BEAT THE MARKET

INVEST BY KNOWING WHAT STOCKS TO BUY AND WHAT STOCKS TO SELL

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Introduction

If you manage your own investments and want to understand what investing methods are worthwhile and what methods are best avoided, this book is for you. It is also for those who wish to manage their own investments but don't know how to do it. You will understand the problems and costs of professional management and the inconsistencies in traditional investment methods. You will explore three methods using different information to buy and to sell stocks. Most books on investment leave out what to do after you have bought stocks. I show you when they should be sold. The historic results of these methods, when melded together, have proven reliable in all kinds of markets over the past 30 years. I show you that the stock market is still the best investment vehicle, how and when to buy and sell individual stocks, when to be out of the market, and how to construct a working portfolio. Above all, I show you that it is impossible to predict markets or the economy, but it is still probable that you can make money. You must react to circumstances rather than predict outcomes. Using these methods, you will find that you can successfully invest for yourself.

My purpose is to show how you, by yourself, can outperform the stock market and reduce the risk of capital loss from poor decisions. You do not need to pay outrageous fees or be subjected to the incomprehensible and often incorrect theories or deceptive jargon that is thrown at you by brokers and money

managers trying to get your money under their management. However, if you prefer to use advisors in the allocation of your assets, please be critical of their past performance, the reasons and history of their advice, and the fee structure and hidden costs not only of your advisor, but also of the investments in which your assets are placed. These fees can act as a significant deterrent to your portfolio's performance.

The opinions contained in this book are from my 40 years experience as a research analyst, portfolio manager, stock market newsletter writer, block desk trader, institutional broker, technical analyst, and hedge fund manager. I have owned a brokerage firm and passed at one time or another the requirements for investment advisor, options specialist, registered representative, and options and financial principal. I am the coauthor of *Technical Analysis: The Complete Reference for Financial Market Technicians*, which is used in many colleges and universities for their investment courses and has become the primary textbook for the Certified Market Technician (CMT) designation by the Market Technicians Association. I am past editor of the *Journal of Technical Analysis* and a past board member of both the Market Technicians Association and the Market Technicians Association Educational Foundation. In addition, I am the only person (so far) to have twice won the annual Charles H. Dow award for research. In short, I have been around the financial and investment markets for a long time, and I have been exposed to just about every technique, method, theory, and sales pitch put forth in the past 40 years. My father was one of the most successful portfolio managers at Fidelity before Peter Lynch. I began the "game" when I was 14, occasionally working for him in following stocks for his trust accounts. I also graduated from Harvard (AB) and the Wharton School (MBA).

CHAPTER 1

INVESTING TODAY

Investment management today has slowly migrated away from the old trust and prudent man concept when an experienced investment manager or trust officer looked after you, your family's investments, and your financial future. As an investor, you have to make decisions affecting your retirement and economic well-being for many reasons. Fear of litigation for poor past performance and the sheer size and complexity of investments have caused the investment industry to consolidate into specialists rather than generalists. As an example, pension funds have changed from "defined benefit" plans, where the pension fund made the investment decisions and guaranteed you a specific income after retirement, to "defined contribution" plans, where you must make your own investment decisions and hope for the best. This change takes the investment responsibility away from the pension fund and places it on you, even while you continue to pay for the "expertise" the fund allegedly offers. Now you must decide how many bonds and stocks to include in your investment program. You must decide whether to own big caps, foreign stocks, midsized, emerging market stocks, and so forth. Not being a professional, you face

a daunting task. Even funds that balance investments between cash, bonds, and stocks are rare today because they are not "sexy" and have almost never outperformed the stock market.

This is unfortunate because the money management business has little incentive to watch out for you and take responsibility for your assets. In many ways, it has become a flim-flam, principally designed to take your money through fees and commissions while appearing to be on your side.

Investment Management

Let's face it, professional money management, on average, is not that great. In fact, it is a disgrace. History shows that the performance of most mutual funds is below that of the market averages. In a study by Motley Fool, from 1963 through 1998 (good years in the stock market), the average mutual fund earned for the investor approximately 2 percent less than the average market return. The study equates this to an investor earning 8 percent per year from professional management versus 10 percent per year from just buying a market average such as the Dow Jones Industrial Index (unadjusted for inflation). Using these figures, over 50 years, $10,000 invested would amount to a total market worth of $1,170,000. However, at 8 percent, the investor would have gained only $470,000. Motley Fool quotes John Bogle, founder of the Vanguard funds:

> "Our hypothetical fund investor has earned $1,170,000, donated $700,000 to the mutual fund industry, and kept the remaining $470,000. The financial system has consumed 60 percent of the return, the fund investor has achieved but 40 percent of his earnings potential. Yet, it

> was the investor who provided 100 percent of the initial capital; the industry provided none. Confronted by the issue in this way, would an intelligent investor consider this split to represent a fair shake?"

With these profits, you can see why the mutual fund industry wants your money.

In the investment industry, there is almost no consideration for getting out of stocks during bear markets, and the popular policy of "diversification" (also called "asset allocation") shows meager results over long periods. In other words, it is mere gimmick with no real substance. The one thing professional management is good at is scaring many people into not investing for themselves and placing their financial assets with management. This is done primarily through investment jargon that makes the subject appear much more complicated than it is. Amazingly, this use of special words and concepts of finance theory intimidates even the higher-ups in corporations, foundations, and the wealthy who are looking for people to invest their funds. I show you that so-called finance theory has enormous logical holes in it, and in fact, it is unable to be used profitably in investing. It is a theory that has not worked well in practice but is useful in bamboozling prospective clients.

Investment Management Incentive

Investment management is not necessarily looking for the same performance of your assets as you are. It is looking at your assets as a business in which it can prosper regardless of whether you make money. Depending on the type of management, this profit incentive can work against you.

Mutual Funds and Professional Management

At one time, in the '50s and '60s, when giants such as Dreyfus and Fidelity were rapidly growing, the incentive to attract assets, as with hedge funds today, was the performance of the fund. It was this background that generated the Peter Lynches and Gerry Tsais who had high-profile performance far outstripping the market averages. However, these managers were few in number, and when other funds attempted to compete, they could not find managers who could perform much better than the market. At that point, different methods of sales and marketing developed. Fidelity and other fund management companies, for example, spent money on advertising and formed new funds every year to soak up the money intended for each investment fad. Different industry groups or themes come and go as "hot" industries in the markets. For example, if airline stocks are strong, people generally want to buy airlines. Fund management formed an airline fund to soak up that demand. Never mind that when the public finally recognized that a new trend was in process, it was near the end of the trend instead of at the beginning. To fund managers, the industry fad was irrelevant. To them, the money (your money) was captured and paying a fee. Later, when a new industry fad roared, your funds easily could be switched to another newly created fund, and the fees derived from this captive money would continue to flow to fund management.

When brokerage commissions declined, other mutual fund management companies developed close relationships with stockbrokers, who, for a portion of the trading commissions (until they became too small) and a portion of the sales fees, would push the funds to their clients. To some extent, this

method still exists today. When the SEC discouraged these kickbacks, the brokerage firms and banks began their own in-house funds and pushed their clients into them, capturing both the management fees and brokerage commissions. However, neither the fad fund nor the brokerage sales methods were, or are, beneficial to the interests of the client. Indeed, they almost guarantee that the client's investments will fall behind in performance because of the high costs and poor management. In Table 1.1, I show the possible fees you may pay for the privilege of owning a mutual fund. Not all funds have all the fees outlined in the table.

TABLE 1.1 MUTUAL FUND FEES
(source: www.sec.gov/amswers/mffees.htm)

Mutual Fund Fee	Brief Description
Sales loads, including Sales Charge (load) on purchases and Deferred Sales Charge	Brokerage sales charges come in two forms: 1. a charge when you buy the fund (front-end sales load) or 2. a charge when you redeem the fund (back-end sales load). The front-end load means you have less of your money invested in the beginning. The fund must perform well before your investment is even. This is limited to 8.5 percent.
Redemption fee	Fee paid to compensate the mutual fund for costs associated with the redemption. This is limited to 2 percent.
Exchange fee	Fee paid for transferring to another fund under the same management.
Account fee	Fee paid for maintenance of an account.
Purchase fee	Fee paid for purchasing shares that goes directly to the fund, not a broker.
Management fee	Fee paid for management of the fund.

(continues)

TABLE 1.1 CONTINUED

Mutual Fund Fee	Brief Description
Distribution (12b-1) fees	Fee paid for distribution expenses and shareholder service expenses. Distribution fee includes marketing and selling fund shares (using your money to raise more money for management) and is limited to 0.75 percent. Shareholder service fee for responding to questions by shareholders and is limited to 0.25 percent. (In 1997, $9.5 billion in these fees paid by mutual fund invesors.)
Other expenses	Expenses not included in management or distribution fees, such as custodial, legal, accounting, transfer agent, and other administrative expenses.

Most investors do not consider the motives of money management firms competing for their accounts. In the past, for example, stockbrokers made their income from commissions on trades. Performance was not as important to them as the number of buys and sells they could generate. It was called "churning," which is a terrible (though profitable) incentive that encouraged high turnover in accounts and worked directly against the interests of the client because commission fees were high. Today, these commission rates have been reduced to extremely low levels and are no longer a major concern to investors. To combat this decline in income from commissions, stockbrokers have joined with the mutual fund industry (directly or indirectly) and are now interested in how much of your assets they can gather under their management. Their economic incentive is the management fee, wrap fee, or 12b(1) fee. John Bogle, in a 2003 interview with Motley Fool, said:

> "It [the mutual fund industry] has a profound conflict of interest between the managers who run the funds and the shareholders who own them … Management fees in this

> industry run about 1.6 percent for the average equity fund. By the time you add in portfolio turnover costs, which nobody discloses, the impact of sales charges and opportunity costs because funds aren't fully invested, and the out-of-pocket fees, you are probably talking about another 1.4 percent of cost, bringing that 1.6 percent management fee or expense ratio up to 3 percent a year. That is an awful lot of money."

At least in the old days, brokers had to know something about the markets. Today, the markets are almost irrelevant to them. A broker is more interested in getting your money under house management and collecting his percentage of the management fees; and, by no small coincidence, the types and names of the fee charges are staggering and complex. A broker doesn't need to know about markets, just as a car salesman doesn't need to know the intricacies of an engine, but a broker does need to know about financial jargon to impress you with his "special knowledge." As a test at your favorite brokerage office, ask how many of the brokers receive the *Barron's Financial* and actually read it. You will be surprised at how few modern brokers closely follow the market. It is unconscionable that brokers generally have separated themselves from direct contact with the markets and are now so closely involved in selling investment management by others.

The incentive of payment for gathering assets under management is also not in the best interest of the client. Fees have tripled since the late 1960s. When I began in the business in 1966, ½ of 1 percent of stock assets and 1/40 of 1 percent of bond assets were the standard fees. Compare those fees with the 2 percent or higher fees of today when performance has not improved at all. In addition, these fees are unrelated to the success of the client's asset growth. They are flat fees, paid regardless of

whether your investment in the fund rises or falls. The fund can perform poorly, but as long as new assets are added to the fund pool, the fund management profits despite the performance for the individual client. Today, the definition of "broker" is what you will be when these modern-day experts are done with you.

The management of your investments only on a fee basis is not necessarily in line with your objectives. You pay the fee whether you profit or lose. There is no incentive for the manager under such an arrangement to perform better than the markets. He is paid no matter what happens. The better fee arrangement is when your manager profits when you do and doesn't profit when your investments fall behind. In this arrangement, you and the manager are on the same side and your fortunes should coincide. Unfortunately for you, but fortunately for the investment management business, the Investment Act of 1940 prohibits this arrangement. When challenges to the act are raised, the mutual fund industry fights vehemently against them. Quite obviously, they prefer the current arrangement of profiting despite your success or failure.

Hedge Funds

The hedge fund industry began as a way of avoiding the 1940 Act. Hedge funds enable the manager to participate in profits and to use investment methods, such as short selling, that are otherwise prohibited. A hedge fund is simply a partnership arrangement between limited partners, the investors whose legal risks are limited, and the general partners (the managers who profit above the investors when the fund does well). The partnership avoids the restrictions of the 1940 Act by operating outside of it. The hedge fund industry has grown considerably since

the days of the original fund created by A. W. Jones who used the classic hedge fund formula that bought strong stocks and sold short weak ones.

DEFINITIONS

Buy long is to pay cash and purchase stock. You are then long on the stock because you own it. You make a profit when you sell it at a price higher than what you paid for it. *Sell short* is to sell stock that you have borrowed from someone else. You or your broker borrow the stock, sell it in the marketplace, and wait for its price to decline. You are then short the stock. Eventually, you must buy it back (a *short squeeze* is when many people have to buy it back because the price suddenly goes up). You buy it back in the marketplace and return it to the lender. Your intention is to sell it first at a high price and buy it back later at a low price, making a profit.

DEFINITIONS

A *hedge* is when you enter a position and enter another position in an investment that will act opposite from your original position. It is like an insurance policy in that it protects your original position from substantial loss. For example, *hedge funds* buy strong stocks and hedge them by selling short, weak stocks. By doing this, they avoid or reduce market risk. Because the longs and the shorts tend to rise and fall with the market, in a rising market, the fund profits from the long positions and suffers from the short positions. Just the opposite occurs during a declining market. The market action on the portfolio is reduced, and profits come from the correct decisions on the stock positions alone.

DEFINITIONS

A *basket of stocks* is a portfolio of stocks. Sometimes the portfolio has a theme, such as a gold basket holding only gold stocks or an airline basket holding airline stocks. The basket can be any size and have any number of stocks. When an institutional customer sells a number of stocks at one time, a brokerage firm may bid for the entire basket. It then can sell each stock individually.

DEFINITIONS

Margin refers to when an investor borrows money to purchase or sell short stock. The Federal Reserve and the exchanges regulate the amount of money you can borrow on a stock position depending on many factors. When you have purchased more stock than what you can pay for and have borrowed to make up the difference, you are said to be *on margin*.

DEFINITIONS

Derivatives are tradable contracts that by themselves have no value, but instead, they depend on their underlying investment for price action. The most common derivatives are options and futures. They have no real value because they are only contracts to buy or sell an underlying stock, commodity, or basket. For example, when you buy a Standard & Poor 500 (S&P 500) futures contract, you promise to pay the amount that the Standard & Poor index (S&P index) is worth (multiplied by some factor) on the day that the contract expires. The price of the future, therefore, oscillates with the price of the S&P index until it expires, but without the S&P 500, it is worthless.

The name "hedge fund" has remained for most investment partnerships, regardless of their investment style or methods. Because the incentive of participation in profits is attractive to investment managers, and was especially during the great bull market of the 1990s, many managers quit the mutual fund industry and began their own funds. They wanted to profit from their decisions rather than receive just a salary and perhaps a year-end bonus. Unfortunately, the Securities & Exchange Commission (SEC) impose limits on the amount of money an individual can invest in these funds, usually a million dollars, putting such investments out of the reach of most people.

There are developing problems in the hedge fund industry as well. Fees are still very high, often 2 percent of assets invested in the fund plus 20 percent of the profits. In addition, because the fees are so attractive to investment managers, the industry has attracted some less-than-scrupulous people. Finally, the market no longer rises every day as it did in the 1990s and easy money is no longer available. Indeed, average hedge fund performance over the past five years is only slightly better than that of the stock market. This means that fund managers will take larger risks with your invested money because they want more than the fixed fee. Generally, they risk the assets of the fund with leverage (borrowed money, sometimes as much as 200 to 1,—that is for every dollar invested they borrow $200) and open themselves to the risk of failure. If they fail, you lose, and they generally walk away.

ETFs (Exchange Traded Fund)

In recent years, tradable securities called ETFs (Exchange Traded Fund) have been introduced to replicate the action of stocks in a known or associated basket. The securities or commodities in the basket are known to the ETF buyer, and unlike

mutual funds, they remain in the portfolio. ETFs can be bought long, sold short, margined, and may even have tradable options and futures. Standard orders, such as market, stop loss, and limit, may be used that are not available for mutual funds. They are priced immediately in the marketplace, not periodically as in mutual funds, and there is no minimum investment required. The components of each ETF follow themes as different and diverse as the Brazilian stock market, high growth stocks, the S&P 500, utilities indices, commodities such as gold or petroleum, and even municipal bonds. The number of possible themes is limitless; thus, these instruments have been introduced at a speedy rate. The costs of ownership are less than mutual funds because there are no high-priced managers (the portfolio is run by a computer). ETF operating costs are usually between 0.1 percent and 1.0 percent. They are generally easy to buy and sell because they are listed on exchanges and Nasdaq, and brokerage costs to trade them are low. Finally, they are taxed for capital gains like a common stock, unlike a mutual fund that must distribute net taxable gains through to you, the shareholder, despite the performance of the fund. You may invest in them based on a theme or as a hedge against an existing portfolio, or you can trade them like stocks. Investment in them is either mechanical as a hedge against another investment, purely technical as is used in a trading system, or speculative as a concentration in a specific theme.

If you insist on owning different funds, perhaps because it is easier and less expensive, the ETFs are far superior to mutual funds. Just remember that with ETFs, you still need a method to decide when to buy and when to sell as they come in and out of favor.

What Do You Do?

So, what can you do to protect and grow your financial assets? You can continue to be smooth-talked by the "professionals" and diversify into a variety of mutual funds and suffer outrageous fees, or you can do the investing yourself. To many, the do-it-yourself method is scary. Not only have they been intimidated by the pros' jargon, but they are also afraid that it requires learning a whole bunch of new things and that it may involve mathematics or other subjects they were not the best at when in school. To a slight extent, there is some basis for the fears, but not to the level that professionals would like you to believe. Most information necessary is publicly available for small fees, considerably less than any management, administrative, trust, or brokerage fees you would otherwise pay. You might have to do a little work at regular intervals, perhaps weekly or monthly, but that work shouldn't take more than an hour per session, provided the appropriate financial information is present. From this analysis, you can outperform the market averages, if history is a guide, and feel more confident that your investments are protected from substantial loss.

Why the Stock Market?

Why the stock market? Stocks have proven to be the best investment over the past 200 years. Wharton professor Jeremy Siegel calculated that in the past two centuries, the U.S. stock market had a total average return of 6.9 percent per year. This, after accounting for inflation, is often called the "real" rate of return. No other investment category has attained results even close to this outcome. The U.S. government's long-term bonds

averaged 3.5 percent, and short-term bills averaged 2.9 percent over the same period. Since 1926, stocks have averaged 6.9 percent, the same as over the entire 200-year period; bond performance declined to 2.2 percent per year, and U.S. Treasury bills declined to 0.7 percent per year. The stock market results are striking. They show that stocks have worked effectively as a hedge against inflation. Inflation is with us, and it accelerated after the U.S. went off the gold standard. It is unlikely that we will return to a gold standard any time soon, and so it is probable that inflation will continue as well. It is the necessary evil of paper money.

Therefore, U.S. stocks, over the long and recent term, have been the best investment. In addition, according to Siegel, over no 30-year period have stocks ended up below their beginning prices. The presumption here is that if you can hold a stock portfolio for 30 or more years, you will always make a profit. I don't buy this thesis. First, there hasn't been many 30-year periods to arrive at a good statistical test. Second, the presumption measures only the performance of those stocks that lasted for 30 years. Finally, most people are not willing to wait 30 years to see if the theory is correct. However, it is undeniable that U.S. stocks, in general, have had a relatively high, sustained growth rate when compared to other financial assets.

By the way, when I mention holding stocks, I mean a portfolio of stocks and not necessarily putting all of your cash into an individual stock for 30 years. No one is capable of predicting anything 30 years from now. Just think of guessing who the president will be or what interest rates will be 30 years from now. Indeed, I am not confident about predicting the market even three months ahead. In addition, there are times when most investments are less than prudent; market trends rise and fall in the short term, and it is impossible to predict longer-term

cycles. In some ways, it depends on how far away from the average 6.9 percent per annum the stock market is at any one moment. Siegel's calculations suggest that at any one time, the stock market can deviate substantially from the average 6.9 percent, but over time, the average of annual returns remains at the established norm. It does not suggest that the stock market, with its mean return of 6.9 percent per year for 200 years, will be up 6.9 percent each year. However, as you look at many years—some with large gains and some with large losses—you see that the overall average return was 6.9 percent. This is the basis for the argument of not worrying about market timing—trying to time the oscillations about the average to improve on the portfolio return. We explore this in more detail when we discuss specific methods for reducing capital risk.

There is also a long-term risk to the stock market. You must not put too much trust in historical figures. According to Harvard ex-professor Terry Burnham, the only stock markets over the past 200 years that have not declined to zero are the U.S. and U.K. markets. All other world markets have gone bust at some time. This suggests either that the constant rise in the U.S. market is somewhat accidental or that it is exceptionally strong and well regulated. Survival until now, however, is not a guarantee that it will survive in the future. This mislaid assumption is why many investors own stocks and won't sell them. They believe that the rise will continue forever. It will not. Therefore, we must be aware that at some time in the future, the U.S. stock market will change from its historical 6.9 percent annual growth to something considerably less and it may even decline. This is the eventual outcome of all nations and is why the "buy-and-hold" investment philosophy is ultimately flawed.

On the other hand, the rise in stock prices can continue for many years to come, and I hope it will. This is my assumption

because I also introduce a simple method of protecting a portfolio from substantial capital loss during any kind of market decline. With this defensive protection method, you will not have to worry about a major market decline—short-term or permanent. In the meantime, as the stock market progresses upward, you will be able to take advantage of it.

Summary

At this point, you may be discouraged from the bad news I have given you so far. Don't give up. The good news is that there are investment methods that do work and are not difficult to use. Before we get to them, you must first come to agree with several conclusions. First, the stock market is likely the best investment arena to outperform inflation as long as you safeguard yourself from large capital losses during market declines. Second, you know you have to make investment decisions for yourself because the investment management business makes more money from you than you do on your investments with them. Third, you are left with the decision to either ride the market's ups and downs in a mutual fund or an ETF, or to select individual stock issues using a demonstrated analytical basis. I believe that the diversity provided with a mutual fund or ETF also inhibits your portfolio performance by spreading out the potential gain from individual winners: Your profit will approximate the average of all stocks in that basket, both good and bad, producing an average return. The buying and selling of individual stocks based on your own study and work has considerably more promise, and you can have fun doing it.

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