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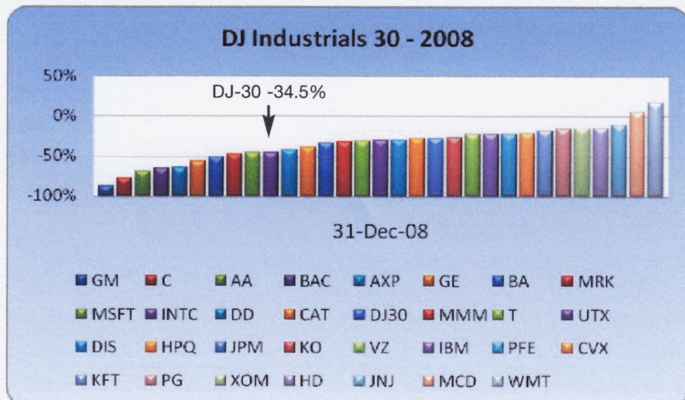
Time to Take Stock! or how being conservative will help you make losses

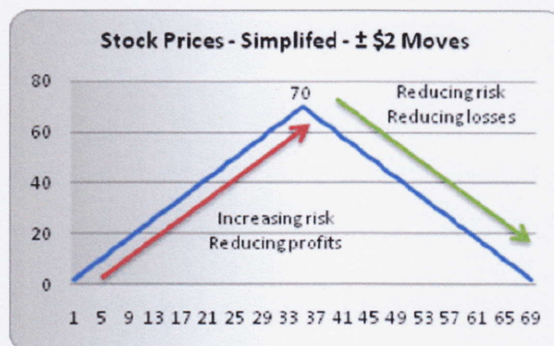
by IMCZ Member John Henry Smith

This graph of the Dow Jones Industrial Average shows that 2008 was one of the worst years we have ever experienced in the stock market. After such a brutal assault on their wealth, "once bitten, twice shy" investors are taking stock of their losses, and with the bleak economic situation that is getting bleaker this year they justifiably ask if they should ever buy stocks again.



In the Swiss TV program 'Cash' of November 20, 2008, Emeritus Professor Walter Wittman acknowledged this stinging sentiment, and added that not just individual investors, but also banks and insurance companies get caught in the same vicious cycle. Facing substantial losses of perhaps a failing buy-and-hold and/or timing strategy and being conservatively driven, they remain on the side-lines in the initial phase of an emerging bull market. Unfortunately for them, coming off of a bear market is usually a rather rigorous affair, and consequently they miss the abundance of opportunities that a grossly undervalued market has to offer[1]. Over time their conservative optimism returns on observing that the market appears to be generating gains that appeal to their risk/reward preferences and taunted by the prospects they reenter the market at the second phase of the cycle, namely when capital gains begin to slow.

Assuming a bullish price formation, this graph illustrates that the earlier a buyer enters the market the lower the risk of reduced profits. Of course, no one knows where or when prices will peak, which is all the more reason why an investor should not leave market entry too late. Conversely, once it is clear that a major bearish pattern has emerged, paradoxically, as prices decline the risk of losses also decreases. Simply put, many investors leave market entry and exit too late, or enter a deteriorating market too early, thus exposing themselves to the same predicament in which they found themselves in the previous cycle.



Theory is all well and good you might say, but what is the real evidence for better timing? From analysis of past crises, stock markets recover from their primary lows quite vigorously. The great contrarian, David Dreman[2], in a study of major crises that occurred between the end of World War II and 1990, found that the market was on average 25.8 percent higher after bottoming out, and two years later was up on average 37.5 percent.

What is significant is that the pent up demand of the bear market generates 'runaway gains' in the first phase of a bull market. One study shows that in the first 40 days of a new bull market, stocks usually regain a third of what they lost in the previous bear market.[3] And, according to Jeff Mortimer, chief investment officer of Charles Schwab's mutual fund group, 47 percent of bull market gains usually come in the first 12 months of the Bull Run[4].

These price patterns are specifically confirmed in numerous transitions from bear to bull! In the wake of the bear market of 1973-74, after a bit of dithering, the S&P 500 recovered about 20 percent of its value in less than two months. By mid-May 1975 - just seven months or so after bottoming - it was up 40 percent!

Finally, the beginning of the bull market late in 2002 shows similar results. After the characteristic slow start in March 2003, the S&P rose about 20 percent by June, and by the end of the year, it was up almost 40 percent.

One important reason for these strong surges was that stocks coming off bear markets were very cheap and were snapped up by savvy investors. Similarly through the aggressive over-reactions of this bear market the S&P 500's Price to Earnings Ratio (P/E) is currently at 12. This compares very favorably with the Index's P/E ratios of previous years, as this table shows and has prompted many a guru, including Warren Buffet to 'Buy America'[5]:

Year	P/E Ratio
2007	22.19
2006	17.40
2005	17.85
2004	20.70
2003	22.81

From this information, it shows that timing is an essential component of successful investing; a fact that William Shakespeare understood magnificently, when he wrote:

There is a tide in the affairs of men,
Which, taken at the flood, leads on to fortune;
Omitted, all the voyage of their life
Is bound in shallows and in miseries.
On such a full sea are we now afloat;
And we must take the current as it serves,
Or lose our ventures.

Julius Caesar, Act IV, Scene III

As the market is the precursor of future value it means that it will begin to signal the economic turnaround at least six months in advance of any upswing. For example, the market performed better during the recessions of 1980, 1981-82, 1990-91, and 2001 than it did in the six months leading up to them. Needless to say, in spite of the empirical evidence presented here, the economy must be seen to be on the road to recovery and not end up getting side tracked that might cause a false rally or two.

So as we stand today, it is indeed the right time to take stock; not to think about leaving the stock market when the evidence shows that there are attractive returns in the offing, but rather to decide what is the right **time to take stocks** otherwise as Shakespeare warned, 'we will lose our ventures!'

1 See John Henry Smith. The Upside of Down Markets. IMCZNEWS Dec. 2008
2 David Dreman. Contrarian Investment Strategies: The Next Generation. New York: Simon & Schuster, 1998.
3 Janice Revell. Forecast 2009: Your Investments. Money Magazine, Nov. 5, 2008.
4 Eugenia Levenson. Get Ready for a Rebound. Fortune Magazine, Nov.26, 2008.
5 Warren Buffet. Buy America. I Am. The New York Times, Oct. 17, 2008