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THE MYTH OF BUY AND HOLD

What do the companies Radio Corporation of America (RCA), Cisco, General Motors (GM), Trans World Airlines (TWA), Admiral, and Pan American Airways (Pan Am), have in common? These are or were significant American, for the most part New York Stock Exchange listed, corporations that have, in years past, risen to and then fallen from grace. Shares of Cisco, for example, rose from a price of 4 in 1992 to 82 in early 2000 before falling back to 8 by the end of 2004. GM, once the granddaddy of all corporations and the largest employer in the country? Priced at 11 at the bottom of the great 1973–1974 bear market, GM recovered to a price of 94 at the start of 2000, before declining to 31 three years later, to lower still and near bankruptcy by the fourth quarter of 2005. Wal-Mart, with more than 1.1 million U.S. employees, has—of course—supplanted GM as the nation’s leading private employer.

RCA, a pioneer in home radios and radio communication during the 1920s, rose from a price of 11 in the mid-1920s to 114 by

September 1929 before plummeting to 3 in 1932. Admiral, a hot television issue in the 1960s, met a similar fate—and never did recover. TWA and Pan Am, once investor favorites, both failed to survive shakeouts in the airline industry. The drug industry has generally been regarded as one of the more consistent investment sectors for investors, but this has not prevented Merck's roller coaster ride from 6 to 72 and down to 28. Another major *M*, Merrill Lynch, has seen its price range from 6 to 91 and then back to 26, like Merck within just one decade.

Such ups and downs are not limited to individual securities. The NASDAQ Composite of more than 3,500 issues rose from a price level of approximately 230 in 1984 to 5133 in 2000, before falling to 1108 at the bear market low in 2002. Even the more venerable Standard & Poor's 500 Index has recently given up as much as 49.7%, declining from 1,527.46 (2000) to 768.63 (2002).

The point of all this is simply that, regardless of what Wall Street and the mutual fund industry would have you believe, there are considerable risks to buying and holding stocks, even for long-term investors, and especially for investors who may need to draw on their assets during periods in which the stock market is showing significant cyclical weakness (for example, during the 1930s, 1973–1974, and more recently, between 2000 and early 2005).

Moreover, buy and hold strategies, which actually worked well during the 1980s and 1990s, the two strongest back-to-back decades in history, are not as likely to work as well in the foreseeable future. The economist Paul Krugman, writing in *The New York Times*, February 1, 2005, observed that whereas annual economic growth in the United States averaged 3.4% over the previous 75 years, it is likely to average only 1.9% between 2005 and 2080. Inasmuch as the progress of stock prices tends to reflect economic growth, investors who limit themselves to just the U.S. stock market may be placing themselves in a position from which it will be difficult to achieve the rates of capital growth required for expenses later in life.

Variable Rates of Return from Stocks

Figure 1-1 illustrates the variability in the performance of the stock market over the 75-year period of 1930 through 2004.

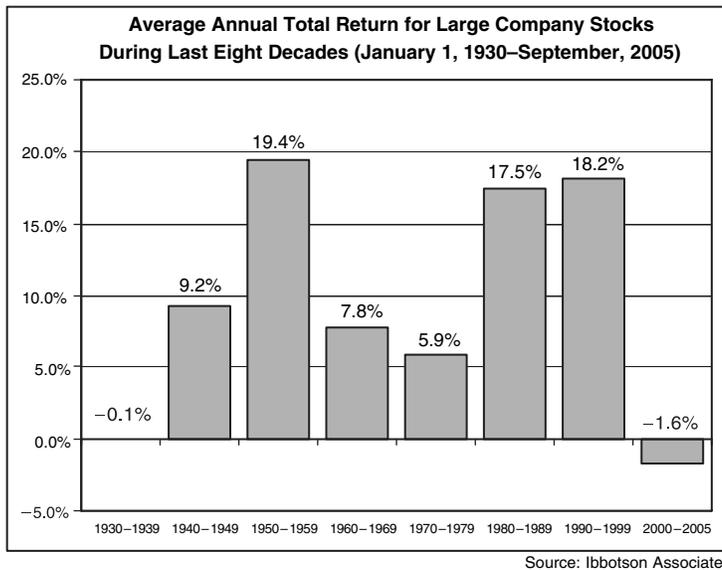


FIGURE 1-1 Strong decades tend to alternate with weaker investment decades.

As a general rule, rates of gain from stock ownership tend to fluctuate, decade by decade, with strong decades generally alternating with weaker decades. The favorable two-decade period from 1980 to 1999 was unusually long in this regard. The weakness between 2000 and 2005 represented the long period required by the stock market to readjust down to more normal valuations following the speculative excesses of the previous two decades.

Investor expectations of the stock market tend to follow rather than lead significant changes in the stock market climate. For example, if investors were “irrationally exuberant” during the 1920s (as Chairman Alan Greenspan of the Federal Reserve said they were during the 1990s), they became extremely cautious following the stock market crash of 1929—a caution fed by the great depression and by the fact that stocks did not do much more than break even

during the 1930s. Stocks were priced to reflect the general pessimism, with “riskier” stock dividend yields higher than prevailing bond interest payouts.

Investors remained cautious into the 1940s, which did show marked improvements in the behavior of the stock market, with annual rates of return from stocks increasing to 9.2% for the decade, roughly average for the stock market during the twentieth century, and increasing still further to 19.4% during the 1950s.

Such growth rates helped to foster more optimistic expectations of the stock market—this was the period of front-end, multiyear, mutual fund purchase contracts; high entry commissions into load mutual funds; and a dramatic increase in the number of American families holding shares. It should not have been surprising then that bear markets developed relatively early during the 1960s—a short but serious bear market during 1962, another during 1966, and another yet as the decade drew to a close. As a whole, however, stocks were profitable during the 1960s.

Stock market instability did extend from the start of a bear market at the end of 1968 into the 1970s, with an ongoing bear market ranging into May 1970 and stocks declining between 1973 and 1974 (and again in 1977). These periods favored stock “traders” as opposed to long-term stock investors. And then came those two glorious decades, the 1980s and the 1990s!

The confluence of developing technologies, the passing of the depression generation, the end of the cold war, economic growth, falling interest rates, and rising speculation resulted in consistently rising stock prices (only occasionally interrupted by intermediate market declines). These gains were fueled by increasing speculation and by a general belief that rising stock prices were going to be forever. By the peak of the bull market in 2000, stocks in the Standard & Poor’s 500 Index were, on average, yielding less than 1% in dividends and were selling at \$46 per share for every dollar of company profits and at nearly \$6 per share for every dollar of company assets—

all told, at the highest ratios of price to measures of actual share values since the early 1930s.

And then, in March 2000, reality returned.

Speculative Bubbles Are Often Followed by Years of Below-Average Investment Performance

The Japanese stock market has still not recovered following the market peak that developed between 1989 and 1990.

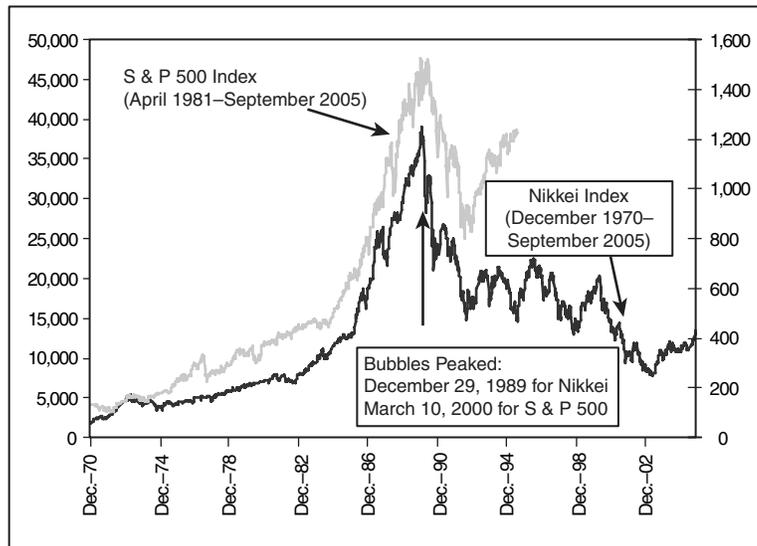


FIGURE 1-2 Fifteen years of underperformance following the peak of the Japanese bull market.

There have been numerous trading opportunities in the Japanese stock market since the peak of its speculative bubble as 1989 drew to a close, but longer-term investors have not had an easy time.

Figure 1-2 shows the Standard & Poor's 500 Index aligned below the Japanese Nikkei Index in such a way that their peaks and prepeak periods align. The similarity of these two markets is actually quite

striking. If the Standard & Poor's 500 Index were to follow the path of the Japanese stock market, a full market recovery would not get under way until at least 2010.

This would not be unusual. Gold reached a peak level of approximately \$800 an ounce during a final buying panic during the late winter of 1980. Prices remained below \$500 an ounce through most of 2005—a full 26 years after—before rising during the first four months of 2006 to above \$650 per ounce.

The Moral of the Story—Be a Flexible, Opportunistic Investor

Please forgive me if I have been belaboring the point, but so much of the “general wisdom” advises investors not to worry, to “stay the course,” to trust in stocks.

I believe that the stock market offers fine opportunity. So does the bond market. So do commodities markets. So do markets overseas, coins, stamps, watches, antiques, art, and real estate. Opportunities for favorable investment occur frequently in some investor areas, less frequently in others. The best opportunities usually develop when the majority of investors are the most cautious or indifferent. They occur less frequently when the universal majority is the most optimistic.

The moral is simple enough. You do not have to be an expert in every area of potential opportunity. Or even in most. Probably not even in many. But you should be sufficiently familiar with at least a sufficient number of investment markets to be able to maintain diversified, flexible portfolios in a variety of investment sectors. In the process, you should be familiar enough with the behavior of the various markets in which you invest to be able to create and maintain exit strategies for when the time comes to cash in your chips.

Growth Targets—“The Magic 20”

Pretty much everyone likes to accumulate as much capital as possible. Some, obviously, succeed more than others. Spending patterns vary from individual to individual, family to family, and often by geographic location. However, the majority of families manage well if they accumulate an amount of capital that amounts to 20 times the amount of annual expenses that they incur—the “magic 20.”

Why 20? Well, if you have 20 times as much capital as you spend each year, and you secure an annual rate of return on your investments of just 5% per year (generally achievable with minimum risk from instruments such as treasury bonds and the like), you will be able to maintain your ongoing living standard with minimal risk—at least for a relatively limited period of time (because a 5% rate of return is equivalent to one twentieth of your assets). It would, of course, be desirable to tack on something extra for the effects of inflation, at least until very late in life when you can allow your asset base to dwindle. It would be even more desirable if you could grow your assets after deductions for expenses, taxes, and inflation.

Inflation, incidentally, is no small matter. Money loses roughly one half its value every 16 years as a result of inflation. At age 60, Americans have an average life expectancy of approximately another 22 years. If you retire at 65, your retirement nest egg will be worth just about half its current value by the time you reach the age of 81. The income your assets produce, if they remain unchanged, will suffice to provide just about one half of the goods, services, travel, home expenses, and everything else that you could afford when you retired.

If we were to assume an average rate of inflation of 4% per year (actually higher than the past average) and an average tax bite of 20%, you would have to earn approximately 11.25% per year on your capital to make up for taxes and inflation if you require a true, inflation-adjusted 5% per annum stream of income.

Example

- \$1,000,000 asset base (required living expense income = \$50,000)
- You earn \$112,500 or 11.25% on your investments.
- Your tax bill comes to \$22,500 (20% of \$112,500).
- This leaves you with \$90,000 after taxes, of which \$50,000 is used for living expenses.
- You add the difference, \$40,000, (4% of your initial asset base) to your asset base to enlarge it to compensate for the 4% rate of inflation.

Looked at in this way, the “Magic 20” should be changed, perhaps, to something closer to the “Magic 40 or 45.”

Growth Target Zone

Well, perhaps it comes down to this. Those of us who happen to be rich enough might well be able to settle for rates of return in the order of 5%. Such a return will probably result in some depletion of assets over the years, but if we are old enough or rich enough or both, this depletion can be tolerated with little risk of running out of money before we run out of time.

Those of us who are not fortunate enough to be that rich, or who are fortunate enough to have a longer-than-expected life span, may have to plan on either reducing our standard of living over the years or, preferably, increasing our rate of return. This second alternative is not necessarily an easy matter, but we will set as a general goal the achievement of rates of return in the order of 11.25% or higher by the use of the timing and asset-allocation strategies that you will be learning.

In short, the “Magic 20” will become the “Hoped-For 45.”

Active as Opposed to Passive Management of Assets

The Wall Street establishment generally espouses the cause of passive investment management. Buy your favorite stocks or mutual funds or bonds, hold on through thick and thin, and hope that the stock and bonds markets are on upswings when you need the money. Not necessarily the worst of strategies—unless, of course, you happened to need to draw on your capital in mid-2002, at a time when stocks were more than 50%, on average, below their all-time peaks.

By the time you finish this book, you can be a successful active manager of your own investments and by so doing add to the returns available from the usual sources to passive investors. As an active manager, you will be able to do the following:

- Actively monitor the investment universe and select investment areas—and individual investments within those areas—likely to outperform the average investment of similar risk. In other words, you will have some idea as to when to emphasize bonds, stocks, gold, real estate, and international positions and when to opt for money market and other safe havens.
- You will have the ability to enter, and will enter, into investments relatively early in their rise and exit relatively close to their peak, either prior to or relatively soon after the final top is made. This does not mean that you have to be the first one in and the first one out. It does mean that you will be able to catch the major portion of up moves, while avoiding at least significant portions of the downswings that plague every investment at some time or other.
- And finally, you will be alert to special opportunities that develop from time to time in almost all investment areas and be able, ready, and willing to take advantage of such opportunities.

The benefits of active and successful management are self-evident.

Diversification—A Major Key to Successful Investing

If you do nothing else as part of your active management, you are likely to reduce risk considerably and probably even add to your returns by maintaining proper diversification in your investment account.

Diversification means allocating your investments in different areas so that your portfolio's various investment segments do not tend to rise and fall at the same time but instead, as a group, move more smoothly and with less volatility than any single investment alone. Mutual funds are popular because, to some extent, all mutual funds provide some element of diversification compared to the purchase of one or two single stocks and therefore involve less risk. You will learn more about diversification as you progress through this book. For now, let's just consider some ways in which you might diversify your portfolios.

Geographic Diversification in the Developing Global Economy

There have clearly been many changes in the balance of economies across the world. For years and years, the U.S. economy and, to a lesser extent, the economies of Europe were dominant in the world, reflected in the strength of the various stock and bond markets of the Western world. Japan eventually emerged, during the 1980s, as a major national success. The Japanese market soared into its own speculative bubble, which came to a conclusion at the end of 1989 and has not fully recovered since.

Figure 1-3 illustrates the significant shift that has taken place in the relative performance of the U.S.-based Standard & Poor's 500 Index and a cross-section of overseas stock markets as reflected in the EAFE Index.

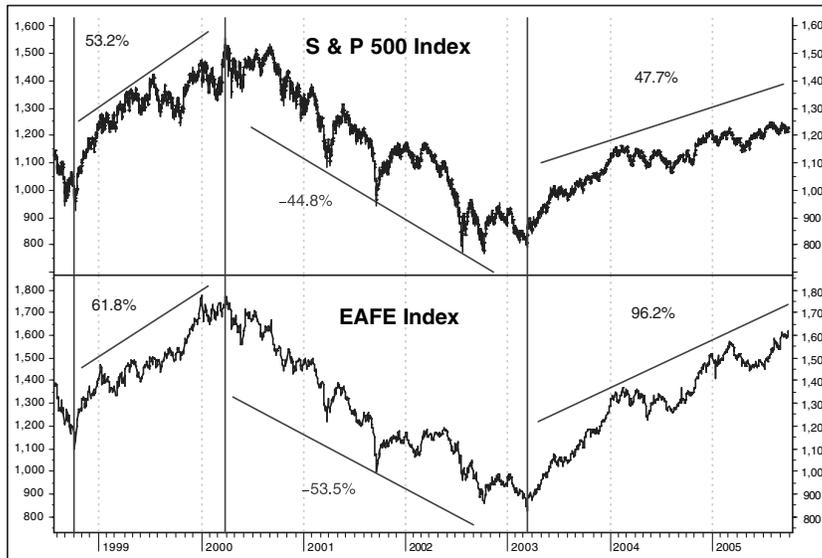


FIGURE 1-3 The Standard & Poor's 500 Index versus the EAFE Index, 1999–2005.

The U.S. market clearly led the EAFE (Europe, Australia, Far East) Index in its performance between 1995 and 1999, rising by 231% compared to 69% for the EAFE Index during this period. The performance of these two indices became more equal during the bear market, 2000–2002, with foreign markets clearly taking the lead in performance starting in 2003.

In recent years, particularly since 2002, economic strength has expanded from the United States to countries such as China (most obvious), India, New Zealand, Mexico, Brazil, and Australia (to name just a few). Whereas manufacturing nations led the world economically in the past, nations that provide the commodities needed by those manufacturing nations have risen more recently in relative

economic strength and power. As a result, the currency of New Zealand, which has a commodity-based economy, has become competitive over the years with the U.S. dollar. The New Zealand stock market, which generally lagged the American stock market in strength, has also, in recent years, become competitive with our own stock market, as have stock markets in many of the emerging nations previously mentioned.

Economic strength abroad relative to strength in the United States has been reflected in the relative strength of currencies as well as the relative strength of stock markets. The Canadian dollar, for example, has shown long-term strength superior to the long-term strength of the U.S. dollar. (We return to currency relationships when we consider investment opportunities in bonds issued by foreign countries.)

The moral of the story should be apparent enough. For decades, even though foreign stock markets did enjoy some periods in which they outperformed the U.S. stock markets, the name of the game was to buy American. This is no longer the case. The present strategy of choice is to keep track of stock markets across the world, identify the market leaders, and diversify at least a portion of your assets among the leading stock markets worldwide. You will learn how to do this and where you can readily find investment vehicles to employ.

Diversifying Geographically in Foreign Bond Markets as well as in Domestic Income Investments

In a similar vein, credit instruments issued by foreign governments often provide opportunities that are superior to domestic credit instruments. For example, at a time during 2004, when American 1-year Treasury notes were yielding approximately 2%, 1-year New Zealand Treasury notes, fully backed by the New Zealand government, were yielding in excess of 6% per year. There was virtually no

credit risk involved, although there were risks associated with currency relationships. Inasmuch as investors had to convert U.S. dollars into New Zealand dollars to make the purchase, and inasmuch as the investment remained denominated in New Zealand dollars, your income would be supplemented by currency gains if the New Zealand dollar continued to rise against the American dollar or would be offset by potential currency losses if the New Zealand dollar were to decline against the American dollar.

In effect, you were virtually guaranteed an extra 4% per year in interest income, and you might or might not improve this differential as a result of currency fluctuations. Given the weakness of the U.S. dollar at the time, the investment offered a double opportunity to aggressive income investors.

Many mutual funds—open-end as well as closed-end funds (funds traded on the various stock exchanges that have a fixed number of shares and that trade between existing shareholders and new shareholders)—provide access into foreign stock markets and into foreign income instruments. You will learn more about such funds throughout this book.

In the meantime, start to think globally. The diversification should reduce risk and, in many cases, will most likely improve opportunity and return, too.

Sector Diversification for Smoother Performance and Risk Reduction

Tables 1-1 and 1-2 illustrate the benefits of diversifying investment portfolios to include a variety of market sectors whose prices do not generally rise and fall simultaneously so that losses in some areas are generally offset by advances or by lesser loss elsewhere. The total portfolio, as a result, usually performs better than its parts taken separately.

TABLE 1-1 Nine Investment Classes*
Performance of Each Class of Investment Taken Separately
June 1980 through November 2004

Sector	Average Gain per Annum	Maximum Open Drawdown**
Financials	17.1%	-35.1%
Health Care	16.0	-39.6
Real Estate	13.1	-21.9
Utilities	11.6	-45.3
Dow Jones Transports	11.2	-45.5
Energy	9.1	-46.7
Gold/Precious Metals	5.0	-68.9
Lehman Aggregate Bonds	9.5	-9.0
Global Bond	9.3	-9.1
Average, All Sectors	11.3%	-35.7%
Average, Excluding Bonds	11.9%	-43.3%

* The above table represents the average performance of universes of mutual funds that designate investments in these areas as their primary objective. The Dow Jones Transports and the Lehman Aggregate Bond Index are the exception. They reflect the performance of these price indices, including in the Lehman Bond Index, interest payouts from bond holdings, and the price movement of bonds included in the index.

** "Maximum open drawdown" represents the largest decline in the value of investments in the above areas from a peak to a low point in value until new highs in equity value were achieved. This must be considered the minimum risk level of any investment because investors, during the period shown, did actually incur these levels of loss.

**TABLE 1-2 Nine Investment Classes—as in Table 1-1—Grouped into
One Portfolio**

Starting with an Equal Amount of Assets in Each
June 1980 through November 2004*

Equal Starting Amounts, Including Bond Sectors, No Rebalancing	
Average Gain per Annum for Total Portfolio	12.6%
Maximum Open Drawdown	-22.4%
Equal Starting Amounts, Excluding Bond Sectors, No Rebalancing	
Average Gain per Annum for Total Portfolio	13.2%
Maximum Open Drawdown	-26.2%

Equal Starting Amounts, Including Bond Sectors.**Equalize Sector Assets at Start of Each Year, Including Bond Sectors**

Average Gain per Annum for Total Portfolio	12.3%
Maximum Open Drawdown	-19.7%

Equal Starting Amounts, Excluding Bond Sectors.**Equalize Sector Assets at Start of Each Year**

Average Gain per Annum for Total Portfolio	13.0%
Maximum Open Drawdown	-24.2%

- ° In portfolios that are not rebalanced, it is presumed that assets were equally divided at the onset of the study period (1980) and from that time forward assets were neither added to nor removed from any segment of the portfolio. At the end of the study period, then, some market sectors had increased in their proportionate size; some had decreased.

In the portfolios that were equalized at the end of each year, assets were redistributed at the start of the new year so that each sector started once again with the same-size portfolio.

Points of Special Interest

- Sectors, taken by themselves, produced an average annual rate of gain of 11.9% (no bonds) and 11.3% (with the two bond sectors). Maximum drawdowns were -43.3% (no bonds) and -35.7% (with bonds), respectively, for the average sector. The inclusion of bonds in the portfolio reduced the average rate of return from 11.9% to 11.3%, reduced the average maximum risk from -43.3% to -35.7% (a fair enough risk/reward tradeoff).
- A portfolio of the above sectors, invested as a portfolio, produced an average annual gain of 13.2% (no bonds) and 12.6% (with the two bond sectors). Maximum drawdowns were -26.2% and -22.4%, respectively. This portfolio was not rebalanced at any time. The inclusion of bonds in the portfolio reduced both average rates of return and risk.
- A portfolio of the above sectors, invested as a portfolio, assets rebalanced so as to start each year equally, produced an average annual gain of 13.0% (no bonds) and 12.3% (with two bond sectors). Maximum drawdowns were -24.2% and -19.7%, respectively.

- Rebalancing portfolios at the start of each year smoothed out performance to some degree—reducing both the average rate of returns and the maximum risks associated with investing in diversified portfolios.

This study illustrates the benefits of diversification. Rates of return generally show moderate rates of improvement. Risk levels generally improve significantly.

We return to issues regarding diversification, including additional ideas for portfolio structure, in Chapter 2, “Putting Together a Winning Portfolio.”

Income Investing—Time Diversification

You will learn more about income investing along the way, particularly in Chapter 4, “Income Investing—Safer and Steady . . . But Watch Out for the Pitfalls,” so at this time we limit the area of income investment diversification to issues involving time diversification in the establishment of a bond portfolio.

As a general rule—not always—the more distant the maturity of a bond (the date when the loan signified by the bond is due to be paid to bondholders), all else being equal, the higher the interest return you will receive as an investor. This should not be surprising. A bond represents a loan by the bondholder to the bond issuer, who is the borrower. A loan that is to be repaid in, say, 20 years, carries many more risks than a loan that is to be repaid in 20 days. Such risks include potential inflation over the life of the loan—the greater the inflation, the less will be the value of the repayment in today’s dollar purchasing power, the higher will be prevailing interest rates in the future, and the lower will be the face as well as the real value of the bonds you own. There are also risks associated with the solvency of

the borrower. (Who would have thought in 1985 that in 2005 bonds issued by General Motors would be down rated to junk status?)

Investors, therefore, must decide between the benefits of receiving higher rates of return from longer-term bond investments and the additional risks involved. As a general rule, it is probably better to purchase intermediate bonds—bonds whose maturities lie, say, between five and seven years—than to purchase longer-term bonds. Intermediate-term bonds pay approximately 80% to 85% the rate of interest of long-term bonds but are considerably more stable in price. For example, in mid-April 2005, 5-year Treasury notes provided yields of 4.13%, whereas 20-year bonds provided yields of 4.87%. The 5-year note's interest payments were as much as 84.8% the size of the 20-year bond, even though the implied loan was for only 25% the length of time.

Creating a Bond Time Ladder

It is possible for ongoing bond investors to gradually develop a portfolio that ultimately secures yields associated with longer-term bonds although the actual holdings of the portfolio are, on average, more intermediate term in nature. The strategy, which reduces many of the risks associated with bond investment, works like this.

Suppose that interest returns from U.S. government bonds, trading at par (face value), are spread so that 2-year Treasury notes are paying 3.7%; 4-year notes are paying 4.0%; 6-year notes are paying 4.2%; 8-year notes are paying 4.4%; and 10-year notes are paying 4.6%. These were rates actually available during the spring of 2005. You are attracted by the higher yields of the 10-year notes but believe that risks in the bond markets may be high and that it might be more prudent to concentrate your portfolio in the shortest-term area, the 2-year note. However, you would prefer returns that are greater than 3.7%. The issue might be resolved by the creation of a bond ladder.

Your bond ladder, in this case, might consist of the following:

20% of assets are placed into 2-year notes, yielding 3.7%.

20% of assets are placed into 4-year notes, yielding 4.0%.

20% of assets are placed into 6-year notes, yielding 4.2%.

20% of assets are placed into 8-year notes, yielding 4.4%.

20% of assets are placed into 10-year notes, yielding 4.6%.

The average yield for the entire portfolio comes to 4.18%. The average maturity is 6 years.

Year-by-Year Management of the Bond Ladder

You have established a portfolio that provides considerable safety, because of the time diversification that is built in to it. Suppose, for example, that interest rates rise during the first 2 years of ownership. Well, at the end of 2 years, your first set of notes will mature. The original 4-year notes now have 2 years of life left; the original set of 6-year notes now have 4 years of life left in them. The original 10-year notes now have 8 years of life remaining. You redeem your original 2-year notes—now matured, ready to be paid off—and use the proceeds to buy new 10-year bonds. Because interest rates have been rising, you will be able to reinvest to secure higher rates of interest for your new investment than were available when you first established your ladder.

If rates had declined instead, your total portfolio would have increased in value, reflecting the reduction in general interest rates, while you were receiving the higher levels of interest rates that prevailed when you first established the ladder.

Every 2 years, you cash in bonds due for redemption, for which you receive their face value, reinvesting in the new longest-term bonds that are coming out. Gradually, your original 10-year notes

become 2-year notes, carrying minimum risk but paying a rate of return more typical of longer-term bonds.

If we assume that at the end of 10 years interest rates stand where they stood when you first established your ladder, your entire portfolio will be yielding 4.6%, the rate paid by the original 10-year note. However, the average maturity of your holdings will have become 6 years. If you go forward, maintaining the bond ladder, your portfolio will continue to produce rates of return associated with longer-term bonds, while it carries risks more associated with intermediate-term bonds.

This is not necessarily the most exciting of investment strategies, but it is a strategy that is relatively simple to follow (certainly so with the help of your brokerage bond department) and is excellent for conservative income investing.

Increasing Returns from the Stock Market while Reducing Risk

The strategies discussed so far relate only to the structuring of more efficient investment portfolios (and particularly to the benefits of various forms of diversification). We have not, as yet, even considered strategies associated with stock market timing, the attempt at least to make investments at the most appropriate periods in the investment cycle: to buy near market lows or at least relatively early in price uptrends and to sell near market highs or at least relatively early in price downtrends.

Successful market timing, like well-considered diversification, can help you to both increase returns from your investments and to reduce risks associated with buy and hold investments. If you are a typical investor, you are probably better off avoiding short-term trading, which places heavy demands on time, increases investment expenses, and which has become generally more difficult in recent years.

Useful Market Mood Indicators That You Can Maintain and Use in Just a Few Minutes Each Week

Market mood indicators are indicators that can help you identify the general outlook for the stock and bond markets—whether credit conditions, public psychology, and the behavior of the stock market itself are suggesting a generally favorable or a generally unfavorable outlook for stocks and bonds. Mood indicators do not provide precise entry and exit points into the stock market but do provide guidance as to how fully you may want to be invested and/or whether you want to emphasize aggressive or more conservative positions in your investment portfolios.

Illustrations of Mood Indicators

Public Psychology Mood Indicator

Probably the best mood indicator of all is the general mood of the investing public and particularly of the financial media. Reflections of public and media investment psychology should be approached in a contrary manner. The more bullish the general public, and especially the more bullish the articles appearing in magazines and newspapers, the closer we likely are to a significant market peak. Conversely, the most bearish articles regarding the stock market tend to appear on the front pages of newspapers *after* the stock market has undergone some serious decline, fairly close to the times that such declines are likely to come to a conclusion.

You can often secure an informal feel for public sentiment from conversations with your friends, family, and acquaintances. The more people who want to tell you how much money they have made and how smart they have been—it is very easy to confuse a rising stock market with being smart—the more likely that trouble is lurking on

the horizon. Conversely, the more people hate stocks, the more fearful they are, the more likely are prospects for a market recovery. (Bad as public timing can be, the media is probably worse.)

Your emotional task, of course, is to avoid being swayed by the crowd and by the appealing newspaper and magazine crews and to be prepared to travel a more lonely, independent, and probably more profitable path to your own rather than the public drummer.

Interest Rate Indicators

As a general rule—not always—stocks tend to perform better during periods of declining interest rates compared to periods of rising interest rates.

It is often worthwhile to follow announcements and commentary from the Federal Reserve Board, which has the ability to control short-term interest rates directly and usually longer-term rates indirectly. In past times, two or three consecutive interest rate reductions by the Fed without intervening actions to increase rates would suffice to end bear markets, and two or three consecutive interest rate increases would suffice to end bull markets. In recent years, market responses to patterns of action by the Fed have taken longer to develop. The 2000–2002 bear market did not come to an end until the Fed reduced short-term rates 12 times in succession. The ensuing bull market did not seriously falter until seven consecutive rate increases were fostered by the Fed.

Significant actions by the Fed—which can include raising or lowering discount rates, setting maximum margin levels, and/or changing the federal funds rate—are reported in financial media such as the *Barron's Financial Weekly*. Television programs that concentrate on financial news report frequently on news releases from the Federal Reserve Board.

Seasonal Mood Indicators

The stock market tends to perform best between the start of November and the end of April, when almost all net gains for stocks take place. The period between May and October tends to do little better than breaking even on balance. The market also tends to perform best during the years immediately prior to years of presidential elections (for example, 1991, 1995, 1999, and 2003), well during the years of presidential elections, and worst during the two years following presidential elections. This pattern seems to be holding as we move into the twenty-first century. Stocks did very well in 1999 (year prior to election), topped a little early in 2000 (year of election), fell badly in 2001 and 2002 (years following election), and then recovered very strongly in 2003 (best year of cycle, year prior to the 2004 election).

These two seasonal indicators—best six months of the year and the presidential market cycle—have actually had a strong history of accurate past performance.

A Great Market Mood Indicator: The NASDAQ/NYSE Index Relative Strength Indicator

The oldest and most established trading exchange in the United States is the New York Stock Exchange, home to most of the largest corporations in the country. The American Stock Exchange lists somewhat smaller companies and has not been nearly as influential as the New York Stock Exchange. The NASDAQ Composite Index, home to over-the-counter rather than exchange-traded securities, used to be thought of as the home of small, emerging, and more speculative companies. This is still the case to some degree, but in recent years many companies listed on NASDAQ—such as Intel, Cisco, e-Bay, Yahoo!, Microsoft, and even Starbucks—have grown to be among the most prosperous of market leaders and technical innovators.

The NASDAQ Composite, like the New York Stock Exchange Index and the Standard & Poor's 500 Index, is weighted by capitalization. Larger companies are given more weight in the index than smaller companies. In fact, in April 2005, the five largest companies on NASDAQ—Microsoft, QUALCOMM, Intel, Apple Computer, and Cisco—represented 25% of the NASDAQ Composite Index. There were, at the time, approximately 3,500 issues listed on both the NASDAQ Composite Index and the New York Stock Exchange, with trading volume more or less equal on both exchanges, increasing on NASDAQ in recent years so that on most days trading volume there exceeds volume on the New York Exchange.

Relationships of Price Movements on NASDAQ and the New York Stock Exchange

Stocks on NASDAQ tend to move more rapidly than stocks on the more conservatively oriented New York Stock Exchange, so the NASDAQ Composite itself is approximately usually 125% to 150% as volatile as indices such as the Standard & Poor's 500 Index. Given this higher volatility, it is not surprising that the NASDAQ Composite often (not always) rises more rapidly than the New York Stock Exchange Index (a weighted average of all stocks on the New York Stock Exchange) when stocks are favorably trended and falls more rapidly during less-positive periods.

In addition, when investors are most optimistic, they are more likely to invest in speculative areas. When investors are most negative, they tend to turn to more defensive and conservative stocks.

For whatever the reasons—and there may be many—the stock market has tended to perform better when the NASDAQ Composite is leading the New York Stock Exchange Index in relative strength and to perform less well when the New York Stock

Exchange is leading in strength. It is not only the NASDAQ Composite that performs best when the NASDAQ is leading in relative strength; the New York Stock Exchange Index produces improved profit/loss relationships during such periods, too. Figure 1-4 illustrates these observations.

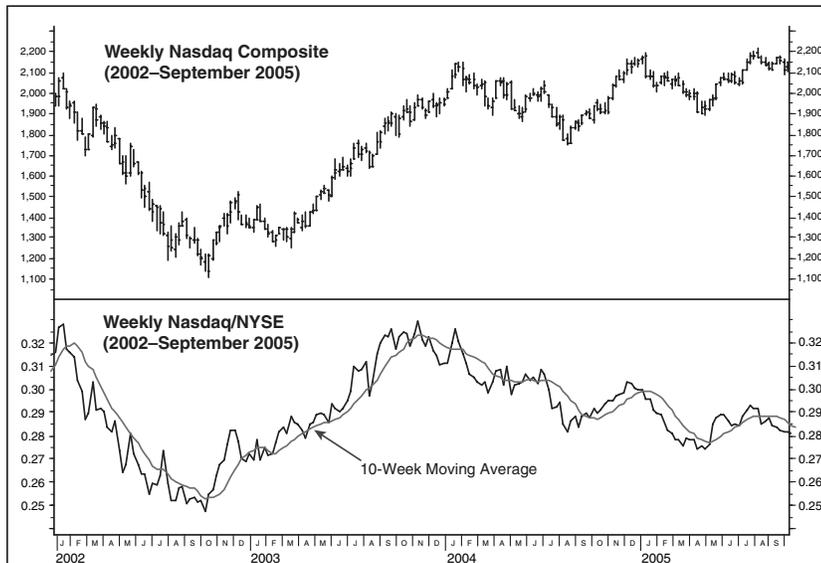


FIGURE 1-4 The NASDAQ Composite/New York Stock Exchange relative strength indicator, 2002–September 2005.

The price movements of both the NASDAQ Composite and the New York Stock Exchange Index have tended to show rising prices during periods that the NASDAQ Composite leads the New York Stock Exchange in strength and to decline when the relative strength indicator suggests that NASDAQ is the weaker market sector.

The stock market does not necessarily decline in price when the New York Stock Exchange Index leads the NASDAQ in relative strength. There are times when stocks advance, nonetheless. However, on balance, net gains take place when NASDAQ leads, again not just in NASDAQ but in other market sectors, too.

The NASDAQ/New York Stock Exchange relative strength indicator is designed to help investors identify in an objective manner

periods in which NASDAQ is leading in strength (and therefore periods when the stock market is most likely to succeed).

How to Identify Periods When NASDAQ Is the Stronger Market Area

The steps involved have to be taken only once each week, after the close of the final trading session of the week. The entire process should take just a few minutes. Signals, created at these times, carry for the entire week following, until the next calculation takes place. Here are the procedures involved:

1. Secure at the end of each week the closing levels of the NASDAQ Composite and the New York Stock Exchange Index. These are readily available in *Barron's*, in the financial pages of virtually any major newspaper, and on almost any Web site relating to the stock market.
2. Divide the weekly closing level of the NASDAQ Composite by the closing level of the New York Stock Exchange Index to secure a weekly NASDAQ/NYSE Index relative strength ratio. For example, on April 22, 2005, the NASDAQ Composite closed at 1932.10, and the New York Stock Exchange Index closed at 7015.85. The weekly ratio, therefore, stood at .2754. ($1932.10 \text{ divided by } 7015.85 = .2754$.)
3. Each week, calculate the average of the most recent 10 weekly ratios that you have calculated, as per Step 2. To do this, you add the most recent 10 weekly ratios and divide the total by 10. On the eleventh week, you drop the furthest week back so that you are always totaling and then averaging the most recent 10 weeks in your calculation. This is called a moving average.

Weekly ratios will increase if NASDAQ is rising more rapidly than the New York Stock Exchange Index. They will decrease if NASDAQ loses strength in relationship to the New York Stock Exchange Index.

4. Compare the most recent reading of the NASDAQ/NYSE Index relative strength ratio to its 10-week moving average. If the weekly relative strength ratio is greater than its 10-week moving average (for example, if the latest weekly ratio stands at .2750 and the 10-week moving average is .2746), consider the NASDAQ to be leading the New York Stock Exchange Index in relative strength. This will usually carry positive implications for the stock market. If the weekly relative strength ratio is below its 10-week moving average (for example, the ratio is .2745 and the 10-week average is .2750), consider the NYSE Index to be the stronger market area. This does not necessarily carry bearish implications but does indicate that the most favorable market climate, at least based on this indicator, is probably not in effect.

The following tabulations in Table 1-3 are hypothetical, based on retroactive research employing the parameters set forth above, and do not represent real-time performance for the entire period. The presumption is that investors would be invested in stocks only during favorable market periods (weekly NASDAQ/NYSE Index ratio above its 10-week moving average) and would be in cash at other times. No allowance is being made for commission and other transaction expenses or for tax consequences. Nor is any allowance being made for interest returns while in cash or for dividend payouts while in stocks.

TABLE 1-3 A 34-Year Historical Performance Record of the NASDAQ/NYSE Index Relative Strength Indicator, February 1971–April 2005*

Performance of the NASDAQ Composite Index		
Buy and Hold	Average Gain per Annum	8.98%
	Maximum Open Drawdown	-77.42%
	Invested 100% of time	
Trading By The NASDAQ/NYSE Index Relative Strength Indicator		
	Average Gain per Annum	11.28%
	Percentage of Time Invested	-54.6%
	Rate of Return While Invested	20.65%
	Number of Round-Trip Trades	-141 (4.1 per year)
	Maximum Open Drawdown	-39.72%
For the New York Stock Exchange Index		
Buy and Hold	Average Gain per Annum	7.60%
	Maximum Open Drawdown	-49.78%
	Invested 100% of time	
Trading By the NASDAQ/NYSE Index Relative Strength Indicator		
	Average Gain per Annum	7.59%
	Percentage of Time Invested	-54.6%
	Rate of Return While Invested	13.9%
	Number of Round Trip Trades	-141 (4.1 per year)
	Maximum Open Drawdown	-23.72%

* The employment of the NASDAQ/NYSE Index relative strength indicator, even as a sole determinant for stock market investment, would have improved both rates of return while invested as well as risk levels for the NASDAQ Composite, more than doubling rates of return achieved while investor capital was at risk in stock portfolios that replicated on a buy and hold basis the performance of the NASDAQ Composite Index. No credit has been given for income received while in cash.

The performance of the NYSE Index improved, too. This index produced almost identical returns when invested all the time as it did when it was invested only when the NASDAQ/NYSE timing indicator was favorable. However, rates of return while invested were clearly superior during periods that this model was favorable (+13.9% rate of return versus +7.59% for buy and hold). Risk levels were lower, too (-23.72% versus -49.78%).

No allowance has been made for trading expenses, but these would almost certainly be offset by additional interest earned while in cash positions.

General Suggestions

Although the NASDAQ/NYSE Index relative strength indicator has been quite useful, and may be beneficially employed by investors who want to spend just a minimum of time in tracking the stock market, you will be learning other, somewhat more time-consuming, timing models that have been more efficient in the past when tracked in a very formal manner.

The NASDAQ/NYSE Index relative strength indicator is a fine “mood indicator,” an indicator that reflects general levels of investor optimism and speculative interest (which usually favor stocks when they are high, if not too exuberant). Although the indicator does have its formal parameters, you might want to also evaluate trends. Is the indicator showing increasing or decreasing strength in NASDAQ versus the NYSE Index, even if no moving average reversal crossings have taken place? Does a crossing of the moving average by the weekly ratio seem imminent? Favorable buying junctures frequently take place when the NASDAQ Composite has been lagging the NYSE Index in relative strength but is showing signs of catching up. You probably have the idea by now.

We return to the matter of market timing in due course. Let’s move along at this time to the creation of efficient investment portfolios.