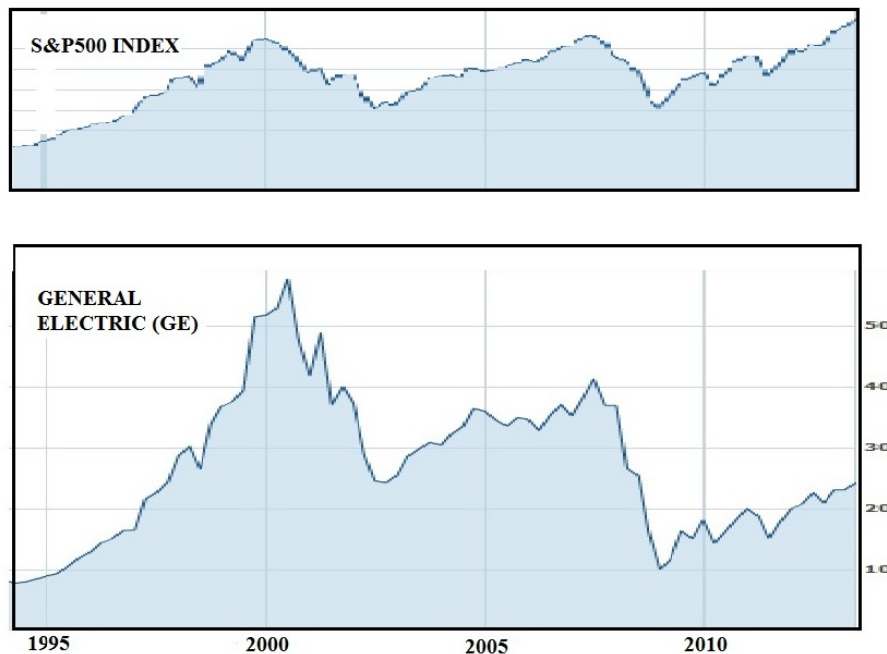


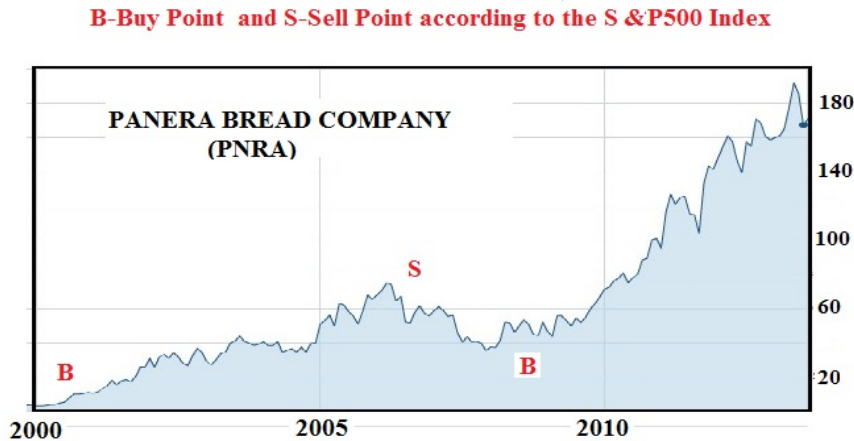
USING DIFFERENT TIME SCALES FOR PROFITABLE MARKET TRANSACTIONS

People often ask the question if it is possible to time equity markets in a manner so as to produce a net long term positive return. Many experts claim it is impossible to do this in a consistent manner since short term market moves are often observed to be random(see Burton Malkiel,"A Random Walk Down Wall Street") while others claim markets follow trends and hence are predictable until reversals occur (see Gerald Loeb,"The Battle for Investment Survival"). Still others claim that markets in equities are essentially controlled by earnings trends (see Benjamin Graham,"The Intelligent Investor") and that overall market phases are immaterial. Certainly an increasing and consistent earnings trend for a stock will cause it to rise provided that one is in the right part of a market cycle. As I have pointed out in an earlier note (see "Do Stock Indexes Worldwide Correlate" of July 11, 2011), stock markets around the world follow essentially the same overall pattern with only a few exceptions. Also one observes that individual stocks tend to rise during bull markets and fall during bear markets with earnings trends being superimposed on such technical trends. We demonstrate such a correlation of stock price with an overall market index by looking at the S&P500 Stock Index versus General Electric stock over a twenty year time period-



We see from the graph that GE closely mimics the S&P500 Index trend with peaks and troughs in price occurring at nearly the same time. Furthermore the chart indicates that GE has lost its growth status since Jack Welsh's departure as CEO in 2001. The stock is seen to be in a gradual downtrend as reflected, among other things, by the shoddy products being offered by the company (I have had my GE repairman over a total of four times during the last decade to fix our brand new GE

cooktop stove and stainless steel refrigerator). This downtrend should be contrasted to that of the Panera Bread Company (PNRA) whose earnings (until a couple of weeks ago) have been in a steady uptrend over the last decade and whose chart looks like this-



I have marked on the chart the points where the S&P500 Index indicates a buy or sell signal. It clearly shows the typical behavior of a growth stock during bull and bear markets. That is-

A growth stock will rise more than the average stock during a bull market and drop less than other stocks during a bear market. The reverse is also true: a stock with declining earnings will drop more than other stocks when the S&P500 average indicates a bear phase.

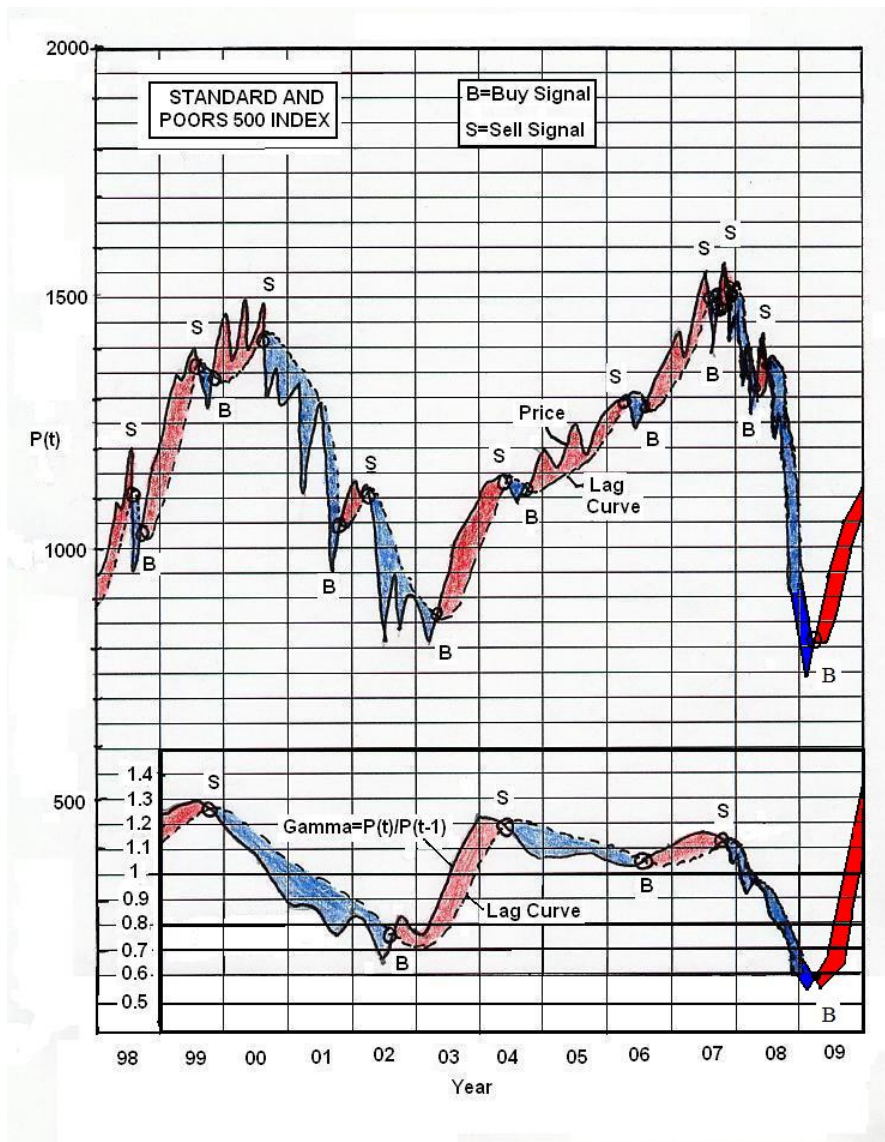
These observations seem to be consistent with observations of most market experts and also agree with each of the above mentioned authors, when looked at in view of the different time frames they are using.

For me the optimum investment strategy is to –

Hold stocks with increasing earnings trend long during bull market phases of the S&P500 Index and sell stocks with decreasing earnings trends in a bear market indicated by a declining S&P500 Index. It is an approach which has worked well for me for over 50 years starting with my first purchase(30 shares of RTN) way back in 1959.

The problem of investment thus is reduced to determining what trend the markets are in and then act accordingly. The difficulty with this scheme is that it is not easy to recognize when a trend has changed until after it has done so and one has

precisely determined over what time scale the change in trend is to be measured. Certainly trends looked at on a daily or hourly basis can be quite different to what is happening when looking at things from a ten or twenty year time perspective. We have found that one of the best time scales to use in analyzing a stock and stock indexes is to use charts based on a five to ten year time period such as we did for the above GE and PNRA charts. It is long enough to hide shorter term changes which many times are indeed random and is also superior to very long term trends in excess of twenty years which tend to overlook important changes occurring on shorter time scales which could be profitable. In our market decisions we typically use the following version of a modified S&P500 Stock Index as a guide-



We see here price changes over a ten year period with a change in trend indicated by the relative behavior of the price curve with respect to a lag curve. The curve in the lower part of the graph is considered a secondary indicator with the upper $P(t)$

versus time t curve being the main decision maker. Red regions indicate definite uptrends while the blue regions indicate bear trends based on the time scale used. Note the sell signal in late 2000 allowed us to avoid the technology crash of 2001. In my own case I sold a large batch of inherited GE stock in late 2000 at \$56/share. This stock is today at the much lower value of just \$24/share. We did not go long stocks again until the middle of 2003. Also the sell signal in November of 2007 got us out of the big market correction associated with the “Great Recession” which followed the next year. We did not go long again until late spring of 2009. In the last five years we have found that trend prediction based on S&P500 Index are becoming more erratic undoubtedly due to the FEDS periodic injection of fiat money into the financial system. Whenever the market averages start to go down there is a sudden upward spike produced by new quantitative easing by the Federal Reserve. As long as Bernanke keeps running the printing presses the net trend in the market will be up although real stock value will actually be decreasing because of money dilution. As soon as this quantitative easing stops or is reduced the markets will crash. It will be an excellent time to be short equities, especially those stocks with poor earnings trends.

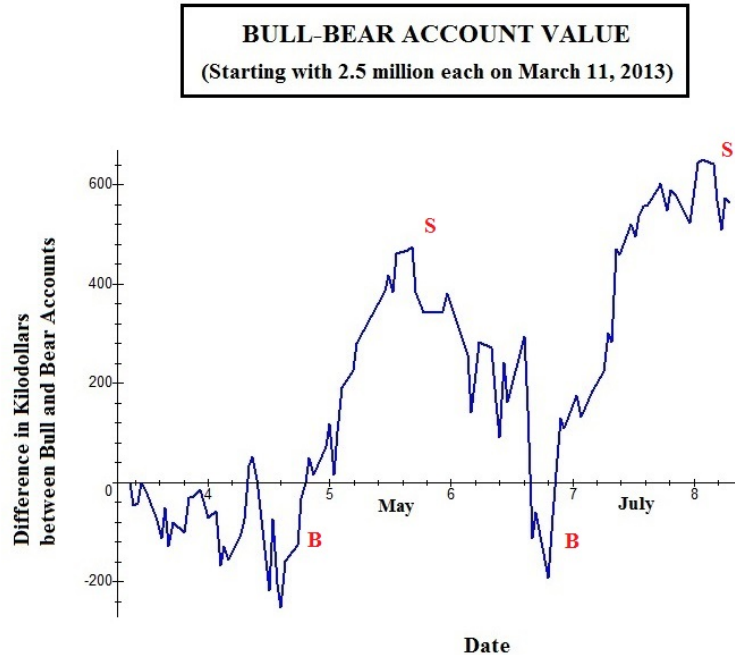
The question which needs to be answered next is—What type of stocks should one be dealing with and should one operate on margin? Clearly the largest gains and losses will occur with leveraged situations involving use of margin and high beta stocks. I find such an approach too risky and have lately confined myself to operating only with Exchange Traded Funds(ETFs) which represent a package of many stocks and thus are less volatile than good individual stocks such as Apple, Amazon, Google, and Facebook. Also ETFs follow the S&P500 Index almost exactly, unlike some individual stocks. In addition, the commissions one pays on transactions are less than they are for stocks. I remember several decades ago, when I was working through a brokerage company in Denver, they would charge me about 0.3% commission per transaction, today with my new broker here in Florida I can purchase a million dollars worth of stock for just \$8 per transaction (a 0.001% commission) It should be remembered that if one can make just a few percent net profit on ones investment per week and do so week in and week out, the net return can become substantial. It does however take quite a bit of nerve to see a stock portfolio fluctuate by as much as one percent a day, even when using low volatility ETFs. Recall that a 1% change in a day on a one million dollar portfolio is still \$10,000.

I am also able to follow shorter term market trends based on a daily closing cost basis using two hypothetical ETF portfolios which I have constructed. One is designed for bull trends and the second for bear trends. Specifically the two portfolios are composed of the ETFs-

BULL ACC: IWM, QQQ , SSO BEAR ACC: EEV, SDS, SKF

Each account is seen to contain only three equally weighted ETFs. They represent hundreds of stocks and move approximately in unison with overall market indexes

or their inverse. I have kept track of the difference in value between the Bull and Bear Accounts on a daily basis starting which each hypothetical portfolio set at 2.5 million dollars apiece on March 11, 2013. The resultant graph through August 9th, 2013 looks as follows-



One sees regions in time where the difference is increasing and where it is decreasing. According to the graph we had short term buy signals about April 24 and June 25, and sell signals May 25 and August 8. A shorter term trader could take advantage of these signals by going long at the buy points using only the Bull Account and go short at the sell signals using just the Bear Account. Be prepared to get out of a position immediately upon noticing a trend reversal. The net return would be the order of 30% per annum with only limited risk. Earnings and other surprises can move an individual stock by a large fraction of its value in just one day. This will never happen with an ETF.

