

No New News

“The bear market is not over... Under no circumstances buy stocks until it is no longer possible to get the smell of investor disgust and dismay out of your clothing. Right now, the market smells too sweet.”

From *fcNOTES*, December 30, 2001

Next month will mark the one-year anniversary of our first newsletter (“Bearish... But Optimistic!”, December 30, 2001). Since we will dedicate the final *fcNOTES* of 2002 to our market outlook for next year, we would like to devote the first part of this month’s issue to examining the market analysis and investment advice we offered during the past twelve months.

We were virtually alone among market observers when we predicted in December that the bear market would continue in 2002; with the S&P having risen 20% since the markets bottomed in September, and the Nasdaq having recorded an even more impressive 40% gain, most Wall Street professionals were heralding the start of a new bull market as they welcomed the New Year.

Our bearish outlook was proven correct when all the major market averages fell well below their respective September lows by mid-summer. But while we are pleased to have kept our readers on the right side of the market this year, we must acknowledge that we were mistaken when we suggested in our December newsletter that the last two quarters of this year would prove to be a good time to own stocks. (Although the fourth quarter is shaping up very nicely, the third quarter of 2002 was a nightmare for investors, the worst since the Crash of 1987.)

There was no shortage of bullish optimism in early 2002, especially after the news broke on January 31 that the U.S. economy had expanded in the fourth quarter of 2001, instead of contracting as nearly everyone had expected. Economists declared the recession over, and Wall Street analysts were confident that the stock market would soon “catch up” with the growing economy.

We weren’t convinced, and in spite of a flood of healthy leading economic indicators in the spring of 2002, we remained bearish and advised our readers to stay on the sidelines. In the March 31 issue of *fcNOTES* (“Decision Time”), we warned of “a continuation of the bear market and a double-dip recession,” even as many economists were suggesting that the Fed had fallen behind the curve by not *raising* interest rates to ward off inflation in an obviously strengthening economy. (Our view on the economy was proven correct when the Fed *lowered* rates by a surprising 50 basis points on November 6, the first change in interest rate policy this year and a sure sign that the risks we identified back in March were finally becoming consensus opinion.)

Our unwavering bearishness gave way to cautious optimism at the end of July when, after four consecutive months of declining stock prices, we began to see an important shift in sentiment that, in our opinion, foreshadowed the start of a new bull market.

Although we were confident in our analysis when we changed our outlook from bearish to bullish, we cautioned our readers that calling a market bottom at the actual bottom is next to impossible, and, for that reason, we recommended that investors start small by allocating no more than one-third of their cash reserves to stocks. This proved to be a prudent decision, as the S&P 500 plunged a gut-wrenching 11% in September (and caused us to feel more than a little chagrined by the unfortunate choice of title for the August 31 issue of *fcNOTES* - “Don’t Fear the Fall”). In spite of the frightening market action in September, however, we are pleased to observe that as of the end of this month, investors who followed our advice at the start of August are in the black today.

“With the media’s attention fixed firmly on the cynicism and gloominess of economists, analysts, and individual investors, we have reached the point at which the risk of missing the next sustained move higher outweighs the possible reward of avoiding more pain in the weeks ahead.”

From *fcNOTES*, July 31, 2002

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On October 31, we increased our recommended equity allocation to 60%. The strength in stock prices in November makes this a good call for now, but more time is needed before we can say with certainty that the fall of 2002 marked the end of this bear market.

Reject Pride

If by recounting the success of our market calls in 2002 we have succumbed to pride (perhaps the most dangerous of emotions for an investor), we would like to remedy this by restating our most important rule of investing: We can *always* be wrong.

This is why we have not recommended a 100% allocation to stocks in spite of our obvious bullishness (to address a question posed by several readers). But this answer begs two more questions: What will we need to see to convince us to move to a fully-invested portfolio, and, conversely, what will we need to see to suggest that our positive outlook might be wrong?

The answer to the first question can be found in the very first issue of *fcNOTES*, in which we warned that, our bearish outlook notwithstanding, "If the S&P 500 and the Dow can break out above their respective 200-day moving averages and stay there for a few weeks (as the Nasdaq has already done), then we will most likely throw in the towel and start buying stocks." (Note: a moving average is simply the average of closing prices for a given number of days; after each new trading day, the oldest price is eliminated and the most recent one is added to recompute the average.)

During the first part of 2002, it looked as though our bearish view might be proven wrong; the Dow broke out above its 200-day moving average in February and remained there for three months, and the S&P 500 also managed to get above its 200-day moving average in March (though it would not remain there for long). But as the Dow and S&P 500 clawed their way higher, the Nasdaq fell below its 200-day moving average in January. When the Dow finally dropped below its 200-day moving average in the first few days of June, we knew that the odds were very good that the next major leg down in the bear market was beginning. And indeed it was.

If the 200-day moving averages on the major indexes were the critical levels to disprove our contention that the bear market was not over, then it should come as no surprise that the same reasoning applies on the other side of the coin; if the Dow, S&P 500, and Nasdaq can all break out above their respective 200-day moving averages and find support there, we will deem this to be technical confirmation of our bullish outlook and finally recommend a fully-invested position.

200-Day Moving Average Strategy

The choice of the 200-day moving average to substantiate our outlook is not arbitrary; the historical relationship between the direction of stock prices and the 200-day moving average has been documented by Jeremy Siegel, professor of finance at the Wharton School of the University of Pennsylvania. In the second edition of his classic 1994 book, *Stocks for the Long Run*, Siegel tested an investing strategy based on the 200-day moving average using the daily price closing price of the Dow Jones Industrial Average from 1886 to 1997. The test assumed that an investor had purchased stocks whenever the Dow closed at least one percent *above* its 200-day moving average and sold stocks whenever the Dow closed at least one percent *below* its 200-day moving average. (The one percent rule was intended to reduce the number of times the investor would get "whipsawed" by false breakouts and thus incur much higher trading costs.) It was also assumed that the cash was reinvested in Treasury bills during periods in which the Dow was below its 200-day moving average.

From a performance standpoint, the 200-day moving average timing strategy does not appear to yield significantly-better results than a buy-and-hold approach. An investor who had purchased stocks whenever the Dow crossed above the 200-day moving average and sold them whenever the Dow crossed below this level would have enjoyed an annualized return of 11.51% from January 1886 to June 1997, versus a return of 9.98% for an investor who had simply held stocks throughout the same period. But the excess returns of the timing strategy are virtually eliminated when Siegel allows for estimated transaction costs (which reduce the annualized return of this approach to just 10.05%).

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So why bother? The answer is that the historical advantage of the 200-day moving average market timing strategy is not better performance; it is getting roughly the *same* performance while also benefiting from a dramatic reduction in downside volatility.

Consider this: An investor using the 200-day moving average strategy would have sold stocks ten days *before* the Great Crash in October of 1927, and would have avoided the longest bear market in U.S. history. Staying with the strategy, this investor would have reentered the market on August 6, 1932, in time to enjoy most of the cyclical bull market that would last until March of 1937. And, more recently, an investor using this timing strategy would have avoided the “Black Monday” crash on October 19, 1987, having sold out just *one* trading day earlier, on Friday, October 16.¹

To anyone who has remained fully invested throughout this most recent bear market (which is rivaled only by that of 1929 - 1932), the appeal of reducing downside volatility without a corresponding adverse impact on investment performance in the long run should be quite obvious.

Although we do not rely on technical analysis to form our big-picture outlook, we believe that technical methodologies such as the 200-day moving average strategy can be very useful not only for determining ideal exit and entry levels, but also for testing and confirming – or challenging – the conclusions we reach based on our primary contrarian approach to the markets.

New News

As we enter the final month of the year, the Nasdaq is touching its 200-day moving average, and several individual sector indexes have already broken through their respective 200-day moving averages. Should the Dow, S&P 500, and Nasdaq trade above their 200-day moving averages but then fail to hold these levels (as happened earlier this year), it is likely that we will resume a defensive posture. But with the indexes still below these levels, what are we looking for *now* to suggest to us that we might be wrong? What if stock prices begin to head south again before breaking through?

The answer is simple: *New news*. As we observed in the January 31 issue of *fcNOTES* (“The Y2K Lesson: Enron, Terrorism, and the Stock Market”), by the time the media identifies a major problem, the perceived danger is either already past or never even existed in the first place: “The intensity and duration of media attention devoted to any major news story is in fact *inversely* related to the probability of that story having a material, long-term impact on the stock market.”

Although there is plenty of bad news all around us (ongoing investigations into corporate malfeasance, more warnings about possible terrorist attacks, continuing talk of an impending war with Iraq, additional reasons to be worried about the economy, etc.), there hasn’t been any *new* bad news for several months now. This suggests to us that the worst-case scenario for each of these problems has already been discounted by the market – it is priced in. So for the bear market to continue, we will need to see a *real* surprise, something the market has not been contemplating for months.

Could it happen? Of course. Anything that can happen probably will – eventually. But with so much bad news already in the market, the odds strongly favor good surprises.

We wish all of our readers only good surprises during this holiday season, and we look forward to welcoming what will be a much better year for stocks in 2003.

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¹ Stock market and 200-day moving average data from: Siegel, Jeremy, *Stocks for the Long Run*, Second Edition, 1998.