Stock Market Perspective: Conventional "Wisdom"?

This is a topic I have discussed from time to time. Some recent developments, market action, and articles have motivated me to write about it again.

Every TV show about markets and investments features at least one, and often more, "experts" who love to tell us what they think the market is going to do in the near future or what stocks or other investments are worth owning now. Most often they are associated with brokers or leading financial publications, but sometimes they are newsletter writers or mutual fund managers. The attraction is that these are people "in the know" who will pass on information that the viewers or readers are highly likely to profit from. I think such is generally a forlorn hope.

(As an aside: even if you think they are providing useful advice, you should keep in mind what Jesse Livermore, the legendary speculator early in the last century, reputedly said. "If you buy on Smith's tip, you better sell on Smith's tip." Do you really think they are going to insist on appearing on the same show and telling you it is time to sell what they recommended? That is a real danger from acting without doing your own research. Too often I have heard moans that such and such an expert said we should buy XYZ Cyber Widgets, so how could I think it would go down.)

Buy and hold (and hope!) supposedly is the best way to invest, but it ignores risk and is extremely difficult to stay with.

▶**Bear Stearns:** You have likely read and heard more about this debacle than you ever wanted to. Later, I'll move on to favorite advice of columnists and most brokers about the benefits of buying and holding, which is more accurately described as buying and hoping.

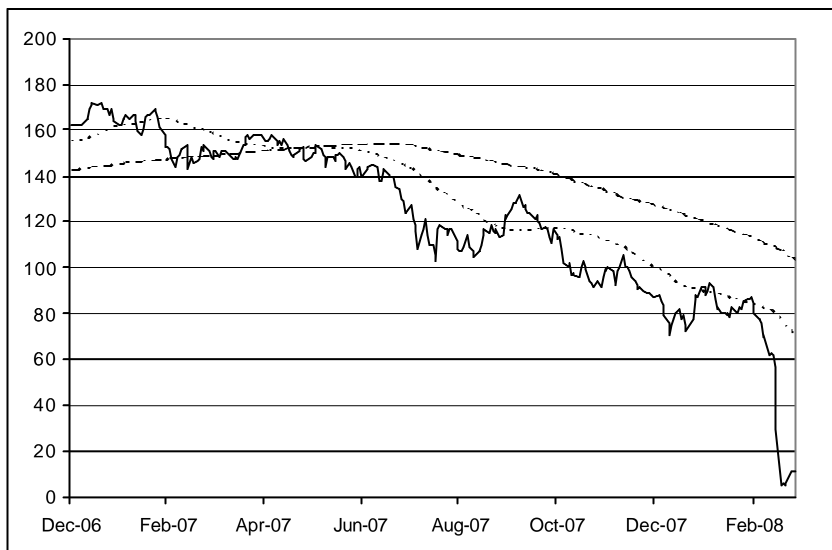
Bear Stearns[1] (ticker symbol: BSC) is one of Wall Street's oldest and largest investment banks. Unlike Bank of America, Citibank, Chase Manhattan, or your local neighborhood bank that serves "retail" customers like us, an investment bank deals solely with other financial institutions. As such, it is subject to far less scrutiny and reserve requirements by government regulators. The thinking is that they are dealing with other "big boys" who have the knowledge and resources to fend for themselves. However, the ever increasing array of mortgage backed securities products has made such knowledge much more difficult to obtain as evidenced by instances of AAA rated debt rapidly becoming far from secure when the subprime house of cards began to crumble.

Bear was one of the largest players in this field, and during the week of March 10-14 they began to suffer something akin to a "run on the bank" similar to what happened to many local banks in the early 1930s. Due to Bear's size and the complex interlocking loan arrangements among major financial institutions, the fear was that there would be a major worldwide financial collapse if something was not done very quickly. Over the weekend the Federal Reserve Board stepped in and issued some guarantees, added liquidity to the financial markets, and struck a deal that had J.P. Morgan Chase buying BSC for $2 per share, which was raised to $10 a week later.

I don't have the detailed knowledge or even the desire to comment on whether the rescue actions were necessary or appropriate. Instead, I want to look at the price of BSC in the year or

[1] I have never owned the stock in personal or client accounts. Although these accounts currently have positions in financial sector stocks, they do not have any interests in J.P. Morgan Chase, a Dow stock, that is buying Bear Stearns.

so before the collapse and the "wisdom" of the "experts" more recently. The nearby graph[2] shows the daily closing prices since the end of



2006. The two broken lines are the 50-day and 200-day simple moving averages, which are commonly used technical indicators to identify trends and generate trading signals.

The stock reached its all-time high value above 170 in January 2007 and then started to fall. I'll get to what some basic trend analysis and technical indicators would have said, but first let's look at some of the "wisdom" being spewed out earlier this year.

Start with the unique (thankfully!) bombastic style of Jim Cramer. He and his many fans who watch on CNBC must believe if you shout something repeatedly, it must be true. To see and hear (loudly!) his "insight" into BSC, go to "www.liveleak.com/view?i=2b7_1205751955". Based on the price of 62.97 shown, this was on Tuesday March 11. For those who want to spare their ear drums, he opined that Bear "is fine," "is not in trouble," and you should "not move your money from Bear" because that would be "silly." He did say it might be taken over, but nothing about $2 or $10 a share. Three days after this ranting, the price of the stock had been more than cut in half before the weekend debacle for the holders of the shares.

A *Wall Street Journal* article said that Buckingham Research analysts in a March 11 report argued that "concerns about Bear's" access to cash were 'overdone.'" Lehman Brothers is essentially in the same business as Bear so one would think they would have a superior understanding of the firm and its potential problems. The same article reported that Lehman "reiterated its $110 price target for Bear on March 13." BSC closed that day at $57 and at $30 the following day. I doubt that the first time the $110 target was issued was in the first half of 2007 when BSC was much higher.

What would basic trend analysis or a simple technical indicator have said about BSC? As I have explained before, the most fundamental trend analysis principle is that a stock, index, or financial instrument trending up will show a series of higher highs and higher lows, and the opposite will be true when it is trending down. The stock made lows above 140 in February and March 2007 before recovering to near 160. That was a lower high and the first indication that the trend up may be ending. In June it was again pushing towards 140 and in late July it moved decisively below that level. By then trend analysis would interpret this new low in conjunction with the earlier lower high as a sign that the stock was moving down and the risks of owning it were on the high side. To be fair, this type of analysis is far from perfect and it is much easier to "trade the middle" of a chart than the rightmost part, which is how real trading is done.

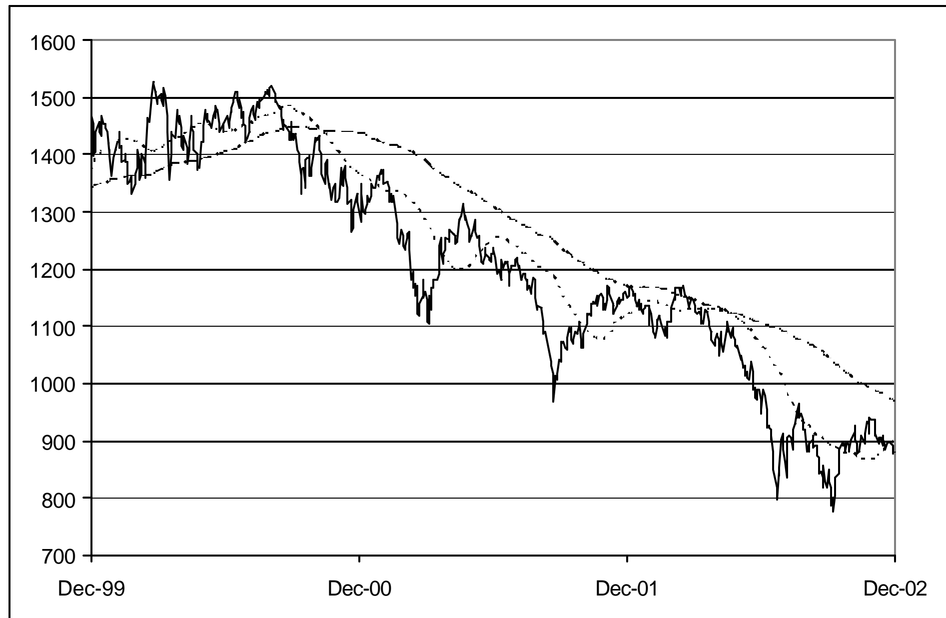
[2] Normally a graph over such a wide range is shown with a logarithmic vertical scale so the fluctuations at the lower prices can be seen. Ironically, doing so in this case would obscure the movements at the higher prices.

The moving averages also provided warnings that the stock was trending down. BSC moved below the 50-day average, which had begun to move lower, in late February. However, the 200-day average was still gaining, so it was not yet clear that the stock was trending lower. For the next few months, the stock moved above and below the two moving averages. In early June, the 50-day average crossed beneath the 200-day one, which is a negative sign and that gap between them continued to widen. There are different ways to interpret what the moving averages say about the trend of the stock. However, I think anyone using trend analysis would have been out of BSC by the end of July when it had fallen into the 120s if not a little sooner at somewhat higher prices.

The key point to me is that by following relatively simple trend analysis, there would have been no reason to own BSC as it continued to fall. What Cramer, Buckingham, and Lehman said would have been completely irrelevant. I would go further and say that the "wisdom" of Wall Street's talking head gurus is always irrelevant and should be ignored.

▶**Buy and Hope:** The *Washington Post's* Sunday investing columnist, Martha Hamilton, had an article in the March 23 paper with the headline "Jumping Out of Stocks Could Sting More Than Staying." The reason given is "if you stay in the market, you will be there for the turnaround, which always comes." Getting out is not a good idea because by the time one gets back in the prices may be higher than they are now. Moreover, "almost every financial adviser I have talked to in recent weeks said that those who keep their money in the market should sit tight." In other words, standard conventional "wisdom."

Needless to say, she did not talk to me. While not discussed in the article, I doubt that many, if any, of those she consulted recommended getting out of the market earlier once it started to trend down.



She provides some data about how the S&P 500 rebounded off of bottoms in 1982, 1991, and 2002. That is not really very meaningful unless one was able to have sold well before those bottoms and bought close to the low prices. Along the same lines she points out that Bear Stearns traded at more than twice the price of the $2 buyout price. (The article was written before the revised $10 bid.) That is misleading in a couple of ways. The first, which is minor, is that nobody bought BSC at 2. It opened on Monday March 17 at 3.17 and its low for the day was 2.84 before closing at 4.81. Much more importantly, she ignores the "wisdom" dispensed about BSC the week of March 10.

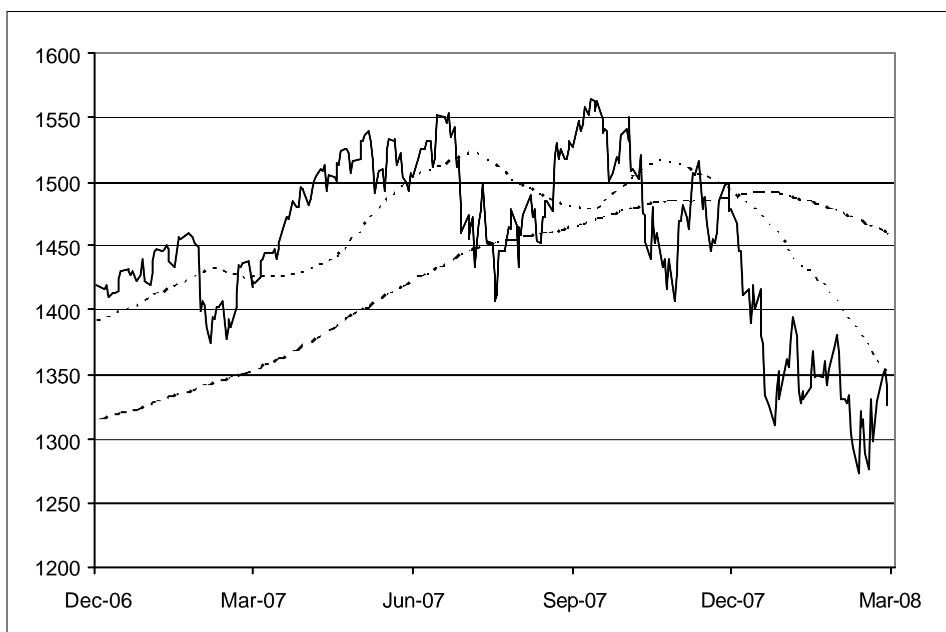
What she said about Bear is a bit of a distraction, so let's look at her thinking about staying in stocks for fear of missing the turnaround. The closing value of the S&P on the Friday before the column was slightly more than 15% below the high in early October.

Earlier in the week, the index had been almost 19% below the high.

To get an idea of the risk from buy, hold, and hope, let's look at what happened in 2000-02, the beginning of the current secular bear market. The graph on the prior page shows the daily closes of the S&P 500 in those years and also has the same two moving averages as the graph for BSC. The S&P peaked in late March 2000 a little lower than the high last October, but in inflation adjusted terms the 2000 high was considerably above the more recent one. After bouncing around for the next few months, the index got within a fraction of a point of its high in early September before starting down in earnest. In late December the index was about 15% below its high, which is about the same as the recent relationship. Presumably Ms. Hamilton would have written then as she did now that one should not exit the stock market because one might miss "the turnaround, which always comes." As the graph shows, that would not have been a savvy course of non-action. At the low point in October 2002, the index had lost just about half of its value from its peak and another 40% from its close on the Friday December 22, 2000. As for the turnaround that always comes, it did come a couple of years later, but the index on the Friday before her column was a mere 2% above 12/22/2000, and that ignores the effects of more than seven years of inflation.

Technical analysis similar to that shown above for Bear Stearns would have indicated the S&P was trending down around 1,300 in late 2000 or early 2001. The highs after September's were lower and the lows began to be lower. About the same time the index crossed below the moving averages and the 50-day one crossed below the 200-day average. Those indicators did not tell how low the market would go and when, but they did clearly say that the risks of owning stocks were higher than normal as long as the trend down was still in place.

Now let's look at a graph of the S&P since the end of 2006 to see what the basic trend analysis and moving averages tells us. The highs after the all-time peak in October were lower, and in January the index moved below 1400, which was below the two lows in the second half of the year and then below the low in March 2007, which is the classic indication of a trend down. Around the same time, the index was below both moving averages, and the shorter 50-day average had crossed below the longer 200-day one, another bearish sign.



I use a related, but different method for deciding when to buy and sell broad based index funds such as those that track the S&P as part of the Tactical Asset Allocation managed account program. The method incorporates trends in the S&P as well as trends in short and long term Treasury rates. Philosophically it is similar to the methods discussed above, but my testing shows it normally provides more accurate signals. That model gave a sell signal in early November, suffered a one week whipsaw in December and has had us

out of the index since mid-December.

Does the model tell me how long the index will go or how long the trend down will last? It does not, but I don't need to know those things. What I need to know is when the risks of losses from owning stocks are high relative to the potential gains. That concept seems to be foreign to many of the conventional "wisdom" pundits and CNBC talking heads.

To provide some perspective, trend analysis is not the only effective method for investing. Moreover, like the others, it is far from perfect. In particular, it is subject to short-term whipsaws like the one the model had in December. Those are a very reasonable price to pay for being on the right side of meaningful market moves. A significant characteristic of trend following is that it will buy after the lows and sell after the highs, not before. Contrary to what the typical pundits imply, there is no claim that it will pick the lows and highs. That is not at all necessary unless one's ego demands such prescience. Some may find being "late" makes trend following hard to stick with. However, experience has shown that buy, hold, and hope is an extremely hard investing method to live with. Many studies of mutual fund and brokerage account trading shows that it is common to buy well after the market has started up, hold on after it starts falling because of "being in it for the long term and because stocks always come back," and then selling in a panic near the bottom when stocks continue to fall. It is much better to pay attention to meaningful trends—of several months to a year a more from my perspective—because that is a much easier discipline (for me) to follow.