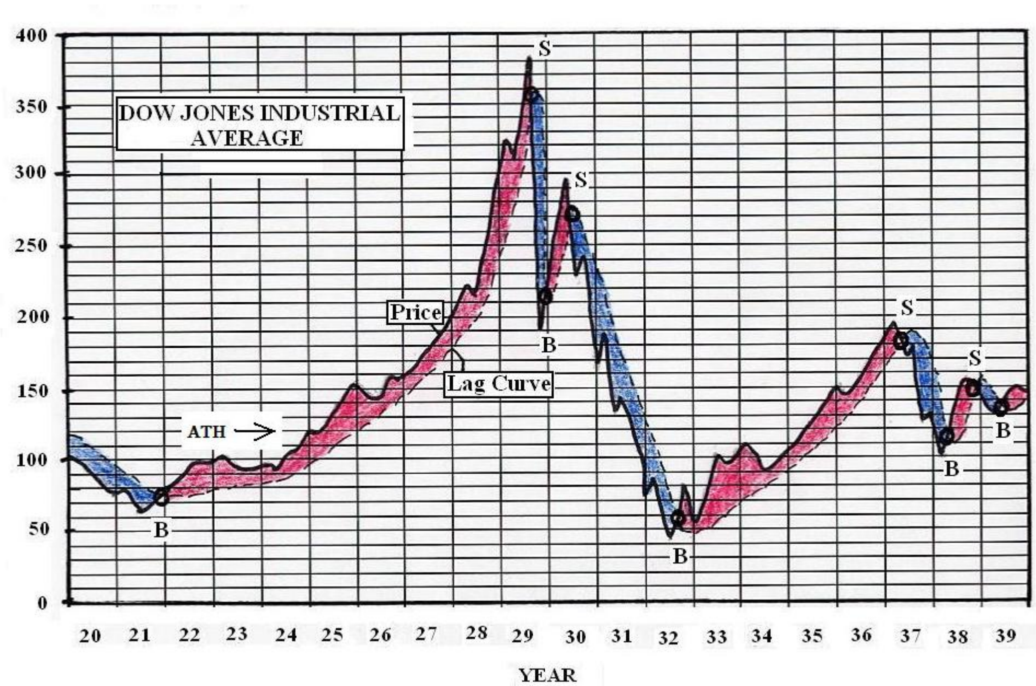
SEVEN RULES FOR SUCCESSFULL STOCK MARKET INVESTING

We discuss here my observations on the movement of stock prices gathered from over fifty years of direct market participation. The basic rules which I have discovered, through experience and which have proved to be profitable throughout the years, are the following.

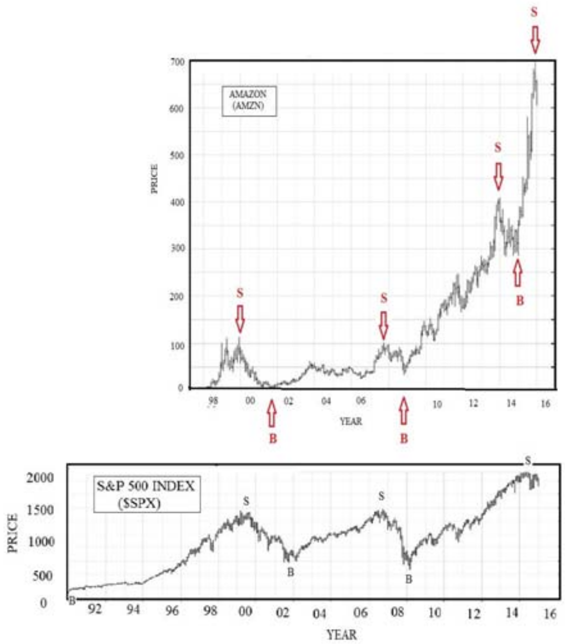
RULE #1-RECOGNIZE THE TYPE OF MARKET ONE IS IN. This observation is easiest to determine by looking at the longer term price trend P(t) of a stock or index versus its lag curve λ. When P>λ one is in a bull market and should only be long in stocks with growing earnings. The reverse condition P<λ indicates a bear market during which one should only be short stocks with a decreasing earnings trend. A good demonstration of this rule, as applied to the overall US market, is found in the following historical graph-

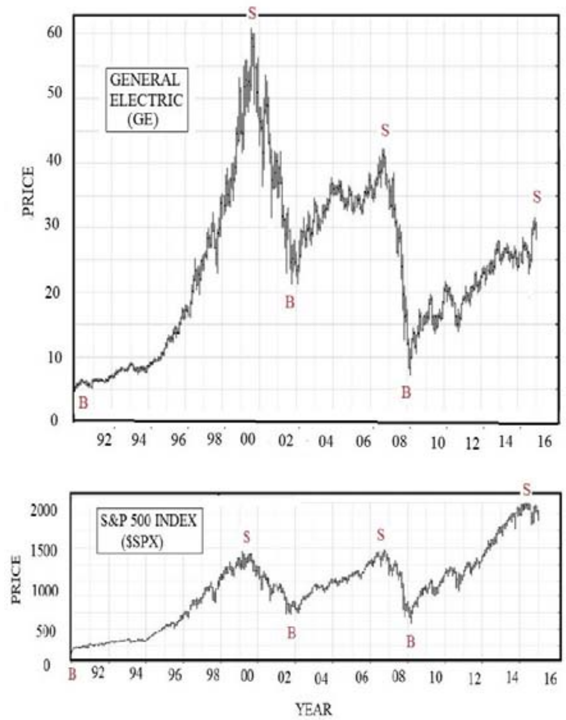


We show there a 19 year graph of the Dow Jones Industrial Average constructed from data available from the internet. The lag curve λ is drawn by eye some ten percent below (or above) the price curve. When the price curve crosses the lag curve a change in markets has occurred. These crossings are marked by B for a buy point and S for a sell point. The lag curve is somewhat faster to respond to changing conditions compared to the standard 200 day moving average. Following this rule would have prevented one from taking a major loss during the 1929 crash and even allowed good returns on shorted stocks during the precipitous declines from 1929 through1932 and the sharp drop in 1937. It also allowed one to participate in the very strong bull market from 1922 through early 1929.

RULE #2-STOCK PRICES AND MARKERT AVERAGES ARE CLOSELY CORRELATED. This means that if the market is in an uptrend, as indicated by the averages such as the S&P500 or the DJI over a multi-year time scale, then a stock's price trend is very likely to also be up. A downtrend in the averages will also most of the time produce a downtrend in a given stock's price.

The following longer term graphs of both AMAZON(AMZN) and General Electric(GE) versus the S&P500 stock averages confirms these observations-

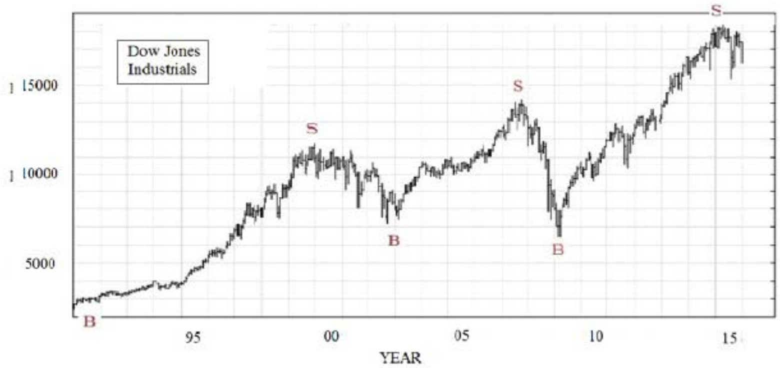


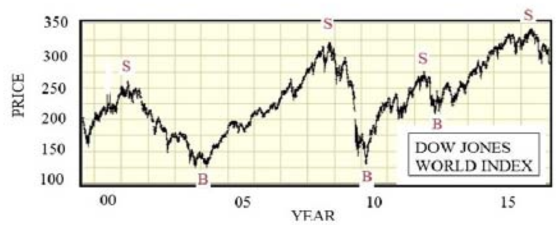


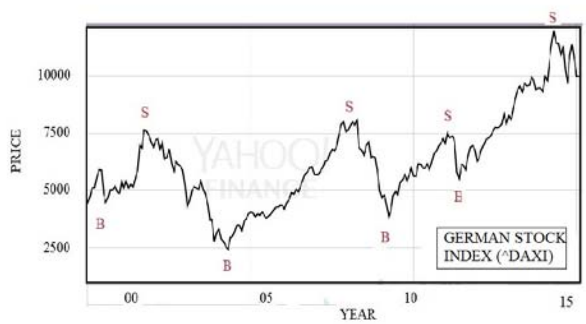
Both Amazon and General Electric are seen to rise in bull markets and fall in bear markets as indicated by the S&P500 average. Note that AMZN in the last decade has increased its value considerably. This stems from the fact that investors consider it to be a rising star with excellent future prospects despite of showing essentially zero earnings and no dividends over the entire time period. During a bear market it will likely show a large drop in value. GE is considered by many to be a has-been stock ever since Jack Welsh retired from the company back in the late nineties. The longer term trend for GE is clearly down although it does rise somewhat during bull markets. One of my best stock transactions took place in 2000 when I sold all my just inherited GE stock near $54/sh. Had one held on it would today be worth only half as much which means a real loss including inflation of 70%.

RULE #3-EARNINGS PER SHARE AND DIVIDEND TRENDS ARE IMPORTANT ONLY IN THE RIGHT TYPE OF MARKET. Earnings per share or it reciprocal price–earnings ratio (PE) when matched with historical trends can be a good indicator of stock value. When the PE ratio of a stock reaches a historically high level then we are likely near the top of a bull run. A very low PE relative to the past indicates one has been in a bear market and is about to enter a bull phase. This was the case in 2009. The main reason for the rise in prices since that time was the unprecedented printing of dollars by the Federal Reserve under Ben Bernanke. The 3 trillion dollars created out of thin air went directly into the stock, art , and real estate markets at the expense of the average American and especially retirees who have been deprived of a reasonable interest return on their lifetime savings. At the moment quantitative easing has stopped and Janet Yellen has reluctantly begun to raise interest rates. As a result we have entered a bear market phase starting in the summer of 2015. This is the time to consider shorting stocks which have lowered earnings expectations.

RULE #4-STOCK PRICE TRENDS ARE CORRELATED WORLD WIDE. I have noticed over the last fifty years of trading in both bull and bear markets that US stock averages correlate reasonably well with other stock markets throughout the world. This fact is demonstrated by the following behavior of the S&P500, the Dow Jones World Index, and the German DAX Index-



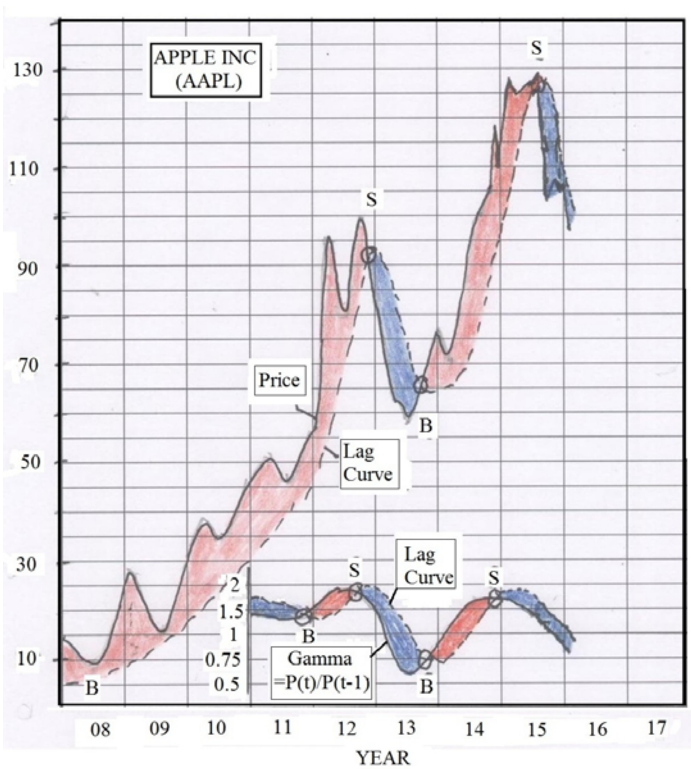




All three indexes show a good correlation with each other indicating the times when the world is in a bull market or a bear market. At the moment (Jan 15, 2016) a bear market appears to be in effect and hence one should consider shorting those stocks with poor earnings trends. This includes one of the bull market favorites AMZN. The exact reason for the correlation of world stock markets with each other is not clear although one suspects the use of arbitrage plus some unknown psychological causes. Unlike what the financial channels perma-bull Jim Cramer would have one believe, it is much more likely that bull and bear markets in different parts of the world move in unison with each other rather than the other way around.

RULE #5- MINIMIZE BROKERAGE FEES BY WORKING ONLY WITH DISCOUNT BROKERS . This is an important rule every investor should be aware of. One should never purchase mutual funds which have brokerage fees as high as 5% or deal with standard brokers charging in the 1% range. Always work only through discount brokers such as Charles Schwab. I remember paying one of my former brokers a commission of $3000 dollars for the same amount of stock for which I now pay just $8 at Schwab. This rule applies especially to those individuals involved in short term trading where brokerage fees can easily amount to a large fraction of any gain.

RULE #6- BE AWARE OF A STOCK'S GAMMA=P(t)/P(t-1) OVER TIME. This is one of the more important technical indicators for judging a stocks future trend. Typically the gamma (representing the present price P(t) to that of a year ago P(t-1)) will rise during a bull market and fall in a bear market. Any sign of a slowing trend usually suggests an upcoming market direction change. We show you below a graph of APPLE, INC. The graph indicates the power of the gamma curve relative to its own lag curve in predicting future trends-



We see that AAPL gave a clear buy signal in late 2013 and a clear sell signal in early 2015. I remember years ago in the late 1950s reading the book "How I made 2 Million Dollars in the Stock Market" by Nicolas Darvas. His investment technique involved following uptrends in stocks whose gamma was two or greater. This worked nicely in the terminal stages of the 1957-58 bull market but is extremely dangerous during bear markets. Following his advice I looked at the stock of Raytheon (RTN) in the late fifties. It had quadrupled (γ=4) in value over the previous year and seemed to be a Darvas candidate. It however quickly reversed course in early 1959 and half a year later was down 50% from its peak value. Being a young and naïve investor I bought a hundred shares of Raytheon at

that point thinking it would soon return to its previous peak value. It turned out this was not the case and I had to wait a full seven years before being able to sell the stock at a slight profit. Needless to say I have never made this type of mistake again. The main lesson learned from the episodes was to never buy a stock when it is in a blue region $P(t)<\lambda(t)$ and when it is coming down from a large earlier gamma value . Unless the price and gamma curve are both in a clear uptrend, indicated as a red region in my graphs , I will not buy the equity. Likewise I will short things only if both curves are in a blue region.
Today Amazon(AMZN) finds itself in a similar boat as Raytheon was back in 1968. AMAZON recently hit an all time high of $670 per share up from $ 340 a year ago. That puts its gamma at $\gamma=670/340=1.97$ indicating a big anticipated drop in price as the present bear market develops.

RULE #7- REDUCE THE RISK OF LOSSES BY DEALING MAINLY WITH THOSE ETFS WHICH FOLLOW ESSENTIALLY THE STOCK MARKET AVERAGES. To minimize risk of losses I have more and more gone to investments involving Exchange Traded Funds (ETFs). These funds have less volatility than individual stocks and are less susceptible to unforeseen events such as the recent stock disasters with Chipotle and VW stock. In bull markets I consider the ETFs SPY, QQQ, and IWM as good vehicles for profitable investment. During bear markets, indicated by the charts, I prefer dealing with the ETFs SDS, SKF, and EEV. These last three ETFs consist of bundles of shorted stocks and so are equivalent to shorting several stocks without the hazard of possible required short covering. At the moment the ETF fund EEV, which deals with shorting emerging markets, would seem to be a good candidate for purchase until the commodity price decline abates. I do not recommend using margin in stock purchases because of the additional risk factors these introduce.

If one sticks to the above rules and follows them unemotionally, a successful investment strategy is pretty much assured. It is when emotions enter the picture that losses will occur. I , for instance, would never participate in the present powerball lottery or gamble at casinos in Las Vegas or Macau. At least stock markets for longer term investors (day traders excluded) offer a better than even odds of coming out ahead of the game.

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Gainesville, Florida
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