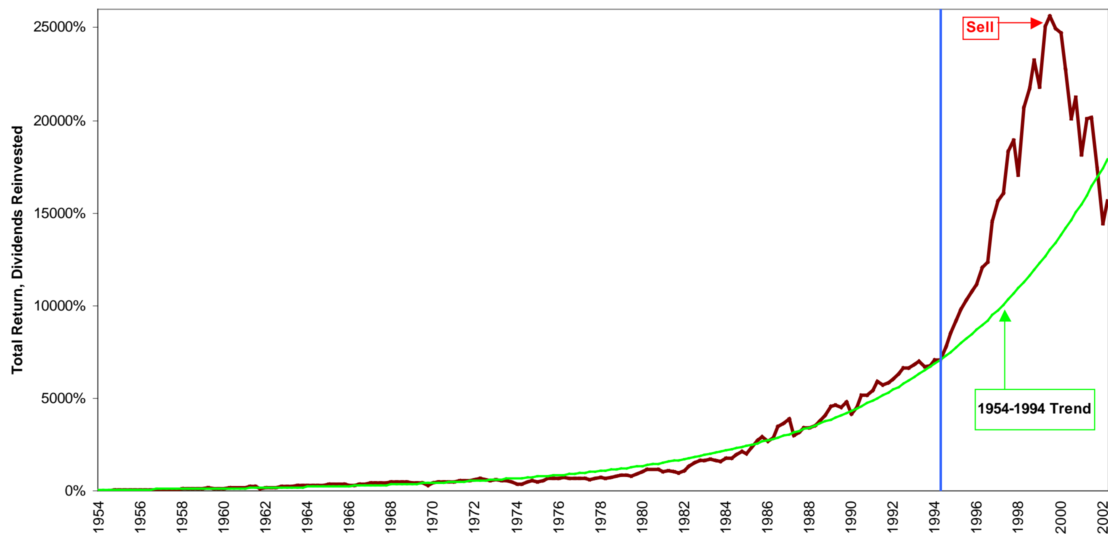
# Everything You Know Is (Still) Wrong

*"There comes a time in the affairs of man when he must take the bull by the tail and face the situation" -- W.C. Fields*

W.C. Fields was a misogynist, an inebriate and a tireless deprecator of all things Philadelphia, so no one could ever accuse him of misplaced priorities. History is silent on his record as a trader, but from the quotation above we can infer he had a keen grip of the obvious and therefore would have been quite puzzled at the way modern investors have rejected the two-trade stock market.

Two-trade market? Yes: In this author's lifetime, which extends back into the early days of the Eisenhower administration, you should have bought the S&P 500 at any time prior to March of 2000 and sold it at any time thereafter. You did not need fancy quantitative indicators, charts, graphs, fundamental analyses, technical analyses, modern portfolio theory, dividend discount models, earnings estimates, indexation, risk premia, arbitrage pricing theorems, global diversification or any other tommyrot.

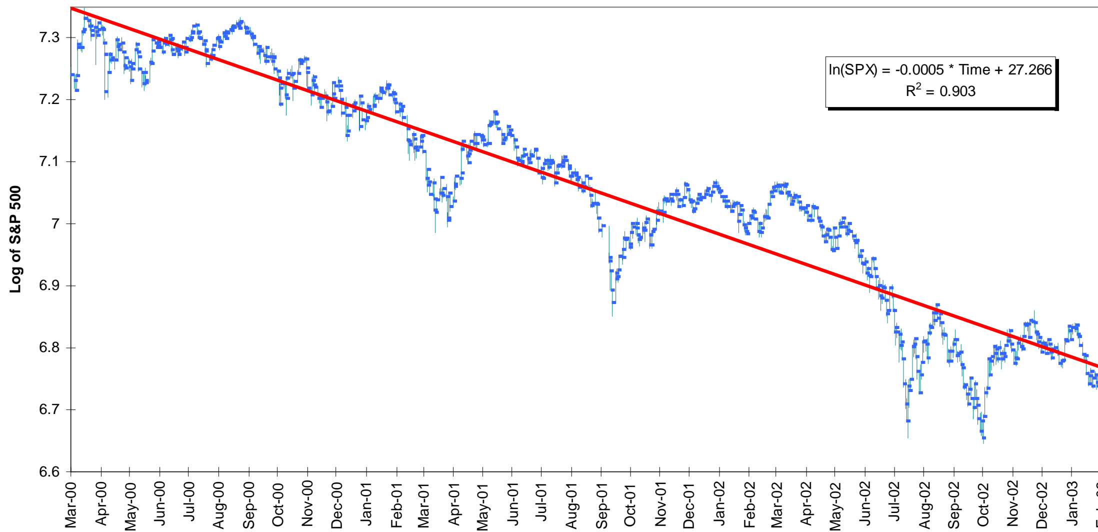



The long-term trend of total return, here calculated with dividends reinvested in the index and without adjusting for taxes or inflation, held pretty well from 1954 to 1994. The late 1990s bubble is strikingly apparent in this depiction; no one reading these pages should expect its reappearance within their lifetimes. The abrupt reversal in March 2000 has extended below the previous trendline, and there is nothing yet to suggest this somehow represents a bargain in equities.

What did you need, then and now, to ride this two-trade market? Just a ruler, just a ruler: As we noted several years ago in this space (see "Everything You Know Is Wrong," *Futures*, August 1999) you simply could have laid a ruler on a semi-logarithmic chart of the S&P 500 and produced a trading system that returned .09% per day over the November 1994 – June 1999 period and explained a stunning 98.2% of the index' growth rate over that period.

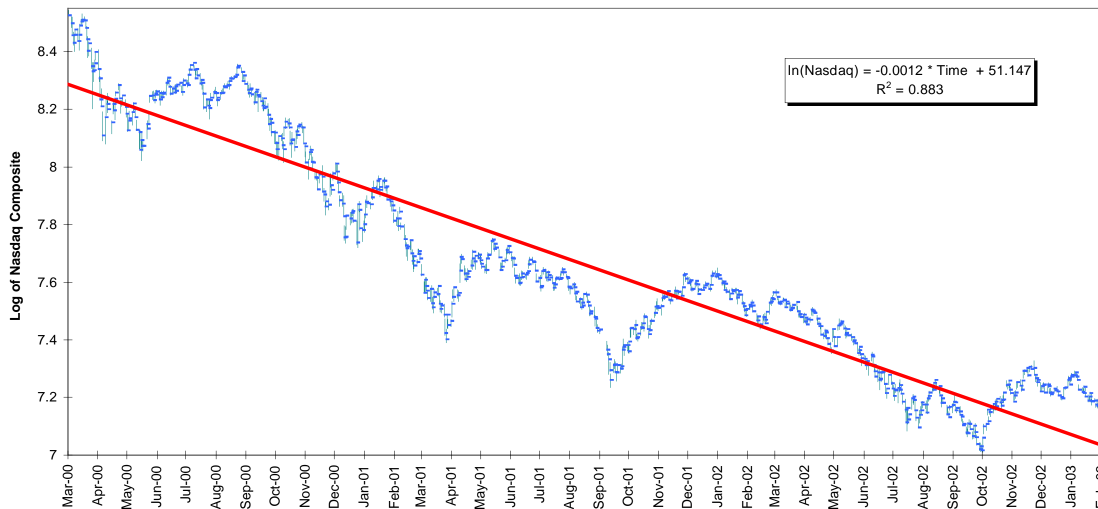
Let's whip out that straightedge once again and see how well it explained the market's unraveling since March 2000. Not quite as well as it did for the market's moonshot rally, but better than nearly all Wall Street prognosticators, present company included, had forecast. The index has bled at a rate of .05% per trading day, and the simple time variable alone explains 90.3% of the index's variance.

**A Straight Line Has Done Fine (Again)**




The Nasdaq, per usual, made it to the downside with a little more enthusiasm than did its larger cousin. It shed, on average, .12% of its value per trading day in the 35 months following its peak.

**A Very Slippery Slope**




## The Toughest Trade

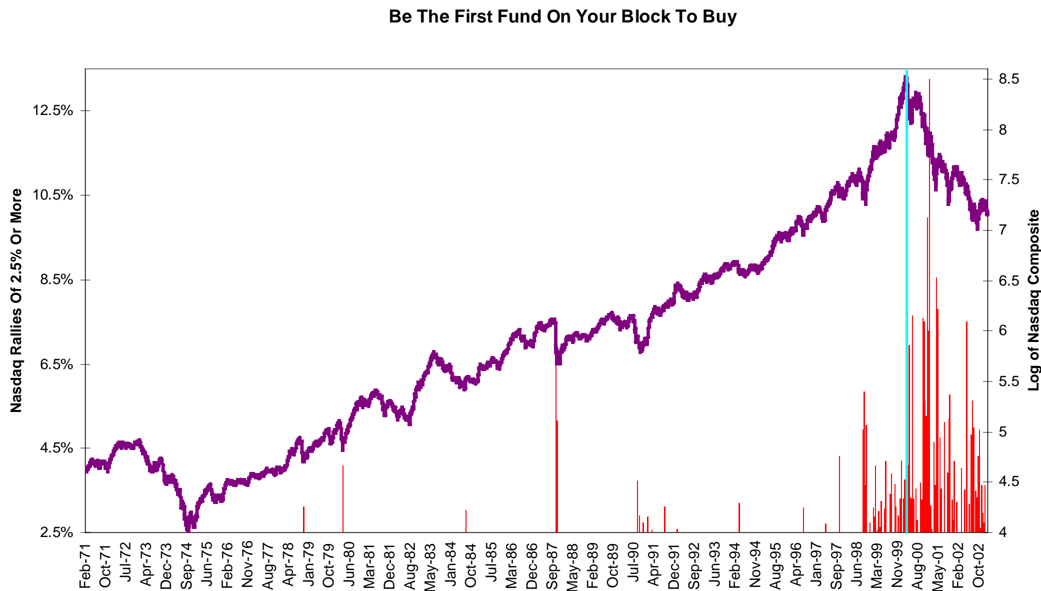
Despite all of the time and computing resources devoted to developing trend-following systems, simply staying with a long-term trend is the toughest trade in the same way that the toughest ball to catch in baseball is one hit directly at you. Several years ago, when Microsoft was still in its glory days, a front-page profile appeared in *The Wall Street Journal* about a fellow who had held it since it went public and now had substantial net worth on paper. The trade is that tough: Stay with a long-term trend, and you are national news.

The urge to reject a long-term downtrend in equities is extreme. It is so easy to articulate, “Sun Microsystems (or whatever) used to be at $60, now it is at $3.00, so it must be a bargain.” No, it is difficult to bounce back after a disemboweling; second acts are as rare in stocks as Fitzgerald said they were in American lives.

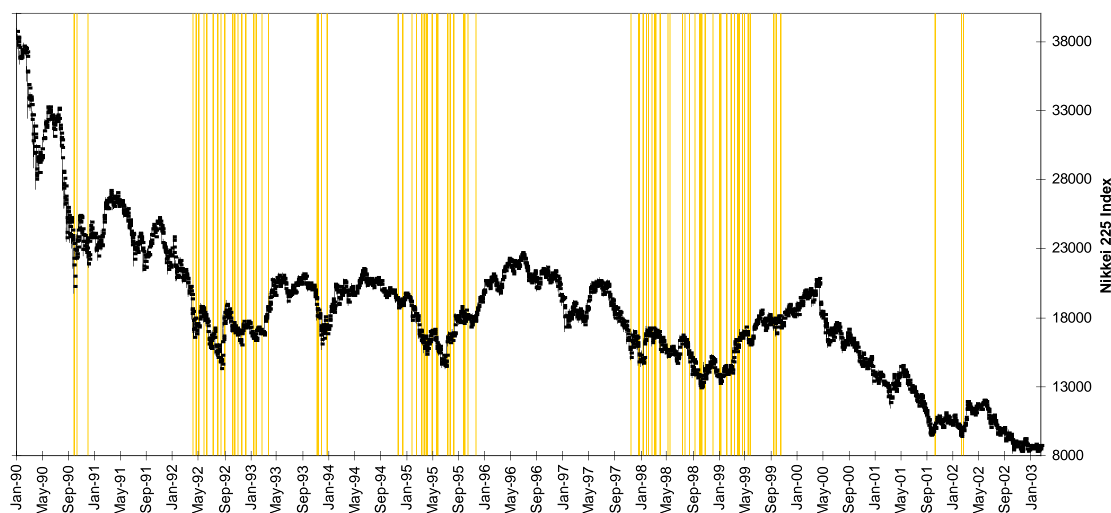
However, the rewards for buying at a perceived low price can be extreme, and since numerous large buyers exist in stocks for whom the question is not whether to buy at all, but simply what to buy and when, it does not take much to

create a buying stampede. Those very sharp rallies within a bear market stand as evidence that more managers are concerned about missing the start of the next rally than in protecting their customers' assets.

Nowhere is this process more visible than in the highly volatile Nasdaq Composite. Between its inception in February 1972 and its March 10, 2000 peak, the Nasdaq saw 69 daily rallies of 2.5% or more, or 0.94% of the trading days. Since it came unglued, there have been 97 such rallies accounting for 13.2% of the trading days.




To be fair, this is a global process as well as an American one. The Nikkei 225 has been in a bear market since the start of 1990; let's see how many times it put in an apparent spike bottom (a "bullish hammer" in Japanese candlestick parlance, if they use Japanese candlesticks in Japan) since the nightmare began. In a measure to be credited to Peter Borish in concept if not calculation, we can calculate the number of "hand" reversals ($L_{t-2}>L_{t-1}>L_{t0}<L_{t1}<L_{t2}$) followed by subsequent rallies of 20% or more.




These reversals clearly are clustered in time in 1992, 1995 and 1998-1999, and there are an astonishing 81 of them out of 3,234 trading days. None yet have occurred in the new millennium, which is indicative of the long-term slough of despond a market can enter. At some point the Nikkei will represent good value; the question will be if

anyone who has tried their hand at buying it will still be solvent or will care anymore. The time to buy is when there is blood in the streets, but it needs to be someone else's, not yours.

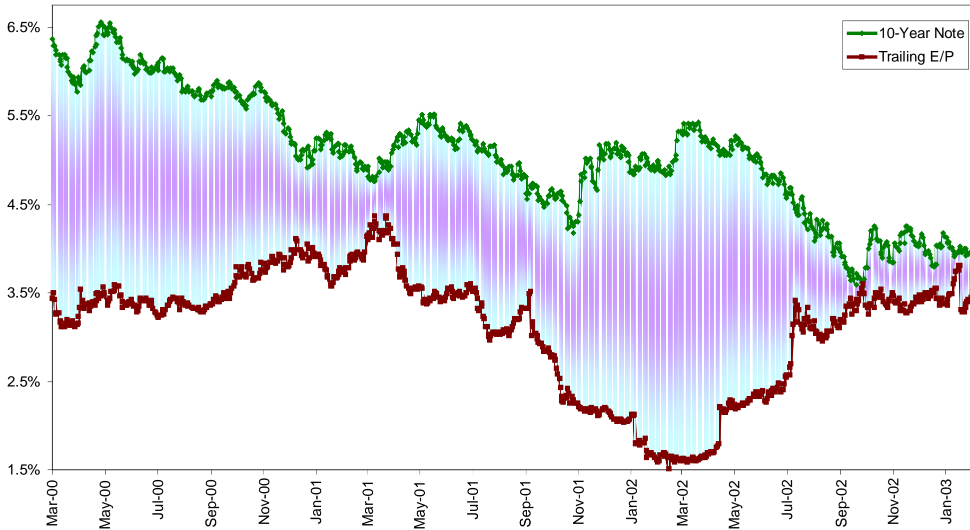
**Candles In The Wind**

While we are on the subject of candlesticks, a generally useful way of organizing price information, let's see how many times the S&P 500 ignored bullish engulfing patterns on the way down. A bullish engulfing pattern is here defined as the combination of yesterday's close being less than the open, today's close being greater than the open, today's low being less than yesterday's open and today's high being greater than yesterday's close. The chart below depicts each occurrence with a small tick at the bottom. If the chart looks a little crowded, it should: No less than 26.36% of the trading days in 35 months of the worst bear market since the Great Depression were bullish engulfments.

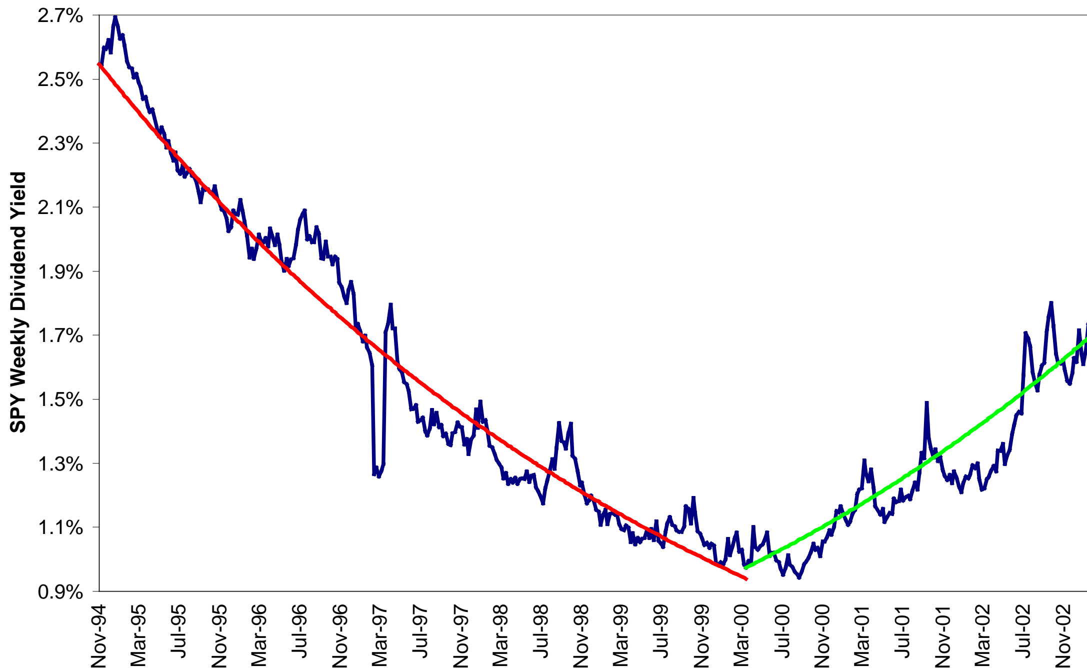
**Engulf This: Failed Bullish Engulfing Patterns**

**Risk Acceptance**

A common way of assessing whether a stock market is at value is to compare its expected price-to-earnings ratio to the risk-free rate; since a bond's yield is an earnings-to-price ratio, we can invert the stock index P/E. Unfortunately, there is no historic time series of what the market's expected P/E ratio was, just its trailing P/E. A wide gap between bond yields and stock E/P's is a sign of – dare we say? – irrational exuberance. Incredibly, this gap widened two years into the bear market. While it has since narrowed considerably, indicating some measure of rationality, the narrow gap seen in early 2003 is an artifact of an outflow from equities driving bond yields lower. We cannot say that stocks are valued more rationally because investors are fleeing them for a competing asset unless we and no one else knew earnings were about to grow rapidly.



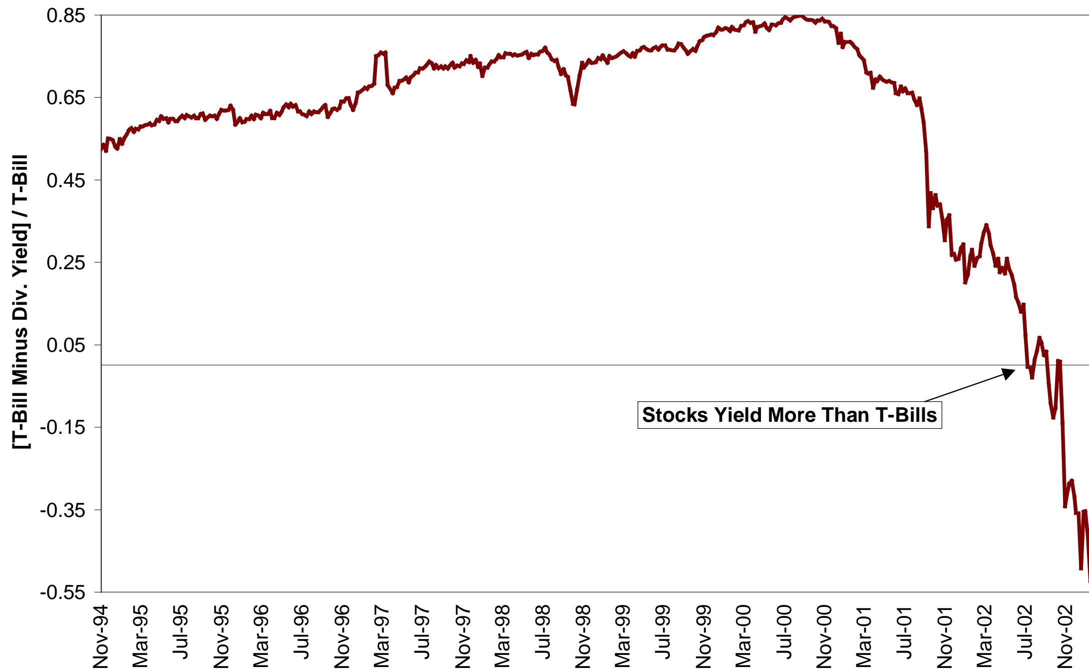

**What About Dividends?**
Dividends were scorned in the bull market for a number of reasons (see "Let's Go Do The Swap," *Futures*, March 2003 or "The Payoff From Payouts," *Futures*, May 2003). There are two ways to increase a dividend yield: Raise the actual dividend payout or lower the index' value. Both forces have been in operation since March 2000, and the result has been a marked reversal of the dividend yield trend for the S&P 500, represented here by the SPDR exchange-treaded fund.




Regardless of the ultimate disposition of the Bush administration's tax proposals, investors are likely to demand a higher dividend payout going forward so they may capture a greater percentage of the total return from equities in

cash rather than in at-risk price appreciation. This will serve, all else held equal, to lower future index price increases and keep the overall index levels under pressure.

Dividend payout preferences can change very quickly and dramatically. We can compare the dividend yield on the S&P 500 to the three-month Treasury bill rate; stocks paid much less than T-bills for all of the bull market. This was one reason many investors assumed the Federal Reserve could support the market with rate cuts; the idea was if stocks yielded less than T-bills, the price of the stock would rise like a bond's price would. Not quite: The coupon rate on a bond is fixed while a stock's dividend can fall with decreased earnings prospects. The so-called Greenspan put, the mythical floor under the market, was just that.




**The Sun Will Shine Again**

One day the two-trade market will turn into a three-trade market. Those who could not understand the bubble and decided to stop fighting it lived to regret their capitulation to the trend. This will happen in reverse: Those who abandon equities will be surprised one day at the next long-term bull market and how long it will last. Everything you know is not always wrong; it may only seem that way.