EPIC
Investment Management, Inc.

Issue 9 March 2012

Mining For Money

As curious creatures, investors typically want to know which money-making ideas have worked well in the past, and which have failed. Yet somewhere in our minds is a suspicion that the future cannot be gleaned from the past, not without a wide margin of error. There are too many variables, too many possible outcomes, for the markets to simply repeat themselves year after year. The suspicion in our minds is justified.

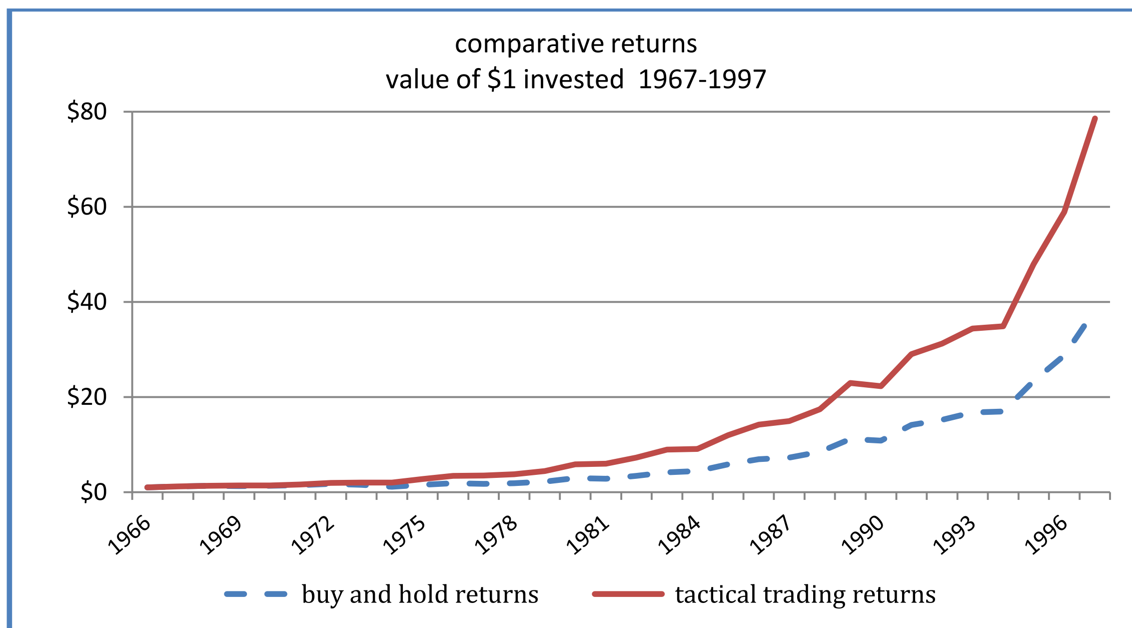
We begin with a slightly tongue-in-cheek study to amplify this point.

The study relies on a simple tactical trading approach, a modified form of market timing, using the S&P 500 as the investment vehicle. The investor is presumed to be either 100% invested, or 100% in cash. The holding period for each 'buy' or 'sell' signal is 12 months.

Fully-invested results are based on total returns for the S&P 500; when out of the market, the assumed return on cash equivalents is 2% per annum.

Bear in mind, the numbers are real. We say this is a tongue-in-cheek study only because the trigger -- the market timing signal -- is so unorthodox.

Here are the results from 1967 through 1997:



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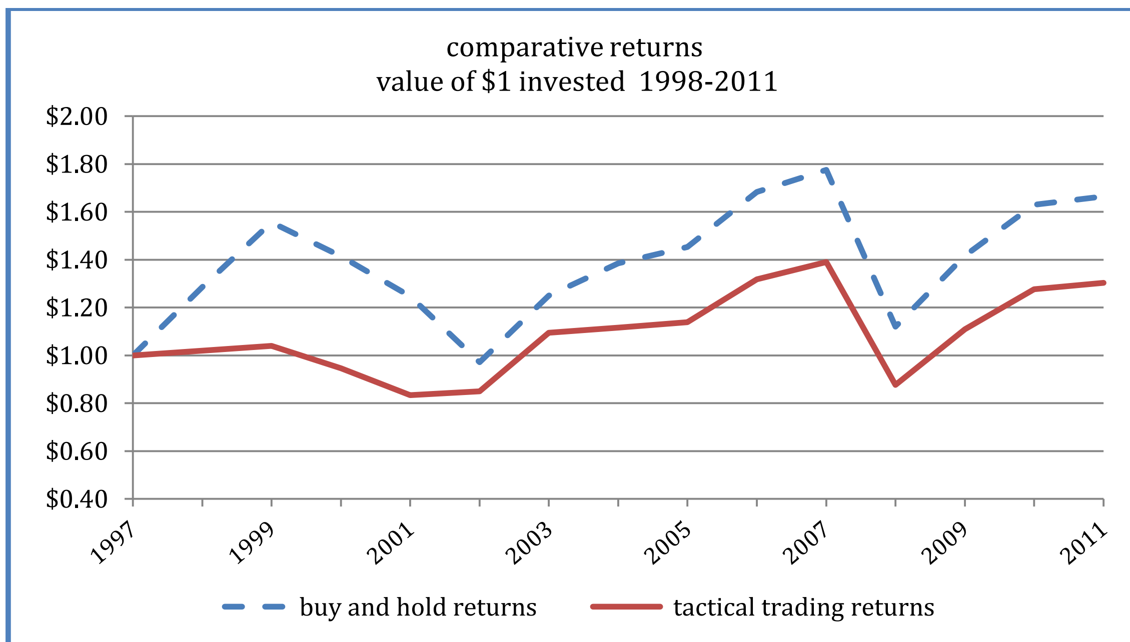
Utilizing this tactical trading approach, an investor would have seen $1 invested in 1967 grow to a value of nearly $80 by the end of 1997. This compares with an ending value of under $40 using a buy-and-hold approach to the market over the same time period.

Knowing how well it performed for the first 31 years, would you invest with this strategy in 1998? Oh come on, of course you would.

But not successfully.
While not a total disaster, investment returns from this strategy for the past 14 years have been extremely disappointing -- less than half the market returns earned in a passive "buy and hold" strategy.



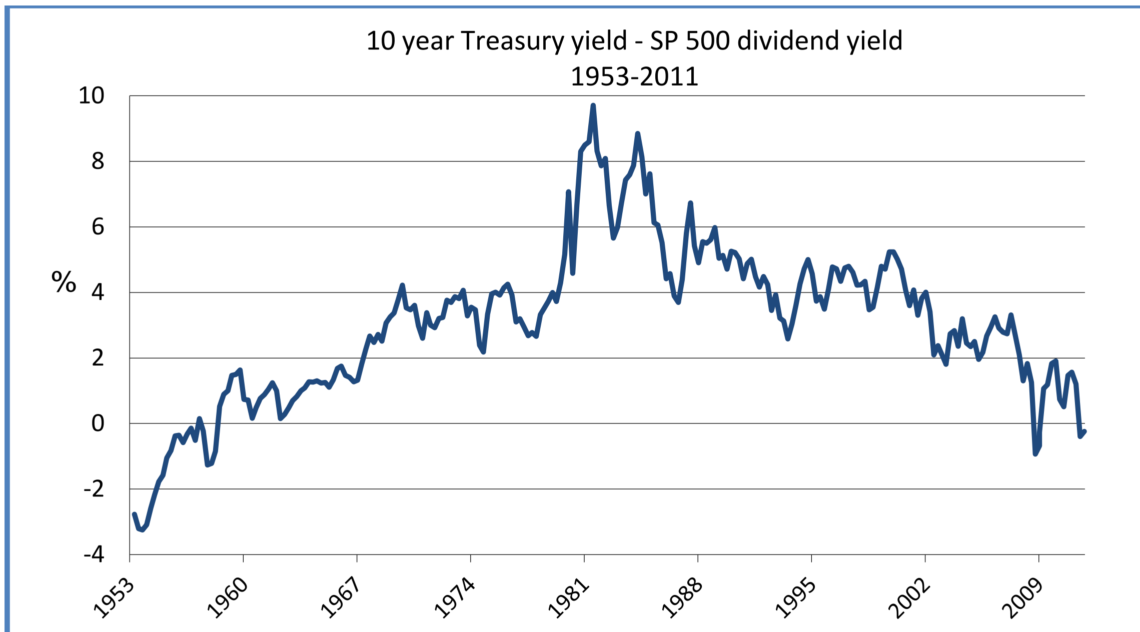
What happened?
In a nutshell, the approach worked like a peach for 31 years, then turned into a lemon. It did not fall victim to market efficiencies, or tighter regulations, or a boom-and-bust cycle. It simply stopped working.

Consider this case:
Since the beginning of US market history, stocks offered dividend yields higher than the yield on long-term Treasury debt. This made sense, as everyone knew that stocks were more risky than bonds. The higher risk required higher yields, to compensate the stockholder.

Savvy investors could employ a simple trading strategy, selling stocks and buying Treasurys whenever the yields on the two approached parity. At that point, Treasurys were the better bargain. In time the yield spread would widen, mostly due to stock market declines. Investors would avoid the market drop and be well-rewarded for owning Treasurys. Once the yield spread widened sufficiently, the trade would be reversed, selling Treasurys and buying stocks.

For decades on end this strategy worked. Then 1958 came along. The yield comparisons not only converged, but crossed. All of a sudden, Treasurys yielded more than stocks, a condition that was simply not supposed to occur, at least not for long. No doubt warning bells were sounded, investors fully aware that stocks were in dangerous territory.

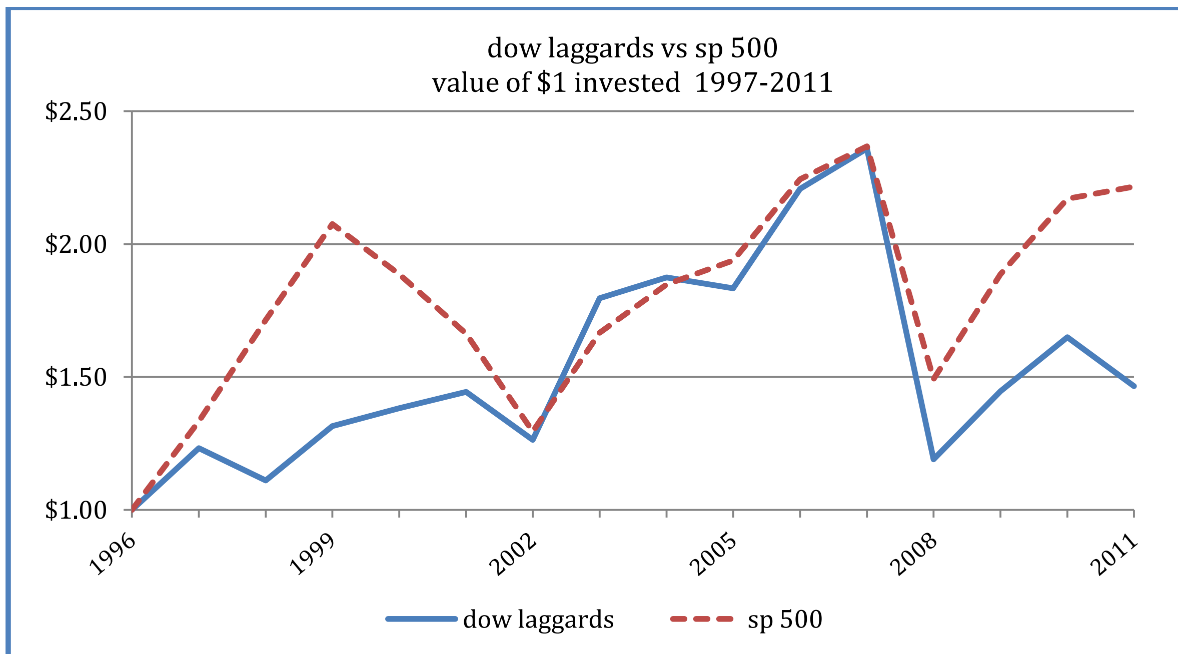
But a funny thing happened at that point -- the yields crossed, and never turned back -- not for another 50 years. After being a fail-safe indicator, an 'absolute truth', the strategy no longer worked. And what of the investor who stuck to his guns, his discipline, his fail-safe trade? He would watch from the sidelines, holding Treasurys for 50 years as the S&P 500 compounded returns at 10% per annum, producing a total return of 14,000%. Now that would be a painful miss, and a valuable lesson: In the investment world, there are few, if any, 'absolute truths'.



Let's look at one more case, a modification of what was, for a brief period, a fairly well-known investment strategy. We start with the 30 stocks of the Dow Jones Industrial Average as our investment universe. Each year we select the prior year's ten worst performers, invest in them on an equal weighted basis, and hold them for an entire year. The next year, we start over and run the same exercise.

The concept is intuitively appealing: in working with the 30 Dow stocks, we are selecting from a fairly exclusive list of blue chip companies; in buying the prior year's worst performers, we are employing a pure contrarian strategy.

Did it work?
Not too well. In the short time period we tested -- the last 15 years -- the strategy produced total returns of only 47%, while the S&P 500 generated returns of 122%. When we reduce the number of positions from ten stocks to six -- working with one-fifth of the universe instead of one-third -- the results are even worse. So much for this theory.



So what are we to make of data mining, of sifting through past results in hopes of foreseeing the future? In light of the evidence, most investors would be skeptical, if not totally dismissive. A cynic might label it as reverse-engineering, and a most expensive form at that. But clarity only comes with hindsight. We are constantly teased with market studies, anecdotes, statistics -- all suggesting favorable outcomes as near certainties; and they rarely are.

In the cases presented, we show three distinct examples of investment folly. In the first, investors recognize a tactical trading pattern producing favorable returns, and expect it to continue. But there is no sound financial theory supporting the pattern. It simply exists as an outlier, akin to a dozen coin tosses all coming up heads. In time, the pattern disappears, as it should.

The second case is most interesting, given the strong historical linkage between bond yields and stock yields. There is sensible financial theory tying the relationship together. But the theory ends up flawed, missing a critical detail. It is the equity earnings yield -- not dividend yield -- that should be compared to Treasury yields. Dividend payout policy is a separate issue, and not especially pertinent to most investment decisions. In time, the theory's flaw was exposed. After so many years, a tried and true rule became obsolete.

The third case flips data mining on its head. Instead of observing favorable returns, then positing a possible cause, the Dow Laggard study starts with a concept and tests its results. Intellectually, this approach is much more honest, as it begins with a theory as opposed to cherry-picking favorable results. The concept seems plausible as a contrarian strategy and is easy to execute, but in the end it does not work. And if a concept has not succeeded in the past, why expect anything more in the future?

Dismissive? No. Skeptical? Yes.
In the end, this is the ongoing conundrum: It is easier to expose a market myth than to discover an absolute truth. And that will never change.

Sources:

1. Bloomberg
2. “Stocks For The Long Run” -- J. Siegel, 2007, McGraw-Hill Publishing

Tidbits..

World Bank cuts 2012 global growth forecast to 2.5%
Keep cutting expectations and they finally match up with reality.

US apartment vacancy rate, at five percent, reaches 10-year low level.
The flip side of the housing bust.

Federal Reserve transcripts show central bankers all but oblivious to onset of housing, mortgage crises.
Risk managers asleep at the switch.

S&P cuts credit ratings of nine European nations.
More to come, but bond markets shrug.

Eastman Kodak, founded 1880, files bankruptcy.
Photo film: the modern day buggy whip.

Federal Reserve extends accommodative policy expectations to late 2014.
The monetary spigot is wide open.

Report claims mortgage agency Freddie Mac trades against its own clients' refinancing interests.
If so, a new low in public policy.

Congressional Budget Office forecasts current year fiscal deficit again over trillion dollar mark.
The red ink goes on and on and on.

Major banks agree to $25 billion settlement of mortgage robo-signing claims.
Government, version 2012: hijack, collect ransom, gloat, repeat.

Brent crude oil reaches $125 per barrel, gasoline exceeds $4 threshold in local markets.
Is it still Bush's fault?

European finance ministers agree to 130 billion Euro bailout package for Greece, includes debt restructuring, austerity measures; long period of retrenchment, internal strife likely for Greece.
Greeks may decide that being saved is worst of all choices.