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Trading Price Swings

A NEW MARKET PARADIGM

At a series of client seminars in February 2000, I made the following statement.

> As we begin the millennium, this 18-year bull market shows all the technical, fundamental, and speculative signs of completion. I am not saying that we are entering a bear market, which when ended, will then allow the resumption of the current bull market. I am saying that we have been in the topping process that will lead into a larger-scale correction. I do not believe we are facing a market crash. I think we're facing a time correction, an extended sideways up-and-down movement that encompasses a number of bull and bear markets.

My thesis was that the 18-year bull market, which began in 1982, with the Dow Jones industrials just under 800, was displaying the classic signs of a major market top. You would think that the classic signs of a major price top are certain economic conditions, but they aren't. The classic signs are (and have always been):

- Extreme overspeculation and interest in stock investing by the public (higher this time than during previous major market tops)
- Very high levels of bullish sentiment, comparable to previous major tops in many indicators

- Large technical divergences in the major market indices (a fact that was being rationalized away by many market technicians who wanted to remain bullish)
- Broad talk of a new era, in which the old rules about stock values no longer apply

In forecasting the end of the 18-year bull market, the problem wasn't so much seeing these classic signs or even deciding they were of sufficient volume to imply a major top. The key was truly believing that these signs were more important than the economic reasons being offered for why prices would go much higher. Once this was accepted, the real difficulty was trying to predict the time, magnitude, and form of the ensuing correction.

I believe a large percentage of investors were expecting some sort of correction, but I think the common belief was that, once the correction was over, the old bull market would resume. I disagreed with that. Bull markets that reach a level of speculative excess like this one are not normally corrected with one declining wave. Therefore, a lengthy trading range market seemed the most probable and was the one postulated. Now that the first declining wave of the correction is no longer just an idea, we are in a much better position to forecast the possible structure and form the complete correction will take.

A Trading Range Market

The ending of a long bull market always brings new experiences for younger investors. Younger investors couldn't remember a time when stock prices didn't go up. During long bull markets, investing becomes too easy—you put your money in, do nothing, and the market takes care of everything. Investors come to think that these spectacular and easy gains are normal and forget that other types of stock markets ever existed. However, the last 20 years have been abnormal times, and it is a mistake to think they are normal. A famous quote from market lore warns against this mindset of high-level normalcy: "Never mistake brains for a bull market."

It is also a mistake to think that all booms will be followed by busts, that periods of extreme overspeculation are always followed by crashes. More often than not, the excess valuations driven into prices by a euphoric public are slowly dissipated by prices going up and down, making little forward progress for some time.

Stock prices don't go straight up or straight down; they move in jerks and starts. For example, a price advance lasting 4 weeks may go strong for 3 days and then hold for 5 days before moving higher again. These brief holding periods act like mini-corrections, effectively slowing the advance to a more normal rate.

The same can happen on a much larger scale, forming what is called a *trading range*. A ***trading range market*** is a period in which stock prices go up and down repeatedly, essentially moving sideways. Prices stay within a price band, with the trading range defined by the highs and lows.

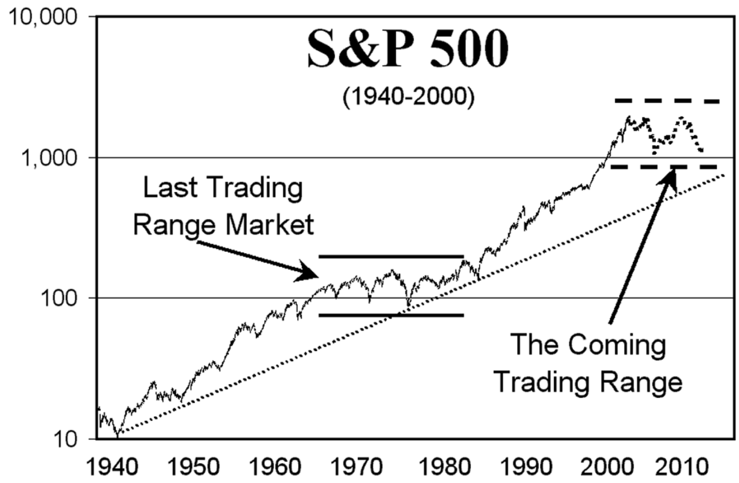
Investors must be reminded that there have been many times in the past when prices didn't go up but trended in long sideways trading ranges. In fact, three major trading range markets have occurred in the past hundred years. During these times, the natural return from stocks falls off dramatically. The first long trading range was the 15 years between 1906 and 1920. The Dow started 1906 at a price of 75 and, after going back and forth in a number of bull and bear markets, finished the year 1920 at a price of 64. Then there was the 12-year period between 1937 and 1949, when the Dow was at 195 in March 1937, ending at a price of 160 by June 1949.

The most recent trading range period was the 16 years between 1966 and 1982. In 1966, the Dow first hit the 1,000 mark. During the following 16 years, it traded between 700 and 1,000 a number of times, making little progress. It wasn't until late 1982 that it finally broke through 1,000 for good. Figure 1.1 shows this most recent period using the Standard & Poor (S&P) 500 index. During these periods, trading market swings again become a popular investment strategy.

Market Timing versus Buy and Hold

It may seem strange to hear that trading market swings was ever an accepted investment strategy. After all, who hasn't heard that investors should not try to time the market or the advice, "It isn't *timing the market* that's important but *time in the market*"? The buy-and-hold investment philosophy is very well entrenched. Its success over the last 10 years of continuously rising prices is unquestioned. However, this philosophy has been espoused primarily by the mutual fund industry, which

FIGURE 1.1 This chart, published in July 2000 before the market decline, shows my expectation of the start of a new trading range market. The straight line at the bottom shows the stock market's trendline since 1928. Notice how the 1982–2000 bull market took prices far away from this trendline. It is normal to expect a trading range that works prices back closer to the line.



wants your money to stay put. The other philosophy—market timing—has been popular during periods when market conditions required it. Let me clarify these two competing theories on how investors should approach stock market investing: buy and hold and market timing.

Buy and hold is the philosophy that you should buy a large basket of good stocks and hold them over long periods, ignoring the intervening price swings. Investors who practice buy and hold believe that predicting price movements is either too difficult or too costly. They recognize that stock price increases through all the bull and bear markets, including the Great Crash of 1929 to 1932, have averaged more than 10% per year. Therefore, if you just hold onto your investments and ignore the wiggles, you will emerge just fine.

Market timing, on the other hand, is the philosophy that you will do better if you try to catch the upswings and sell just before the major downswings. Investors who practice market timing think that it can be done in an advantageous and profitable way. They believe that strategies that attempt to time the market are more natural than buy and hold and that such strategies follow the normal tendencies of investors to avoid losing principal.

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Which investment philosophy is better? This question is really answered by determining the type of market one is in. I don't think there is any doubt that, in long bull markets, the buy-and-hold philosophy does best. Like many others, I've seen that almost any effort to time price movements during a long bull market generally worsens the investment return, sometimes considerably.

Over long trading range markets, however, buy and hold does not work well. Almost any well-thought-out trading strategy does better than the simple buy and hold. The question of which is the better strategy becomes the question of determining what type of stock market one expects to have in the near future.

Since I believe that we have entered a trading range market, I think that investors are going to be very disappointed with the investment results they get from the buy-and-hold strategy. Investors will have to learn to trade the swings of the market, just like their forebears did during other trading range periods. To be successful, they will have to gain a lot more investment knowledge and skill—much more than the do-nothing approach required of the buy-and-hold method.

Isn't Everyone Really a Market Timer?

I claim that even investors who have been invested for a long time are in fact market timers. There is always a day when they buy stocks and a day when they sell them. It seems that most people consider it okay to market time as long as one is timing the long-term trend and the basis of the decision is some fundamental value formula. But that is semantics—it is still market timing. For example, it is considered acceptable if you decided to buy stocks in 1980, when price and earnings (PE) ratios were 10, and decided to sell them in 1999, when the PE ratios got to 35. Although this is market timing, it seems to be considered acceptable market timing. The question then is, "How long do you have to hold an investment before it crosses the line from market timing to buy and hold?" There is no realistic answer, so the idea of market timing is really that of degrees.

The buy-and-hold philosophy says, "Don't sell every time the news gets bad and the market begins a severe decline." In other words, don't react to quick price changes. However, how do you avoid major crashes that wipe people out or what *do* you do when the stock market has entered a long trading range? Investors will become very disappointed with buy and hold as they watch their investments fall, rise, and then fall again and again. Their investment returns will come off the previous higher levels, and they'll notice that doing nothing, which worked so well before, is no longer working. They'll become willing to consider the idea that it might be okay to sell their stocks after a 30% gain and be out of the market, waiting on the sidelines for a new opportunity to present itself. During a trading range market, the price action slowly induces people to become market timers.

Why Buy and Hold Is Hard to Apply

Although theoretically sound and well intentioned, the buy-and-hold strategy is very difficult for investors to apply. Why? It is a little like telling someone that the way to walk from Los Angeles to New York is simply to put one foot in front of the other until you arrive. You can't argue with the instructions, but can anyone really do it? The formula omits too many important details.

The basic concept behind buy and hold is the idea that when investors try to time the market, more often than not, they buy at the top and sell at the bottom. Moreover, many studies on market timing have shown that when you factor in timing errors and commissions, investors would be better off leaving their investments alone. I do not argue against these conclusions here (but I will in Chapter 8); in fact, I will agree with them. After accepting these arguments, however, I still believe market timing is preferable—even if it produces a worse result on paper. How can I say that? With market timing, there is a better chance that the investor will be around to earn that smaller return than if he or she tries to buy and hold because the buy-and-hold philosophy omits a fundamental factor from the equation.

Buy and hold is predicated on the belief that the investor will never have a strong opinion about the direction of stock prices, or if the investor does have a strong opinion, will refrain from acting on it. Right there is the problem. More often than not the first part is true; an investor does not have a strong opinion and so is willing to wait and see what happens. At other times, however, the investor will develop a very strong opinion. He or she becomes sure of what is going to happen next and, whether right or wrong, acts on this certainty. Let me illustrate with an example of a possible conversation between and advisor an his client.

CLIENT: My stocks have gone down 10% and things aren't looking very good.

ADVISOR: Yes, I know, but just stay put and all will be okay.

Two weeks later:

CLIENT: My account is now down 15%. The market fell almost every day over the last 2 weeks. The newspeople are saying that the economy is going to get worse and the future looks pretty bad. There isn't any reason for stocks to go up.

ADVISOR: Yes, but don't do anything—we planned to buy and hold.

One week later, with the stock market selling off severely:

CLIENT: Sell me out before I lose any more money.

ADVISOR: I hear you, but remember we intended to buy and hold.

CLIENT: That's what you've said for the last 3 weeks, and it has cost me a lot of money. Now I'm sure the market is going lower, absolutely sure. There isn't one good reason for it to go up. Are you telling me that I should voluntarily stand pat and lose more money? Let's at least get out and, once prices move lower, we can get back in. Do what I tell you or I'll get a new advisor who can see what's happening.

When investors reach a point of certainty or conviction, they act on that certainty. To ask them to do otherwise—to refrain from action at those moments—is like asking them not to turn the steering wheel to avoid the train they see coming right at them, whether that train is real or not.

Therefore, it is my belief that market timing is a more natural investment strategy to use than the buy-and-hold method. As an added benefit, once investors are willing to consider market timing and give it a try, they now have the luxury of thoroughly planning what kind of timing strategy to use. This advance planning should help investors sidestep market timing based on emotional decisions that truly do destroy investor confidence and investment returns.

As mentioned, market timing is much more difficult to execute than the do-nothing approach of buy and hold. To do market timing, you have to establish an opinion about what is going to happen in the market. You need a basis to believe that the market is now ready to go up or go down. You also have to know that there are times when no opinion is possible, the market is unpredictable, and no forecast should be made. To do these things you have to know when and how to develop an investment opinion.

DEVELOPING AN INVESTMENT OPINION

Stock market investing, or speculation, is one of the most exciting activities you can undertake. The word *speculation* comes from the Latin word *speculare*, which means "to look." The problem is that there are simply too many things to look at. Stacked top to bottom, one page at a time, Wall Street probably produces over 20 feet of data on any given trading day. Lack of data is not the problem—in fact, the problem is the opposite: the overwhelming volume of data and not knowing what is important and what isn't. Without realizing that more than 99% of the data on Wall Street are immaterial to an investment decision, most people simply get lost in the confusion of too much information.

Most investors think that to make timely, correct investment decisions, you must pore over this mountain of data and know many facts. I have found that the opposite is true. You achieve insight by simplifying your thinking, by focusing on only a few important points and never deviating from those points. You do this by continually discarding the mountain of unnecessary information to find the few important concepts.

Early in my studies, I had a friend who used more than 100 indicators to analyze the stock market. At first, I envied his superior knowledge, but eventually I came to feel sorry for him: He was always confused. I finally figured out that he simply had too much information. At any given time, only one or two points were vital, and the rest just served to divert his attention to unimportant and contradictory data. He had never learned that the secret to a clear and accurate picture of the market is finding the few truly important pieces of information and downplaying or discarding everything else.

Holding to an Investment Viewpoint or Position

Holding to an investment viewpoint or opinion is very similar to the action of anchoring yourself at a location against a physical force. If you are facing a strong wind, you have to anchor your feet in firm ground or get blown away. Similarly, when you hold a market viewpoint, that viewpoint must be anchored in facts and theories that you know are correct and true. You must solidly believe them, and they must be founded on established and tested ideas. Otherwise, you will not be able to hold to your investment position, and your viewpoint will flip-flop in the face of almost any concept or compelling idea that comes along.

I remember the first time I saw this happen in myself. It was embarrassing how flimsy my ideas proved to be and how vulnerable they were to contradictory evidence. Although much of my wavering was attributable to age and inexperience, I wasn't used to seeing it in myself. I stood there amazed as I watched my opinions flip-flop like a rag doll throughout the day.

That time was October 1971, after Nixon had announced wage and price controls. I had just become interested in the stock market and was working at night, watching the stock market every day on the new stock market channel, KWHY, in the Los Angeles area. I was learning by reading books and listening to brokers, commentators, and economists discuss the economy and the market.

Prices had rallied for 2 weeks after Nixon's announcement, and I became, like everyone else, bullish. Then, the market started a mild-sell off that soon stopped. I expected prices to begin a major rally and so bought two stocks—my first trades in fact. In a few days, the market started to decline again, and then the selling really started to pick up steam. It declined almost every day, and I started to get nervous.

I began listening in earnest to every commentator, trying to understand what was happening. On one particular day, I got bullish, bearish, then bullish again, agreeing each time with the bullish or bearish arguments of each commentator who came on the air. My ideas were like papier-mâché against almost any idea.

I wasn't used to this. I had studied mathematics and the physical sciences, and in these disciplines there is always one clear answer. Now, I was unable to hold to my ideas against almost any other idea that was expressed. It was obvious to me that I didn't know anything. If I was to become successful, I would have to establish for myself what was important and what wasn't. Only then would I be able to say, "That's balderdash," or "That is important." It would take a lot of study, experience, practice, and application.

Finding Out What Is Important

Countless books have been written on technical analysis. The majority of market technicians have read them all, and yet history usually finds them holding wrong opinions at critical market junctures. The problem isn't with the information in these books—the basic data and theories are correct. The problem is that the books often omit the practical instruction on how to apply the information in real time. For example, when two important indicators are pointing to opposite scenarios for the market, how do you determine which one to choose?

Stock market books seldom address this question, but it is key to the whole activity. I'll tell you the answer: To achieve understanding, you must find out what is truly important, rank the data by relative importance, and then learn how to fit the rankings together to see the correct stock market story. Yes, stock markets do tell stories through their price action. The art is learning how to use the available statistical information to figure out the story. The friend I mentioned previously failed because the books never instructed him on how to put all 100 indicators together to see what that story is. He became immersed in all the indicators, looking for some great truth. He missed the idea that these were only clues to help uncover the story the stock market was telling.

Evaluating the relative importance of data is extremely important. Much of the information that Wall Street uses to think with is simply wrong or not really vital. Without correct information or information that is correctly evaluated, you can't reach correct conclusions. Moreover, sometimes because of excessive publicity, it is very difficult to evaluate a fact: The data have been made to appear more important—or less important—than they are. This distortion, too, can make it difficult to reach correct conclusions.

Following are two examples. The first concerns the current popular idea about the strength of the baby boomer wave. The second concerns the question of whether stock prices are controlled by an invisible set of insiders.

The Baby Boomer Misconception

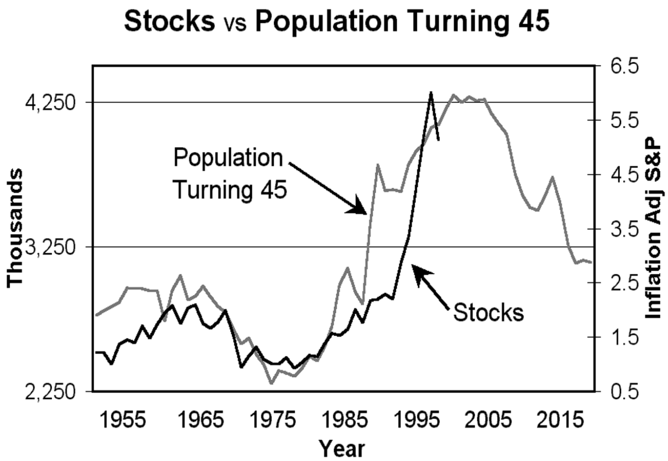
Whenever I see an idea that has wide acceptance in the investment community, I start looking for the holes in it. I do this because of my deep belief in the theory of contrary opinion (explained in Chapter 5). When I saw Wall Street fall in love with the idea that the baby boomer wave would drive stock prices higher for another 8 years, I got very interested. At a seminar where a hundred brokers were listening to this idea, I saw almost every head nodding in agreement. So I did my own study of the situation.

The baby boomer idea is a simple one. It holds that money drives the stock market and that the expanding number of baby boomers reaching their prime investment and buying years (ages 45 to 48) is a huge, irresistible force that will drive stock prices higher for a long time. Figure 1.2 shows the correlation between stock prices and the number of people turning 45. The idea is that age 45 is generally the point at which a person has the greatest purchasing power. This buying is good for business and translates to higher prices for stocks. Forty-five is also the age when the average person starts saving and investing the maximum amount, as they approach retirement. The way the stock market seems to follow the population curve is uncanny. The chart leads people to these conclusions:

- The baby boomer wave is very large.
- There is a strong correlation between stock prices and the number of people turning 45.
- The stock market will continue to rise until the year 2007.

This chart makes a strong visual impact and can create unswerving conviction about the power of the baby boomer wave. Both the plausibility of the idea and the strong correlation between the two curves give the baby boomer idea its wide acceptance and apparent importance.

FIGURE 1.2 The popular baby boomer wave graph, which shows the number of people turning 45 plotted against the inflation-adjusted S&P 500.



Notice that the baby boomer idea does not consider the possibility that stock prices may already be too high. The concept is simple: With a large number of people turning 45, stock prices will continue to rise due to their sheer buying power.

When I started studying the baby boomer data, the first thing I noticed was that the Y-axis started not at zero but at 2.25 million births. This had the effect of making the births after WWII look larger than they really are. More importantly, I concluded that the chart plotted the wrong item. The more important and accurate item to plot is the *percentage* of the population turning 45, not the actual number. Certainly, 1 million people turning 45 when the population is 300 million ($\frac{1}{3}$%) is less important than 1 million people turning 45 in a population of 100 million (1%). As the population gets larger, a larger number of people are needed to produce a comparable economic impact. I calculated the percentage of the population turning 45 and graphed that against the same inflation-adjusted S&P 500.

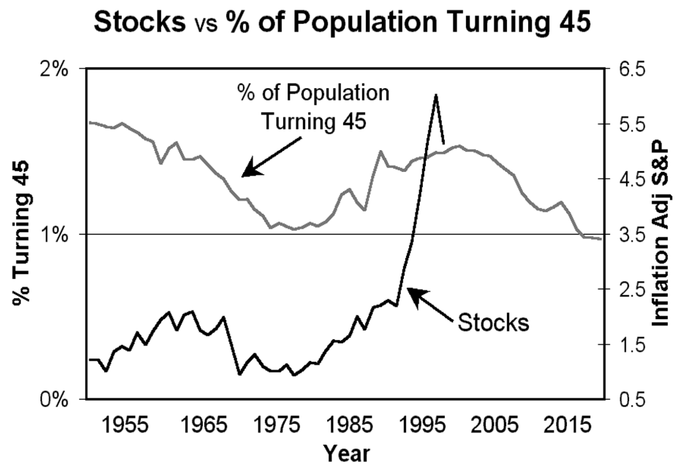
Figure 1.3, plotting the percentage of the population turning 45 against the stock market, presents an entirely different picture:

- The baby boomer wave exists, but it's much smaller and less important than many people think.
- The wave might be peaking right now.

Therefore, the idea of the stock market constantly advancing against a wave of baby boomers is far overrated. If the stock market is too high and the economy is facing real economic problems, prices can and will decline—and decline severely. In fact, this baby boomer idea has all the classic signs of an old pattern: Near the top of a major bull market, a new idea emerges that convinces people that a new era has arrived and that bear markets are a thing of the past.

Stock market lore holds that every great bull market generates such ideas. (Because of it, well-schooled investors usually greet the emergence of a new era as one of the classic signs of a bull market end.) The new era always signifies a new viewpoint and originates from the unique ideas and apparent new economy of each period. The new era appears so powerful and so obviously right that a bear market seems almost impossible. Investors usually ignore any negative ideas because they seem so unimportant when viewed against the new economic viewpoint and because they think any correction will be relatively mild. As soon as a correction continues and slips into a major bear market, people's thoughts about stocks shift, and the fallacy in the idea is soon uncovered.

FIGURE 1.3 The percentage of the population turning 45 plotted against an inflation-adjusted S&P 500. This chart shows that the baby boomer wave is not as important as some have said.



Do Insiders Control the Market?

One of the most persuasive—and pervasive—of the old ideas is the theory that stock prices are controlled and manipulated by a large and powerful group of insiders. Over the years, I've investigated this idea in its many guises—from corporate insiders, to mutual fund money managers, to stock exchange specialists—and I have always found it to be false.

My first contact with this idea came in 1971, when it was popular to assume that the specialists on the floor of the exchange control stock prices. All orders to buy and sell are processed through a specialist, who matches and executes all incoming buy and sell orders for a stock. The specialist also has the famous black book. This book (now a computer) contains all the orders made away from the market that clients have entered with their brokers—orders to buy or sell if the stock hits a certain price. With these data, the specialist knows at what price heavy demand and heavy supply will occur.

Besides matching up orders, specialists are also charged with buying and selling in their own accounts to help stabilize prices if supply and demand get out of balance. Because specialists trading for their own accounts can amount to approximately 20% of the daily trading volume, this is significant. The black book and insider trading led to the belief that specialists control stock prices to their advantage. At one time, a specialist short-selling indicator seemed to prove this contention. However, by 1974, after a careful analysis of specialist data, I was able to prove to myself that this is not the case. The specialist data and the indicator that technicians had invented were not measuring what technicians thought they were. It is an example of a conclusion based on a mistaken concept. Therefore, I became convinced that floor specialists do not control price movements over the intermediate or long term. As I analyzed more and more information, I came to similar conclusions about other forms of possible insider manipulation.

It was once true that markets were manipulated and conspiracies were possible, but no longer. Furthermore, holding to the viewpoint that prices are controlled and manipulated by insiders is destructive to correct market thinking. It is destructive because *it puts the cause of stock price movements, and therefore your ability to predict these movements, outside your perimeter of knowledge*. When you discover, by careful analysis, that prices are not manipulated, you are somewhat free; you are finally in a position to figure out what is really happening in the stock market.

Daniel Drew, Robber Baron

Daniel Drew was the king of stock manipulation and short selling—one of the infamous robber barons of 200 years ago. His story illustrates how it used to be.

> Daniel Drew was born in New England around 1800. A man of low business ethics, he prided himself on the swindle. One idea he invented was that of *watering the stock*. As a young cattle drover, he would deliver a large herd and then have his men lay out salt for the cows to lick. The next morning he allowed the thirsty cows to drink until they almost burst. The butchers, faced with the fattest cows they had ever seen, paid top dollar.
>
> Later, Drew gained control of the Erie Railroad and became rich by manipulating Erie stock. He would sell the stock short and then release bad news about the company. After the price

fell, he would profit by buying back the shares at the low price. He would then release good news. He did this repeatedly until, after 10 years, the Erie was almost bankrupt and Drew was a rich man.

He also participated in one of the most colorful financial battles in American history. Commodore Vanderbilt got tired of the Scandal of the Erie and decided to buy the company away from Drew by secretly purchasing a majority of shares on the New York Stock Exchange. Drew, with the help of Jim Fisk and Jay Gould, fought back. Using the company printing press, the three printed illegal shares of Erie, flooding the exchange with counterfeit stock as Vanderbilt's brokers purchased every share in sight. On learning that he held worthless stock, Vanderbilt sent the law after the trio, who now had his money. The three went to New Jersey, bribed state officials, and fended off the Vanderbilt legal attack. Eventually, they returned Vanderbilt's money and he abandoned his efforts to buy the Erie.

A while later, Drew, having again shorted Erie stock, was caught in one of his own traps. Jay Gould, Drew's former sidekick, wiped him out by manipulating the price higher, thereby forcing Drew to buy back stock at astronomically high prices.

The era of the robber barons is long gone now, and the use of inside information and the release of misleading data to manipulate stock prices are now illegal. There is no longer a powerful *they* who can control stock prices. We don't know how investors survived in an environment like that, but somehow they did, long enough to bring about the reforms that created the fairer markets we enjoy today. (Source: Kean Collection/ Archive Photos™.)

WHAT'S COMING NEXT?

Market timing presents the purist with a major theoretical problem. The standard academic models for stock prices hold that stock prices are basically random and unpredictable. If I and many others believe that market timing is possible, we must have a different model in mind than these academic models. Chapter 2 introduces the stock market model that I use to understand price movements. It allows for a stock market that is sometimes predictable and therefore makes market timing possible.

The model provides further benefit in its ability to align and unify other stock market information that was previously confusing or in conflict. For example, for years an argument has raged between the market technician and the market fundamentalist about whose discipline is better at predicting the stock market. As you will eventually see, both disciplines are correct when applied to the correct time scale.

During a long bull market, when the buy-and-hold philosophy works so well, it is not so important to clarify these points. During a trading range market, it is vital. To time the market successfully, you must establish two points: (1) the expected size and time scale of the price moves you want to catch and (2) methods to determine when the market has shifted from a random state into a predictable one. This requires skill and experience and—most importantly—a willingness to change your mind when you are wrong. You must learn how to do this in such a way that your confidence in your own judgment is not undermined.

What follows in this book is my understanding of what it will take to be successful through a market environment like this. I address the investment tools that I have come to use during 30 years of market study. If you are going to be successful through a market like the one I'm expecting, you will have to use many tools.

The following chapters explain how I use information to do this. In Chapter 3, you learn the role of the fair-value term *D/I* in this model. Chapters 4 and 5 explore the area of technical analysis, as well as why it can help locate unstable markets that are ready to undergo a strong feedback-loop movement. In Chapter 6, you'll see how new discoveries in chaos theory help explain the fractal nature of stock price charts and how they give a firmer theoretical foundation for the controversial Elliott wave theory.

Chapter 7 broadly outlines the pattern the market may make during its expected long sideways run. Chapter 8 presents certain studies I did a few years ago on strategies for sideways markets. These studies backtest various moving-average methods and how they performed on paper through the last trading range market, from 1966 to 1982. Alternative investments, such as hedge funds, are also discussed.