

Stock Market Perspective: Calendar Based Investing Revisited

I have written about such methods several times. Four years ago, I had my most extensive discussion, which included historical returns and comparisons to a trend-following model I use to trade the funds that track the S&P 500. I focused on three calendar based methods: the January Barometer (when stocks are up in January the rest of the year figures to be a good one, but we have no predictive information when they are down); own stocks from November through April and be out of the market May-October; and the presidential cycle (the two best years on average are the one before the election—2011 is particular—and the election year).

Jay Kaepfel is an author who develops and writes about trading strategies in books, magazines, and a weekly column on Optionetics.com. His latest book, *Seasonal Stock Market Trends*, came out about two years ago. I heard him talk about some of the ideas in his book along with some not there in November at a one and a half day conference of the National Association of Active Investment Managers (NAAIM), of which I am a long time member. Hearing him motivated me to buy and study his book, which is the basis for this issue's perspective.

Kaepfel discusses the three methods listed above, with his own wrinkles added in some cases, and quite a few others. He puts everything together at the end of the book in what he calls "Known Trends Index"¹ (KTI). It combines thirteen indicators. A buy signal is when at least three (four in September) indicators are positive, and the very best times to own stocks is when the index reads five or

above. The maximum value is eight as best I can tell.

The KTI is based strictly on the calendar, so the January Barometer is not part of it. Modified versions of the other two mentioned above are included along with eleven others incorporating a variety of effects. Some, such as days around the beginning of a month and around a holiday have been written about by several others.

As a general rule, no mechanical trading method is worth following unless at least two conditions are met. The first is that there is a logical reason why the rule can be expected to indicate the likely future direction of stocks. An example of one that does not, but which seems to be written about every year, is the "Super Bowl Indicator." Having good reasons why

It is dangerous to adopt a model based only on hypothetical performance; out-of-sample results are far more important.

calendar based rules work is especially important because with enough computing power patterns can always be found. The

second condition is that there are enough historical instances to engender quite a bit of confidence that the effect will be effective in the future. As we shall see, the methods promoted by Kaepfel and many other writers often fail to meet one or both of these requirements.

Kaepfel can be guilty of "20-20 hindsight" in the development of his rules. One example is in the treatment of presidential election cycle. He and the others who have written about it have pointed out the year before the presidential election, which we have just begun, is historically the best of the four in the cycle. His rules in KTI concerning this cycle do not have October of the pre-election year being a positive indicator. Why is that? As he explains, October 1987 was a very bad month due to "Black Monday" that year. He does not give any reason why October in a pre-election year

¹ Since the calendar based methods are not trend-following, a better name would be the Known Tendencies Index, which is still the KTI.

should be bad for stocks, and with that one exception it has not been a remarkable month. It is no surprise that eliminating it from the KTI greatly improves the hypothetical performance.

Examples of indicators that do not have enough historical instances are those based on the year of the decade. Superior performance of years ending in 5 has been written about by several authors, including Kaepfel. The first full decade using the Dow, which is the oldest index, is 1900-09, so counting 2000-09, which was not complete when the book was written, yields eleven instances. There are so many possible patterns that can be examined that finding a few that happened each decade is not meaningful. Kaepfel has three such effects in the KTI including one that only applies in even numbered decades (2000-09, 1980-89, ...) which has only six historical instances. Worse yet, he just presents the patterns without trying to give a reason of why we should expect them to keep happening, most likely because neither he nor anyone else has been able to figure one out that has any more meaning than the Super Bowl indicator.

Not surprisingly, the historical performance of the KTI, which he shows trading the Dow starting at the end of 1933² through 2007, is quite impressive. One type of research I enjoy is finding books and articles with “holy grail” trading methods and seeing how they have done out-of-sample, after the book or article appeared. There are valid and effective trading methods, and some have been written about, so perhaps KTI is another one. I would prefer to have more than three years beyond what the book shows to analyze, but in this case, it will be enough.

I use the S&P 500 for testing trading methods, and I start my analysis at the end of 1962 when

² Since the Dow in its current form of 30 stocks dates back to 1928, the obvious question is why not start then or even earlier when all one needs is a calendar to determine the buy and sell dates? Could it be that avoiding the Dow's losing almost 90% from its peak in 1929 to low in 1932 had something to do with that?

possible as it is for the KTI. The reason for starting then is that was as far back as I could find the data needed to analyze the stock index trading method I use for managing TAA accounts. For 1963-2007, using the KTI to trade the S&P yields impressive returns with very reasonable risk levels. It is clearly superior to the method I use in TAA accounts over that period. However, 2008, an election year that “should” have been a good one, is a very different story. Trading an S&P index fund such as the Vanguard Index 500 according to the KTI would have resulted in a loss of 33.8% for 2008 and a drawdown of over 50% from the peak in 2007 into March 2009. Both are a little better than buying and holding the index fund, but would be little comfort and likely quite shocking to an investor applying the KTI. By contrast, the model I use for TAA accounts would have hypothetically lost a little over two percent that year with a drawdown around ten percent. That model combines trend following indicators for stocks and interest rates.

Was 2008 an aberration? No, because trading it using the KTI would have greatly underperformed the index fund the next two years. 2009 was a great year for stocks, contrary to the typical presidential cycle, as the index fund moved ahead by 27.5% for the year after falling almost that much to the low in March. Trading according to the KTI would have produced a profit of a mere 2.5%. The maximum drawdown was a bit less, not quite 24%, but that would be scant compensation for the much lower return.

In 2010, the index fund gained 14.9%, so the first two years of the presidential cycle totally confounded those who adhere to it this time around. Following the KTI would have yielded a profit of only 2.2%. Like the prior year, the maximum drawdown was a little less than buy and hold, which was fairly modest. To illustrate the problem, as discussed above, the entire gains in stocks last year were obtained in the last four months of the year. There were 85 days the stock market was open in that period,

but the KTI would have been in the market for only 27 of them, less than a third of the time.

I applied the stock trend following indicator from the TAA model to the KTI. Doing so produced a method that greatly reduced KTI's drawdowns and improved its returns a little. Am I going to use this "improved KTI" to manage personal or client accounts? I am not. The reason is that the primary value comes from the stock trend component. I prefer to use interest rate trends rather than the calendar effects in conjunction with the stock trends because I know that interest rates reflect real economic factors while I can't say that for many of the indicators in the KTI. Additionally, keeping the trading model simple increases the chance it will work effectively in the future. Interest rate trends are much simpler than the KTI with its thirteen indicators.

One important lesson from the above is that trading stocks without incorporating a trend indicator is very dangerous. I have seen quite a few systems with impressive hypothetical performance that fail badly out-of-sample, as does KTI, because they are unable to avoid a severe drop in the market that is sufficiently different from any in the back testing period. While trend following is far from perfect, it does sidestep major declines in stock prices.

Another critical lesson is that hypothetical testing of trading methods is useful, but one should not use them with real money without some meaningful period of out-of-sample testing. There are effective trading models with excellent back tested results and effective real-time performance, so it is foolish to move to a new one based solely on hypothetical performance, no matter how impressive.