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When everyone and his uncle start piling into a particular sector of the market, it's usually the time to get out

Invest wisely: don't follow the 'dumb' money

Back in late 2007, I received one of the best compliments an investment pro could ever get.

I was still working for CIBC Wood Gundy in Barrie, Ont. And one of my clients, during the course of an interview with a Canadian newspaper, gave a glowing review of my contrarian approach to investing.

He noted how I'd spared him, along with several of my other clients, the massive losses that hit many investors during the meltdown in income trusts.

In late 2006, you may recall, income trusts were all the rage. Not only were their unit prices rapidly rising, but they were paying out hefty distributions.

As well, they were making brokerages rich, given the trusts' never-ending need for new financings.

But the party came to a halt that fall when Jim Flaherty, then federal finance minister, announced he would close the tax loophole that had made income trusts such hot investments.

Yet even before Mr. Flaherty's move, I knew the sector was ready for a hit. I'd been tracking the inflow of capital by retail investors, the so-called "dumb money," into new issues, as well as into mutual funds holding income trusts.

So, when I saw money pile into income trusts, I knew the good times would soon be over. As a result, I cashed out, thereby saving my clients a lot of grief.

Still, is it really fair to call investors who follow the crowd dumb? In a word, yes. Not only are they usually the last to get into a particular sector, they're usually the last to get out as well.



Keith Richards

Put simply, when making investment decisions, these folks favor emotion over logic.

In the newspaper interview, my client took note of another one of my contrary stances back then: my bearishness on oil.

As with income trusts, I'd been tracking the flow of retail money into the energy sector — a sector which, in 2007, was also the flavor of the month. As a result, I sold most of my energy positions either late in 2007 or early in 2008.

I was smart to do so, as things turned out, given that a year after my client's interview, oil fell to less than US\$40 a barrel from a peak of \$145 in the summer of 2008.

After the crash, I moved back into the sector as energy formed a new base and began to recover.

Of course, contrarian investing should rest firmly on sentiment indicators and volatility studies. Merely going against the crowd for the sake of being contrary is sil-

ly, if not downright dangerous.

After all, as the great British economist, John Maynard Keynes once noted, the market can remain irrational longer than you can remain solvent.

So, having said all this, let's look at a classic tool of contrarian investing: the VIX, or volatility index. If this doesn't ring a bell, go to Investopedia or www.stockcharts.com.

Essentially, the VIX attempts to discover if volatility is too high — specifically, if investors are unduly fearful — or if volatility is too low — in other words, if investors are unduly complacent.

The VIX is best used as a tool of relative measurement — in other words, as a way of determining if the market is expecting too much volatility (a buy signal), or too little (a contrarian sell signal).

On the opposite page, the VIX chart shows that since the bull raged out of its pen in 2009, we've gone through two volatility ranges.

The first, from 2010-2013, saw investor complacency register at

roughly 15; investor fear, at 27.

Although this range did have outside spikes to the upside, the bulk of the movement was between 15 and 27.

So a trader looking at movement in or around either of those areas would have one more piece of evidence of an opportunity to buy or an opportunity to sell.

Keep in mind that the VIX must never be the sole reason behind a buy or a sell decision.

You also need to study market chart patterns, as well as indicators. In fact, they should be your main trading tool.

The next range, which began in early 2013, signalled the start of the recent non-stop uptrend, having apparently changed from 12 (complacency) to 18 (fear).

Blip would be signal

Interestingly enough, at 10.3, the VIX reached a new low level of complacency (circled on the chart), before undergoing the recent correction.

Yet now, because we're once



again approaching 12, complacency has set in.

So, traders over the coming weeks, should keep an eye out for another corrective blip.

Still, if the VIX repeats its July performance, this may not happen until it drops to 10 or even lower.

The VIX now suggests that volatility may increase again over the next month or two.

Because I'm still bullish over the long term, I'll utilize any market correction as a buying opportunity, provided it's flagged by abnormally low VIX readings.

Now, let's consider some stocks you might want to consider. One name I've profiled before and that remains a long-term buy for us is **Texas Instruments Inc.** (TXN-NYSE, \$47.63).

Headquartered in Dallas, the company continues to post good numbers in its core business — analog and embedded processing — having recently seen revenue

rise 14 per cent year over year.

Equally impressive, Texas Instruments generated free cash flow of US\$3.2 billion, equating to 25 per cent of revenue on a trailing 12-month basis

Another one of our U.S. picks for the long haul is **Microsoft Corp.** (MSFT-NASDAQ, \$44.88) whose CEO, Steve Ballmer, recently resigned after 34 years with the software giant.

Purchase was big

And although Mr. Ballmer will now be helming the Los Angeles Clippers basketball team, he did leave Microsoft stockholders a nice farewell gift: a 17.5 per cent jump in revenue YOY.

Meanwhile, Microsoft's aggressive foray into cloud computing is starting to pay off, says Mr. Ballmer's successor, Satya Nadella, under whom the company should continue to deliver strong returns.

True, Microsoft's recent foray into telecom has been a bit of a drag. In late April, you'll recall, it bought the mobile phone unit belonging to **Nokia Corp.** (NOK-NYSE, \$8.16) for US\$7 billion.

But the drag should slacken, now that Microsoft is cutting 18,000 jobs — the biggest layoff in its 39-year history.

A third U.S. company we continue to hold for the long haul is **American International Group Inc.** (AIG-NYSE, \$56.18), the New York-based insurance giant which boasts operations in 130 countries.

This fall they'll be a changing of the guard at AIG, as Peter Hancock takes over the CEO slot from Robert Benmosche.

Mr. Benmosche, who will stay on in an advisory role, brought AIG back from the brink of disaster after the market meltdown of 2008.

Not only does the company

now have the capital, but it also has the cash flow to support its growth over the next several years.

Not surprisingly, AIG's shares have broken out of the technical lid where they had languished in the mid-\$40 range.

But because we think AIG's turnaround has just begun, we believe that in a few years, its shares will be worth double the price at which we originally bought them, which was less than \$50.

Keith Richards, who's based in Barrie, Ont., is portfolio manager of Value Trend/Wealth Management. On Tue., Sept. 30, Keith will appear on BNN's MarketCall Tonight at 6 p.m. Eastern Daylight Time. To ask Keith questions about technical analysis on your favorite stocks, call toll-free during the show at 1-855-326-6266. Or, e-mail your questions — specify they're for Keith — to marketcall@bnn.ca.