CHAPTER 1

Being Right or Making Money

NED DAVIS

Bad News about Forecasting (Being Right)

Later in this book there are several chapters about factors—including a potential cyclical bear market, demographics, and the U.S. energy renaissance—that could be game changers, and might help forecast the future. I hope you will find the perspectives useful, even though after studying forecasting for over 40 years I realize I do not always know what the market is going to do.

You may have heard of the Texan who had all the money in the world but who had an inferiority complex because he felt he wasn't very bright. When he heard about a brilliant doctor who was offering brain transplants, he immediately consulted him to find out if it were true and how much it would cost. The doctor told him it was indeed true that he could boost intelligence quotient (IQ) levels. The doctor had three types of brains in inventory: lawyer brains for $5 an ounce, doctor brains at $10 an ounce, and stock-market guru brains for $250 per ounce. The Texan asked, "Why in the world are the stock-market guru brains so much more expensive or valuable than those of doctors or lawyers?" And the doctor replied, "Do you have any idea how many gurus it takes to get an ounce of brain?"

People laugh at that joke because unfortunately there is a lot of truth to it. I don't know in what direction the markets will go, and neither does Janet Yellen or Barack Obama. Even George Soros, whose modest $1 billion take-home pay of a few years ago qualifies him as a bona fide market guru, says in his book *The Alchemy of Finance*,[1] "My financial success stands in stark contrast with my ability to forecast events . . . all my forecasts are extremely tentative and subject to constant revision in the light of market developments."

While 95 percent of the people on Wall Street are in the business of making predictions, the super successful Peter Lynch, in his book *Beating the Street*,[2] says, "Nobody can predict interest rates, the future direction of the economy, or the stock market. Dismiss all such forecasts. . . ." And as Mark Twain once observed, "The art of prophecy is difficult, especially with respect to the future."

I think it was Alan Shaw, one of the more successful practitioners of technical analysis, who said, "The stock market is man's invention that has humbled him the most." Fellow legendary technician Bob Farrell warned, "When all the experts and forecasts agree—something else is going to happen."[3]

Economist John Kenneth Galbraith put it this way, "We have two classes of forecasters: those who don't know and those who don't know they don't know."

Financial theorist William Bernstein described it similarly, but with an even darker message: "There are two types of investors, be they large or small: those who don't know where the market is headed, and those who don't know that they don't know. Then again, there is a third type of investor—the investment professional, who indeed knows that he or she doesn't know, but whose livelihood depends upon appearing to know."[4]

Despite my realization that forecasting is difficult, I haven't become a spoilsport and turned away from predicting the market's course entirely, because I've had my share of really good forecasts. Perhaps recounting how I came to distrust "being right" and instead embraced techniques that allowed me to make money consistently will be helpful.

Like nearly all novice investors and analysts, back in 1968 I was convinced that all I had to do was discover the way the investment world worked, develop the best indicators available to forecast changes in the markets, have the conviction to shoot straight, and gather my profits. And my record of forecasting stock prices from 1968 to 1978 was so good that during a *Wall $treet Week* broadcast in 1978 Louis Rukeyser said, "Ned Davis has had an outstanding record in recent years . . . and has been absolutely right about most of the major ups and downs. . . ."

The only problem was that at the end of each year, I would total up my capital gains and unfortunately I would not owe Uncle Sam much money. Before someone else could question me, I asked myself, "If you are so smart, why aren't you rich?" It was about that time (1978–1980) that I began to realize that smarts, hard work, and even a burning desire to be right were really not my problems, or the solution to my problems. My real problems were a failure to cut losses short, a lack of discipline and risk management, letting my ego color my market view (which made it difficult to admit mistakes), and difficulty controlling fear and greed. *It was thus a lack of proper investment strategy and good money management techniques, not poor forecasting, that was holding me back.*

I dealt with those problems, and by 1985 *Barron's* magazine was interviewing me and saying on its cover: "No Bum Steers from This Raging Bull: Ned Davis Has Been Dead Right on the Market."

Over the years I have seen scores of very bright investment advisors turn into hugely successful gurus who blaze into the investment business with spectacular forecasts. Yet, I've watched each and every one of them crash back to earth when a big subsequent forecast inevitably proved wrong. The Bible says, "Live by the sword, die by the sword." As my late friend Marty Zweig and I watched these forecasting gurus fail, we often said to each other, "Live by the forecast, die by the forecast."

Before examining indicators, I'd like to discuss the record of some professional forecasters. Perhaps the biggest myth in financial markets is that experts have expertise or that forecasters can forecast. The reality is that flipping a coin would produce a better record. Therefore, relying on consensus economic forecasts to provide guidance for investment strategy is almost certain to fail over the long run.

What is my evidence? Consider forecasts from the Survey of Professional Forecasters released by the Federal Reserve Bank of Philadelphia and shown in Figure 1.1 (solid line). The dashed line shows real GDP. The chart shows seven recessions (shaded zones) since 1970. As a group, professional economic forecasters did not correctly call a single one of these recessions. In fact, they have never predicted a recession, period. Since the first edition of *Being Right or Making Money* was published in 2000, on average economists have been 59 percent too high in their 12-month forecasts (predicted growth: 3.1 percent; actual growth: 1.9 percent).

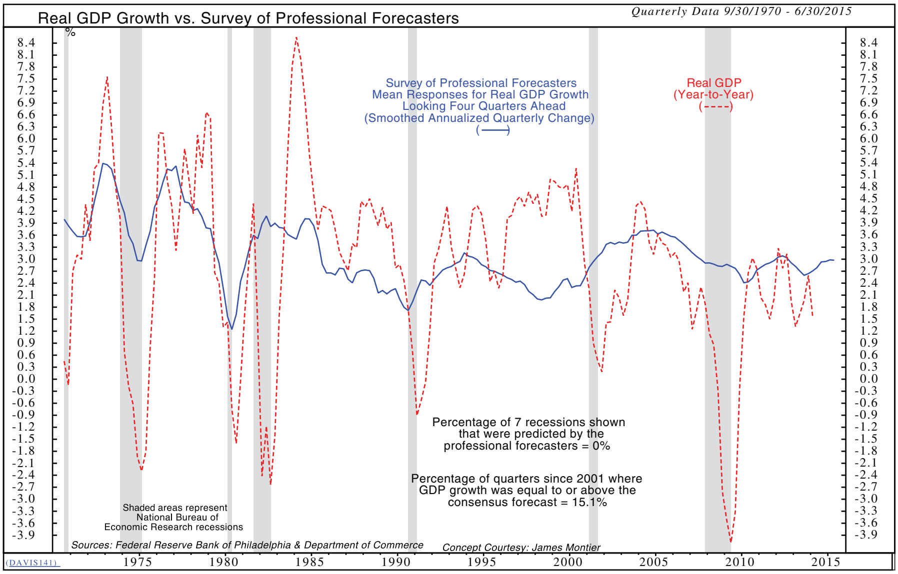


FIGURE 1.1 **REAL GDP GROWTH VERSUS SURVEY OF PROFESSIONAL FORECASTERS**

Well, what about the experts at the Federal Reserve? They are supposed to be independent. They have a lot of money to spend on research, a full professional staff, and they have expanded their projections from a year or so to five years ahead. Two years ago the initial projection for 2013 was 4.15 percent real growth. In Figure 1.2 we plot the wide range of projections by the Fed (not the central tendency or specific point forecast) and then see how real GDP performed since 2000. And as shown, the Fed was actually correct (actual GDP fell within the Fed's wide range) just 26.3 percent of the time!

The last word I'll offer on predictions is from the Fed's leader during much of the period covered by the chart. In October 2013 Alan Greenspan said, "We really can't forecast all that well. We pretend we can, but we can't."

Forecasting the economy and the investment markets consistently and reliably is very difficult. In fact, consensus predictions often contain the seeds of their own destruction by altering human actions. Most crowds are usually wrong at sentiment extremes as I will discuss later in this chapter.

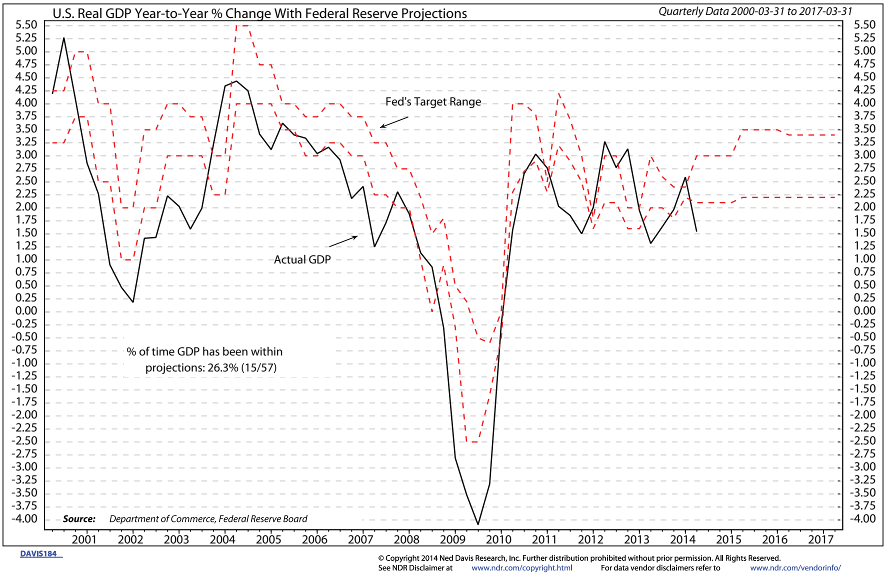


FIGURE 1.2 **REAL YEAR-TO-YEAR PERCENTAGE CHANGE IN U.S. GDP VERSUS FEDERAL RESERVE PROJECTIONS**

Good News about Making Money

After studying winners in the investment world over many years, I found some good news. While *nobody was right* year in and year out, a number of advisors and investors did in fact *make money* year in and year out. I decided I would follow their advice on how to make money consistently.

In 1980 I acquired a computer and a good program, and started building timing models that I felt would give me the objectivity, discipline, flexibility, and risk management that I needed to make consistent profits. And since 1980 the Ned Davis Research Group has been dedicated to building timing models that do not forecast, but are simply designed to make money. These models have made a real and substantial change in my investment profits, and both Uncle Sam and I are now much better off. As far as my forecasting of the market goes: if anything, it suffered. Timing models that make money invariably are less cocky than a crystal-ball guru. The models are so concerned with minimizing disastrous risks that they try to hit singles and doubles rather than home runs. And they definitely limit the number of strikeouts.

Again, my financial well-being improved significantly, and the humility and discipline that the timing models forced upon me relieved me of a lot of stressful anxiety. I shifted my focus from gaining glory and prestige to designing a business focused on making money while managing risk.

Timing models have permitted me to make money on a more consistent basis. Throughout my career I have followed a number of renowned market winners, and though their methods do not all include timing models, these winners share certain investment-strategy characteristics that we have tried to incorporate into our models.

I found winners such as Marty Zweig, Dan Sullivan of *The Chartist*,[5] and Value Line,[6] who have consistently made money since 1980 (according to Mark Hulbert, who rates advisors). I found investment legends who consistently win, including John Templeton, Warren Buffett, Peter Lynch, George Soros, Stan Druckenmiller, Paul Tudor Jones, Bill Gross, and Jim Stack. What commonalities do these winners share?

Being Right and Other Investment Techniques Are Overrated and Are Not the Keys to Success

It's not the markets they trade or even the techniques they use. These are people who rely on different philosophies, ranging from Ben Graham's long-term valuation techniques to in-and-out technical commodity trading . . . from dollar-cost averaging to market timing . . . from buying high-yielding stocks to buying relatively strong stocks with almost no yield. Clearly, a variety of techniques can make money. I find it exciting that numerous techniques can make money, as investors can choose the technique that best fits their own psyches.

The winning methods of successful professional investors are even sometimes contradictory. For example, in the book *Market Wizards*[7] the successful pro Jim Rogers is quoted as saying that he often examines charts for signs of "hysteria," and also that "I haven't met a rich technician." In the same book an equally successful pro, Marty Schwartz, is quoted as saying, "I always laugh at people who say, 'I've never met a rich technician.' I love that! It is such an arrogant, nonsensical response. I used fundamentals for nine years and then got rich as a technician." If you think that is confusing, in the book *What I Learned Losing a Million Dollars*[8] the legendary

John Templeton is quoted as saying, "Diversify your investments." In the same book, the equally legendary Warren Buffett says, "Concentrate your investments. If you have a harem of forty women, you never get to know any of them very well."

So as I studied other long-term winners on Wall Street, I found that instinctively or otherwise, they had come to the same conclusions that I had. While the methods of Warren Buffett, Peter Lynch, and John Templeton are very different from my risk-management, asset-allocation, market-timing orientation, all of these men have been exceedingly humble, made multiple mistakes, and rarely (if ever) get headlines about a spectacular call. Yet they all use objective methods for picking stocks, their investment philosophy is disciplined and designed to limit risks, and they are flexible when they must be.

This book is not designed to challenge those of you who are long-term fundamentalists or short-term technicians. Instead, we offer some tools that hopefully will help you to be more right more often. But much more importantly, this book will show you that being right is not really where it's at, since at least as much of your focus should be on risk management, a disciplined strategy, and flexibility.

The Four Real Keys to Making Money

As I continued studying legendary investors, I discovered that all of these winners shared four key characteristics, some of which I had already learned by the time I completed kindergarten.

1. **OBJECTIVE INDICATORS:** These legendary investors all used ***objectively determined indicators*** rather than gut emotion. We have a little riddle about this. In a room there were three people: a high-priced lawyer, a low-priced lawyer, and the tooth fairy. In the middle of the room was a $100 bill. Suddenly the lights went out, and when they came back on the $100 bill was gone. Who took it? The answer, of course, is the high-priced lawyer—because the other two are figments of the imagination. We want to make sure that what our indicators say is factual and not a figment of our imaginations. As our teachers tried to help us understand in kindergarten, it is critical to learn what is real and what is imaginary.

What is an objective indicator? It must be mathematical, with long historical analysis to demonstrate its effectiveness. One example might be the rate of inflation. Perhaps it is because the Fed is supposed to control inflation, or perhaps it is because bond yields have an inflation premium, but inflation is one of the best macroeconomic indicators to use to call the stock market.

But in all of the noisy data, how much does inflation need to rise or fall on a monthly basis to be important? The chart in Figure 1.3 looks at the year-to-year rate of inflation relative to a five-year moving average. In the 41.3 percent of the time since 1952 that the year-to-year inflation rate was at least 0.5 of a percentage point below the five-year average, the S&P 500 shot up at a 13.5 percent annual rate—almost double the 62-year buy-and-hold average of 7.2 percent. And when inflation was more than one percentage point above the five-year average, one actually lost money in stocks.

2. **DISCIPLINE:** All the winners are very ***disciplined***, remaining faithful to their systems through good and bad times. I sometimes

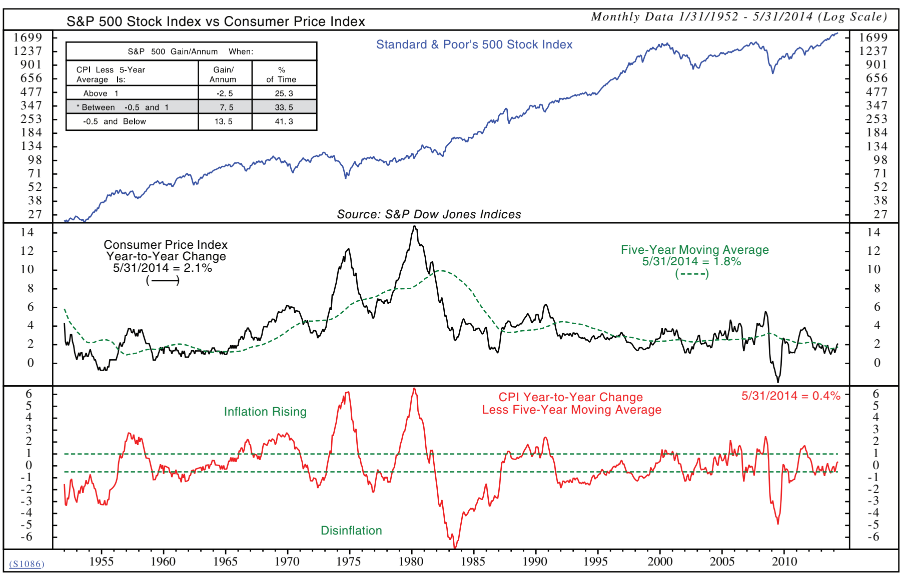


FIGURE 1.3 **S&P 500 INDEX VERSUS CONSUMER PRICE INDEX**

compare investing to classical Greek tragedies, in which the hero is inevitably ruined by some character flaw. My own biggest flaw in investing, as noted earlier, is letting my ego get involved in my market view. This makes it very difficult to admit mistakes. Thus, to shift from concentrating on being right to making money, I had to learn discipline. That is how I came up with the idea of using computer-derived mathematical models for stock-market timing that would *force* discipline upon me. That discipline may not have made me more right over the past 40 years, but it did control my mistakes and allowed me to be a much more successful investor. In June 1998 Dan Sullivan said in his *The Chartist* newsletter, "Successful investors have several things in common. First, they have patience. Second, successful investors are like great athletes, they adhere to a strict discipline." As my teacher taught me in kindergarten, there will be chaos if you don't have discipline.

3. **FLEXIBILITY:** While disciplined, these winners were ***flexible*** enough to change their minds when the evidence shifted, even if they did not understand why. In his book *Winning on Wall Street*,[9] Marty Zweig talks about how bearish he was during a sell-off in February and March 1980: "I was sitting there looking at conditions and being as bearish as I could be—but the market had reversed. Things began to change as the Fed reduced interest rates and eased credit controls. Even though I had preconceived ideas that we were heading toward some type of 1929 calamity, I *responded* to changing conditions." In conclusion he states, "The problem with most people who play the market is that they are not flexible . . . to succeed in the market you must have discipline, flexibility, and patience."

Barton Biggs once called Stan Druckenmiller "the investment equivalent of Michael Jordan. . . . He is the best consistent macro player." Biggs said, "He is a combination of being very intellectual and analytical, but also using technical analysis." In *Market Wizards*, author Jack Schwager writes of Druckenmiller:

> Another important lesson . . . is that if you make a mistake, respond immediately! Druckenmiller made the incredible error of shifting from short to 130 percent long on the very day before the

> massive October 19, 1987, stock crash, yet he finished the month with a net gain. How? When he realized he was dead wrong, he liquidated his entire long position during the first hour of trading on October 19 and actually went short. . . . The *flexibility* [emphasis added] of Druckenmiller's style . . . is obviously a key element of his success.

So as I learned in kindergarten: expect surprises. Things change.

4. **RISK MANAGEMENT:** Finally, all of these successful investors were ***risk managers***. I asked Paul Tudor Jones once what he does at work all day, and he answered, "The first thing I do is try to figure out what is going to go wrong, and then I spend the rest of the day trying to cover my butt." In *Market Wizards*, Paul says, "I am always thinking about losing money as opposed to making money." And he is widely known as a risk taker!

Nearly all of the pros I have studied are clear about one thing: *they want to control their losses*. In *Market Wizards*, fundamentalist Jim Rogers says, "Whenever I buy or sell something, I always try to make sure I'm not going to lose any money first . . . my basic advice is don't lose money." In the same book, technician Marty Schwartz says, "Learn to take the losses. The most important thing in making money is not letting your losses get out of hand." In his book, *Pit Bull*,[10] Schwartz says, "Honor thy stop . . . exiting a losing trade clears your head and restores your objectivity." Controlling losses is one lesson I wished I had learned in kindergarten. They did tell me to be careful, but it wasn't until much later that it sunk in. I learned this from Warren Buffett, who once stated his two favorite rules for successful investing: Rule #1: Never lose money. Rule #2: Never forget Rule #1. In *What I Learned Losing a Million Dollars*, the legendary Bernard Baruch is quoted as saying, "Don't expect to be right all the time. If you have a mistake, cut your loss as quickly as possible."

In *Reminiscences of a Stock Operator*,[11] the hero (widely believed to be the legendary trader Jesse Livermore) says, "A loss never bothers me after I take it. I forget it overnight. But being wrong—not taking the loss—that is what does the damage to the pocketbook and to the soul." Echoing that sentiment, Druckenmiller in *The New Market Wizards*[12] says of George Soros,

"Soros is also the best loss taker I've ever seen. He doesn't care whether he wins or loses on a trade. If a trade doesn't work, he's confident enough about his ability to win on other trades that he can easily walk away from the position." Finally, the last word on the subject of taking losses (and making money) goes to Leo Melamed, chairman emeritus of the Chicago Mercantile Exchange. In the book *The Inner Game of Trading*,[13] in response to the question, "What do you think are the primary psychological barriers that prevent most traders from being successful?" Leo answered: "One of them is the ability to take a loss. You've got to know that no risk taker is going to be right all the time. As a matter of fact, I figured out when I was trading that I could be wrong 60 percent of the time and come out a big winner. The key is money management. You must take your losses quickly and keep them small and let your profits run and make them worthwhile. . . ."

In the December 12, 2013, edition of *The Chartist Mutual Fund Letter* was a list of seven insights from John Bogle, founder of the Vanguard Mutual Fund Group, that I found helpful in making money. He says:

1. Balancing of return and risk is the task of intelligent investing.
2. Predicting stock-market returns has a very high margin of error.
3. Impulse is your enemy.
4. There is no escaping risk; a well-diversified portfolio should provide remarkable growth over the long term.
5. Investing is simple, but it is not easy. It requires discipline, patience, steadfastness, and common sense.
6. Be patient and ignore the crowd. If you can't resist temptation, you absolutely must not manage your own money.
7. The secret to investing is there is no secret.

So, in conclusion, what I've learned after all these years is that *we are in the business of making mistakes*. I've never heard Peter Lynch give an interview where he didn't point out some mistake he has made. And he has said, "If you are right half of the time (in the markets), you have a terrific score. It is not an easy business." So if we all make mistakes, what separates the winners from the losers? The answer is simple—*the winners make small mistakes*, while the losers make big mistakes.

The Battle for Investment Survival and Handling Mistakes

When I first became professionally involved in the stock market, a book by Gerald M. Loeb, who was called "the dean of Wall Street," made a big impression on me. The book is *The Battle for Investment Survival*.[14] I have battled in the marketplace daily for over 40 years and in my opinion Loeb was right—*investment survival* is everything. In 1994, the hugely successful George Soros said in his book *The Alchemy of Finance*, "If I had to sum up my practical skills, I would use one word: survival." He writes about how his father, who lived through the Russian Revolution as an escaped prisoner of war, taught his son "the art of survival." I don't think you need to be a prisoner of war to be successful on Wall Street, but I do think you often need to react as a survivor would.

In a recent *Business Week Investor* interview, successful money manager Michael Orkin said, "Have caution and respect for the market. The first job is survival."

I feel I have been a fairly high achiever in my life, and yet as I reflect on my successes, I also see failure after mistake after failure. Being a survivor means you must be able to handle these mistakes. I usually pick myself up and say: you have done the best you can; that's all you can ask of yourself—period, end of discussion. I also tell myself that failure is just the opportunity to start over with a lot of important new information. Another lesson I have learned during the ups and downs of my career is that when someone criticizes me, I let it go to my head because there may be something constructive I can learn from it. But I never ever let criticism go to my heart, where it can hurt me. Likewise, when people compliment me, I let it go to my heart, but I try not to let praise go to my head. Being caught up in the manic-depressive crowd psychology world of the stock market, it is important to have a balanced view of both successes and mistakes.

Here is a recent example of my personal struggle with making mistakes. On March 12, 2013, I authored a commentary *Hotline* entitled "Stubborn on Gold." I said:

> This is a commentary *Hotline*, as it is not my usual objective, disciplined analysis. As you know, I like to have both the Fed and the tape together to make a strong bet. I also look at sentiment and macro factors, like inflation.

> In the case of gold, I've largely lost the tape. Gold is in a major consolidation. It has not broken support around 1530, but it sure rallies poorly. I think it would need to break its downtrend line to get a more hopeful tape message. Moreover, while I think of gold as a currency hedge, history also argues it has served as an inflation hedge, and inflation has been very, very quiet. It may not stay quiet, but for now it is not at all a trigger for gold.
>
> So I am left with just the friendly Fed and some sentiment factors. Nevertheless, I am a little stubborn on gold, and I am convinced that it is going quite a bit higher in the long run . . . [due to Fed monetary-base growth] . . . my opinion is that a gold insurance position, relative to *global* money-printing, is still a prudent investment.

I bring up this mistake in hopes that eating some humble pie will prove a useful lesson. Even after 40 years in this business and preaching about being open-minded and disciplined, it is still very easy and very human, to fall into a stubborn desire to be right. Ouch!

In listing the personal qualities it takes to succeed in his book, *One Up on Wall Street*,[15] Peter Lynch does not mention being smart or being right, but rather he lists things like patience, persistence, humility, flexibility, and a *willingness to admit to mistakes*.

Paul Tudor Jones puts a positive spin on mistakes in *Market Wizards*, saying, "One learns the most from mistakes, not successes." He talks about a very intense gut-wrenching loss on a disastrous cotton trade he made early in his career, saying that his experience altered his whole trading style in terms of risk. He first called himself Mr. Stupid and said, "I am not cut out for this business; I don't think I can hack it much longer." But "that was when I first decided I had to learn discipline and money management. It was a cathartic experience for me, in the sense that I went to the edge, questioned my very ability as a trader, and decided that I was not going to quit. I was determined to come back and fight. I decided that I was going to become very disciplined and businesslike about my trading."

I have heard Paul tell another story that contains a critical message. He says that one time when he was trapped in a losing trade, he went to a pro for advice as to whether he should honor his stops. The pro said, "The markets are going to be here 20 and 30 years from now; the real question is, will you be?"

Stories of Five Successful Winners

I thought about calling this section of the book "Being Wrong and Making Money." My experience tells me investors will be right enough that the profits will take care of themselves (being right and making money), but the key is how you handle your losses and your mistakes. So I thought telling stories about five successful winners in the investment world might help illustrate the point. I talked about three of them in the previous edition of this book, when all were near the top of their fields. Also, all five are and were successful money managers who approach the market as I do, as a market timer or tactical asset allocator. All have been hugely successful on Wall Street. They are Marty Zweig, Paul Tudor Jones, Dan Sullivan, Chris Cadbury, and James Stack.

Before and during the 1987 crash, Marty Zweig was widely labeled as a prominent gloom-and-doomer due to his vocal warnings that there might be a 1929-style crash, followed by an economic depression. His forecasts were ubiquitous on television and in major media newsmagazines. I had talked to Marty several times during the crash, and if anything, he was more bearish than he was being portrayed.

Thus, I was surprised when a few days after the crash he told me he was going to turn all out bullish. I asked him why, given his concerns about a depression. He said, "I have spent the last 20 years of my life building indicators and most of them are flashing buys—what is the use of building them if you aren't going to follow them?" Thus, his keen mind was so *flexible* that he was able to forget his *deep-seated worries* and follow his indicator rules, correctly turning bullish very quickly. This kind of flexibility, an ability to let his prior stance be and thus shift with the indicators, made Marty one of the top investment advisors from July 1980 until he quit publishing his investment newsletter in December 1997. He never had a down year. When I asked Marty why he changed a position, he simply said, "I'm just trying to stay out of trouble." He turned his nervous, worrying nature into a profitable risk-management virtue. To sum up, Marty was hardly ever 100 percent in or out of the stock market, rarely forecasted where stocks were going, rarely achieved the number one advisory spot in a single year, only took small risks, and paid a lot of commissions since he often shifted his stance. Yet over the long run, he ended up well ahead of other advisors and many hedge funds.

As for Paul Tudor Jones, $1,000 invested in his Tudor Futures Fund on September 18, 1984, would have been worth $669,670 on December 31, 2013, a gain of 668.67 percent in just over 29 years, or a whopping 24.8 percent per annum, perhaps one of the greatest money-management success stories ever achieved. The Tudor Futures Fund has *never* had a losing calendar year since its launch in September 1984. This record led *Barron's* to feature Paul in its year-end list of experts for many years. In a *Barron's* Roundtable discussion at the start of 1989, Paul was quoted as being very bearish on both the U.S. stock market ("The fact is I think the stock market is a low-risk short.") and the Japanese market ("I couldn't sleep at night if I were long the Japanese market.") However, he was very wrong on both counts (although a year later, his call on Japan proved prophetic). But this super speculator was so good at money management, flexibility, and cutting losses short, and so adept at being objective and disciplined, that he ended 1989 making 42 percent for his investors and returning some $200 million to his partners.

Lest you think that was a fluke, Paul spoke at a Ned Davis Research (NDR) investment conference in early 1991. His number one trade for the year was to short the Dow and buy gold. Again, he was wrong. Paul recently told me *the* reason for *all* the Wall Street success stories he knew was clear—"money management, money management, money management." I am certain that Paul has been right many times and has made much money when he was right, but these stories show that the top pros can be wrong and still make money!

The Chartist has been highly ranked by the *Hulbert Financial Digest*[16] for returns for over 21 years. In a letter, Dan Sullivan, *The Chartist*'s editor, once said:

> For the year-to-date, the Actual Cash Account, which buys and sells in sync with our consensus Model, has lost $22,525, –3.71 percent. The Aggressive Account has lost $12,849, –6 percent. . . . To be absolutely candid, the losses we have sustained, given the high standards we have always set for ourselves, border on disastrous. . . . While no one enjoys taking losses, there are times when to do so is absolutely essential. One of the main planks in our stock-market methodology is the preservation of capital. This involves taking losses quickly, before they become unmanageable.

The September 12, 2013, issue of *The Chartist* newsletter listed four negative behaviors and attitudes that can lead to poor investment returns:

1. Failing to take losses.
2. Being overly fearful at market bottoms and overly optimistic at market tops.

3. Failing to take responsibility for your own money.
4. Not following a disciplined strategy.

And it has worked. *The Chartist Mutual Fund Letter* (February 13, 2014) says:

> The Actual Cash Account now stands at $1,327,947, still another record high on a monthly basis. Per our usual policy, a month-by-month performance of the Actual Cash Account since its inception is available to any subscriber. The Actual Cash Account has outperformed the benchmark S&P 500 with dividends factored in since we started it with an original $100,000 back in August of 1988. What we are most proud of is the fact that the profitable results have been accomplished with considerably less risk than buy and hold because this real money account has the ability to move to the sidelines during adverse periods. We are using basically the same methodology that we deployed when we started this newsletter some 25 years ago. It has stood the test of time.

Since our philosophy is somewhat like Sullivan's, I'd like to quote a few of the things he has written. On January 17, 1991, after having just sold a group of stocks at a loss and before correctly turning bullish again to catch the 1991 bull market, Sullivan observed:

> Here's what you get with *The Chartist*. We are not going to be right all of the time, but be assured that we back our recommendations with our own money. We're not going to ask our subscribers to take any risks that we are not willing to take ourselves. When we are wrong, we are going to admit it flat out. You're not going to see us loaded up with a portfolio of losing stocks for an extended period of time, hoping that the market is going to bail us out.
>
> As stated previously, our philosophy is to cut losses quickly. At the outset of a buying campaign, we think 'short-term'. If the stocks we select are not living up to their expectations, we act quickly to cut losses. However, once we find ourselves on the profit side of the ledger, you will not find us all that anxious to sell. In essence, we are quite willing to risk paper profits. Most investors are too slow to cut losses and too quick to take profits, which is the exact opposite of our approach to the market.
>
> The market is going to be there tomorrow and it will present us with many opportunities in the future. It is not the slightest blow to our ego or self-esteem to tell you that our timing was off the mark. We were wrong. But, that is how we do it here at *The Chartist*.

Winners like Dan Sullivan are very flexible and very disciplined, and they're risk managers. While I am not trying to knock the importance of study, hard work, and being right in terms of investment success, the key is how to make money. My own strategy choices are explained in Chapters 2 and 3 of this book. If you choose not to follow my exact rules, or even if you decide to throw out market timing altogether, I still believe that objectivity, flexibility, discipline, and risk management are the keys to making money, and this book can help your understanding of the importance of those factors.

I am including two advisors who did not appear in the last edition. Only one is still practicing. But I wanted to include both because their general approach is similar to mine. Again, I am not trying to push my investment strategy on anyone. It just so happens that I have the psyche of a hedge-fund trader, and so I sought out winners who used tools similar to those I use to make money consistently.

The differences between Chris Cadbury and Jim Stack are striking. Cadbury's approach was very short-term, and Stack's is more cyclical. Cadbury, who recently retired, was more focused on mean reversion, sentiment, and overbought/oversold indicators, while Stack is more technical-trend and macro-oriented. Personally, I try to fuse all of these factors. Yet, both have made money by cutting risks short and letting profits run.

Cadbury was ranked number one in the United States by *Timer Digest* at some point each year from 2002 to 2011, according to the one-year performance metrics used by that publication. He had more than 45 years of trading experience. In 2011 *Timer Digest* said:

> In terms of performance, as measured by *Timer Digest*, Chris Cadbury has distinguished himself across multiple time horizons and in response to various market environments.
>
> He ranked No. 1 for both 5- and 10-year periods ending on December 31, 2010, as well as No. 2 for 3 years and No. 3 for 8 years. Over the 10-year horizon, the market has essentially gone nowhere. And within that time period, there have been several difficult bull and bear cycles to negotiate.

When the market gets oversold and excessive pessimism exists, Cadbury likes to go contrary to sentiment extremes with buy signals. But once he buys (for example, the S&P 500 futures), he generally sets a five-point stop-loss. I have seen him be wrong with several five-point losing trades in a row, but he will stay with his indicators. I've seen him go from three or four small losses to a 100-point gain. Cadbury is also quite flexible. He can lean bearish for an extended period (1987 and 2007–2008) and then flip and lean bullish (since 2009). This flexibility is rare for market-letter writers.

Jim Stack publishes a newsletter called *InvesTech Research* and conducts his research from Whitefish, Montana, far from the maddening crowd on Wall Street. He uses objective indicators, historical research, and a disciplined safety-first approach to investing that has been successful for over 30 years.

Besides "objectivity," Stack lists "humility" and "integrity" as fundamental principles for survival in this business. Mark Hulbert rates Stack as a market timer, but Stack prefers to think of himself as more of a risk manager (as I prefer to think of myself). Stack says:

> The April [2013] issue of the *Hulbert Financial Digest* released its latest Stock Market Timers Honor Roll. As described by Mark Hulbert, making it onto their honor roll requires producing above-average performance in both up and down markets.
>
> In our view, managing risk through portfolio and sector allocation isn't the same as market timing, so we don't consider ourselves to be market timers. Yet we are honored to be included in the 4 percent of advisors who made this respected list. In the performance Scoreboard of the same issue, the InvesTech Research Portfolio Strategy was the only service to make it into the top five in risk-adjusted ranking over the past 5-, 10-, and 15-year time periods.[17]

While Cadbury and Marty Zweig both used stop-loss strategies effectively to move into cash and manage risks, Jim Stack does not use published stops and feels he manages risks simply by following his indicators in a disciplined, patient manner. He basically uses the trend as a stop-loss. I saw him turn mostly optimistic too soon, before the 2009 lows, but he maintained his position, thanks to numerous historical studies that showed an "upcoming buying opportunity of a lifetime."[18] Again, after seeing him squirm in the tumultuous year of 2012, I thought his description of risk management was insightful and useful:

> Managing risk will be increasingly important as this bull market matures. But risk management does not mean jumping into a high-cash position every time fearful headlines appear or one becomes nervous because of a market correction. If that was the case, one would have moved to cash and been whipsawed at least four times since this bull market began.

> Managing risk requires setting aside one's emotions and relying on discipline. That's easy to say, but very difficult to do without time-tested technical models and extensive historical knowledge. This bull market, like every predecessor, will someday draw to a close. And while there are no guarantees, we are confident that our tools and 33 years of analytical experience will help us recognize the warning flags when they start to appear.

Objective risk management can take different forms, but it works.

Making Our Own Reality

I've often wondered why the crowd and popular forecasts are so often wrong. My favorite theory is that crowd psychology and liquidity (potential demand) are inversely related. For another explanation, in the foreword to Charles Mackay's book *Extraordinary Popular Delusions and the Madness of Crowds*,[19] the legendary Bernard Baruch says that "all economic movements by their very nature, are motivated by crowd psychology. . . . Without due recognition of crowd thinking (which often seems crowd-madness) our theories of economics leave much to be desired." But listen to how he views crowd thinking, "Schiller's dictum: Anyone, taken as an individual, is tolerably sensible and reasonable—as a member of a crowd, he at once becomes a blockhead."

Baruch, who wrote this foreword in October of 1932, prescribes a "potent incantation" to use against crowd thinking:

> I have always thought that if, in the lamentable era of the "New Economics," culminating in 1929, even in the very presence of dizzily spiraling prices, we had all continuously repeated, "two and two still make four," much of the evil might have been averted. Similarly, even in the general moment of gloom in which this foreword is written, when many begin to wonder if declines will never halt, the appropriate abracadabra may be: They always did.

Some other quotes I like regarding crowds, reality, and human nature are these:

Jonathan Swift: "Truths languish, while myths flourish."

Bennett Goodspeed: "Man is extremely uncomfortable with uncertainty. To deal with his discomfort, man tends to create a false sense of security by substituting certainty for uncertainty. It becomes the herd instinct."

Edwin LeFèvre, *Reminiscences of a Stock Operator*: "The speculator's chief enemies are always boring from within. It is inseparable from human nature to hope and to fear."

Or as Shakespeare put it in *Julius Caesar*: "The fault, dear Brutus, is not in our stars / But in ourselves, that we are underlings." Or as Pogo said, "We have met the enemy and they are us."

Additionally, I have become fascinated with the concept that we all *create our own realities*.

An important truth is that people will view reality according to how they *want* to perceive it or believe it *should be*. I found a powerful illustration of this principle in a human-relations class I was taking, in which we read a quote from a long-serving warden of New York's infamous Sing Sing prison. According to the warden, "Few of the criminals in Sing Sing regard themselves as bad men. They are just as human as you and I. So they rationalize, they explain. . . . Most of them attempt by a form of reasoning, fallacious or logical, to justify their anti-social acts even to themselves . . . the desperate men and women behind prison walls *don't blame themselves for anything*." *Rationalization is a powerful coping mechanism.*

People who seemingly *have to* gamble provide another good example of the human tendency to create our own realities. Despite the fact that casinos make hundreds of millions of dollars every year, I've almost never met a gambler who claimed to have been a loser. Gamblers will look you straight in the eye when they tell you that. It is my belief that the pain of losing is so great, they actually forget the losses. *Denial is a powerful defense mechanism.*

Yet another illustration: in listening to the sexual harassment testimony given during the Clarence Thomas confirmation hearing, I found that it was impossible for me to discern who was telling the truth and who was lying, but clearly, I believed, he or his accuser had to be lying. That is, until I heard a wise psychiatrist say that she thought that both of them were telling the truth. At least it was the *truth as far as each of them saw it*. *Illusion or delusion is a powerful psychological force.*

Some time ago I read a fascinating magazine interview with actor Ralph Fiennes, who played the evil Nazi Amon Goeth in the film *Schindler's List*. He said, *It's not a rational thing, but it's an instinctive thing.* . . . If you're playing a role, you are immersing yourself in thinking about that character—how he moves, how he thinks. In the end he *becomes an extension of your own* *self. You like him.* It just throws up all kinds of question marks about acting, about human behavior, about how evil is probably a lot closer to the surface than we like to think."

When asked whether there was an emotional residue from the experience of playing a character he views as obscene and sick, after a long pause Fiennes answered softly, "I think there was a price to pay for this one. When you're investigating behavior that is so negative, so intensely for three months, then you feel sort of peculiar because you might have at moments enjoyed it and at the same time you feel slightly soiled by it. . . . "[20]

A person's mind can sometimes get badly twisted under intense emotional pressure.

Then there's the O. J. Simpson case. Was he guilty? Two-thirds of whites said yes. Three-fifths of blacks said no. William Raspberry, the black Pulitzer Prize-winning journalist, asked: "How can that be? Are white people, less invested in Simpson's fate, being objective, while blacks are being emotional? Have we come to the point where color is of such importance as to override every other consideration, to render us, black and white, *incapable* of a *shared reality*?"[21]

The recent trial of George Zimmerman, a white man, for the death of Trayvon Martin, a black teenager, provides similar examples:

> *Washington Post*, July 22, 2013
>
> Among African Americans, 86 percent say they disapprove of the verdict—with almost all of them saying they strongly disapprove—and 87 percent saying the shooting was unjustified. In contrast, 51 percent of whites say they approve of the verdict while just 31 percent disapprove. There is also a partisan overlay to the reaction among whites: 70 percent of white Republicans but only 30 percent of white Democrats approve of the verdict.
>
> Gallup, April 5, 2012
>
> U.S. public opinion about the Trayvon Martin case in Florida reflects the same type of racial divide found in 1995 surveys asking about the murder trial of O. J. Simpson in Los Angeles. In one Gallup poll conducted Oct. 5–7, 1995, for example, 78 percent of blacks said the jury that found Simpson not guilty of murder made the right decision, while only 42 percent of whites agreed.
>
> Pew Research Center poll, July 22, 2013
>
> Younger Americans express far more dissatisfaction over the Zimmerman trial verdict than do older Americans. Among those

> under 30, 53 percent say they are dissatisfied with the verdict and just 29 percent are satisfied. The balance of opinion is the reverse among those ages 65 and older: 50 percent are satisfied and just 33 percent dissatisfied.

Finally, as an avid basketball fan, my favorite example of imagination distorting reality comes while watching games. And I'm willing to admit to being guilty of succumbing to this particular distortion myself. Almost always, the vast majority of home fans at a game will swear that the referees favored the opposing team (many even proclaiming that the other team has paid off the refs), even though their home team won the game, and even though objective statistics generated by academics based upon NBA games show that if there is a bias, the calls in an average game favor the home team. Crowd psychology is contagious and can influence even what we see with our own eyes. *One's perception equals one's reality.*

So the bottom line is that *people often create their own realities*, based upon things that may have happened to them as far back as the very early years of life. We are all subject to that condition. We are human. This means what feels right and easy and obvious in your gut is quite often wrong.

The reason I believe people make their own realities and see and hear what they want to see and hear is not that they are not looking for reality, but rather that they are hardwired to have a certain nature. Shown a half glass of water, many people simply will describe it as half full while others insist it is half empty. A lot of us just get up in the morning as natural-born optimists or pessimists. On the other hand, I would probably look at the glass and ask, are we sure that is indeed water? I am a natural-born skeptic. One needs to know one's nature, but to make money consistently in stocks, one must also be able to be an optimist or a pessimist when the objective indicator evidence so dictates.

The Ned Davis Research Response to All This

To avoid being swept up by the crowd, and to prevent our own reality from becoming badly distorted, we need an unbiased, objective standard that weighs the evidence and passes judgment devoid of emotionalism. In applying this concept to the financial markets, Ned Davis Research builds *objective, mathematical timing models*, which we believe are the best tools to overcome emotional rationalizations.

Ned Davis Research has two mandates—we are trying to make money and we are trying to stay out of big trouble. Thus, we tell our clients that the *art* of forecasting is something we do only for fun, but that making money is something about which we are serious, and we approach it in as *scientific* and *quantitative* a manner as is possible.

I like to think of *money management* today as similar to the beginning of the European Renaissance. While there were many invaluable contributions to the arts during that period from men such as Michelangelo and Rembrandt, much of what has shaped the world since then came from those who were bold enough to venture forward with scientific investigation, including da Vinci, Galileo, and Newton.

So while we are in an industry that often blends art and science, our preference is to have a strongly objective, scientific, and quantitative bias to our work.

Most technicians look at stock charts and see patterns that, unfortunately, exist only in the eyes of the beholder (just as many observers of art can find many different meanings in a painting). Most fundamentalists look at a company and profess to be able to envision earnings way into the future. We simply try to get into harmony with the impartial reality from the numbers (the weight of the evidence) available today.

Timing Models

I developed my basic approach to the stock market when studying high school economics. The teacher said that prices are determined by supply and demand. So when I got into the business, I tried to focus on areas of analysis that give one clues about the forces that drive those variables. The three areas I found were the tape, the Fed, and crowd psychology.

Since prices are the equilibrium points between supply and demand, it follows that if prices are rising broadly, demand must be stronger than supply, and vice versa. Since it controls interest rates and the amount of money available, the Fed should never be ignored when trying to ascertain supply and demand. Likewise, extremes in crowd sentiment can tell us if demand is largely satisfied or if nervous holders of stock have mostly sold out.

In an effort to make money, we build timing models that we will explain in this book. But first, let's discuss five key rules we use when we build our models, which include the three areas that give clues about supply and demand.

The primary rule that we use in our models is something I modestly call Davis' Law.

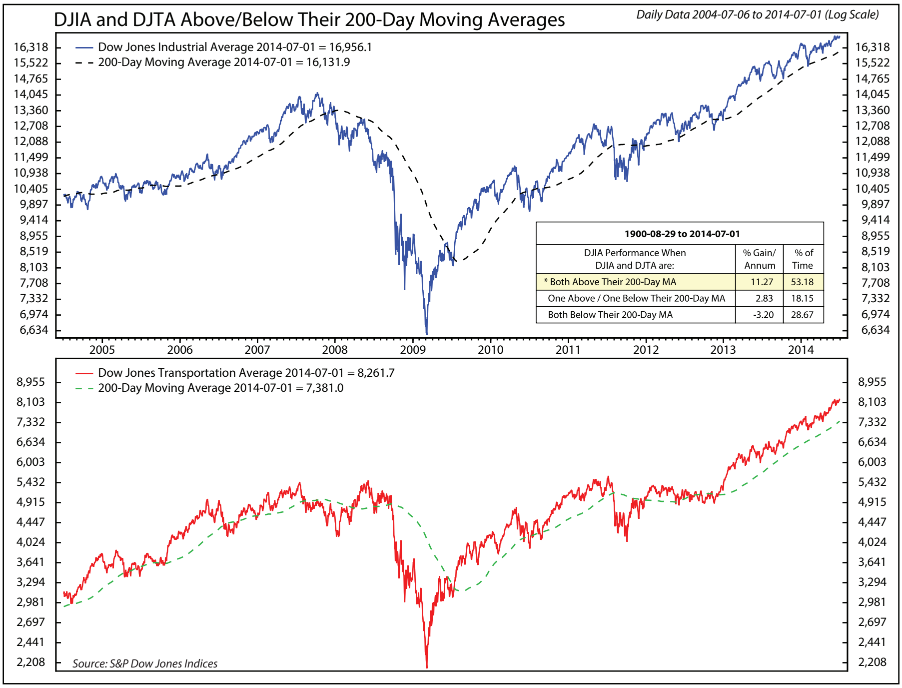
> Davis' Law
>
> The degree of unprofitable anxiety in an investor's life corresponds directly to the amount of time one spends dwelling on how an investment should be acting, rather than the way it actually is acting.

Rule No. 1. Don't fight the tape. We do not like to fight the harsh reality of the tape (market trend), and we try to get in harmony with the cold, bloodless verdict of the market. To enforce Davis' Law, our models are at least 50 percent price- or trend-sensitive, which we believe means we can never be fully invested during a vicious bear market or never miss the bulk of a roaring bull market.

As Marty Zweig said in *Winning on Wall Street*: "To me, the tape is the final arbiter of any investment decision. I have a cardinal rule: never fight the tape. . . . I'm a trend follower, not a trend fighter." We think our emphasis on trend- and price-sensitive indicators means that if we make a mistake, the trend will change and bail us out with a small mistake, and if we are right and it turns out to be a big move, we are almost guaranteed to get a good part of that large gain. In other words, dwell on the reality of market action rather than hopes, wishes, and imagination.

A key point on the tape/trend. In the 2010 edition of *Reminiscences of a Stock Operator*, there are some thoughts from Paul Tudor Jones. He talks about many of the disasters from the bubbles over the past decade or so, but he ends up with this conclusion: "The whole point of *Reminiscences* was that all of those very serious economic issues should be largely irrelevant to a great operator. Yes, they are interesting to debate, important to know, but always secondary to the tale the tape tells us on a continual basis."

Later in this book, we will feature many of the indicators in our timing models. But, in each section, I also wanted to illustrate what I am talking about through indicator examples that are not in the models. For example, Figure 1.4 looks at price trends in the Dow Jones Industrial Average (DJIA) and Dow Jones Transportation Average (DJTA). The results, shown in the box in the



DAVIS167

FIGURE 1.4 **DJIA AND DJTA ABOVE/BELOW THEIR 200-DAY MOVING AVERAGES**

top clip, go back 114 years, to 1900. As can be seen, the market has advanced at double-digit rates of gain (dividends not included) in the 53 percent of the time demand was above supply, as measured by when both the DJIA and DJTA are above their respective 200-day average prices. One actually lost money on the DJIA when both were below their smoothed 200-day trend.

As I learned in kindergarten: don't pick fights with bullies (the tape).

Rule No. 2. Don't fight the Fed. We are not pure technicians. Why stand on one foot, when two feet give you better balance? So we also try not to fight city hall—the Federal Reserve Board. The Fed often writes the script for Wall Street.

In *Winning on Wall Street*, Marty Zweig said, "The major direction of the market is dominated by monetary considerations, primarily Federal Reserve policy and the movement of interest rates." Like Zweig and Ned Davis Research, Dan Sullivan of *The Chartist*, who along with Zweig has consistently outperformed in the Hulbert Advisory Service rankings since 1980, puts most of his emphasis on market trends, market momentum, and monetary conditions. Sullivan says, "The Monetary Model gauges the direction of interest rates. There is a direct correlation between the movement of interest rates and stock prices. Favorable monetary conditions (declining rates) provide the catalyst for bull markets. Conversely, rising rates hinder the upward movement of stock prices as fixed-rate investments become more attractive to investors."

One classic indicator of Fed easing or tightening is the yield curve, featured in Figure 1.5. By forcing the T-bill yields (which the Fed largely controls) above T-bond yields, the Fed can push up long-term interest rates that compete with stock dividend yields. And in the 58.5 percent of the time in which the central bank has pushed short-term rates well below long-term rates, the S&P 500 has shot ahead at double-digit rates, as you can see on the chart.

One example of the availability of money can be seen on Figure 1.6. All of the net gains in stocks since 1925 have come when the Fed was

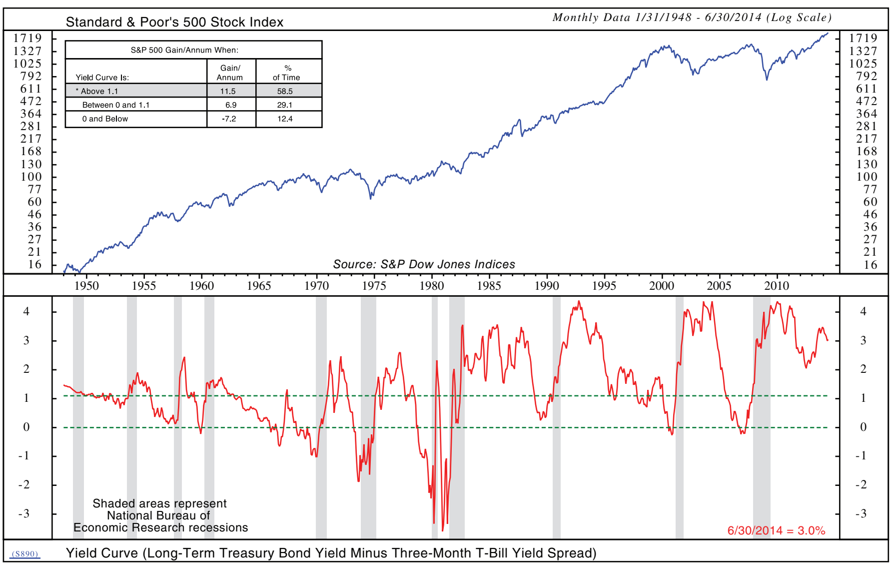


FIGURE 1.5 ***TOP*, S&P 500 INDEX; *BOTTOM*, YIELD CURVE (LONG-TERM TREASURY BOND YIELD MINUS THREE-MONTH T-BILL YIELD SPREAD)**

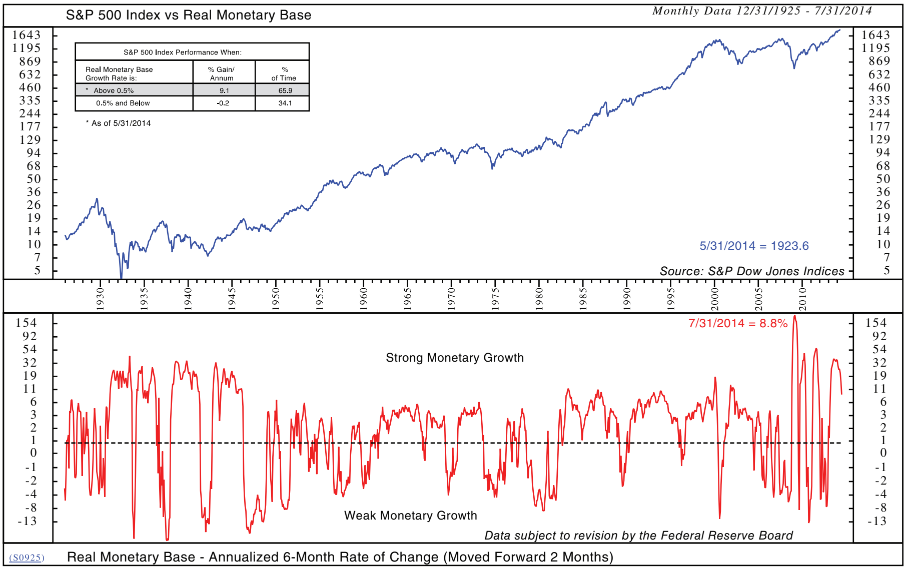


FIGURE 1.6 ***TOP,* S&P 500 INDEX; *BOTTOM,* REAL MONETARY BASE: ANNUALIZED SIX-MONTH RATE OF CHANGE (MOVED FORWARD TWO MONTHS)**

providing monetary-base growth above 0.5 of a percentage point on a real basis (above inflation). The Fed has a definite impact on supply and demand for stocks.

As we learned in kindergarten, try to be friends with the biggest kid in class—in this case, the Fed.

Rule No. 3. Be wary of the crowd at extremes. I believe that the stock market is a fairly efficient mechanism. If you are good at controlling your losses, the market presents you with the likelihood of about a 9 to 10 percent gain per year over the long run. To beat that return—to beat the efficient market—you are going up against not only some of the smartest people around, but also some of the most sophisticated technology.

Much of the time, the crowd is right. Yet almost by definition, the only way to beat the majority is by selectively taking a position against them. So we use numerous ways to measure majority crowd sentiment, to gauge market risk. For example, we monitor valuation and sentiment indicators, such as new-issue speculation, advisory-service sentiment, put/call ratios, the Dow earnings yield, and mutual fund cash/assets ratios to measure emotional moves in and out of the market. What distinguishes our philosophy from others is that our indicators are generally built to go *with* the majority flow until the indicators reach extreme readings and begin to *reverse*. It is at that point that it usually pays to be contrary.

In *Beating the Street* Peter Lynch said, "Over the past three decades, the stock market has come to be dominated by a herd of professional investors. Contrary to popular belief, this makes it easier for the amateur investor. You can beat the market by ignoring the herd."

Even Max Lucado, best-selling author, writer, and preacher, points out, "A man who wants to lead the orchestra must turn his back on the crowd."

In *Winning on Wall Street* Marty Zweig said, "Just because 51 percent of the crowd is bullish and 49 percent bearish is no reason the market cannot go higher. In fact, it probably will advance at that point. The time to be wary of crowd psychology is when the crowd gets extraordinarily one-sided. . . . The idea is: Beware of the crowd when the crowd is too one-sided."

Warren Buffett said one of his secrets to success is "we simply attempt to be fearful when others are greedy and to be greedy only when others are fearful." And this value investor explains the connection between sentiment and values:

> The most common cause of low prices is pessimism—sometimes pervasive, sometimes specific to a company or industry. We want to do business in such an environment, not because we like pessimism, but because we like the prices it produces.[22]

Technical analyst Joe Granville said, "If it is obvious, it is obviously wrong." I think what he meant is that what everybody knows is already priced into stocks (discounted), and it is, thus, not worth knowing.

The last word on sentiment goes to another very successful investor, Sir John Templeton, who ostensibly invested based upon fundamentals and values. He said, "Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria."

As I learned in kindergarten, if you want good reports or the teacher's praise, you need to be able to stand out from the crowd. It is not always good to follow the other kids, especially when they're really emotional.

What Is Contrary Opinion and How to Use It

If you want to try to be a genius and catch major market turning points, you can start with contrary opinion—wait for majority opinion to reach an extreme and then assume the opposite position. At turning points, contrary sentiment indicators are nearly always right. Almost by definition, *a top in the market is the point of maximum optimism and a bottom in the market is the point of maximum pessimism*.

To better understand how contrary opinion operates, think of money as financial liquidity. And think of an extreme in liquidity as the direct opposite of an extreme in psychology. If everyone decided that the Dow Industrials would rise by 25 percent, for instance, they would rush out and buy stocks. Everyone would become fully invested, the market would be overbought, and nobody would be left to buy, in which case the market wouldn't be able to go any higher. *When optimism is extreme, liquidity is low.*

On the other hand, if everyone was pessimistic and thought the Dow would drop by 25 percent, the weak and nervous stockholders would sell, the market would be sold out, and nobody would be left to sell, in which case the market wouldn't go down any more. Whereas increasing optimism and confidence produce falling liquidity, rising pessimism and fear result in rising liquidity.

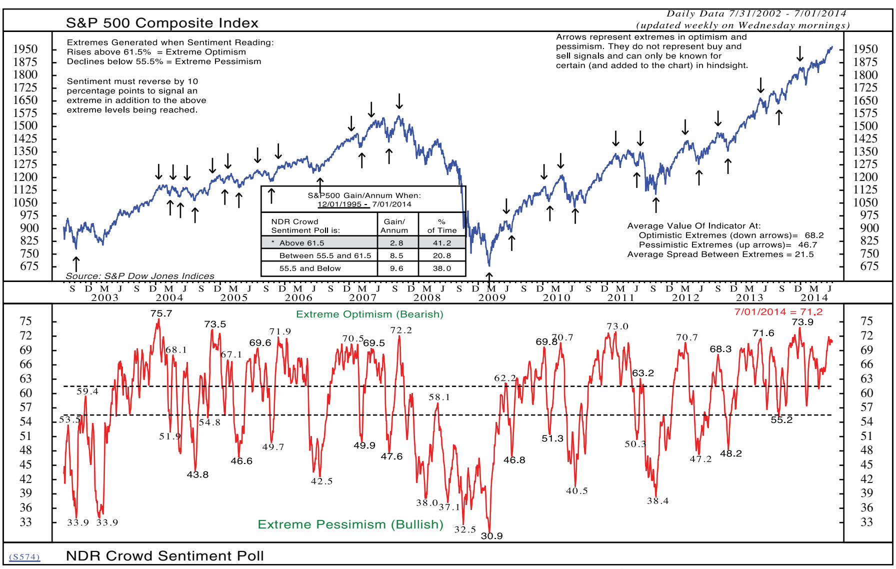
My favorite way to describe this inverse relationship is to compare liquidity to a car's shock absorbers. As you drive down the road, you will inevitably encounter some potholes—some random, unpredictable, negative events. If your car has good shocks (abundant liquidity), you will be able to continue merrily along your journey after encountering a pothole. But if your car has poor shocks (no liquidity), you may crash.

Another way of looking at contrary opinion is to compare stockholders to nuts in a tree. An investor once wrote to me, asking, "How do you get nuts out of a nut tree?" The answer, he said, is through a nut-shaking machine, which is hooked to the nut tree. The machine rattles the tree, and the nuts drop until all of the nuts have fallen out. In other words, when there is enough fear in the market, all of the weak holders are shaken out, and there is no selling left to be done. "Have the nuts been shaken out," the contrarian asks "or are all of the speculative traders fully invested?"

The impact of contrary opinion can also be illustrated by comparing the market to a theater. If someone yelled "*fire*" in a theater full of people, panic would break out and people would get crushed in the ensuing rush to the door. But if someone yelled "*fire*" in a theater with very few people, the people would be more likely to walk out in an orderly manner. In looking at any market, it is important to determine the degree to which it is crowded.

What makes contrary opinion really valuable is that it opens your mind and keeps you from being swept up in the crowd. With an open mind, you can say to yourself, "I know the majority is right, and I know the world is going to hell in a handbasket, but what if the minority is right? What if there is a silver lining in the cloud out there?" *Contrary opinion allows you to be flexible, enabling you to turn your emotions inside out, and to act when you need to act.*

Psychology plays into the supply-demand equation through valuation and emotional buying and selling when greed or fear takes over. To show clients why they should be wary of the crowd at extremes, many years ago I put together a composite of seven sentiment indicators and called it the NDR Crowd Sentiment Poll. The record can be seen in Figures 1.7 and 1.8, and in Table 1.1.



Please see important disclaimer at the beginning of the book.

FIGURE 1.7 ***TOP*, S&P 500 COMPOSITE INDEX; *BOTTOM*, CROWD SENTIMENT POLL (2002–2014)**

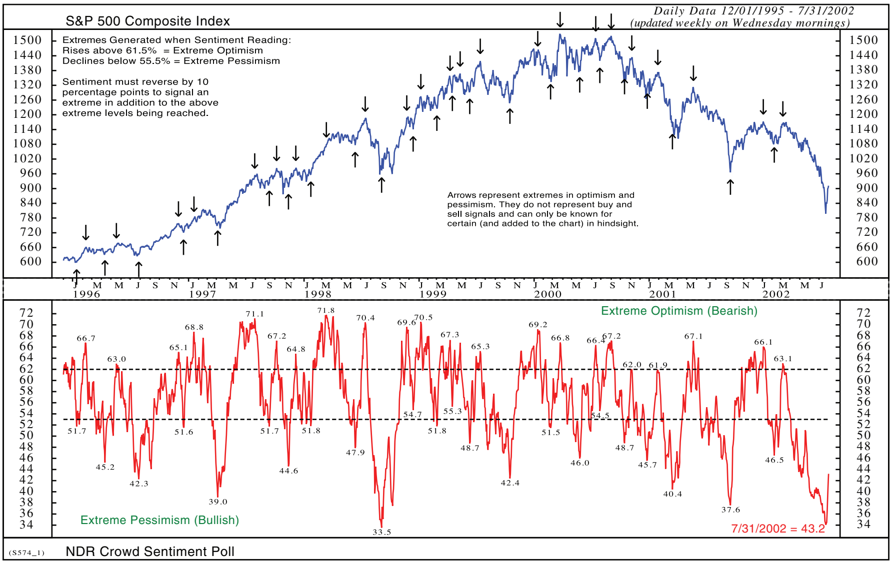


FIGURE 1.8 ***TOP*, S&P 500 COMPOSITE INDEX; *BOTTOM*, CROWD SENTIMENT POLL (1995–2002)**

When I built the NDR Crowd Sentiment Poll, my main goal was to prove to clients that the crowd was *usually* wrong at extremes in sentiment. We tried to judge the extremes objectively by defining certain levels as excessive and looking for big shifts. But as proven by the historical record (1996–2013), shown in Table 1.1, the crowd has yet to be right even *once* at extremes in sentiment. In fact, following the crowd at extremes would have cost one over 10,000 S&P 500 points since 1996.

To be fair, the extremes can *only* be known for certain in hindsight, and the optimistic extreme of 71.6 percent bulls on May 22, 2013, was almost correct. More importantly, the extreme pessimism in 2008 and early 2009 was largely correct, even if the *exact* extreme was wrong. Sentiment indicators are not perfect in runaway momentum moves, but they can help one keep a clear head when the crowd is fearful or euphoric.

TABLE 1.1 **CROWD SENTIMENT POLL**

NDR CROWD SENTIMENT POLL (S574)

Date	Extreme Pessimism	Extreme Optimism	S&P 500	S&P Point Profit/Loss	Crowd Right	Crowd Wrong	Date	Extreme Pessimism	Extreme Optimism	S&P 500	S&P Point Profit/Loss	Crowd Right	Crowd Wrong
1/15/1996	51.7		600	-61		x	9/21/2001	37.6		966	-207		x
2/12/1996		66.7	661	-24		x	1/4/2002		66.1	1173	-77		x
4/12/1996	45.2		637	-32		x	2/8/2002	46.5		1096	-68		x
5/17/1996		63.0	669	-38		x	3/8/2002		63.1	1164	-387		x
7/29/1996	42.3		631	-126		x	10/9/2002	33.9		777	-371		x
11/29/1996		65.1	757	-36		x	1/21/2004		75.7	1148	-39		x
12/16/1996	51.6		721	-56		x	3/25/2004	51.9		1109	-36		x
1/20/1997		68.8	777	-19		x	4/12/2004		68.1	1145	-51		x
4/4/1997	39.0		758	-194		x	5/21/2004	47.3		1094	-47		x
7/30/1997		71.1	952	-32		x	6/30/2004		66.6	1141	-76		x
9/15/1997	51.7		920	-63		x	8/13/2004	43.8		1065	-119		x
10/7/1997		67.2	983	-77		x	11/18/2004		73.5	1184	-13		x
11/12/1997	44.6		906	-78		x	1/28/2005	55.4		1171	-39		x
12/5/1997		64.8	984	-27		x	2/15/2005		67.1	1210	-57		x
1/26/1998	51.8		957	-122		x	4/19/2005	46.6		1153	-91		x
3/16/1998		71.8	1079	-2		x	8/2/2005		69.6	1244	-66		x
6/15/1998	47.9		1077	-107		x	10/18/2005	49.7		1178	-90		x
7/16/1998		70.4	1184	-210		x	11/25/2005		71.9	1268	-28		x
9/4/1998	33.5		974	-214		x	7/21/2006	42.5		1240	-191		x
11/23/1998		69.6	1188	-47		x	1/17/2007		70.5	1431	-44		x
12/14/1998	54.7		1141	-134		x	3/16/2007	49.9		1387	-126		x
1/8/1999		70.5	1275	-49		x	5/9/2007		69.5	1513	-102		x
3/2/1999	51.8		1226	-124		x	8/16/2007	47.6		1411	-151		x
4/13/1999		67.3	1350	-44		x	10/12/2007		72.2	1562	-879		x
4/20/1999	55.3		1306	-62		x	3/6/2009	30.9		683	-262		x
5/13/1999		66.8	1368	-74		x	6/11/2009		62.2	945	-44		x
6/14/1999	48.7		1294	-125		x	7/13/2009	46.8		901	-246		x
7/16/1999		65.3	1419	-165		x	1/11/2010		69.8	1147	-71		x
10/18/1999	42.4		1254	-196		x	2/12/2010	51.3		1076	-136		x
1/13/2000		69.2	1450	-97		x	4/15/2010		70.7	1212	-152		x
2/24/2000	51.5		1353	-174		x	7/7/2010	40.5		1060	-283		x
3/24/2000		66.8	1527	-145		x	2/18/2011		73.0	1343	-71		x
5/25/2000	46.0		1382	-128		x	6/17/2011	50.3		1272	-72		x
7/17/2000		66.4	1510	-90		x	7/8/2011		63.2	1344	-220		x
7/28/2000	54.5		1420	-101		x	10/4/2011	38.4		1124	-286		x
9/1/2000		67.2	1521	-147		x	3/19/2012		70.7	1410	-124		x
10/13/2000	48.7		1374	-58		x	6/5/2012	47.2		1286	-175		x
11/6/2000		62.0	1432	-117		x	9/19/2012		68.3	1461	-108		x
12/26/2000	45.7		1315	-59		x	11/15/2012	49.5		1353	-302		x
1/30/2001		61.9	1374	-223		x	5/22/2013		71.6	1655	-15		x
3/16/2001	40.4		1151	-158		x	9/3/2013	55.2		1640	-201		x
5/22/2001		67.1	1309	-343		x	12/30/2013		73.9	1841			?
							Average	46.7	68.2	Total	-10501		

Ned Davis Research Group *S574_IND.RPT*

History and Risk Management

Two other rules we use in building timing models are these:

1. When I asked in kindergarten why we needed to study boring old history, the teacher said, "Those who do not study history are

condemned to repeat its mistakes." Ned Davis Research takes great pride in our large historical database. We are able to take our models back as far in history as possible, so they have a chance to adjust to as many different environments as possible.

We also conduct many historical studies for investor perspective. Two real-time examples follow.

Table 1.2 is a little subjective for my taste, but it is also one of the studies of which I am proudest. I put it out on the morning of 9/11, right after the horrible attacks on the World Trade Center. It shows how the study of history can provide perspective and help one stay grounded.

Using history for perspective and keeping one's mind open and flexible is critical for investment success. Nearly all surveys of Wall Street investors show that they lean Republican, so it is widely believed that the stock markets prefer Republicans. And, in fact, the market and economy performed very well under Eisenhower and Reagan.

When President Obama was elected in late 2008, many wealthy investors got out of stocks, predicting disaster. They were particularly upset with Obama's calls to sharply raise taxes on the top 2 percent, a group that happens to be large holders of stock. The market did continue to decline sharply in early 2009. However, I wrote a *Hotline* arguing that in order to make money in stocks consistently, I believed that one should analyze them with an apolitical mindset. In fact, I featured Table 1.3, and wrote that, "The historical record shows the stock market doing better under Democratic presidents, but also with more inflation."

No matter how things eventually turn out or what one thinks about President Obama, certainly a study of history provides a useful perspective. I believe the record since 1901 suggests stressing factual reality over Wall Street myths. Also, while people fret about a gridlocked government, the limited historical examples suggest that this, too, has not been a big problem for stocks.

President Harry S. Truman once said, "My choice early in life was either to be a piano player in a whorehouse or a politician. And to tell the truth, there's hardly any difference." Regardless of what people think about politicians, I still try to respect people's political

TABLE 1.2 CRISIS EVENTS, DJIA DECLINES, AND SUBSEQUENT PERFORMANCE

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Our updated table of crisis events is featured in the table below (study T_900). It shows that the DJIA has dropped by a median of 5% during crisis events, but has rallied afterwards. The table's implication is that after an initial negative reaction to today's tragic events, a recovery could be expected. Of course, the list is subjective, and even the reaction dates are subject to interpretation in some cases. Please let us know if you would like to see the table modified in any way. Future NDR publications will have more details and perspectives, including statistics on the performance of other assets during and after previous crises.

CRISIS EVENTS, DJIA DECLINES AND SUBSEQUENT PERFORMANCE

Event	Reaction Dates	Date Range % Gain/Loss	DJIA Percentage Gain Days After Reaction Dates 22	63	126
Fall of France	05/09/1940 - 06/22/1940	-17.1	-0.5	8.4	7.0
Pearl Harbor	12/06/1941 - 12/10/1941	-6.5	3.8	-2.9	-9.6
Truman Upset Victory	11/02/1948 - 11/10/1948	-4.9	1.6	3.5	1.9
KoreanWar	06/23/1950 - 07/13/1950	-12.0	9.1	15.3	19.2
Eisenhower Heart Attack	09/23/1955 - 09/26/1955	-6.5	0.0	6.6	11.7
Sputnik	10/03/1957 - 10/22/1957	-9.9	5.5	6.7	7.2
Cuban Missile Crisis	10/19/1962 - 10/27/1962	1.1	12.1	17.1	24.2
JFK Assassination	11/21/1963 - 11/22/1963	-2.9	7.2	12.4	15.1
U.S. Bombs Cambodia	04/29/1970 - 05/26/1970	-14.4	9.9	20.3	20.7
Kent State Shootings	05/04/1970 - 05/14/1970	-4.2	0.4	3.8	13.5
Arab Oil Embargo	10/18/1973 - 12/05/1973	-17.9	9.3	10.2	7.2
Nixon Resigns	08/09/1974 - 08/29/1974	-15.5	-7.9	-5.7	12.5
U.S.S.R. in Afghanistan	12/24/1979 - 01/03/1980	-2.2	6.7	-4.0	6.8
Hunt Silver Crisis	02/13/1980 - 03/27/1980	-15.9	6.7	16.2	25.8
Falkland Islands War	04/01/1982 - 05/07/1982	4.3	-8.5	-9.8	20.8
U.S. Invades Grenada	10/24/1983 - 11/07/1983	-2.7	3.9	-2.8	-3.2
U.S. Bombs Libya	04/15/1986 - 04/21/1986	2.6	-4.3	-4.1	-1.0
Financial Panic '87	10/02/1987 - 10/19/1987	-34.2	11.5	11.4	15.0
Invasion of Panama	12/15/1989 - 12/20/1989	-1.9	-2.7	0.3	8.0
Gulf War Ultimatum	12/24/1990 - 01/16/1991	-4.3	17.0	19.8	18.7
Gorbachev Coup	08/16/1991 - 08/19/1991	-2.4	4.4	1.6	11.3
ERM U.K.Currency Crisis	09/14/1992 - 10/16/1992	-6.0	0.6	3.2	9.2
World Trade Center Bombing	02/26/1993 - 02/27/1993	-0.5	2.4	5.1	8.5
Russia Mexico Orange County	10/11/1994 - 12/20/1994	-2.8	2.7	8.4	20.7
Oklahoma City Bombing	04/19/1995 - 04/20/1995	0.6	3.9	9.7	12.9
Asian Stock Market Crisis	10/07/1997 - 10/27/1997	-12.4	8.8	10.5	25.0
U.S. Embassy Bombings Africa	08/07/1998 - 08/10/1998	-0.3	-11.2	4.7	6.5
Russian LTCM Crisis	08/18/1998 - 10/08/1998	-11.3	15.1	24.7	33.7
Mean		**-7.1**	**3.8**	**6.8**	**12.5**
Median		**-4.6**	**3.9**	**6.7**	**12.1**

Days = Market Days T_900 9/11/2001

Source: NDR.

beliefs. But the study of history tells me that investing based upon politics is a poor way to make money.

2. Despite all our efforts to build models that will provide good gains going forward, we realize that we will never find the Holy Grail, and thus, we try to build *good money management* into our timing

TABLE 1.3 **PERCENTAGE GAIN PER ANNUM FOR STOCKS, INDUSTRIAL PRODUCTION, INFLATION, BONDS, AND THE U.S. DOLLAR BY PARTY OF PRESIDENT AND MAJORITY PARTY IN CONGRESS, 1901–2014**

GAIN/ANNUM (%) FOR STOCKS, INDUSTRIAL PRODUCTION, INFLATION, BONDS, AND U.S. DOLLAR ($) BY PARTY OF PRESIDENT AND MAJORITY PARTY* IN CONGRESS (03/04/1901 - 07/01/2014)

	Stocks (DJIA)	Industrial Production	Inflation (CPI)	Since: Real Stock Returns	1925 Long-Term Gov't Bonds	1971 Fed's U.S. Dollar
Democratic President	7.97	5.18	4.35	3.47	3.53	-0.25
Republican President	3.02	1.80	1.80	1.20	7.74	-1.39
Democratic Congress	6.21	4.45	4.29	1.85	5.28	-1.21
Republican Congress	3.62	1.45	0.65	2.95	6.39	-0.23
Dem. Pres., Dem. Congress	7.53	6.14	4.48	2.92	2.57	-2.38
Dem. Pres., Rep. Congress	9.76	1.11	3.78	5.76	8.12	3.93
Rep. Pres., Rep. Congress	1.70	1.56	-0.37	2.07	5.48	-4.24
Rep. Pres., Dem. Congress	4.46	2.05	4.01	0.43	8.99	-0.52
All Periods Buy/Hold	5.28	3.38	2.99	2.22	5.57	-0.94

**Majority Party = Party with average of % control in House and % control in Senate greater than 50%.*

Ned Davis Research, Inc. T_50.RPT

models by attempting to cut losses short and letting profits run. There are periods, historically, in which model indicators tend to fail or stay wrong against a major move. Accordingly, we put stop-losses in the indicators, where the indicator weight goes to zero until the indicator gives a new signal. As we learned in kindergarten, sometimes doo-doo happens, so we need to be prepared.

Finally, we see ourselves as risk managers. Here's a story about risk management I want to share with you.

Two cowboys, having lost their jobs, went into a bar to drown their sorrows. Over the bar was a sign that said, Bear Hides $25. When they asked the bartender what that meant he said, "It means what it says," so the two cowboys went out, came back with two bear hides, and received $50. One of the cowboys was a capitalist and he said, "All we need now is inventory," so they got on their horses and rode deep into bear country. It was dark out, so they put up their tent and went to sleep. Early the next morning they heard a rumble, so one cowboy looked outside to see what it was. When he opened the tent he saw 10,000 growling bears. He looked at all the bears and then looked at the other cowboy, and with a grin said, "We're rich!"

One good definition of the difference between professionals and amateurs is that amateurs ask what the potential rewards are, while professionals ask what the risks are. Take our composite timing models, for example. If we have a model composed of 10 indicators, all of which are bullish, we would obviously be extremely bullish. But let's say two of these 10 reliable indicators turn bearish. Obviously, with eight bullish indicators and just two bearish indicators, we would stay with the investment, but we might take 20 percent of our chips off the table out of respect for the higher risks. This is not a black-and-white world that we live in. It's beautifully composed of shades of gray and degrees of bullishness and bearishness.

Thus, the bottom line at Ned Davis Research is that our timing models, at every stage of development, are designed with one thought foremost in mind, and that is *controlling big mistakes*.

The Rest of the Book

Chapter 2 explains our process for building models. Chapter 3 features one of our key cyclical models for stocks from my research assistant, Loren Flath. Loren did much of the model building, and he addresses the many questions we get about various indicators and models. In Chapter 4 Loren updates a bond-timing model he originally built for Marty Zweig's 1987 book, *Winning with New IRAs*. In Chapter 5 I present a case for a potential bear market in 2014. Chapter 6 is from Ned Davis Research's senior international economist, Alejandra Grindal, regarding demographics, and finally, Chapter 7 is about the U.S. energy renaissance from NDR's commodity strategist, John LaForge. I am confident that if you are objective, disciplined, flexible, and manage risk, the methods presented in this book can turn you into a moneymaking machine.

Good Luck!

Ned Davis

The Nine Rules of Ned Davis Research Group

The nine rules that follow are a teaching aid for new NDR employees.

1. **Don't Fight the Tape**
   The tape provides a stop-loss for should-be beliefs.
   The trend is your friend (smoothings, slopes, and stop-losses).
   Go with Mo (momentum, breadth thrusts, signs of churning).
   Listen to the cold, bloodless verdict of the market (pay special notice to indicators on the leading edge of the market like volume,

new highs or lows, the Dow Utilities, bonds, relative strength, etc.).

Moves with a lot of confirmation are the healthiest, and huge moves are often global in nature.

2. Don't Fight the Fed

Remain in harmony with interest-rate trends (rates dropping is good; rates rising is bad).

Money moves markets. Stay in line with monetary trends (especially money less economic demands equals liquidity left over for financial markets).

Economic strains: inflationary pressures lead to Fed tightness (up commodities, up gold, down dollar, rising real interest rates).

Economic ease: disinflation leads to Fed ease.

3. Beware of the Crowd at Extremes

Go with the flow until it reaches a psychological extreme and begins to reverse. At that point, it pays to take a contrary approach (reverse inverted brackets).

Key relationship: liquidity and psychology are inversely related.

Extreme optimism equals low cash. Extreme fear equals high cash.

Liquidity is like shock absorbers on a car.

Is the theater crowded or empty?

Top is the point of maximum optimism. Bottom is the point of maximum pessimism.

Valuation measures long-term extremes in psychology.

4. Rely on Objective Indicators

Rather than using gut emotions to determine the supply and demand balance, use the weight-of-the-evidence approach (computer-derived mathematical measurements).

5. Be Disciplined

Our mandate is to follow our models, forcing us to be *disciplined*.

Benchmark or anchor composite model determines core invested position.

6. Practice Risk Management

We are in the business of making mistakes. Winners make small mistakes, losers make big mistakes. We focus on a risk management strategy to keep mistakes small (use stop-losses and a heavy dose of technical trend-sensitive indicators).

(*continued*)

7. **Remain Flexible**
   Indicators change and data is revised. Scenarios change. Use dynamic modeling, such as standard deviation brackets. Review models on an objective and timely basis.
8. **Money Management Rules**
   We are more interested in making money than being right.
   Be humble and flexible (be ready to turn emotions upside down and thus be open-minded).
   Let profits run, cut losses short.
   Think in terms of risks, including the risk of missing a bull market.
   Buy on the rumor, sell on the news.
   Consider cyclical, seasonal, progressive trading patterns that do not add to models (for fun).
9. **Those Who Do Not Study History Are Condemned to Repeat Its Mistakes**
   Go back as far as possible. Use bull, bear, and neutral cycles.

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