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When will the Bear Market Rally End?

By John Mauldin

This week we re-visit one of my favorite themes: Why Investors Fail. I am doing the final edits on my book, Bull's Eye Investing, and when I came to the chapters on the psychological hard-wiring we have as humans, which causes us to make the same investment mistakes over and over, it just reminded me how important it is to understand why we do the things we do, and then stop doing them!

There are over 50 pages in the book on these issues, so I am just going to pull out a few points for this week's letter. It also let's me get back to editing the final version, which must be done this weekend, as the book must get to the press soon. It will be out in the bookstores in only a few months. More on that below, but now let's examine a few reasons why humans are such investment head cases.

Why Investors Fail: Analyzing Risk

Like all the children from Lake Wobegon, I am sure all my readers are above average investors. But I am also sure you have friends who are not, so let's look at the reasons why they fail at investing, how they should analyze funds and determine risk. Hopefully this will give you some ways to help them. **I will show you a simple way to put yourself in the top 20% of investors.** This should make it easier to go to family reunions and listen to your brother-in-law's stories.

A big part of successful Bullseye Investing is simply avoiding the mistakes that the large majority of investors make. I can give you all the techniques, trading tips, fund recommendations, forecasts and so on, but you must still keep away from the patterns which are typical of failed investors.

What I want to do in this section is give you an "aha!" moment: that insight which helps you understand a part of the mysteries of the marketplace. We will look at a number of seemingly random ideas and concepts, and then see what conclusions we can draw.

Investors Behaving Badly

The Financial Research Corporation released a study prior to the bear market which showed that the average mutual fund's three year return was 10.92% while the average investor in those same periods gained only 8.7%. The reason was simple: investors were chasing the hot sectors and funds.

If you study just the last three years, my guess is those numbers will be worse. "The study found that the current average holding period was around 2.9 years for a typical investor, which is significantly shorter than the 5.5 year holding period of just five years ago.

"Many investors are purchasing funds based on past performance, usually when the fund is at or near its peak. For example, $91 billion of new cash flowed into funds just after they experienced their "best performing" quarter. In contrast, only $6.5 billion in new money flowed into funds after their worst performing quarter." (from a newsletter by Dunham and Associates)

I have seen numerous studies similar to the one above. They all show the same thing: that the average investor does not get average performance. Many studies show statistics which are much worse.

The study also showed something I had observed anecdotally, for which there was no evidence. Past performance was a good predictor of future ***relative*** performance in the fixed income markets and international equity (stock) funds, but there was no statistically significant way to rely on past performance in the domestic (US) stock equity mutual funds.

"The oft-repeated legal disclosure that past performance is no guarantee of future results is true at two levels:

1. **Absolute returns** cannot be guaranteed with any confidence. There is too much
variability for each broad asset class over multiple time periods. Stocks in general may provide 5-10% returns during one decade, 10-20% during the next decade and then return back to the 5-10% range.

2. **Absolute rankings** also cannot be predicted with any certainty. This is caused by too much relative variability within specific investment objectives. #1 funds can regress to the average or fall far below the average over subsequent periods, replaced by funds that may
have had very low rankings at the start. The higher the ranking and the more narrowly you
define that ranking (i.e. #1 vs. top-decile [top 10%] vs. top quartile [top 25%] vs. top half), the more unlikely it is that a fund can repeat at that level. It is extremely unlikely to repeat as #1 in an objective with more than a few funds. It is very difficult to repeat in the top-decile, challenging to repeat in the top quartile, and roughly a coin-toss to repeat in the top half." (Financial Research Center)

The chances of you picking a stock today that will be in the top 25% of all companies every year for the next ten years is 50 to 1 or worse. In fact, the longer a company shows positive earnings growth and outstanding performance, the more likely they are to have an off year. Being on top for extended periods of time is an extremely difficult feat.

Yet what is the basis for most stock analysts' predictions? Past performance and the optimistic projections of a management that gets compensated with stock options. What CEO will tell you his stock is over-priced? His staff and board will kill him, as their options will be worthless. Analysts make the fatally flawed assumption that because a company has grown 25% a year for five years that they will do so for the next five. The actual results for the last 50 years show the likelihood of that happening are small.

Analyze This: Analysts Are Useless

David Dreman points out in a study that he conducted from 1982 through 1997 analysts were ON AVERAGE wrong by 200%. (Forbes, July 8, 2002)

Dreman tells us, "Earnings performance for 2002's first half was a sorry one. Company after company was forced to lower expectations or restate past results downward. How can the consensus justify such a healthy-looking multiple for the year as a whole? By forecasting a second-half profit boom that gushes up from nowhere: a 48% gain (from a year earlier) in the third quarter and a 45.7% one in the fourth, according to S&P analysts' forecasts. Included in the forthcoming profit explosion, as reported in *First Call*, are a 127% income increase in technology stocks in the third quarter and a 73% jump in the fourth and a hardly modest 19-fold rise in transportation earnings in the third quarter (mainly airlines), with an even larger gain forecast for the fourth."

Another longer-term study published by the National Bureau of Economic Research shows that analysts typically overstate earnings by at least a factor of 2. From the report: "**Analysts predicted a five-year growth for the top 20% of companies to be 22.4% which turned out to be only 9.5%.** [The researchers also pointed out the actual return rate should be lower because many companies actually failed over that period.]

They created sample portfolios based upon analysts' forecasts. **Predictably, the top portion of the portfolios actually returned only about half of what the analysts predicted**: 11% actual versus 22% predicted. "These results suggest that in general caution should be exercised before relying too heavily on long-term forecasts as estimates of expected growth in valuation studies."

As we go to press, the pattern is still there. Analysts are predicting the miracle turn around within just a few quarters.

Given the new accounting standards, the probability that these estimates are realistic is exceedingly slim.

Here's a business opportunity for some enterprising new analyst. Start your own analysis firm. Go to First Call (a firm which compiles estimates from numerous sources) and look at the consensus estimates for earnings on any given company. Cut it in half and publish your estimates. Hire a few MBA financial types to write reports that reflect your "estimates." Then go to work on your golf handicap for the rest of the month.

Results: you will be closer than 90% of all analysts. After a year or two, you will look like a genius. You will be able to sell your analysis to firms all over the world for big bucks. You will be rich and you will have a single digit handicap. The irony is that your analysis has a better basis in historical fact than the guys who are actually trying. If you can deal with the conscience thing (which does not seem to be a problem for some analysts), it would not be a bad life.

Tails You Lose, Heads I Win

I cannot recommend highly enough a marvelous book by Nassim Nicholas Taleb called "Fooled by Randomness." The sub-title is "The Hidden Role of Chance in the Markets and in Life." I consider it essential reading for all investors, and would go so far to say that you should not invest in anything without reading this book. He looks at the role of chance in the marketplace. Taleb is a man who is obsessed with the role of chance, and he gives us a very thorough treatment. He also has a gift for expressing complex statistical problems in a very understandable manner. I intend to read the last half of this book at least once a year to remind me of some of these principals. Let's look at just a few of his thoughts.

Assume you have 10,000 people who flip a coin once a year. After five years, you will have 313 people who have come up with heads five times in a row. If you put suits on them and sit them in glass offices, call them a mutual or a hedge fund, they will be managing a billion dollars. They will absolutely believe they have figured out the secret to investing that all the other losers haven't discerned. Their 7 figure salaries prove it.

The next year, 157 of them will blow up. With my power of analysis, I can predict which one will blow up. It will be the one in which you invest!

Ergodicity

In the mutual fund and hedge fund world, one of the continual issues of reporting returns is something called "survivorship bias." Let's say you start with a universe of 1,000 funds. After five years, only 800 of those funds are still in business. The other 200 had dismal results, were unable to attract money, and simply folded.

If you look at the annual returns of the 800 funds, you get one average number. But if you add in the returns of the 200 failures, the average return is much lower. The databases most statistics are based upon only look at the survivors. This sets up false expectations for investors, as it raises the average.

Taleb gave me an insight for which I will always be grateful. He points out that because of chance and survivorship bias, investors are only likely to find out about the winners. Indeed, who goes around trying to sell you the losers? The likelihood of being shown an investment or a stock which has flipped heads five times in a row are very high. The chances are that hot investment you are shown is a result of randomness. You are much more likely to have success hunting on your own. The exception, of course, would be my clients. (Note to regulators: that last sentence is a literary device called a weak attempt at humor. It is not meant to be taken literally.)

That brings us to the principle of Ergodicity, "…namely, that time will eliminate the annoying effects of randomness. Looking forward, in spite of the fact that these managers were profitable in the past five years, we expect them to break even in any future time period. They will fare no better than those of the initial cohort who failed earlier in the exercise. Ah, the long term." (Taleb)

Why Investors Fail

While the professionals typically explain their problems in very creative ways, the mistakes that most of us make are much more mundane. First and foremost is chasing performance. Study after study shows the average investor does much worse than the average mutual fund, as they switch from their poor performing fund to the latest hot fund, just as it turns down.

Mark Finn of Vantage Consulting has spent years analyzing trading systems. He is a consultant to large pension funds and Fortune 500 companies. He is one of the more astute analysts of trading systems, managers and funds that I know. He has put more start-up managers into business than perhaps anyone in the fund management world. He has a gift for finding new talent and deciding if their "ideas" have investment merit.

He has a team of certifiable mathematical geniuses working for him. They have access to the best pattern recognition software available. They have run price data through every conceivable program and come away with this conclusion:

Past performance is not indicative of future results.

Actually, Mark says it more bluntly: Past performance is pretty much worthless when it comes to trying to figure out the future. The best use of past performance is to determine how a manager behaved in a particular set of prior circumstances.

Yet investors read that past performance is not indicative of future results, and then promptly ignore it. It is like reading statements at McDonalds that coffee is hot. We don't pay attention.

Chasing the latest hot fund usually means you are now in a fund that is close to reaching its peak, and will soon top out. Generally that is shortly after you invest.

What do Finn and his team tell us does work? Fundamentals, fundamentals, fundamentals. As they look at scores of managers each year, the common thread for success is how they incorporate some set of fundamental analysis into their systems.

This is consistent with work done by Dr. Gary Hirst, one of my favorite analysts and fund managers. In 1991, he began to look at technical analysis. He spent huge sums on computers and programming, analyzing a variety of technical analysis systems. Let me quote him as to the results of his research:

"I had heard about technical analysis and chart patterns and, looking at this stuff I would say, what kind of voodoo is this? I was very, very skeptical that technical analysis had value. So I used the computers to check it out and what I learned was that there was, in fact, no useful reality there. Statistically and mathematically all these tools—stochastics, RSI, chart patterns, Elliot Wave, and so on—just don't work. If you code any of these rigorously into a computer and test them they produce no statistical basis for making money; they're just wishful thinking. But I did find one thing that worked. In fact almost all technical analysis can be reduced to this one thing, though most people don't realize it: the distributions of returns are not normal; they are skewed and have "fat tails." In other words, markets do produce profitable trends. Sure I found things that work over the short term, systems that work for five or ten years, but then fail miserably. Everything you made, you gave back. Over the long term, trends are where the money is."

When will the Bear Market Rally End?

First, let me make this very clear: There is no technical indicator, or even fundamental system, that can tell us when this next bear market rally will end, or when the bear market is over and a new bull will begin. All of this talk on TV or in newsletters about this indicator or that system telling us we are at the exact top or bottom is just voodoo investing. It is an exercise in wishful thinking.

The Nobel prize in economics in 2002 went to a psychologist, Dr. Daniel Kahneman, who helped pioneer the field of behavioral economics. If I can crudely summarize his brilliant work, he basically shows that investors are irrational. But what gets him a Nobel is he shows that we are predictably irrational. We continue to make the same mistakes over and over. One of the biggest is our common inability to take a loss. He goes into long and magnificent explanations of why this is, but the bottom line is that taking a loss is so painful, we simply avoid it.

While technical indicators cannot be rigorously programmed to yield an automatic, always winning, low loss, don't think about it trading system, they do provide some useful insight. Volume, direction, momentum, stochastics, etc. are reflective of market psychology. With a great deal of time and effort, astute traders can use this data to determine what Mark Finn calls the "gist" of the market.

The great traders become adept at using this data to help them determine market psychology and thus market movement. They also employ excellent money management and risk control skills. My contention is they have the "feel." Just like some people can hit 95 MPH fast balls, they can look at amazing amounts of data and feel the market. They use solid money management techniques to control the risk, and they make money for themselves and their clients. Like Alex Rodriguez at the plate, they make it look easy.

That's why analysts like Richard Russell are so important. After watching the market and tons of data (one might say obsessively, but that would be the pot calling the kettle black) for 45 years, he has developed an intuitive feel that is very valuable to his readers. He makes it look easy.

And thus many ordinary people think they can do it. And most fail.

For some reason, we take this failure personally. It seems so easy, we should be able to do it. But after years of interviewing hundreds of managers, and looking at thousands of funds, and mounds of data, I have come to believe it is a gift, just like hitting baseballs or golf balls.

If it were easy, everybody could do it. But it's not, so don't beat yourself up if you are not the one with the gift. It would be like me getting angry at myself for not being a scratch golfer. It is not going to happen in my lifetime. It does not mater how much I practice. I simply don't have the talent to be a scratch golfer. If I wanted to bet on golf, I would bet on a pro, not on me.

Becoming a Top 20% Investor

Over very long periods of time, the average stock will grow at about 7% a year, which is GDP growth plus dividends plus inflation. This is logical when you think about it. How could all the companies in the country grow faster than the total economy? Some companies will grow faster than others, of course, but the average will be the above. There are numerous studies which demonstrate this. That means roughly 50% of the companies will out-perform the average and 50% will lag.

The same is true for investors. By definition, 50% of you will not achieve the average; 10% of you will do really well; and 1% will get rich through investing. You will be the lucky ones who find Microsoft in 1982. You will tell yourself it was your ability. Most of us assign our good fortune to native skill and our losses to bad luck.

But we all try to be in the top 10%. Oh, how we try. The FRC study cited at the beginning of this chapter shows how most of us look for success, and then get in, only to have gotten in at the top. In fact, trying to be in the top 10% or 20% is statistically one of the ways we find ourselves getting below average returns over time. We might be successful for awhile, but reversion to the mean will catch up.

Here is the very sad truth. The majority of investors in the top 10-20% in any given period are simply lucky. They have come up with heads five times in a row. Their ship came in. There are some good investors who actually do it with sweat and work, but they are not the majority. Want to make someone angry? Tell a manager that his (or her) fabulous track record appears to be random luck or that they simply caught a wave and rode it. Then duck.

By the way, is it luck or skill when an individual goes to work for a start-up company and is given stock in their 401k which grows at 10,000%? How many individuals work for companies where that didn't happen, or their stock options blew up (Enron)? I happen to lean toward Grace, rather than luck or skill, as an explanation, but this is not a theological treatise.

How to be a Top 20% Investor

Read the Millionaire Next Door. Most millionaires make their money in business and/or by saving lots of money and living frugally. Very few make it by simply investing skill alone. Odds are that you will not be that person.

But I can tell you how to get in the top 20%. Or better, I will let FRC tell you, because they do it so well:

"For those who are not satisfied with simply beating the average over any given period, consider this: **if an investor can consistently achieve slightly better than average returns each year over a 10-15 year period, then cumulatively over the full period they are likely to do better than roughly 80% or more of their peers.** They may never have discovered a fund that ranked #1 over a subsequent one or three year period. That "failure," however, is more than offset by their having avoided options that dramatically under-performed. **Avoiding short-term under-performance is the key to long-term out-performance.**

"For those that are looking to find a new method of discerning the top ten funds for 2002, this study will prove frustrating. There are no magic short-cut solutions, and we urge our readers to abandon the illusive and ultimately counterproductive search for them. For those who are willing to restrain their short-term passions, embrace the virtue of being only slightly better than average, and wait for the benefits of this approach to compound into something much better…"

That's it. You simply have to be only slightly better than average each year to be in the top 20% at the end of the race. It is a whole lot easier to figure out how to do that than chase the top ten funds.

Of course, you could get lucky (or Blessed) and get one of the top ten funds. But recognize it for what it is and thank God (or your luck if you are agnostic) for His blessings.

I should point out that it takes a lot of work to be in the top 50% consistently. But it can be done. I don't see it as much as I would like, but I do see it.

Bull's Eye Investing

As I noted above, I am feverishly working on the final edits for my book. Wiley and Sons, the publisher, sent me 800 double spaced manuscript pages back from their copy editor. There are an average of about 15 edit marks per page, each of which require me to think about them, at least for a moment. You do the math. I think the copy editor was getting paid by the edit, or maybe I just need to stop making so many mistakes. Next week it gets sent to the typesetter, we get a few days to proof the galleys and then on to the printer and finally the bookstores! It is an exciting, if somewhat exhausting, process.

I will start on the first 2004 issue of my accredited investor letter this weekend. For those who are interested and who qualify, I write a free letter on hedge funds and private offerings called the Accredited Investor E-letter. You must be an accredited investor (broadly defined as a net worth of $1,000,000 or $200,000 annual income – see details at the website.) You can go to www.accreditedinvestor.ws to subscribe to the letter and see complete details, including the risks in hedge funds. (In this regard, I am a registered representative of the Williams Financial Group, an NASD member firm.)

Next week I take my bride to Lake Louise, north of Calgary, to what I am told is one of the most beautiful parts of the world. I will be speaking at a conference for the energy investment banking firm of Peters and Company. I will be on the platform with George Gilder, so that should be interesting. While I no longer ski (I never got the hang of controlling my falls), I look forward to seeing the mountains in winter for a few days.

My bride, who used to work for the Dale Carnegie Group as a trainer (yes, she is a professional nice person) tells me that Dale Carnegie wrote "How to Win Friends and Influence People" at the resort in Lake Louise where we will be staying. I intend to once again read the book while I am there, as well as make a number of new friends.

Enjoy your week, and take time to make a few new friends. That is a trend that always pays big dividends.

Your making my shadow work hard to keep up with me analsyst,

John Mauldin