A Little Bull's Eye Investing

By John Mauldin | April 21, 2012

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> "Would you tell me, please, which way I ought to go from here?"
> "That depends a good deal on where you want to get to," said the Cheshire Cat.
> "I don't much care where . . . " said Alice.
> "Then it doesn't matter which way you go," said the Cat.
> ". . . just so long as I get SOMEWHERE," Alice added as an explanation.
> "Oh, you're sure to do that," said the Cat, "if you only walk long enough."
> —Lewis Carroll, *Alice in Wonderland*

Bull's Eye Investing was the book that really helped establish this letter. It dealt with a host of investing ideas, secular market cycles, value investing, alternative investing, and more. It is still in print some nine years later and has had a very positive response. Today I can share that I have taken that material, updated it, and written a new book, part of the Little Book series done by Wiley, called ***The Little Book of Bull's Eye Investing – Finding Value, Generating Absolute Returns, and Controlling Risk in Turbulent Markets.***

Rather than talk about a book I am going to do, I have waited to announce this one until it is off the presses and being shipped. Technically, the publication date is May 8, but Amazon will be shipping before then and it will be in book stores in short order. I am quite pleased with it and think you will find it's a great way to "catch up" with my thoughts on the nitty-gritty of investing and allocation.

Today's e-letter is the introduction and part of the first chapter of the book. You can order the book on Amazon at http://www.amazon.com/bullseye. And get a few extra for friends, family, and clients! Now, let's get started.

An Introduction to Bull's Eye Investing

Every hunter knows you don't shoot where the duck is; you shoot where the duck is going to be. You've got to lead the duck. *Bull's Eye Investing* simply attempts to apply the same principle to the markets. In this book, I hope to give you an idea of the broad trends that I believe are at work now and will persist for the remainder of this decade. Then I'll help you target your investments to take advantage of those trends.

Through the Looking Glass

"You're sure to get somewhere if you only walk long enough…"
—The Cheshire Cat (Lewis Carrol)

When I was invited to do this *Little Book of Bull's Eye Investing*, I wondered whether the original *Bull's Eye Investing* (written nine years ago and dense in data and research and not little at all) could be shortened and still deliver what put the book on the best-seller lists, made it a choice for the New York Times best summer reading list, and earned it the top spot on *Forbes* publisher Rich Karlgaard's roll call of the decade's most important books on investing. It's since been published in several foreign languages and is still in print.

Thinking about doing the *Little Book* made me go back and carefully read the original, and I was pleased to find how much of it is still useful today. Much of the research that it reports is timeless and still will be valuable a generation from now. Many of the predictions, whether by luck or skill, were spot on. We are still on the path I mapped out but are much further along it. The task for the *Little Book* is to collect the parts that have held up well and then bring things up to date, to introduce new readers to the concept of Bull's Eye Investing.

As I write this introduction (the final element), I've just come from Hong Kong, where the original *Bull's Eye Investing* still has something of a serious following. Publishers are eager to do a Chinese-language version for distribution in Hong Kong and the mainland. The principles of the long-term ebb and flow of markets really do work wherever human beings are involved in investing, which is to say, everywhere.

Successful investing for the remainder of this decade will mean doing things differently from what people did so profitably in the 1980s and 1990s and from what Wall Street is still telling people to do. We started the last bull market, in 1980, with high interest rates, very high inflation, and low stock market valuations. All the elements were in place to launch the greatest bull market in history.

The environment now is just the opposite. Stock market valuations are still relatively high (though well down from the stratosphere where they were flying at the beginning of the decade), and interest rates will eventually have to go up. In addition, gold is volatile, as is the dollar against other currencies, and the twin deficits of trade and government debt stare us in the face.

Everything Is *Not* Relative

So which way is the stock market going? And how about bonds? Gold? Real estate? Where should you invest?

Wall Street and the mutual fund industry say, “The market is going up, you should buy stocks, and now is the time to do it. You can’t time the markets, so you should buy and hold for the long term. Don’t worry about the short-term drops. And my best advice is to buy my fund.”

Wall Street is like the carpenter who only has a hammer: everything looks like a nail. Those brokers are in the business of selling stocks because that is how they make their real money. Whether they are sold one by one or packaged in mutual funds or as IPOs or in wrap accounts or in variable annuities or in derivatives, what the brokers want to sell you is some type of equity (stock), and preferably today. They have rigged the rules against investors who would prefer more and safer choices, so that most investors are unaware of the options.

Their advice for you to buy what they're selling has been their same advice every year for a century. And it has been wrong about half the time. There are long periods when stock markets go up, but there also are long periods when markets go down or sideways. And by “long,” I mean longer than almost anyone is prepared to wait.

These cycles are termed secular bull and bear markets. (Secular as used in this sense is from the Latin *saeculum*, which means a long period of time.) Each cycle has its own good investment opportunities. When I wrote the introduction to *Bulls Eye Investing* in 2003, I said we were in a secular bear. Now, nine years later, we are in what I think is the latter part of that same trend.

The problem with Wall Street is that most of what it sells does poorly in secular bear markets, so most traditional portfolios have suffered since 2000. But they still tell you that things will get better, so buy and keep buying. “Just look at this chart prepared by our independent economists that proves the market will go back up. Just have patience, and please give us more of your money.”

In secular bull markets, an investor should search for assets that offer **relative returns**—stocks and funds that will perform better than the market averages. If you beat the market, you're doing well. Even though there will be losing years, the strategy of staying invested in quality stocks during a secular bull market will be a long-term winner.

In a secular bear market, however, that strategy is a prescription for disaster. If the market goes down 20 percent, and you just go down 15 percent, you'd be doing relatively well, and Wall Street would call you a winner. Your broker would expect a pat on the back. But you are still down 15 percent.

In markets like those we face today, the essence of Bull’s Eye Investing is to focus on **absolute returns.** Your benchmark is a money market fund. Success is measured by how much you make above Treasury bills.

Some will say, as they say each year, that the bear market is over and that the book you are reading is about ancient history. But experience says otherwise. A secular bear market can see drops much bigger than we have already been through, and it can last as long as 20 years. The shortest has been 8 years. *None has ended with valuations as high as they were at the bottom* *in 2009.* And that touches on one of the novel ideas in this book: bull and bear cycles should be seen in terms of valuations, not price.

Investors who continue to listen to the music from Wall Street will be sorely disappointed, in my opinion, as the facts I will present show that this bear market has years to go. For buy-and-hold investors planning to retire within a decade and live on their stocks, the results could be particularly devastating.

Walking "Long Enough"

Bull's Eye Investing is not, however, about doom and gloom. Despite what Wall Street wants you to believe, there is no reliable connection between how the economy does and how the stock market performs. As we'll see, the economy should muddle through, with just the usual kind of recessions sandwiched between periods of growth. The world as we know it is not coming to an end. It is merely changing, as it is always doing. There are numerous possibilities for investment growth while the secular bear market proceeds. You just won't find them on any standard Wall Street menu.

What I hope to do is give you a road map to the future by looking at how and why markets have behaved in the past. We will debunk many of the myths and so-called scientific studies used by Wall Street to entice investors into putting their money into buy-and-hold, relative return investments. As should be no surprise, they use "facts," theories, and statistics that are carefully selected and in many cases plain wrong. And when the market goes down, they just shrug their shoulders like a Chicago Cubs (or my own Texas Rangers) fan and say, "Wait till next year. And buy some more, please."

[And now a part of Chapter One]

It's Good to Be King – But Beware of Tailors Using Invisible Cloth

The traditional wisdom of Wall Street is to buy low and sell high. While it sounds simple enough, the philosophy has fostered an entire industry of financial advisors, prognosticators, and experts. When you reflect on the carnage on Wall Street in the last few years, it is easy to place stock market experts in the same category as TV weathermen. Television shows parade a seemingly endless lineup of financial, economic, and stock market experts who freely give this stock tip or suggest that investment strategy. Yes, they say, the economic outlook may seem gloomy, but happy days are right around the corner. This is the time to buy.

Every talking head seems to have an opinion. (Note: I am frequently be one of those talking heads!) Often a show's producer will recruit talking heads with conflicting views and let them battle it out. It can make for interesting viewing for some and confusion for others. How can a few sound bites really give you the information you need to confidently invest in today's volatile markets?

Timing Is Everything

There’s a Wall Street legend that Joseph P. Kennedy, the paterfamilias of the Kennedy clan, survived the 1929 crash because he had divested all of his holdings in the summer of 1929. He said that he knew it was time to get out when he started receiving stock tips from the shoeshine boy. If you were one of the smart or prescient investors who got out of the U.S. stock market before October 11, 2007, consider yourself lucky. Between 1929 and 1932, the stock market declined 89 percent, which contributed to the Great Depression. From October 2007 until March 2009, the market lost about 55 percent of its value; the second biggest decline in our nation’s history.

The U.S. economy began shrinking in December of 2007. The recession, by the technical definition of the term, ended in June of 2009, because that's when the economy began growing again.

A nontechnical definition of a recession’s end has to do with consumer confidence and a general sense of optimism about the financial future of the country. We are now in the first quarter of 2012, and people are still looking for solid proof that the worst is behind us. Consumer confidence is at a level typical of a recession and that is anomalous two years into a recovery. Instead of signs of fiscal hope, we are faced with daily reports of persistent high unemployment, declining home prices, increasing rates of foreclosures and bankruptcies, persistent federal deficits, high gas prices, and hints of coming inflation.

In the face of all the negative news, it would be easy to conclude that investing in the stock market with the hope of making any profit at all would be a fool’s errand. You might even believe that the safest course is to stick your money under your mattress and hope your house doesn’t burn down. You *could* do that, but you would be absolutely wrong.

Where Were We, Again?

A secular bear market is loosely defined as a period of years or even decades when stock prices are either flat or falling (think Japan since 1990 or the United States from 1966 to 1982). Historically and classically defined, secular bear markets are as short as 8 years or as long as 17. By a broader definition that I prefer and will explain, the range is 13 years to as long as 20 years. For the last century in the United States, the length has been remarkably consistent—about 17 years from the beginning of a secular bear to the beginning of the next true secular bull. My friend Art Cashin, head of UBS Floor Operations and dean and sheriff of the New York Stock Exchange, recently sent me a note he wrote at the beginning of the last decade.

“Floor brokers have lots of theories of cycles and such. There’s even a fat and lean cycle theory. Just as in the Bible there were seven fat years followed by seven lean years . . . brokers claim to see a similar thing in Wall Street. Ours is much longer . . . 17.6 years.

“You may think what I am about to tell you is negative. I suggest to you it is not. It raises your opportunity by eliminating mindless competition. It just means you have to work at it—seeking advice and information—and not leaving your investment policy on autopilot. That was what folks did in the fat cycle. That doesn’t work any more.

“In the fat cycle, which ended with the bubble, the Dow went from 900 to 11,700. You could throw a dart and pick a winner . . . lots of folks did. Those days are gone. Getting a decent return will be hard work for the next decade. You will need good judgment and good advice. Put the dartboard away. Just so you understand better, let me walk you through this concept.

“The tech bubble or the bull market topped in about February 2000. Just so it works on your calculator—let’s call that 2000.2. The Dow is around 11500. Subtract 17.6 years and you are in the middle of 1982. The Dow is around 900. It will soon embark on the greatest bull market in history. Subtract another 17.6 years from June of 1982 and you are back to the beginning of 1965. The Dow is around 900.

“Yes . . . that’s the same area you will find it in 17 years later. This clearly is the lean cycle. The Dow will go above and below 900 many times. Money will be made and new industries flourish, but it will require skill and hard work to find them.

“Subtract another 17.6 years from 1965 and you are back around the middle of 1947. The war has ended. Smokestack prosperity is in the offing. The Dow is around 220. This was to be a fat cycle.

“Subtract another 17.6 years and you are back in early fall 1929. The Dow is around 380 – but not for long. This . . . clearly . . . will be a lean cycle.

“Now—on the slim chance that this is any more than an oddity—what does it mean to you?

“It means you have to get off autopilot. In a fat cycle people can almost throw darts and hit a winner. In a lean cycle they need to pay attention and seek advice from someone with skill and brains.”

My contention, and I think the clear lesson of history, is that we are still (as of 2012) in the secular bear market that began in 2000. If the recent pattern holds, the bear market will continue for another five to six years in terms of valuations, if not in price. The key to successful investing will be to hold the types of stocks, funds, and other investments that do well in a secular bear market (when valuations are contracting), while avoiding the types that history has shown have less chance for success in such an environment.

Understanding the environment and investing accordingly are critical to your success. But before I can tell you how to invest in a secular bear market, you need to understand for yourself what these cycles are and why and how they happen.

When Past Is Not Prelude

We are looking for clues as to what the stock market is likely to do in the future. If reviewing the past gives us some idea of what the future will be, we will be way ahead of the crowd.

We can find some clues in a groundbreaking book by Michael Alexander called *Stock Cycles.* What he wrote early in 2000 accurately anticipated the behavior of the markets since then, and I recommend the book as important reading. (You can order it from Amazon.com.)

Let's jump to the conclusion: Alexander's work shows that using past market cycles to predict the performance of stocks over the coming 12 months isn't much better than flipping a coin (and so does Ed Easterling's later work!). Statistically, from almost any starting point, you have about a 50–50 chance of the market going up or down, using past price movements alone to make your prediction. **Even in a secular bear market, the market goes up in 50 percent of the years, and often quite substantially**.

But there are certain long-term cycles that are not random, and the probability of those repeating is higher than 50 percent. As you would expect, the patterns and techniques of successful investing change somewhat dramatically from phase to phase. The trick, of course, is to figure out where you are in the cycle.

I have long been suspicious of stock market cycle theory, especially Long Wave theory. Long Wave (or Kondratieff Wave) theory says the economy and markets repeat every 56 or 60 years. Granted, there seem to be patterns that recur, but there are not enough data points to provide statistical confidence. It is an interesting theory that tells you where you have been and where you are going, but it does not tell you reliably where you are or when you will arrive somewhere else.

I remember, as will many of my (ahem – somewhat older) readers, how Long Wave theory predicted the end of the economic world in the late 1980s. How many of you remember the flood of direct mail promotions, not to mention the books, screaming gloom and doom? Obviously, they were wrong.

The reason is that analysts try to make Long Wave theory a precise predictive model. They do not look at the fundamentals that drive the cycles.

It is like watching two men seemingly walking in the same direction in a large city. Maybe they are friends and are walking together. They could be total strangers going to the same location, or they may part ways in the next block. Until you know who the men are and where they are going, using their past travels to predict their movements is simply guessing.

It is one thing to use the stars, as the ancients did, to construct a calendar to predict seasons, planting times, and weather patterns. It is another to use the stars to predict personal fortunes. One methodology has a basis in fundamentals, the other (astrology) simply notices patterns that have no causal connection to anything else.

Alexander provides, at least for me, the needed link between the patterns in long-wave stock cycles and the underlying economic fundamentals. He shows, as it were, a causal connection between the position of the stars and the seasons.

Alexander doesn't claim these cycles are as precisely predictable as the spring equinox. Rather, he suggests that when certain fundamental conditions occur, we can look for spring-like events. Just as you plant certain types of food and plants in spring and certain types in winter, there are some investments that do better in their respective parts of the stock cycle. Carrying the analogy further, it is easier to grow your portfolio in economic spring than in economic winter. In spring, you have a much wider variety of "plants" from which to choose.

You can plant spring crops during the winter, but you're going to have to wait until spring to see them come up. In the meantime, it can be a long, cold season.

It is time to close but I will not leave you totally hanging. The connection between long-wave economic cycles and markets is actually highly attributable to the introduction of technology revolutions (steam, railroads, electricity, telecommunications, etc.) As an aside, as major technological innovations are being introduced at a faster pace than in the previous 500 years, it is highly likely that the long-wave cycle will completely break down, although I am sure that will spark a lot of disagreement among some readers. Which, by the way, does not make Long Wave analysis useless. On the contrary, it shows us something new and entirely different. I find it all very intriguing.

Again, you can buy the book at http://www.amazon.com/bullseye. Do it now and be among the first to get a copy!

A final thought: Many of you know that I'm a firm believer in alternative investments. Institutions have been using them for years to help diversify their portfolios. Recently, a number of individual investors and advisors have asked me, "What type of alternative investment strategies should I be looking at now?"

While I don't believe in "timing" alternative investments, I do believe that there is a particularly compelling case for allocating to managed futures at this time. Last year, the Altegris 40 (an index of managed futures) was down more than 3%. In the last 14 years, the Altegris 40 has only been down twice.

The ability of managed futures managers to go long or short the four major asset classes (stocks, interest rates, commodities, and currencies) is a principal reason why the strategy has historically provided strong risk-adjusted returns in both up and down markets. As a longtime investor in alternatives, I always recommend holding a core position in managed futures. If you don't currently invest in them, I believe that now is the time to do so. And if you do, look at your allocation level and – depending on your long-term investment goals or those of your clients – this may be the time to consider an increase.

There are a variety of ways to invest in managed futures. As most of you know, I have partnered with Altegris Investments, one of the world's premier providers of alternative investments. Their singular mission is to find the best alternative investments strategies for their clients, and they have an extensive track record of providing access to best-of-breed managers in the managed futures space.   I strongly encourage you to learn more about managed futures and Altegris' range of products, at http://www.altegris.com.

Next Week: Austin, New York, Philadelphia, Washington DC, and Fort Lauderdale

My schedule is rather hectic this next week. This very moment I am in Austin getting ready to go to Lacy Hunt's (and his new bride JK's) wedding reception, where he has the iconic Texas band Asleep at the Wheel playing. My good friend Scott Burns will also be there (he has an important new book out, which I was reading on the plane and which I will write about later), plus lots of new friends, I am sure. Then back tomorrow and off on Sunday to New York, where I will have dinner with Dr. Mike West and his team at Biotime, then attend their shareholder's meeting the next day (and briefly speak). I then catch the train to Philadelphia for dinner with Bill Dunkelberg and the other speakers at the following morning's GIC conference on demographics. Partner Steve Blumenthal is also scheduled to join us.

Then I hop a train to DC for an event with Altegris Investments, before moving on to Fort Lauderdale on Thursday for the Casey Conference, where there are lots of friends and a very solid speaker line-up. Then it's home on Sunday for a few days before going to my own conference (co-hosted by Altegris) on Wednesday in Carlsbad, California. Tonight marks the first of three straight Friday nights I will be with Lacy (the chief economist for Hoisington, and no stranger to the readers of this letter). Maybe some of his brilliance and economic wisdom will rub off on me.

A quick note. I will be speaking May 8 at the CFA Institute Annual Conference in Chicago, May 6–9. They have a great line-up of speakers, from Eugene Fama, James Montier, Sam Zell, Gary Brinson, and former Fed Governor Randall Kroszner, to Nobel laureate Daniel Kahneman, Abby Joseph Cohen, and Michael Pettis from Beijing.

You don't have to be a CFA (chartered financial analyst) to attend. You can click on the link above or below for more information. If you decide to attend and take in my panel on "World Debt Crisis: Endgame Scenarios and What They Could Mean for Investors and the World" (with Anatole Kaletsky, Barry Ritholtz, David Rosenberg, and me), you can register at the conference website and save $100 on your registration fee by using the discount code **FRIEND**.

It really is time to hit the send button. Dinner and a very edgy type of Texas Swing music are waiting for me. Asleep at the Wheel has toured with a score of very big names over the last 40 years, as well as done their own road trips and had their share of hits. I have never heard them live and am really looking forward to it. Lacy knows how to do it in style.

(Last-minute note back from the party. It was as awesome as I thought it would be. You can take the boy out of the country but you can't take the country out of the boy. And so many friends were there. You really have to enjoy nights like tonight.)

Your just ready to go to sleep (but not at the wheel) analyst,

John Mauldin