

**Even Stopped Clocks are Right
Twice a Day:
Assessing the Credibility of Market Pundits**

At times when market valuations are at extremes people tend to attach the most credibility to the persons extrapolating the current trend. Thus when a television commentator like Jim Cramer goes on the “Today” show and tells the world to sell enough investments to have cash to meet expenses for the next three years the statement gains credibility due to the downward direction the market was moving at the time the recommendation was made.

In a similar vein last summer the President of Venezuela predicted that oil would reach \$200 per barrel by the end of the year and an official of the Russian Oil Ministry followed up with a forecast for \$250 per barrel oil. Since oil was going up in price at the time the forecasts had great credibility. With oil currently below \$70 per barrel the forecasts are at best premature and more likely no more valid than a random guess. At the time the pronouncements had the effect of yelling “fire” in a crowded theater. Tellingly, no one for the record examined the self-serving nature of the statements at the time. Few recall the forecasts since the time oil prices turned down.

Since this is a free country anyone is entitled to espouse a forecast. Who is considered prophetic is declared so only in retrospect. On any given day someone is advocating that the market will go up, while another person will advocate its demise. Depending on which way things go, the “accurate” (in retrospect) call is considered the work of a Delphi oracle, while the inaccurate forecast is assigned to the dustbin of history.

This begs a question: Are all market forecasts random? The person who has done the most to answer this question is Mark Hulbert. Mr. Hulbert keeps tabs on a number of market predictors. His service, *The Hulbert Financial Digest*, is considered the most rigorous and unbiased source of market commentary evaluation. To be a candidate for the universe of managers Mark Hulbert evaluates a service must have at least ten years of verifiable data under the same investment manager or editor. The newsletter must make unambiguous market calls or list specific investments for evaluation. If investments are listed they are evaluated for risk, as risky investments will outperform in an up market only to underperform in a down market.

In his letter published early this month, Mr. Hulbert noted that letters with the best long-term track records over ten or more years turned in some of the worst performances last September, while the top performing newsletters for September had some of the worst three, five and ten year track records. He then posed the question: Should investors switch to the September advice leaders and reject the firms with the best long-term records?

He answered this question by studying another period when this reversal occurred. September of 1987 saw a pattern of long-term market forecast leaders being upstaged by firms that had previously been forecasting underperformers. Yet within the following three, five and ten year periods the firms with better long-term track records came back and trounced the supposed timers of the 1987 crash. Even if the firms are compared in terms of performance from August 1987 to September 2008 the best performers in the September/October 1987 market decline are left in the dust. Being right about one market decline did not improve their performance over time.

This data suggests that short-term performance is an unreliable indicator of long-term returns. As the title of this piece would suggest, just about everyone is right about the market at one time or another. The real issue is: Who is right more of the time given that no one is right all of the time? Answering this requires more than a few months of data, or even one market cycle.

According to Hulbert, the long-term newsletter leaders are as a group bullish. They see the current correction as a buying opportunity. Unlike the short-term leaders that successfully called the market in September and October of this year, the long-term leaders freely admit to not being able to predict the short-term swings in the market. They have a more optimistic outlook on the future both for this country and the world than their short-term counterparts.

Those like Jim Cramer who have advocated going into cash during this market downturn will have a second decision to make: when to reinvest. History indicates that usually the more successful a forecaster is in calling a downturn the more reluctant he or she is in committing to the next upturn. The accolades for calling a downturn weigh heavily on the person who has to decide when to get back in. Consequently the next upturn or a great part of it can be missed. Among better known forecasters the careers of Joe Granville and James Dines attest to this problem.

A better position to take is to acknowledge that, if the funds are not immediately needed, the investor can wait out the market cycle. The difference between a portfolio loss and a portfolio decline is that one is realized (i.e. securities are sold at the lower prices) and one is not. Unless the fundamentals of an investment have changed there is really no reason to sell just because the investment is down. In a taxable account with the corresponding capital gains implications, this effort to avoid compulsive selling should be

even greater. So long as the investor keeps in mind that he or she is buying into a business and not investing in the randomness of the universe the ability to take the longer view becomes more distinct and more compelling.

The Economy

Economic activity has begun to show declines year to year. In the third quarter the economy began to contract, although signs of an economic slowdown could be foreseen as far as a year earlier.

The Government has been aggressive in its response. Over \$1 trillion has been earmarked for offsetting the effects of the current slowdown.

As a rule it takes about six to nine months for economic stimulus to make itself felt in the economy. As the first Government funds were authorized in mid-September, the economy should show benefits sometime between mid-March and mid-June.

On the other hand, the salutary effects of a \$2 per gallon decline in gasoline prices should be more immediate. This should add about \$780 million per day to the pockets of consumers and businesses.

Inflation

While the potential for the Government stimulus packages to be inflationary exists, at this point there seems to be no evidence of the same. Since most of the funds have been used to displace losses the effect has been more to avoid deflation than add to inflation.

Much of the declines in commodities have been the result of investors pulling investments from hedge funds. As the typical hedge fund uses a dollar of investment to acquire three to five dollars in assets (with borrowed funds providing the difference), the withdrawal of funds from hedge pools has a similar exaggerated impact on investment liquidations. Add to this the fact that most hedge funds in a given category invest in the same securities, the bottom line is a sharp decline in asset values as everyone heads for the exits at once.

Many commodities are selling for not much more or even less than the cost of extraction. For this reason it is expected that commodity prices will stage at least a modest rally once hedge funds positions are sold off.

Interest Rates

Short-term rates are as low as they will probably go. The Federal Reserve has never in its history gone below a rate of one percent for short-term loans between banks.

While the lending rate between banks (called the LIBOR rate) continues to drift down, the standards for bank loans continue to rise. Loans are available to those with high credit scores and collateral in excess of the loan value.

For others loans are either expensive or non-existent. While lending standards will probably loosen over time, they will not return to the aggressiveness of the 2000-2007 period. This has implications to the pace and direction of the next economic expansion.

The Stock Market

The stock market is showing firmness this week for the first time in over a month. This is in part due to the washout of weak holders of securities as well as the fact that the market is an anticipatory mechanism. Historically the stock market turns up three to six months before the economy. Thus if the economic stimulus is set to kick in during the second quarter of 2009 it would stand to reason that the market would start to turn up between now and the first of the year.

The complexion of the next market will differ from the previous up cycle. There will be less consumer emphasis and more on international opportunities. If the current strength in the dollar is reversed the emphasis on international opportunities will become even more compelling.

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