MARKET OUTLOOK

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Barring the unexpected, watch for a market recovery

The first of 17 consecutive Federal Reserve interest rate hikes began June 30, 2004. So the recent decision to not raise rates came a little more than two years later. The day the rate hikes began, the Nasdaq closed at 2048. After the Aug. 8 announcement, the Nasdaq ended trading at 2061. In other words, in the ensuing two-plus years, the Nasdaq essentially made no progress.

There certainly has been volatility during the past two years. But much of it has been confined to choppy, daily price movements within fairly tight ranges. Long trends have been non-existent.

At right is a chart that will help you see the situation more clearly. The black line shows the daily price movement. The red line marks the level of the Nasdaq when the Federal Reserve began raising interest rates two years ago. The green line is a support line. I believe it gives a clue about where the Nasdaq could be headed.

First I need to emphasize that I do not claim any special ability to forecast market movement and I don't believe anyone else has that ability, either. The investment markets are influenced by so many fundamental and technical variables that it is impossible to account for the potential impact of every one. I do, however, believe that by carefully assessing fundamental, technical and cyclical factors it is possible to identify periods when market risk might be higher or lower than normal.

After throwing out a couple of cautions, I'm going to detail why I think the Nasdaq is likely to soon stage a rebound. The first caution is a seasonality issue. September is the weakest month of the year for market returns going back to 1926. It is the only month where the S&P 500 averages a negative return. October is the next weakest month, although it averages a gain of about a half percent. Certainly there is no guarantee that stocks will lose month over the next two months. But neither should this tendency be ignored.

The second caution is the political situation in the Middle East and already record oil prices. A single, unforeseen event could easily drive oil prices above $100 a barrel in just a day or two. That would sent stocks plunging and push the world economy to the brink of recession.

Now for the positive view.

• The economy remains strong. Although preliminary second quarter GDP figures showed a sharp decline from the first quarter, the 2.5% annualized rate is more in line with what the Federal Reserve wants.

• The Fed chose not to raise interest rates for an 18th consecutive session. The markets initially sold off on the news that Fed official were

holding the line. While this might not be the end of rate hikes, additional increases will likely be few and far between.

• The overall economic picture isn't too bad. Unemployment remains low. Corporate earnings for the prior quarter have generally been better than expected. By historical standards, mortgage rates are still low and the housing market has slowed but not collapsed.

• The current correction is already the steepest in two years. Now in its fourth month, the market seems to be forming a bottom. Unless this is going to turn into a massive correction, downside risk should be minimal and certainly less than it was four months ago.

• Seasonality again. The three strongest consecutive months for the broad market are November, December and January. If stocks can hold ground for a few more weeks, seasonal momentum should kick in.

• The S&P 500 and the Dow are both showing strength. Each is trending above 50 and 200-day moving averages and the Moving Average Convergence Divergence (MACD) for each is positive. Neither corrected as sharply as the Nasdaq and both have made substantial recoveries.

• The chart mentioned above. While the Nasdaq broke through support from the rising green trendline, it found support at the 2050 level marked by the red line. I expect it to bounce from this level back to the area of its most recent high at about 2300. That could happen in just a couple of weeks or it might take until the end of the year. And while the MACD for the Nasdaq is still negative, it is moving up and could quickly turn positive.

• When assessing overall market health, I like to look at the universe of Exchange-Traded Funds (ETFs) because they include virtually every market and industry sector. There are currently just over 300 ETFs. Over the past 30 days, half have had positive returns. That is much better than a few weeks earlier.

That's how I see things right now. I don't discount the possibility that the market could tumble again from here. I just think there are more reasons for it to go up than down.

—Flint Stephens

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Misinformation Hinders Successful Investing

Watching the evening news as they devote about five seconds to the stock market can give you a misleading, and often wrong, perspective. Considerably more time is spent in mindless banter between anchors during a 30-minute broadcast than is spent on the stock market. That tells you where they place the largest capital production device (stock market) on earth and what they think you should know.

During the second week of May, the financial media was hosting analyst after analyst and the topic was the approaching new high in the Dow Jones Industrial Average. The excitement of the event dominated the news. Sadly, they never considered the fact that the Dow Industrial Average was also the first market index to hit a new high in January, 2000, while most of the others did not peak until March of that year.

Remember the following key points about new highs:

• New highs are almost always good news; it's just the last one that is not. In other words, you should worry when something IS NOT reaching new highs.

• To say that something is about to make a new six-year high is essentially the same as saying it has not gone anywhere for six years. It took the Dow 16 years to reach a new high between 1966 and 1982.

I think I know why there is such a misguided focus on the Dow — Charles Dow was neither a broker nor financier, but a journalist. Keep your focus on more than one market index and do not let a talking head influence your investment decisions.

I focus on the Nasdaq Composite (large dynamic blend marketplace), S&P 500 (large cap blue chips), and the Russell 2000 (small cap issues). My once favorite New York Composite Index now contains entirely too many stocks that are interest sensitive. That means they could be influenced as much by the movement of interest rates as they are by normal market forces.

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Contrary to conventional wisdom, you do not make money 75% of the time just because the market rises 75% of the time. Why not? Because the market must recover from the down years before you can start making money again. During the last 50 years, the market reached new highs just 40% of the time. In other words, buy and hold investors have spent 60% of the time losing money or trying to get back to even.

The forces driving the markets are far too complex and forward looking to credit or blame any single event for any given day's activity. Do not focus on short-term, news-driven explanations of stock market results.

In the world of investments and money management, exceptional discipline and objectivity will keep you from falling victim to short-term emotion. The uncertainty of the market requires a methodology that allows you to participate in most of the good times and avoid most of the bad times. With that said, the only thing worse than being wrong, is staying wrong. So why do we want to believe information that does not hold up under scrutiny?

Being human is something that has some real baggage with it. Behavioral psychologists tell us that what we remember about the past is tainted with our perceptions, our education, and a personal understanding of things in general. Reconstructing the past generally involves piecing together a few significant facts sprinkled with personal beliefs and opinions. This is quite natural and attributable to human inability to deal with uncertainty and randomness.

A detective will tell you that the eyewitness giving an account of events must happen as soon as possible and multiple eyewitnesses must be kept separate from one another. This is because each individual eyewitness will associate personal understandings, education, and beliefs into their account of the event. Allowing eyewitnesses to discuss the event amongst themselves will allow a dominant personality to reconstruct the event, correctly or incorrectly.

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This reconstruction usually goes unchallenged by the others.

Other curious human failings and misunderstandings come to mind. Many believe George Washington cut down a cherry tree. This was a story by Mason Locke Weems (early 19th century) who was trying to humanize Washington by this fictional story.

Also contrary to common lore, Washington did not throw a silver dollar across the Potomac. As for scientific misunderstandings, a vague and incomplete understanding of the Coriolis Effect has many believing that water drains from a tub in a counter-clockwise direction in the northern hemisphere. Other examples of common misunderstandings are that Panama hats are from Panama; catgut comes from cats, on and on.

Similarly, in the investment world, we have many ideas that seem to go unchallenged. These notions include common preachings, such as: buy and hold investing is a good long-term strategy, economists are good at predicting the markets, diversification will protect you from losses, compounding is the eighth wonder of the world, missing the best days of each year can be devastating, probability and risk are the same thing, and chasing performance will work.

Here is a discussion of a some of these unchallenged assumptions:

Buy-and-hold is a proven strategy for the stock market. In 1976, a Yale professor named Roger Ibbotson, produced a study showing the returns of various investments since 1924. This study clearly showed that small company stocks outperformed not only large company stocks, but also bonds, bills, and inflation, all by a significant margin.

Today, the study reflects the same, if not better, results from the last 80 years. This is convincing evidence that buy-and-hold is a valid strategy for stock market investing -- that is, until you realize that you might not have an 80-year horizon to accumulate your investment wealth.

Most investors have only 15 to 20 years to accumulate their retirement nest egg. During the 80 years of the Ibbotson study, there were many 15-year periods where a buy-and-hold approach would have resulted in significant losses.

A few examples include the period that began in 1929. After the market crashed, it took 25 years to break even. In 1966 it took 16 years to break even. In 1973 it took 10 years. Remember, breaking even is not a successful strategy. How long will it take to break even from the lows of 2000? It's been six years and the market still has not broken even; how much time do you have to invest?

Economists are good at predicting the markets. It is odd that one of the components of the Index of Leading Indicators (designed by economists) is the performance of the stock market. Yet, economists are paraded through television studios at alarming rates to offer their stock market predictions.

It seems they have it backwards. The truth is the stock market predicts the economy. In 1973, a young economist named Alan Greenspan stated, “Now may be the best time in history to buy stocks.” This proclamation was made just days before the beginning of the 1973-74 bear market that took the S&P 500 Index down over 48% in a little less than two years time.

Taking this economist's advice meant you would have broken even in 1983. (Of course that doesn't take into account the huge inflationary

effects that were in place then.)

These two examples show us where human misunderstanding translates into investment errors. They also attempt to show how humans take perceived “common knowledge” for granted. If we so easily accept these falsehoods as truth, then how much more investment-related information do we treat the same way?

Diversification protects against losses. Harry Markowitz won a Nobel Prize in 1990 for his ground-breaking research on diversification (modern portfolio theory) in 1952. The simple explanation of this theory is that by diversifying across a wide range of asset classes, one will not be devastated by a significant decline in any particular asset type.

Prior to Markowitz's work, investors focused on assessing the risks and rewards of individual securities in constructing their portfolios. Typical investment advice was to identify those securities that offered the best opportunities for gain with the least risk and then construct a portfolio from these.

Following this advice, an investor might conclude that airline stocks all offered good risk-reward characteristics and compile a portfolio entirely from these. Intuitively, this would be foolish. He proposed that investors should focus on selecting portfolios based on their overall risk-reward characteristics, instead of merely compiling portfolios from securities that individually have attractive risk-reward characteristics.

In a nutshell, investors should select portfolios, not individual securities. Here is what Peter Lynch, former successful manager of Fidelity's Magellan mutual fund had to say, "Diversification is not a guarantee against losing money, it is just a guarantee that you won't lose all your money at one time."

If you miss the 10 best days each year you will not perform as well as the market. This is certainly a true statement. It is commonly touted to further convince you that you must invest for the long term.

Another statement that is also true is "If you miss the worst 10 days each year you will greatly outperform the market." Studies have shown that missing the worst 10 days each year will offer exceptional returns, significantly better than the market, and much better than those generated by missing the 10 best days each year.

For the period 1979 through 2004 (25 years), using the S&P 500, a buy-and-hold strategy yielded a return of +10% per year. If you had the misfortune of missing the best 10 days for each year, your annualized return would be -10%, significantly worse than buy-and-hold.

Convincing, isn't it? However, if you missed the 10 worst days of each year, your annualized return would be +38% per year. Of course, both of these scenarios are hypothetical and neither are a realistic investing strategy, but the point is that missing the down days is much better than missing the up days.

Probability and risk are essentially the same thing. The dependence on statistics (probabilities) for investment forecasting is tantamount to stating that with one foot in the fire and the other in ice water, things feel about average. The investment world is full of “rules of thumb” and statistical evidence. Behavioral psychologists refer to this a heuristics. These statistical rules of thumb are widely covered in the media and by many analysts. Usually such statistics are only used to add support to their current market hypothesis.

Investors’ understanding of probabilities is usually not good. A simple example is that as a coin is tossed, if heads comes up many times in a row, most think the odds are better for the next flip to be tails. In reality, the odds are 50/50 independent of the previous coin flips.

A good friend likes to tell a story about offering someone a chance to win at a game by telling him he will guarantee his winning five times out of six. Most eagerly accept such odds. That is, until you tell them that the game is Russian roulette. The focus then shifts to the risk of the loss, not the probability. Most investors forget to incorporate risk into their decision-making process. The truth is, managing and assessing risk is key to investment success. As Thomas Gilovich says, "Odds are you don’t know what the odds are."

Chasing performance will work. Investors have a habit of jumping from one strategy or manager to another during times of diversity. This performance chasing can also be devastating to their investment health. There are a host of reasons a manager might outperform or under perform their benchmark, not the least of which is the benchmark itself.

Many times the benchmark is inadequate for the manager’s style. Past performance is not predictive, it is only a measure of how a manager achieved past success (or not). Success (or failure) can be attributed to style (growth, value, large cap, small cap, etc.), economic conditions, bull/bear markets, etc.

Past performance is about hope, which is a comforting companion but a poor indicator of the future. One should adopt an investment philosophy that realizes the market has its good periods and its bad periods, and the philosophy adjusts to them as needed. A technical approach that follows the intermediate trends of the market with strong risk management offers a peace of mind dividend.

Each of these examples shows us where human frailty translated into investment errors. They also attempt to show how we humans tend to take perceived "common knowledge" for granted. If we so easily accept some things as true, then how much investment-related information do we treat the same way? Think about it.

—Greg Morris

Greg Morris is employed by PMFM, the company that serves as strategy consultant for the Strategis Asset Commitment Strategy.