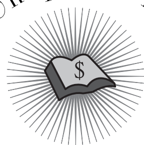
Chapter One



It's Good to Be King

But Beware of Tailors Using Invisible Cloth

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The traditional wisdom of Wall Street is to buy low and sell high. While it sounds simple enough, the philosophy has fostered an entire industry of financial advisors, prognosticators, and experts. When you reflect on the carnage on Wall Street in the last few years, it is easy to place stock market experts in the same category as TV weathermen.

Television shows parade a seemingly endless lineup of financial, economic, and stock market experts who freely give this stock tip or suggest that investment strategy. Yes, they say, the economic outlook may seem gloomy, but happy days are right around the corner. This is the time to buy.

Every talking head seems to have an opinion. Often a show's producer will recruit talking heads with conflicting views and let them battle it out. It can make for interesting viewing for some and confusion for others. How can a few sound bites really give you the information you need to confidently invest in today's volatile markets?

Timing Is Everything

There's a Wall Street legend that Joseph P. Kennedy, the scion of the Kennedy clan, survived the 1929 crash because he had divested all his holdings in the summer of 1929. He said that he knew it was time to get out when he started receiving stock tips from the shoeshine boy. If you were one of the smart or prescient investors who got out of the U.S. stock market before October 11, 2007, consider yourself lucky. Between 1929 and 1932, the stock market declined 89 percent, which contributed to the Great Depression. From October 2007 until March 2009, the market lost about 55 percent of its value—the second biggest decline in our nation's history.

The U.S. economy began shrinking in December 2007. The recession, by the technical definition of the

term, ended in June 2009 because that's when the economy began growing again.

A nontechnical definition of a recession's end has to do with consumer confidence and a general sense of optimism about the financial future of the country. We are now in the first quarter of 2012, and people are still looking for solid proof that the worst is behind us. Consumer confidence is at a level typical of a recession, and that is anomalous two years into a recovery. Instead of signs of fiscal hope, we are faced with daily reports of continuing high unemployment, declining home prices, increasing rates of foreclosures and bankruptcies, persistent federal deficits, high gas prices, and hints of coming inflation.

In the face of all the negative news, it would be easy to conclude that investing in the stock market with the hope of making any profit at all would be a fool's errand. You might even believe that the safest course is to stick your money under your mattress and hope your house doesn't burn down. You *could* do that, but you would be absolutely wrong.

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With every challenge, there is an opportunity for growth. In the middle of the chaos of war and disaster, there can be a moment of clarity and inspiration in which a hero emerges. We are in the midst of an economic war, and now is not the time to run and hide. Now is the time to take a deep breath, regain your focus, concentrate on your investment target, and pull the trigger.

Bull's eye!

Where Were We Again?

A secular bear market is loosely defined as a period of years or even decades when stock prices are either flat or falling. (Think Japan since 1990 or the United States from 1966 to 1982.) Historically and classically defined, secular bear markets are as short as 8 years or as long as 17. By a broader definition that I prefer and will explain, the range is 13 years to as long as 20 years.

For the last century in the United States, the length has been remarkably consistent—about 17 years from the beginning of a secular bear to the beginning of the next true secular bull. My friend Art Cashin, head of UBS Floor Operations and dean and sheriff of the New York Stock Exchange, recently sent me a note he wrote at the beginning of the last decade:

> Floor brokers have lots of theories of cycles and such. There's even a fat and lean cycle

theory. Just as in the Bible there were seven fat years followed by seven lean years . . . brokers claim to see a similar thing in Wall Street. Ours is much longer . . . 17.6 years.

You may think what I am about to tell you is negative. I suggest to you it is not. It raises your opportunity by eliminating mindless competition. It just means you have to work at it—seeking advice and information—and not [to leave] your investment policy on autopilot. That was what folks did in the fat cycle. That doesn't work anymore.

In the fat cycle, which ended with the bubble, the Dow went from 900 to 11,700. You could throw a dart and pick a winner . . . lots of folks did. Those days are gone. Getting a decent return will be hard work for the next decade. You will need good judgment and good advice. Put the dartboard away. Just so you understand better, let me walk you through this concept.

The tech bubble or the bull market topped in about February 2000. Just so it works on your calculator, let's call that 2000.2. The Dow is around 11,500. Subtract 17.6 years and you are in the middle of 1982. The Dow is around 900. It will soon embark on the greatest bull market in history. Subtract another

17.6 years from June of 1982 and you are back to the beginning of 1965. The Dow is around 900. Yes . . . that's the same area you will find it in 17 years later. This clearly is the lean cycle. The Dow will go above and below 900 many times. Money will be made and new industries [will] flourish, but it will require skill and hard work to find them.

Subtract another 17.6 years from 1965 and you are back around the middle of 1947. The war has ended. Smokestack prosperity is in the offing. The Dow is around 220. This was to be a fat cycle.

Subtract another 17.6 years and you are back in early fall 1929. The Dow is around 380—but not for long. This . . . clearly . . . will be a lean cycle.

Now—on the slim chance that this is any-more than an oddity—what does it mean to you?

It means you have to get off autopilot. In a fat cycle people can almost throw darts and hit a winner. In a lean cycle they need to pay attention and seek advice from someone with skill and brains.

My contention, and I think the clear lesson of history, is that we are still (as of 2012) in the secular bear market

that began in 2000. If the recent pattern holds, the bear market will continue for another five to six years in terms of valuations, if not in price. The key to successful investing will be to hold the types of stocks, funds, and other investments that do well in a secular bear market (when valuations are contracting) while avoiding the types that history has shown have less chance for success in such an environment.

Understanding the environment and investing accordingly are critical to your success. But before I can tell you how to invest in a secular bear market, you need to understand for yourself what these cycles are and why and how they happen.

When Past Is Not Prelude

We are looking for clues as to what the stock market is likely to do in the future. If reviewing the past gives us some idea of what the future will be, we will be way ahead of the crowd.

We can find some clues in a groundbreaking book by Michael Alexander called *Stock Cycles*. What he wrote early in 2000 accurately anticipated the behavior of the markets since then, and I recommend the book as important reading. (You can order it from www.Amazon.com.)

Let's jump to the conclusion: Alexander's work shows that using past market cycles to predict the performance of

stocks over the coming 12 months isn't much better than flipping a coin. Statistically, from almost any starting point, you have about a 50–50 chance of the market going up or down, using past price movements alone to make your prediction. Even in a secular bear market, the market goes up in 50 percent of the years—and often quite substantially.

But there are certain long-term cycles that are not random, and the probability of those repeating is higher than 50 percent. As you would expect, the patterns and techniques of successful investing change somewhat dramatically from phase to phase. The trick, of course, is to figure out where you are in the cycle.

I have long been suspicious of stock market cycle theory, especially Long Wave theory. Long Wave (or Kondratieff Wave) theory says the economy and markets repeat every 56 or 60 years. Granted, there seem to be patterns that recur, but there are not enough data points to provide statistical confidence. It is an interesting theory that tells you where you have been and where you are going, but it does not tell you reliably where you are or when you will arrive somewhere else.

I remember, as will many of my readers, how Long Wave theory predicted the end of the economic world in the late 1980s. How many of you remember the flood of direct mail promotions, not to mention the books, screaming gloom and doom? Obviously, they were wrong.

The reason is that analysts try to make Long Wave theory a precise predictive model. They do not look at the fundamentals that drive the cycles.

It is like watching two men seemingly walking in the same direction in a large city. Maybe they are friends and are walking together. They could be total strangers going to the same location, or they may part ways on the next block. Until you know who the men are and where they are going, using their past travels to predict their movements is simply guessing.

It is one thing to use the stars, as the ancients did, to construct a calendar to predict seasons, planting times, and weather patterns. It is another to use the stars to predict personal fortunes. One methodology has a basis in fundamentals; the other (astrology) simply notices patterns that have no causal connection to anything else.

Alexander provides, at least for me, the needed link between the patterns in Long Wave stock cycles and the underlying economic fundamentals. He shows, as it were, a causal connection between the position of the stars and the seasons.

Alexander doesn't claim these cycles are as precisely predictable as the spring equinox. Rather, he suggests that when certain fundamental conditions occur, we can look for springlike events. Just as you plant certain types of food and plants in spring and certain types in winter,

there are some investments that do better in their respective parts of the stock cycle. Carrying the analogy further, it is easier to grow your portfolio in economic spring than in economic winter. In spring, you have a much wider variety of "plants" from which to choose.

You can plant spring crops during the winter, but you're going to have to wait until spring to see them come up. In the meantime, it can be a long, cold season.

To help us see what part of the cycle we are in, he first describes several types of stock cycles and then looks at why the cycles occur.

First, he takes a purely statistical view of the stock market, looking for repeating patterns. For his purpose, a period when the stock market outperforms money market funds is "good" and when it underperforms is "bad." Is there any pattern to good and bad?

It turns out the only nonrandom cycle he can find is a 13-year cycle. Since 1800, there have been 15 alternating good and bad cycles of 13 years, from stocks being undervalued to being overvalued and back again. There was one period where the pattern, instead of reversing, continued for an additional (and exact) 13 years. The year 2000 was a 13-year peak in his model. There is a probability of only 3.9 percent that this pattern is random.

Alexander's findings suggested that index investors had little hope for capital gains over the 13 years following

2000. Buy-and-hold investors would probably be better off in cash, just as they were in 1966 and 1929.

Simply based on this model, Alexander concluded there is a 75 percent chance of a negative capital return for index fund investors who hold from 2000 to 2020. However, returns in any one-year period are essentially random. Even in overvalued markets, the odds are essentially even that an index fund will outperform a money market fund in a given 12-month period.

"Given today's low dividends and high valuations, a money market fund is, on average, a better investment over the next 5 to 20 years than the S&P 500 Index. . . . In the case of overvalued markets (like today), holding for longer time periods, even up to 20 years, does not increase your odds of success." Alexander wrote that in early 2000, prior to the first crash.

Let me stop here and say that Alexander is not telling us to avoid the stock market. He is simply pointing out, consistently with the theme of this book, that buy-and-hold index investing will not work in the current long-term trend. Simply picking any old mutual fund and expecting a rising tide to raise your boat will give you no more than a 50–50 chance of success in any given year until the secular bear market has run its course. To improve your odds for success, you need a different investment strategy.

Alexander looked at the historical cycle of bull and bear markets. He points out that stocks have returned about 6.8 percent per year in real returns (adjusted for inflation) over the last 200 years, but two-thirds of that came from dividends. The remainder corresponds to the real annual growth in gross domestic product (GDP) over the two centuries. A National Bureau of Economic Research study also demonstrates this very point. The stock market does not grow faster than the economy over the long term. If it goes too high or too low, it *always* comes back to trend.

But stock prices fluctuate dramatically. There have been seven secular bear markets and seven secular bull markets since 1802, according to Alexander's way of looking at things. These are periods of at least 8 and up to 20 years when stocks are either generally rising or falling over the entire period. There are, of course, bear market rallies and bull market corrections, but the long-term trend is still either up or down.

If you were in the stock market during the 95 years of the bear market cycles, you achieved only a 0.3 percent annual average rate of return. If you picked the 105 years of the bull market cycles, you made a 13.2 percent rate of return. Your *actual* returns for any one 10-year period would be totally dependent upon when you made your initial investment. On average, the cycle's duration from peak to peak is 28 years.

Is there some model we can use to examine the long cycle to help us determine what drives the dramatic price movements? Here, Alexander provides a new way to look at price fluctuations.

He looks at a ratio he calls P/R, or price to resources. "Resources are simply the things (plant, equipment, technical knowledge, employee skills, market position, etc.) available to the business owner to produce a profit. R is essentially retained earnings, or that portion of profits used to invest in the business to grow the business," he writes.

While P/R isn't particularly useful for predicting the performance of individual companies or industries, it follows a clear pattern for the market as a whole. P/R peaks at bull market tops and begins to rebound at bear market bottoms (as indicated by price).

But the fluctuations in P/R are less volatile than fluctuations in the price-to-earnings (P/E) ratio. That's because while earnings may swing wildly from one year to the next, actual resources don't.

Over longer periods, however, there is a direct relationship between earnings and resources. As the resources of a company accumulate and are put to work, the company's earnings tend to increase. The collective P/R ratio is the estimate of the value investors put on the ability of an economy to produce earnings. With this understanding, it now gets interesting—at least for me.

And what we will see is that valuations at the time you invest determine the returns you will get over the next 10 to 15 to 20 years. Looking at cycles in terms of valuations is one of the keys to Bull's Eye Investing.

Long Waves Explained (Finally)

Alexander then jumps to the Long Wave cycle. Greatly simplifying, the theory says that there are two sets of stock market cycles in each Long Wave. There are a bull market and bear market that are influenced primarily by monetary events. Those price movements are followed by a bull market and bear market that are influenced primarily by "real" events such as earnings and economic performance.

The theory then says:

> The extraordinary gains in recent years result from investors discounting future earnings growth over longer periods of time. This makes the market extraordinarily leveraged to the economy. . . . The average length of economic expansions was shorter during the 1970s than they were either before or since. The [coming cycle] could also be characterized by short business cycles like in 1883–1896 rather than a lengthy slump like in the Depression. Shortened expansions would gradually shift the market from a future-oriented

> to a present-oriented valuation scheme, resulting in a contraction in P/E. The result would be a secular bear market as the valuations slowly adjust, even though economic growth might be fairly good. This, of course, is what is predicted to be imminent by P/R.

Alexander shares my concern, which I mentioned previously, about the lack of connection between the Long Wave theory and the actual economy. But he has, in my opinion, found the missing link and touched on some very exciting prospects for future investments.

The economists Schumpeter and Mensch both tried to establish a theory of the Long Wave based on bursts of innovation. More recently, Harry Dent (*The Roaring 2000s*) has expanded upon their work. Alexander uses Dent's terminology to put forth his own new thought.

The importance of this process is straightforward. If you agree with Alexander's logic, then you will have "two, largely independent, periodic phenomen[a] that we can use to characterize the changing economic environment that brings about the stock cycle."

Dent sees the innovation cycle comprising four periods: the innovation period, the growth boom, the shakeout, and the maturity boom. Alexander calls the end of the maturity boom the economic peak, which is the time

when the economic impact of an innovation has been completely played out.

Basically, a new process or technology is invented, such as the cotton gin, telephone, electricity, airplanes, or computers. Following the period of innovation, there is a rapid growth of the "new economy." But too much capacity is built, and a number of companies falter.

During the shakeout, another process is going on—a second innovation phase that develops the mature technology. Companies with additional innovations experience a second growth boom prior to the final maturing and the economic peak. The new technology finally reaches it technical growth limits and succumbs to the inevitable force of economic gravity. At maturity, a company focused on technology can grow no faster than the overall economy. (Think railroads after 1860 and electricity after 1900.)

Now we come to the best part of Alexander's work. He identifies nine innovation cycles, the earliest starting in the 1500s, and relates the cycles to their importance to the overall economy: what share of the GDP growth did these innovations contribute?

Over time, as the innovation becomes mature and new innovations come on the scene, the talk is of the new economy changing the world and replacing the "old economy." But eventually even the "new, new thing" becomes mature and plays a less significant part in economic

growth as even newer innovations appear. It is a repetitive cycle. It is no different from what we see today. The cycles and phases are eerily the same.

There is a connection between the Long Wave and the innovation cycle that seems to have worked well enough for about 500 years. Alexander notes that the Information Economy seems to have come about 17 years later than the average 53 years. Thus, rather than being mature in the 1980s, it was just beginning. If nothing else, that explains why the Long Wave theorists were wrong about the world ending in 1989 or 1995 or (pick a year).

There is nothing magic about a Long Wave of 53 or 56 years. What is important is the innovation cycle. It is the latter that influences the economy. Analysts who used the Kondratieff or Long Wave as a time prediction tool were wrong. The usefulness of the Long Wave is to help us understand how the innovation cycle is affecting the underlying economy.

Thus, Long Wave theory can help us know what to expect at the end of the innovation cycle. It cannot predict the exact timing, but it discloses the general shape of things to come.

Catching the Next Wave: Something New This Way Comes!

Notice two implications of the innovation cycle. First, investing in stocks at the end of the cycle is problematic.

Growth slows down and stocks are overvalued relative to growth potential. Slowly, the realization seeps into the minds of investors that the new, new thing is becoming commonplace.

Electricity used to be new. Railroads used to be new. Both changed the world dramatically. Now both are prosaic. Airlines, radio, television, and the automobile all had their boom and bust cycles.

In a few years, investors will realize that computer and telecom stocks simply do not have the growth potential they once had. While there will continue to be success stories, the large companies simply don't have room to grow at 20 percent to 40 percent year after year. As we'll see, growing at even 10 percent for any length of time is hard for a big company.

The second implication is far more exciting: something new this way comes! Another innovation cycle lies in our future. I call it the Millennium Wave, as I think it will bring multiple innovations, waves happening all at once, compounding the opportunities and growth potential. It will be an opportunity to get in at the beginning of new industries that will change the world as profoundly as electricity, the telephone, or the computer.

We do not yet know what all of them will be, but biotechnology, wireless communication, fusion power or some other new energy source, robotics, and artificial intelligence

are on my list. And it may include things not yet on anyone's list. We could see more change in the next 20 years than we have seen in the last 110!

Duck, Duck . . .

- From October 2007 until March 2009, the market lost about 55 percent of its value, the second biggest decline in our nation's history.
- We are still (as of 2012) in the secular bear market that began in 2000. If the recent pattern holds, the bear market will continue for another five to six years in terms of valuations, if not in price.
- Valuations at the time you invest determine the returns you will get over the next 10 to 15 to 20 years.
- At maturity, a company focused on technology can grow no faster than the overall economy.
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