

**Will the Market Lows be Tested?  
Should You Care?  
The Issue of Investment Time Frame**

Since its most recent low set on March 6, the stock market has climbed some 20-25 percent, depending on the market yardstick used. This has sparked a lively debate over whether this is a temporary rally that will see prices again decline or the beginning of a major advance.

This debate obscures the fact that the trend can be both. It is not unusual for markets to rally and decline several times before marking a consistent rise. This is part of the process of ridding the market of investors who lack conviction, to be replaced by those who do. Furthermore, whether this is an entry point or a place to take profits probably depends on the time frame of the investor.

With the advent of cable news channels there has been a great deal of discussion of the futility of “buy and hold” investing. According to the programs on these channels, the way to make money is to aggressively trade one’s account, taking short-term profits (or losses) in the process. Usually these television programs are sponsored by firms that cater to such strategies with subscriptions to charts, low brokerage rates, etc.

Some people make money trading short-term. Most do not. Even if commissions are eliminated, the cost of the spread between bid and ask prices can remove an amount that, with the passage of time, can be quite high. This is lost on the investor who, having ridden the market down since last year, is now trying to play catch-up by trading short-term. The blandishments of the advertisers for various trading systems obscure their risk and expense.

Such trading systems are spiritual descendents of the philosopher’s stone. This was the term given for the hunt for a refining system to turn base metals into gold. The idea first gained currency in the Middle Ages. Such luminaries as Sir Isaac Newton were forced into bankruptcy as the result of their investment misadventures in this regard.

It should be obvious that anyone with a foolproof trading system would not need to sell it to others. Indeed, if it were foolproof, the creator of the system would eventually wind up owning the wealth of the world. That this does not happen suggests that such systems have their limitations. Most of the limitations stem from the fact that a system needs to exploit market inefficiencies to make a profit. Once such limitations are observed so many people target the inefficiency that the profit disappears. This assumes that the strategy had potential to make money at one point. Many such strategies are simply momentum investing that requires increasing levels of adroitness to book a gain as the strategy becomes more commonly accepted.

Lost in the discussion of short- versus long-term investing is the tax advantage of holding stocks for a year and a day. The long-term capital gains rate is the cheapest form of tax shelter. It does not require a promoter, lawyer or CPA to bring it about.

It does require gains, which posits the question of what the odds are for the market to rise in the next five years. Actually the prospects are excellent. Research work done recently by Steve Leuthold and Mark Hulbert suggests that the Standard & Poor's index historically appreciates 12-15 percent per year for five years after a decade of flat performance such as we have seen recently. The rationale for this is that stock valuations have come down more than corporate earnings, making stocks more compelling bargains. Low valuations are typically required for a period of above trend appreciation. By this yardstick the Dow Jones averages should be back to their 14,000 level in about four and a half years.

This is not to say all stocks will go back up or all will go up the same amount. Averages obscure the fact that some companies will do better than others. Investors who change strategy due to recent events perhaps will have the most to lose of all. Neither Generals nor investors should execute a strategy based on the last war.

Investing is a numbers game in that it deals in probabilities over time. The best way to improve the probability for a superior outcome is to study future trends and the health of the companies which are by proxy the best way to take part in such trends. Diversification to some extent will reduce risk, but will not eliminate it. Cash flow from investments will aid in avoiding selling an investment at an inopportune time to attain funds. Portfolios with little or no cash flow do not have such an option.

When portfolios go down in value there is a desire to switch from one investment to another. In markets like that experienced last year, such switching would have little impact on the portfolios' performance. Going to cash is the best strategy for a down market. Cash however has the lowest return of any asset class over time. Thus what works in the short run may cost in the long run. This goes back to the issue of time frame for investments. One does not build a long-term portfolio on a short-term strategy.

## **The Economy**

Economic activity shows signs of stabilizing. Initial unemployment claims have leveled off on a weekly basis. Companies are assessing hiring needs in light of whatever Government stimulus plan is most relevant to them.

Lower interest rates are making housing more affordable to those who qualify for purchasing the same. This should put a floor on housing demand. The number of homes available for sale is showing signs of shrinkage. This is necessary before housing construction can resume in a meaningful way.

Longer term, the changes in the terms of credit will make consumers more frugal, while less available corporate financing will restrict corporate expansion. The combination of consumer and bank deleveraging will result in slower growth going forward for some time.

## **Interest Rates**

The prospect of large volumes of Government debt being sold to finance the stimulus plans underway is causing interest rates to level off. Depending on the strength of the world economy the next move in Government bond yields will be up. This move will have the result of creating losses for holders of Government debt at this level.

On the other hand, corporate debt is continuing to appreciate due to the willingness of investors to assume risk in light of the low returns available on cash and Government bonds. Inflows into corporate bond mutual funds have been positive for the past month, reversing a trend of withdrawals over the prior six months.

## **Inflation**

At this juncture inflation continues to be something more forecast than experienced. The willingness of consumers to spend less than they earn is leading to more aggressive pricing by merchants to entice consumers to spend.

At this point the biggest potential force for inflation would be a weaker dollar. However, so far there has been no evidence of prolonged dollar weakness in the international data of currency movements.

## **The Stock Market**

After the consistent and at times sharp declines in 2008 and 2009 up to March 8, the stock market has adopted a pattern of sharp gains and fewer sharp losses followed by periods of relative inactivity. This is actually more in tune with the way markets normally move.

Part of the reason for market volatility aside from the movement of the short-term traders described above is the fact that trades themselves are for larger numbers of shares than a decade or so ago. This reflects the institutionalization of the market as more investors buy stocks through mutual funds, exchange-traded funds and the like. Such trading sizes create inefficiencies as it becomes harder for large firms to get into or out of a stock without upsetting the short-term price of the shares.

Warren M. Barnett, CFA  
April 29, 2009

### **Robert Crabtree Joins Barnett & Company**

Robert Crabtree has joined Barnett & Company as Director of Marketing. He will be providing marketing and public relations services for the firm.

Mr. Crabtree has been a resident of Chattanooga since 1975 and lives on Lookout Mountain with his wife, Catherine Clark Crabtree. He is an alumnus of the University of Tennessee at Chattanooga.

Should you know of someone who would like to discuss his or her investments feel free to call Robert at 423-756-0125, extension 1006 to arrange for a meeting.

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