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Highly volatile markets, trend following, E*Trade meltdown

My last interim newsletter in August was about how to keep one's sanity during highly volatile market times. This time I will dig into the benefits of trend following although the methods, like all others, are far from perfect, and that is particularly true during market conditions such the current ones which have seen the Dow drop 360 points last Wednesday, fall by 224 last Friday, and then bounce back up by over 300 points yesterday. Moreover, some of the intraday fluctuations have been dramatic.

The highly visible "experts" who appear on the likes of CNBC love to tell us what they think the market is going to do next, although they usually hedge enough so that they can't be said to be really wrong. That is what they get paid to do and presumably what many in the audience want to hear. How what they say can be useful is beyond me since one can usually hear conflicting opinions during every hour. While it is certainly gratifying to foresee what the market is likely to do through insightful analysis and even better to make some money that way, I don't think it is a practical way to invest or consistently show good profits and reasonable levels of risk. Instead, I believe that trend following is the better way for most of one's portfolio although that method is reactive rather than anticipatory.

I still believe we are in a secular bear market even as some indices have made new highs. (See my interim #2 for a discussion: http://www.pankin.com/Interim2.pdf) In the secular bull that began in 1982 and ended in 2000, taking risks was usually rewarded since drops, even fairly severe ones, were usually recovered in a few months. During a secular bear market, set backs tend to be long lasting and in extreme cases (such as the Nasdaq Composite index which is still at only about half of its all-time high more than seven years later) it may take many, many years to recover the losses. In other words, during a secular bear market, risk reduction is the key to investment success. Even during strong markets, risk reduction has significant benefits even if investment returns trail the popular indices.

The “hypothesis testing” in a basic Statistics course (don’t worry, nothing technical follows) provides a nice framework. The standard method involves comparing a “null hypothesis” that is usually the status quo and is often denoted by “H0” with an “alternative hypothesis (H1)” that will be accepted if the statistical evidence supports it by saying it is much more likely to be true than H0. There are two types of errors that are possible in the process. One is rejecting H0 and accepting H1 when in fact (although we do not know the fact) H0 is correct. The other is accepting H0 when it should be rejected because in fact H1 is correct.

A student of a fellow instructor when I was teaching at Marshall University presented him with a pair of drawings that emphasize these types of errors. In both there was a hippo with H0 on its side, the “null hippopotamus.” In the first picture, the statistician is pointing toward the door while the animal heads towards it with tears falling from its eyes. That illustrates the improper rejection of H0. In the second picture that illustrates a disastrous failure to reject H0, the hippo has grabbed the statistician in its mouth ready to chomp down with great force.

While amusing, the pictures also make the point that often it is more important to avoid one type of error rather than other. As a simple practical example, I may be concerned that it may rain today and wonder if I should take an umbrella. One type of error—not taking the umbrella when it rains—clearly has worse consequences than the other type since it isn’t hard for me to carry the rain gear.

When it comes to investing, the two types of error are not being (fully) invested in a rising market and being (over)invested in a falling market. Most investors feel more pain from losing a lot of money than the pleasure they get from making a lot. That is one indication that it is better to avoid the second type even if that increases the chance of missing some rising markets. In a secular bear market, I think that preference should be even stronger.

The trend following methods I use in my Tactical Asset Allocation (TAA) accounts are designed to reduce the risks and avoid the error of not getting out of falling markets. Most of my other managed accounts also employ methods to reduce risks. In particular, the model I use for deciding when to own broad based equity funds gave a sell signal based on last Friday’s data. Accordingly, on Monday I sold mutual funds that closely track the S&P 500 Index. Seeing the market bounce back up yesterday is certainly frustrating, but it is not really bothersome when I keep in mind the type of error I want to avoid.

To illustrate the concept further, let's look at E*Trade Financial (ticker symbol: ETFC), a major on-line discount broker and bank. (Disclosure: My wife has some certificates of deposit with them that were first bought from a bank they purchased that had an office, no longer in existence, near where we live. I used to have a brokerage account with them after they purchased Brown & Co., one of the original discount brokers where I had an account for about 30 years. I closed that account and moved the assets to a different broker because I was unhappy with E*Trade for several reasons. I have never owned or traded the stock in client or personal accounts.) The stock fell by over half on Monday when a bank's analyst downgraded the stock and suggested they may need to file for bankruptcy. There are several interesting aspects in all of this.

Two are the influence and "perspicacity" of Wall Street's analysts. Although this was an extreme case, I find it amazing how an analyst's upgrade or downgrade of a stock can result in a large move. It is like the apocryphal stampede of elephants trying to go through the same door at the same time. It is a big reason we see a lot of the volatility we do. Too many money managers want to be "safe" in the herd by not performing too far below their benchmarks.

According to an article in today's *Wall Street Journal*, twelve analysts follow ETFC. Three have some type of buy rating on the stock, nine say hold, and only one, the one who downgraded it on Monday, has a sell recommendation. As the graph on the next page shows, his sell recommendation was not at all close to being timely. It was not even practical since the stock opened about 35% below its close on Friday. The article says some of the other eleven analysts were highly critical of the sell recommendation that raised the possibility of bankruptcy. Apparently original thinking that deviates too much from the crowd is a *faux pas*.

Even with the downgrade, the herd instinct continues. One of the analysts issued a report yesterday saying he thought a bankruptcy filling was highly unlikely. In reaction the stock gained over 40%, but is still well below its close on Friday of $8.59. It has also gained a good percentage today and closed at $5.54.

So the analyst who issued the sell provided good advice about trading ETFC? Hardly. The stock traded above $25 in June. Presumably his previous stance had been to hold the stock, so he was willing to let it fall to under $9 before saying it should be sold, and as a practical matter one would get far less than that. See the graph below.

Here is a graph from today's *Wall Street Journal* showing how the stock has done over the past year. After rising by over 400% in 2003-2005, the stock essentially went sideways in 2006 staying in the 20-25 range. Any reasonable trend following method would have generated a negative reading some time this summer if not considerably earlier.

Pedestrians walk past an E*Trade Financial branch in New York.

The simplest one, which can be quite effective, is reading the chart. A trend down is characterized by a series of lower lows and lower highs. In July the stock rallied a bit but did not come close to getting above the June high. More telling, once it fell to the $20 area, it was going to make a low lower than any seen for over a year. That was a clear indication of a trend to the downside. Keeping in mind what type of error is most important not to make, the prudent course was to get out of the stock this summer. Why did all of the highly paid and supposedly knowledgeable Wall Street analysts think this trend was to be ignored until one "brilliantly" thinks it is time to sell after the stock has fallen by about two-thirds?

While E*Trade is an extreme example, it shows the value of trend following methods as a risk reduction tool. There are certainly going to be times when they do not work well. In those times keep in mind what we are trying to avoid and don't be distracted by missing some rising stocks and markets.

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