CHAPTER 1

The Only Constant

It is not necessary to change. Survival is not mandatory.

—W. Edwards Deming

My first car was a used '49 Chevy. We could pull it into the garage and change the plugs, set the timing, clean the carburetor and be on our way. Back then, it was relatively easy to understand engines and how to keep them running smoothly. Today, if someone asked me to explain the first thing about what's happening under the hood of my car, I wouldn't have a clue.

There's a parallel between that Chevy and my first excursion into the world of investing. When I became a stockbroker in the late sixties, my choices were pretty simple: common stocks, preferreds, a few warrants, limited over-the-counter options, U.S. government treasuries, municipals and corporate bonds, and cash. While there were mutual funds, they were extremely limited and many brokerage firms discouraged brokers from selling them to customers.

The financial markets have moved from simple to complex at a rate of change that is impossible to fully grasp. This accelerating complexity has been multiplied by the Internet explosion, global expansion, and myriad other factors, leaving individual traders and investors bewildered and grasping at narrow fragments of the larger picture, or subscribing to the beliefs of supposed experts who promise clarity and shelter from the information maelstrom. It's no wonder that the current financial atmosphere is one of continual change and uncertainty.

In his landmark book, *The Structure of Scientific Revolutions* (Chicago: University of Chicago Press, 1962), Thomas S. Kuhn examines the way change realigns the "received beliefs" of any given community; because a community's participants define themselves according to the ideas they share, they often take great pains to defend those ideas. In fact, it's not uncommon for this defensive posture to result in the active suppression of new theories that undermine reigning assumptions. Therefore research, Kuhn writes, is not about discovering new truths, but rather "a strenuous and devoted attempt" to force new data into accepted conceptual boxes.

In short, change threatens the very terms with which we identify who we are (and how we invest our money).

But history has proved that in all things stasis never lasts—eventually an anomaly arises that is so compelling it cannot be ignored or dismissed as a "radical theory." Inevitably, the anomaly unseats the norm, resulting in a paradigm shift in shared assumptions. These shifts, as Kuhn describes them, are nothing short of revolutionary.

Paradigm shifts force a community to reconstruct its foundation of belief. Facts are reevaluated. Data are examined through new lenses and, despite vehement resistance by those who refuse to let go of outdated ideas, the old paradigm is overthrown. A new community is established, and the "radical theories" are accepted as the new normative establishment.

The cycle of change begins again.

How important is change? Think about the many powerful institutions and intrepid individuals that once lead the fray and who are now long gone; those who recognize change early can take advantage of change, those who can't overturn their past beliefs get left behind. That pattern repeats itself endlessly in all human endeavors.

In *The Tipping Point: How Little Things Can Make a Big Difference* (Boston: Little, Brown, 2000), Malcolm Gladwell defined the way people react to change by classifying them on a spectrum:

innovators : early adopters : early majority : late majority : laggards

We are going to show you how to use market-generated information to identify and adapt to change before your competitors—once the majority recognizes that change is occurring, all assymetric opportunity is lost. This book challenges you to be an innovator, to overturn (change) many of the assumptions that now guide your perception of economic and market conditions. You may be faced with information that runs counter to the prevailing beliefs of those whom you have trusted for guidance. Daniel Kahneman said it best: "Resistance is the initial fate of all new paradigms. Often this resistance is strongest among the institutions responsible for teaching and upholding the status quo."

To begin, we address change in the financial markets from the broadest perspective, which is from the point of view of investors who operate in the longest timeframe. But it is important to note that this same process occurs for traders/investors of all timeframes—those who capitalize on five-minute price swings, day traders who make several daily decisions, short-term traders who hold positions for several days, intermediate-term traders who track bracket extremes, as well traders who hold their positions for several months or even years.

What we are addressing, across all timeframes, is how change occurs.

We believe that the financial markets—and therefore all participants, businesses, and industries dependent on the markets—are at the vortex of a truly significant change. Over the coming years, investors, traders, portfolio managers, financial advisors, pension consultants, and even academics will all have to pick their spot on the spectrum of change . . . and win or lose because of it.

There is no single key driver behind the change we're experiencing. Rather, a series of developments—some connected and some not—over the past 30 years have created the evolution that is now underway. The balance of this chapter introduces these events and their implications on the financial markets and those who operate within them (traders, portfolio managers, advisors, etc.). To help you visualize the following discussion,

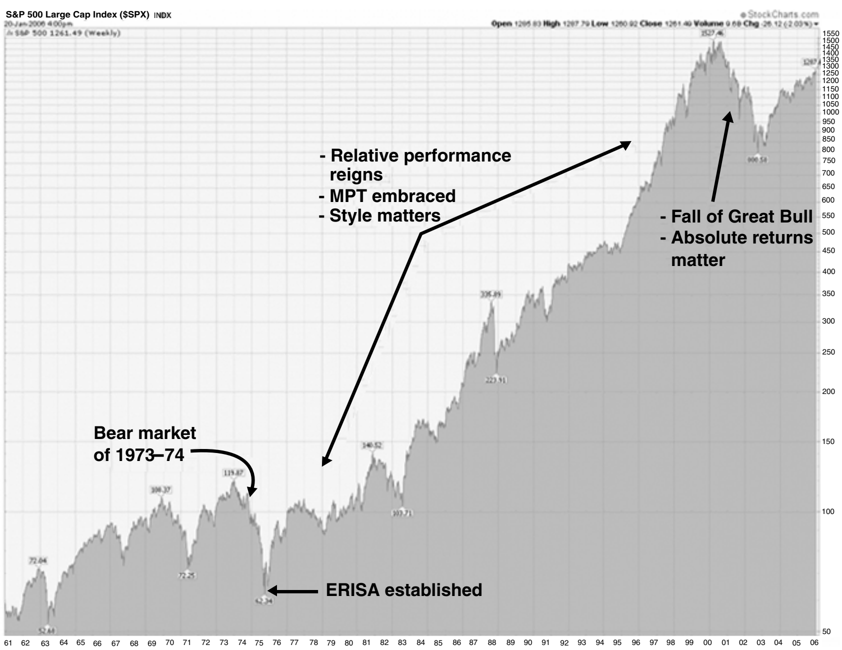

FIGURE 1.1 Events shaping market and investor behavior: S&P 500, 1965 to 2004.
Source: Chart courtesy of StockCharts.com.

Figure 1.1 illustrates several key developments of recent market history in the context of the U.S. equity market.

THE CREATION OF ERISA

The first serious change in the modern financial services business took place in the early seventies, partly as a result of the U.S. bear market that culminated in October 1974. Leading to the trend's nadir, equity valuation had decreased by approximately 40 percent (see Figure 1.1), the bond market had dropped an equivalent amount, and there was an estimated 35 percent decline in purchasing power. It should come as no surprise that innovation flourished under these extreme conditions; change demands the surrender of security, and in 1974 the very notion of security was cast in doubt.

Not surprisingly, new government regulations designed to protect employees' hard-earned retirement funds followed closely on the heels of this cataclysmic plunge. Enter ERISA (Employee Retirement Income Security Act), enacted in 1974 and designed to protect employee pensions. While performance measurement had got under way in the 1960s, ERISA increased focus on return relative to risk, which jumpstarted a new era of corporate accountability.

While this new accountability was clearly needed, ERISA was concerned more with the *process* by which pension-investment decisions were made, rather than with the investments themselves, which had the effect of ushering in an industry that focused on asset allocation, manager selection, and performance evaluation. Pension funds began to exercise more prudence when selecting money managers, hiring consultants to assist them in meeting their fiduciary responsibilities. The pension-consulting industry-began to boom.

On the surface, ERISA had many positives—it improved diversification and disclosure and promoted standards that enabled investors to better understand and compare investment performance. However, lurking below the surface was a negative that would take years to fully reveal itself: many of the processes implemented as a result of ERISA served to stifle innovation and creativity in the investment management business.

THE RISE AND FALL OF RELATIVE PERFORMANCE

The push toward improved diversification and process transparency resulted in managers developing extremely specific approaches to investing (see Figure 1.2). In turn, consultants needed improved ways to judge how

Large Cap Growth	Large Cap Core	Large Cap Value
Mid Cap Growth	Mid Cap Core	Mid Cap Value
Small Cap Growth	Small Cap Core	Small Cap Value

FIGURE 1.2 Typical U.S. equity styles.

individual managers were performing relative to the market, and relative to each other. Consultants initially used broad markets indices to gauge performance. However, as more and more specialty managers began to appear, benchmarks began to evolve and, as with all change, these evolutions became increasingly complex. Specialized market indexes were employed to gauge performance. Categories were formed so that managers could be compared against their peers. Consultants pigeonholed asset managers into distinct styles so they could more easily monitor their activity and fire them (or not hire them) if they didn't fit neatly into preconceived categories. Over time, this forced many money managers to become highly specialized, focusing on individual styles like growth or value, which in turn were further broken down into large-cap, mid-cap, and small-cap strategies, as well as a host of other variations.

Throughout the Great Bull market that began in 1982 and ran for almost 20 years, managers that attempted to be creative and innovative sometimes found that their ability to raise assets diminished—even if they had stellar track records—because they no longer fit within a convenient category.

The perceived institutional need to compare performance to peers and market benchmarks resulted in most of the focus being on *relative performance*, rather than *absolute performance*. (In short, "relative return" has to do with how an asset class performs *relative* to a benchmark, such as the S&P 500. "Absolute return" speaks to the *absolute* gain or loss an asset or portfolio posts over a certain period.) The relativistic approach to evaluating performance proved to be a boon for asset managers, in that they could now focus on constructing portfolios that had only to equal or perform marginally better than market benchmarks—*regardless of whether performance was positive or negative.*

Relativism provided a windfall for asset managers, in that it often masked poor absolute performance; an asset manager with a negative return could still win the Boeing pension fund simply by outperforming peers and benchmarks! As long as performance was measured on a relative basis, the money management industry continued to raise significant assets (upon which fees could be charged). While this wasn't so detrimental during the rising markets of the time, the relative-performance crutch did little to prepare managers to compete in the less certain markets that followed the end of the great bull market in 2000.

The tide would soon turn: Once it was clear that the market was no longer going up, clients would begin to demand that their managers do more than simply match the market.

THE FALL OF THE GREAT BULL

Coupled with an extended bull market, the enactment of ERISA had the effect of codifying *modern portfolio theory* (MPT) in the eyes of the majority of investors and investment managers. (In a nutshell, MPT emphasizes that risk is an inherent part of higher reward, and that investors can construct portfolios in order to optimize risk for expected returns.) For fiduciaries, the concept of controlled risk through diverse asset allocation is certainly appealing. When markets are "behaving" (as they were for nearly two bullish decades) the return, risk, and correlation assumptions used to generate asset allocation analyses tend to sync relatively well with market activity; a trend is predictable as long as it continues. In this environment, modern portfolio theory became the comfortable thread that held the financial markets' complex patchwork quilt together. Within this model, asset managers that performed well on a relative basis within a single, easily identifiable style could consistently raise assets. Once they stepped away from their advertised style, however, their opportunities became limited. An unfortunate result of this phenomenon was that this narrow, restrictive environment tended to limit the growth of asset managers' skill base. It's difficult to understand how talented, competitive individuals allowed themselves to remain locked into one specific management style for so long, especially when that style had clearly fallen out of favor. I saw managers literally go out of business rather than change their investment approach.

As the great bull began to show signs of strain and the equity markets began to behave with far less certainty (no longer trending up). It became apparent that the relativistic, MPT-driven business model embraced by traditional asset managers—one in which money was managed on a relative basis, track records were marketed based on relative performance, and performance was measured in relative terms—was plagued by significant weaknesses.

Alexander M. Ineichen of Union Bank of Switzerland (UBS) estimated that total global equity peaked at a little over $31 trillion at the top of the bull market, falling to approximately $18 trillion at the 2002 low—a decline of approximately 42 percent. As during the 1974 period, the investment community reluctantly began to embrace change in order to cope with the divide that opened between the objectives of traditional money managers and the needs of their clients.

One of the prime causes for this divide was that MPT depends on "reasonable" assumptions for each asset class. Implicitly, this requires a very long-term view; investors must plan on holding their investments for a long time in order to reap the desired rewards. Unfortunately, when markets failed to cooperate toward the end of the bull market, it became evident that most individuals and institutions have a vastly different perspective of what "long-term" means, especially when short-term performance is on the line. During times of market stress, the correlations between asset classes often fall apart, which often results in unexpectedly poor performance.

THE RISE OF ABSOLUTE RETURN

There appears to be a dearth of insight into how investors respond when the shorter timeframe delivers significantly different results than was advertised and expected for the longer term. But there is no lack of evidence that long-term-minded investors, when confronted with unexpectedly poor short-term results, tend to liquidate their holdings at precisely the wrong time.

As the markets became more volatile and uncertain, traders and investors who had broken free of the relativistic herd, embracing an absolute-return philosophy, continued to produce positive returns at a time when the majority of traditional asset managers were posting consistently negative returns (along with the market). Because absolute-return investors measure themselves against the risk-free rate, rather than relative to a market index, they must be more flexible and nimble. They must have the ability to employ a much broader arsenal of investment strategies in order to achieve their goal of delivering consistently positive performance. This group can employ all styles across all capitalizations. They can also short securities, which creates even more opportunities and enables portfolio managers to exploit both overpriced as well as underpriced securities.

The end of the great bull served as the catalyst for a much more adventurous and entrepreneurial environment. In today's atmosphere, it's harder for the traditional money management firms to hold on to talented traders and portfolio managers, as the financial rewards for stepping out solo can be extremely large for truly capable individuals. The firms that want to survive and prosper in the absolute-return milieu must adapt and find new incentives for attracting and retaining such innovators. An article in a leading U.K. newspaper, the *Observer*, reported that Dillon Read Capital Management, the new hedge fund unit established by UBS in 2005, earmarked $1 billion in bonuses for its first three years in business to ensure that it continued to attract and retain successful traders. When the article appeared, there were only about 120 employees in that unit, which would work out, on average, to about $3 million per employee. It's no wonder that we continue to see a steady exodus of portfolio managers from the traditional asset management firms toward those organizations that offer more challenging opportunities in the new world of *absolute return*.

SUCCEEDING IN AN ABSOLUTE RETURN MARKET ENVIRONMENT

Following a strong rise or bubble, markets historically remain within bracketing ranges for many years. As most equity markets peaked in early 2000, we are in the fifth year of a bear market at the time of this writing. Although the term "bear," in this context, is misleading, it is more useful to think of current conditions as indicative of a "consolidating," "trading," or "bracketing" market. The high-to-low range of a consolidating market offers excellent opportunities for traders who are adaptable enough to trade them. John Mauldin, in *Bull's Eye Investing: Targeting Real Returns in a Smoke and Mirrors Market* (Hoboken, NJ: John Wiley & Sons, 2005), states that the shortest bear on record is eight years, with the average being 16 years. During these periods, it seems as if the market's actions are guided by some shrewd NFL offensive coordinator—just when it looks like the market is going long it pulls up short, jukes left and rolls right, leaving a pile of stunned investors in its wake.

Consolidating markets are tricky. Just when you think you've got them figured out, you end up the wrong way on a big move and you feel like you've been betrayed by everything you know. Many traders begin to think of the market as a cunning adversary who tries to foil their best-laid plans, or perhaps a tempting siren, bent on luring them to the bottom of their bank accounts.

In a long-term bull market, or a "relative-return market," you can succeed by simply staying fully invested and matching the market's steady rise. In a bear, or consolidating market, such as the one we're in now, savvy traders seek to identify and profit from mispriced securities, both on the long as well as short side of the market. Achieving "absolute returns"

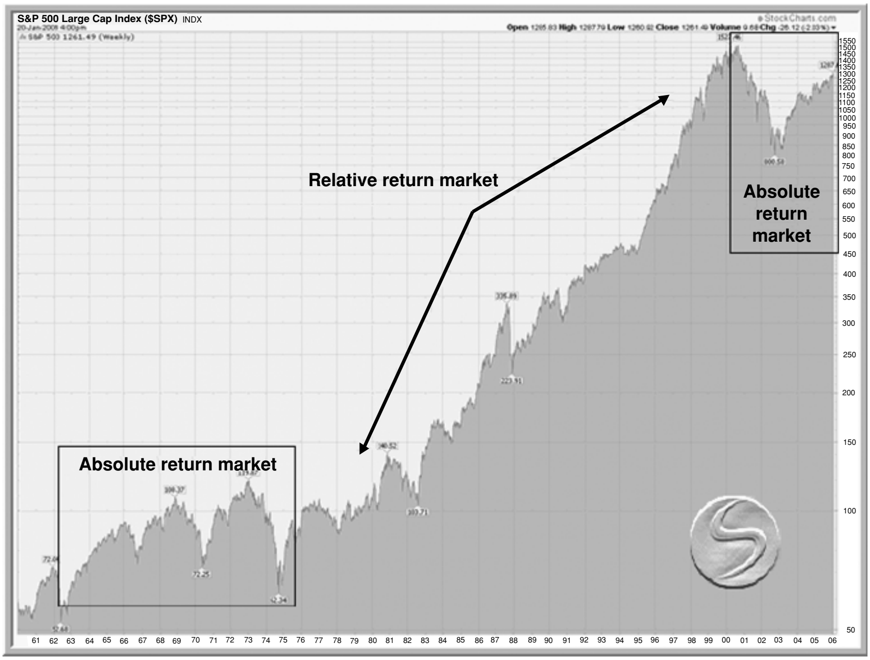

FIGURE 1.3 Absolute vs. relative return market conditions: S&P 500, 1965 to 2004.
Source: Chart courtesy of StockCharts.com.

(returns that consistently exceed the risk-free rate, regardless of market direction) requires skill, self-knowledge, an understanding of market and investor behavior, and trading maturity. The point here is that the relative and absolute approaches exist at opposite ends of the spectrum, and bracketing market conditions reward absolute-return investors—those individuals who are concerned with the value of their portfolios *at every point in time*, not just at some predetermined maturation (see Figure 1.3).

If history continues to repeat itself, as it has for the past five years, then the 20-year bull run will fade farther into the past, and a substantially different approach to market understanding will be required to consistently succeed.

It is worth noting here that *Mind over Markets*, the first collaboration between these authors, was written in the middle of the great bull market, when most investors had already climbed aboard the relative-return train. The theories and practices prescribed in that book are as applicable today as they were then—there is still unexpected volatility in bull markets, and *Mind over Markets* provided a detailed treatise on taking advantage of such volatility. Since the great bull, market mechanics and human behavior have not changed, although much around them has. With the proliferation of hedge funds, for example, there is more short-term momentum trading, which means that markets tend to move faster and go further once a movement has started.

But bull or bear or bracket, markets always conform to the fundamental dictates of time, price, and volume. We'll revisit some of the principles set forth in *Mind over Markets* within new context in this book.

PURE, UNBIASED INFORMATION

As you have already surmised, the volatility of consolidating markets is generally far greater than that experienced in bull markets. This increased volatility provides both risk and opportunity. Traders who are ruled by their emotions (or led by nearsighted analysts) will continue to chase upward swings and bail out on downward swings, which results in temporarily mispriced securities, as well as the financial destruction suffered by those who get whipsawed. This progression between bracket extremes provides prime opportunities to take advantage of fleeting discrepancies between price and value.

Markets in Profile is in large part dedicated to explicating this phenomenon in the clear light of *market-generated information*—not the deluge of hype and conflicting information that serves only to fuel the emotional panic behind most market movement. Those individuals who have the trifecta of market experience, self understanding, and skill can avoid the classic "panic in/panic out" whipsaw and take advantage of those who don't. Absolute-return investing is a zero-sum game, with a few highly skilled professionals taking from those who run, generally terrified, with the pack.

Who are those few? They are investment professionals with the experience to take a long-term view while capitalizing on short-term inequities in market structure; those who understand their own foibles, so they don't fall prey to the slings and arrows of doubt, anger, and fear; those who have the discipline to focus solely on relevant, market-generated information while the data explosion rages on around them.

Market-generated information is the pure, unbiased information that comes directly from the market itself. Structuring and interpreting this information is an excellent way to get a truly objective opinion about what's driving market movement, as it's based solely upon real order flow. Market-generated information represents a composite of all available information at any given moment—from macro and micro. And by organizing this information using the CBOT's Market Profile, you can monitor market

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FIGURE 1.4 A market profile of a market in balance showing symmetry in market structure.

structure in real-time context, which enables you to recognize paradigm shifts in equilibrium. When there is symmetry to market structure (as shown in Figure 1.4), which manifests itself in a traditional bell-shaped curve, then there is generally a balance between good opportunities and bad.

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FIGURE 1.5 A market profile of a market moving out of balance, showing asymmetric opportunities.

When the market profile becomes asymmetric (as shown in Figure 1.5), then there is a lack of balance, which results in opportunities to distinguish favorable (and unfavorable) investment opportunities.

Structuring and reading market-generated information via CBOT's Market Profile is about identifying opportunities where risk is considerably less than the potential reward. Asymmetric opportunities are often caused by irrational human behavior, such as the herd instinct that pushes price away from value. We'll delve more deeply into using the Market Profile tool and behavioral finance (often referred to as *neuroeconomics*) in later chapters. The point is that having a reliable, objective information source becomes more important every day. Markets continue to exhibit overwhelming, ever-increasing complexity, driven by growing diversity, globalization, technological advances, an increasing numbers of participants, and almost limitless outside factors that result in constant change. The remainder of this book is about how you can better understand and interpret the most objective source of information—the market itself.

PEOPLE CHANGE MARKETS, MARKETS CHANGE PEOPLE

Change is the beating heart of this book. *Markets in Profile* addresses the nature of change as it relates to markets and market participants of every type and timeframe, from macro to micro, from large institutions to investors who hold positions for decades and traders who roll with the market's daily vacillations. Everything in this book is equally applicable to individual traders, money management organizations, the proprietary trading units of major financial organizations, and all the newly formed alternative-investment shops.

For all market participants, the financial world has changed dramatically in the last two decades. This change can work to your advantage—most practitioners have either failed to recognize this change, or, more likely, have chosen not to adapt, blinded by the assumption (or the desperate hope) that what has worked in the past will continue to work in the future.

Your second, and more important advantage, is that despite the astonishing rate of change in the investment world, the fundamentals of market activity are just as they have always been: price and volume move over time to facilitate trade in the pursuit of value. It really is that simple.

It is the belief of the authors that in order to better manage risk, you must first understand the ways in which people change markets, and the ways in which markets change people. We will endeavor to investigate the nature of change, starting with a general discussion of perceived paradigms and culminating in a close look at the specifics of securing favorable trade location in the active, endlessly changing market.

On a final note, *Markets in Profile* is also about addressing what could be your greatest adversary: yourself.