Partners, and serves as the Chief Information Officer as well as Chief Operating Officer. He's very talented with spreadsheets and formula writing. Without him, the three of us would be lost sometimes.

J: You publish The Madison Letter, which is a retail version of your BFG Outlier Research service. Tell me about that.

George: Our BFG Outlier Research is meant for institutions. Its goal is to help large inves-

THE GOLD AND ENERGY ADVISOR

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tors move in and out of the markets as the trends change direction.

We provide buy/sell recommendations on major indices, sectors, groups, and ETFs (exchange traded funds). The recommendations include exact entry/exit points for investors, and very detailed commentary and analysis.

Geoff: The Madison Letter is a lighter version of that. It doesn't include all the analytical tools that the full service provides, but the philosophy behind it is the same.

J: *Your track record in Madison and BFG is very impressive. Before I talk about it, tell our readers about your trading pattern. In a spectrum with day traders on one end, and buy-and-hold-forever investors on the other, where do you fall?*

Geoff: We call ourselves swing traders. We're trying to capture trades from 3-4 days up to 2 weeks. Sometimes our ETF trades or index trades will go as long as a month, but that's an extreme.

Our sweet spot for an index, a stock, or an ETF trade is to make 3-5 percent. For options, we're looking for 25 to 100 percent.

Those are our goals. We've definitely demonstrated that we have the capability of doing that.

J: *And when you make those kinds of numbers in just a week or two, and add them up over a year, you can get great returns.*

So let's talk about your returns. Obviously, we're not promising our readers any particular return, but your record is superb.

I have a spreadsheet here with the track record for the Madison Letter, since we started working together a couple of years ago. It shows a total of 115 trades, of which 74.7 percent were winners. Total net gain was 264.87 percent. That's great.

However, I also see that my spreadsheet is a few weeks out of date. It doesn't include your most recent 15 stock trades, of which 12 were winners.

Not only that, I also see 9 option trades that aren't on my spreadsheet yet. Their total net is 336 percent. That's an average profit of 37 percent per trade. Wow.

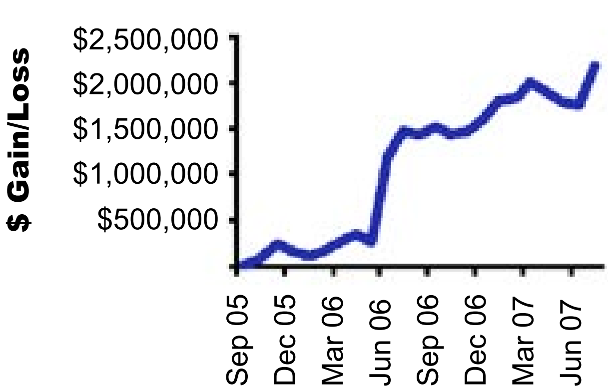
Having said all that, I know you don't like to pat yourself on the back.

Geoff: No, I'm more concerned with what we're going to do than what we've done. That's the bottom line.

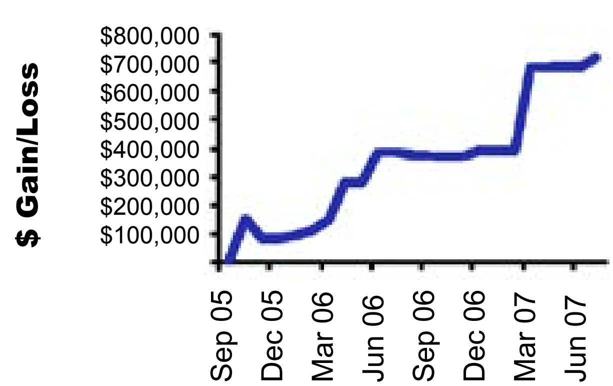
When Michael Jordan played basketball, I don't think he cared if he scored 35 points the prior night. When he went out to play again, he started from scratch each time. That's how I feel about the process.

In BFG, we recently picked up 9 buys institutionally. Those 9 buys are up over 50 percent now. That's sweet—the average is about 6 percent per idea on those trades. But I'm more concerned

ETF Group Buy/Sell Signals



Major Index Buy/Sell Signals



BFG Outlier Research launched 22 months ago. Geoff, George, and Mike Foley have made cumulative profits of over $2.8 million for their institutional clients (assuming clients had invested $1 million per idea, or about 25,000 shares on a $40 stock).

about when we are going to pick up the sell signals.

So that's how we approach things.

J: How would you summarize your investment philosophy?

Geoff: It's simple. We buy low, and sell high.

J: Lots of advisors try to do that. How are you different?

George: We're quantitative and not qualitative.

J: Explain what you mean by that.

George: Qualitative analysis includes non-quantifiable things—like your emotions about a stock. For example, a qualitative analyst could look at General Motors and say, "I want to buy this stock. They're just killing the bonds, and Toyota is kicking their butt, but I don't care what my stuff says. I have a gut feeling about this, so I'm a buyer."

That's not us. We're all about data, data, data.

J: Aren't the data and numbers driven by emotions in the market, though?

George: Yes, absolutely. We rely on it.

J: How so?

Geoff: We wait until emotions are at extremes. We buy when people are freaking out about the market, and they think the world is coming to an end. Then we sell when everyone thinks everything is great, and nothing can go down. Our model tells us when these points occur.

George: Fear and greed drive the markets. The continuum between those is what we look at every day. Any time the market swings from fear to greed, a buy is created. And when it goes the other way, from greed to fear, a sell is created. That's an oversimplification, but it's a good description.

The markets have always been this way. You can go back years and years and see it. It was written about back in the 1920s and 1930s by W.D. Gann and Edson Gould—the great technicians of the past. The market is always on a continuum between fear and greed.

Our model is based on history. We have some unbelievably powerful historical research and data from which we've gleaned these things. We can look for that sweet spot because history repeats itself.

In fact, we believe that all markets go through cycles. Think of any of the manias that you've ever seen: real estate, dot coms, even the stock market itself when everybody started trading and had their own accounts, and so on.

Cycles are prevalent in the markets. It's kind of like gravity. You can ignore it. You might not even believe in it. But it's still doing its job 24/7.

We just assign a mathematical, non-emotional value to what is happening. Then we can act on it when the timing is right.

J: How do you do this?

George: We're looking at what the market is actually doing. Without getting into proprietary techniques, if we can gauge the mathematical mean of the market, and the market deviates from that, it becomes very interesting.

We're looking for points where emotion has taken over, not mathematical truth. We distill the data down to see what's going on, to see if emotions have reached an extreme in a particular sector. If they have, if the market is either overbought or oversold, we can expect it to return to normal eventually.

That's oversimplified, but that's what it's about. We analyze, and look for an overbought or oversold condition. When we see one, we can get into position and profit when the market corrects itself back to normal.

Geoff: We make it simple for our readers. All the numbers are distilled down into what we call the Madison score. When you hit +20 you're overbought, and when you hit -20 you're oversold.

J: How is that number obtained?

Geoff: When we first started, we were only doing our own proprietary standard deviation work. Then we added trend into it, and next we've added volume into it. Now we are working on adding alpha analysis—accounting for excess returns on a stock-by-stock basis.

That's one key thing about the model—it

will evolve through time. As we see the markets change, we will modify the model.

J: Geoff, you've written before about the need to improve market models. Comment on this please.

Geoff: The biggest flaw to any model is to assume it will always perform at a certain level. That's just not true. For example, in the Morning Briefing I recently described William O'Neil's CAN-SLIM momentum model. That model was great when it was first introduced, but it gets crushed in bear markets.

Markets change. So people who build models need to observe what happens and improve their models over time. Even if your model is doing well, you need to try and do better. Why do you think Tiger Woods is the best player in golf? Even though he's at the top, he's always tweaking and improving his swing and his game. He's willing to throw everything away and start from scratch if he has to. We need to do the same thing.

J: So you're willing to go back to the drawing board periodically, if you have to.

Geoff: Yes. We're always trying to improve it, even though it already works well.

J: You don't seem to be the nerdy statistician types, though.

Geoff: I don't consider myself or George or Mike to be quants [quantitative analysts]. I consider us to be what I call lay quants, if that makes sense.

J: I think you need to explain that.

Geoff: None of us have PhDs, none of us were statistics majors. But among the three of us, we have almost 80 years on Wall Street. We've been around this stuff long enough, we know it extremely well. We come at it from more of an objective viewpoint. So we're almost quant laymen, as opposed to being guys that are 100 percent in statistics only.

We just have a really good tool for capturing this stuff. So I just allow the model to do what it does.

J: Your approach has interesting implications as far as risk is concerned.

Geoff: Nothing is risk-free, but our approach is pretty good. For example, we closed out 17 ETF trades this year, and we've got 16 winners and one loser so far and two open trades that are losers. Nothing is perfect.

George: I like to be precise in my words, so let me say this. We're trying to apply observed phenomena that, mathematically speaking, have achieved the potential for the lowest risk that we can possibly offer. Statistically speaking, we're putting risk in the investor's favor.

Our big calling card is time in the market. If you are able to make a return by looking at overbought and oversold conditions, then you are guaranteed to have less time when your money is at risk in the market.

J: What's the most important part of your model?

George: The entry point—our timing on getting into a trade—is our most important dynamic. The timing, from a quantitative series of formulas, takes the emotion completely out of it. You just do what the model says.

So why is that relevant in this day and age? Because we're using a lot of different data fields that will take away the human factor. The human factor could be the emotions of the trader. It could be the potential for CEOs and CFOs to be defrauding the public—we're not relying on a 10K and a 10Q and so on. We're relying on the dynamics of the market.

If you believe that what is real is what is occurring, and not what you feel is happening, or what someone told you is happening, then you should be a lot more comfortable with our technique.

Overall, we're trying to take the emotions of the trader out of it. We try to be that calming voice in the middle of the screaming and yelling that occurs when fear shifts to greed, or vice versa. On the way down, we might say, "Now wait, this looks bad, but it's going to get worse. Don't try to catch a falling knife." That is what happened in late July and early August. Or we might caution people not to sell yet, even though the market has gone up.

The extremes are the most profitable points to buy and sell. We just wait until they occur. It's like when I go out my door to fish in the streams around Idaho. Sometimes the pickings are slim and sometimes you can't keep the fish off the reel.

J: Practically speaking, how do you get the returns that you do?

Geoff: Our goal is to give excellent buy and sell signals on the markets. A key thing is to use options. If you're making 3-4 percent, that's not a lot—but when you make 3-4 percent on an option, done correctly you can make some really nice money.

J: You're not just about options, though.

Geoff: No, we're not exclusively options. We do lots of stuff.

J: One of the reasons I like your approach is that you aren't married to one particular technique. You'll go long or short, buy or sell, use stocks or options, or whatever. But your recommendations are still usable by an average trader—you aren't using anything overly exotic.

Geoff: About the most complicated thing we'll recommend is a call or put spread.

For example, we just closed a call spread on Agilent. We bought the $32.50 call for $1.69, and sold the $35 call for 66 cents. So we went long the stock at $32.50, for only $1.03 net.

Once the stock moved up higher, we closed out both positions. We made over 32 percent on the trade in just one week.

On the reverse side, let's say we think the S&P is going back down to 1400. Let's say we buy a 1450 put, and we sell a 1400 put. As we get down to 1400, then we would take that trade off. We sell the put that we bought, and we cover the put that we sold. That's as complicated as it gets.

I have been doing these trades on a stock by stock basis institutionally with Seth Shalov of the Incremental Return Advisor, and we have a pretty good history of doing these trades. We've done 84 long ideas, and 59 short ideas so far. On the longs we had 59 winners, and on the shorts 43 were winners.

We have a really good batting average on the short side. Most people are lucky to go 50-50 on the short side. Seth and I are deploying this strategy for you with the *Gold & Energy Options Trader,* and there is definitely a bit of Madison built into that product.

Now with Madison this year, as you said earlier we're 12 for 15 on stock trades, and we're averaging 37 percent profit per trade on the options through the end of August.

J: Let's talk a little about the problems the market has had this summer.

Geoff: A lot of money managers were surprised by the market's performance, but they were lacking in common sense. July to October is traditionally a tough time for the markets anyway, and this time it was even worse than usual—the breadth measures never validated a bull market. I called it the impending hurricane season on Wall Street. Either we would come a long way up so the bull could emerge, or the bottom was going to fall out. Guess what happened? The bottom fell out.

George: The quant funds fell apart because they got handed two things that don't go together really well: horrible fear, and the realization that they owned a bunch of crap. All that subprime crap rolled up in those CDOs and CMOs and all that stuff.

Everybody suddenly found out that the credit rating agencies don't actually do any due diligence—they just hand out ratings, apparently.

J: So what really brought on the subprime catastrophe?

Geoff: I was recently re-reading "Panic on Wall Street," a book by Robert Sobel from 1968. He talked about the crash in 1929, and I was struck by how closely it matches our current situation.

I love this quote from the book: "The speculators of the 1920s used margin in a similar fashion, but for a different reason. The rationale could be summed in one word—the magic word on Wall Street in the twenties—'leverage'. Just as a lever may be used to raise a heavy weight which could not be lifted otherwise, so leverage was employed to purchase securities worth far more than the original investment in cash."

Back in the 1920s, banks loaned cash to people who wanted to buy stocks. This was fine when stocks were moving higher, but when they crashed in 1929 the investors lost their capital and couldn't repay their loans.

Now think of 2005, which is when we started to hear about massive speculation in real estate. People were buying houses with no-documentation loans and little money down. Mortgage companies were loaning money to speculators in the housing market, just like banks lent to stock speculators in the 1920s.

The difference is that this time, the lenders have sold their loans. The mortgage companies sold them to banks and brokers, who packaged them into CDOs [collateralized debt obligations] and sold them to hedge funds and other players.

Over time the CDOs accumulated more and more exposure to subprime loans. Then the loans started to have defaults. Now the hedge funds get hit, but they can't afford to lose anything. They're overleveraged. In fact, from February to July the average hedge fund went from 150% long and 30% short, to 185% long and 50% short. They were way overleveraged.

Well, once they start losing money from CDOs, they have to lower their leverage. As they sell off their positions, the market weakens further.

And then everybody is affected.

J: Neither of you were really surprised by this, right?

George: There's a macro-economic analyst on Wall Street—very exclusive, very well known, but only to hedge fund managers. He knew two and a half years ago that this subprime mess would happen. He said this was going to be horrible, and the middle class would be the greatest victim. Consumer spending will be dramatically reduced, because nobody will be able to refi their homes.

We've actually been waiting for the current problems for six months. Yes, we expected it to be horrible. We've been watching LEND since it was $55—we couldn't wait until it got to $5. Countrywide, and the homebuilders—what phenomenal trades those were.

Obviously this will permeate all aspects of the capital structure. I do a lot of work in Chapter 11 bankruptcy. A year ago, people said, "Why are you working in Chapter 11? There's nothing to do!"

I said, "Because I like to buy the fire extinguisher before the fire. It's easier to get!"

J: So you expect the contagion to spread further?

Geoff: It's already spread further. The flu has moved onto those selling commercial paper that have CDOs in them.

According to Bloomberg, there's $550 billion in commercial paper coming due in the next 90 days. That's half the total market of $1.1 trillion. Right now, this is like yelling "fire" in a crowded movie theater. Prices of commercial paper are dropping—there aren't any bids.

J: In your opinion, what happens next?

Geoff: I hope the dislocation is over quickly. If it is, I think there will be good opportunities in going long the survivors of the mortgage contagion. My favorite is Fannie Mae.

If it's not over quickly, here's what can happen. Houses would stop selling, and sellers would be forced to drop their prices far enough so that someone could get a loan or even pay cash for the house.

As housing sales slow, suddenly there's no one buying new furniture anymore. Demand drops for things like particleboard. The sales rep at U.S. Gypsum can't make his particleboard sales quota and loses his job. Now his family is no longer a customer at American Eagle Outfitters, and sales drop there too. The contagion spreads and spreads.

If the mortgage market fails to function the way it has in the past, we can move from a slowdown to a recession to a full-blown depression.

J: What effect do you think the Fed's rate cut will have?

Geoff: Often, the Fed has bailed out a weak stock market. But the dollar is already very cheap. Earlier last month, the Fed announced that it wasn't going to change rates, and that was a good thing. That day, I wrote in the Morning Briefing that I was glad they made this decision. A rate cut would only encourage inflation, along with the financial excesses that got us into this situation in the first place.

But then the Fed panicked and cut rates anyway. As we're talking today, it seems to have stabilized the markets a bit. But there will be a lot more damage long term. The Fed has confirmed the 'Greenspan Put', and there will be lots more excess financial leverage in the future.

George: I've been told to expect further rate cuts. Of course, that's no guarantee that cuts will happen. But I expect the Fed will give us another 50 basis points, whether it's over the next six months, or over the next 90 days.

Unfortunately, we are the most fiscally irresponsible people on the planet. So if the Fed gives us any ease, that will just start the speculation roaring back in.

Right now, the Fed is just trying to give the ARMs [adjustable rate mortgages] a soft landing. They've done a pretty good job so far. Unfortunately, there's a lot more coming due.

For as many ARMs that have been tripped this year, there's something like four times the amount coming next year. And bankruptcies and foreclosures are already at mind-boggling highs. Historically unprecedented highs.

If they can give enough of an ease to get these ARMs triggered at a low enough rate, then maybe half those people can keep their houses. That's what they're trying to get accomplished.

J: So more rate cuts are probably coming, even though they will push the dollar further into the toilet.

George: The dollar being pushed into the toilet wasn't an accident. It was *policy*. We were trying to reduce that ugly, ugly trade deficit.

If I'm the government, having to report all-time record trade imbalances month after month, what am I going to do? I'm going to try and take care of that glaring overhang. So I will crush the dollar and let it freefall. Which is exactly what's happened.

As you must know, this paper currency game is just about over. And it's going to have a troubling end. Like it has throughout all time, all of history. It's gone on too long, and when you can just print money, what happens?

"Oh, we owe them a trillion dollars? Okay, go ahead and print up a trillion dollars, then!"

"Alright, here's your trillion. Thank you, goodbye."

J: You don't even need to print the dollars nowadays. You can just credit them to an account somewhere and save yourself the paper costs.

George: Yes, save on the ink and that special paper.

Yes, I definitely love gold. And not because I'm expecting it to go to $700. I want to be there when it goes to $1,700.

J: Geoff and George, this has been a fascinating interview. Thank you for your time.

Geoff and George: Thank you.

How to get up-to-date trading recommendations from Geoff and George

By now I'm sure you understand why I've been so impressed with the performance of The Madison Letter. Along with their partner Mike Foley, Geoff and George have a stellar track record.

In fact, I'm so impressed that I'm launching their Madison Letter into a separate trading service.

If you'd like to get Geoff's and George's trading advice—if their strategies and track record appeal to you—then this will be your opportunity to get immediate access to their recommendations each day, as they're issued.

Their BFG Outlier service for institutions charges a whopping $30,000 per year. But I've convinced them to offer their new Madison Letter service—which is based on the same principles—to my readers for only $30 per month.

This new service is only a few weeks away from being launched. As a *GEA* reader, you'll be the first to hear when it's available. Stay tuned!