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Retail investors express worry over potential for correction, but keep money in market anyway

Signs indicate imminent pullback

Keith Richards

A report issued by my favourite sentiment research firm, Sentimentrader, notes that retail investors are massively invested in stocks. This is despite the retail investors' supposed "attitude" towards stocks, which (funnily enough) is becoming more bearish.

According to the American Association of Individual Investors' (AAII) sentiment survey, retail investors are indeed worried. However - as Sentimentrader notes— actions speak louder than words. Despite their worry, they are buying equities hand over fist.

The problem with a high commitment to stocks, equity ETFs or mutual funds by retail investors is that they are traditionally wrong at market extremes. In other words, retail investors tend to hold more stocks at the top, and hold fewer stocks at the bottom.

Retail investors are currently – by Sentimentrader's sources- holding about 67.6 per cent in equities, 15.5 per cent cash, and the balance in "other" investment assets (bonds, commodities, etc.). Research shows that when retail investors are holding more than 52 per cent in equities compared to other asset classes, the market has tended to correct within a three-month window.

You can see this on the chart on the following page, courtesy of www.sentimentrader.com. I've circled areas of extreme levels for stock allocation going back to 1999.

The bottom of the chart shows us periods when stocks were "under-owned" by retail investors. Note how those low levels of stock ownership line up nicely with market bottoms- which I've marked on the S&P 500 line with arrows. The top levels of stock ownership are also circled on the chart. Note how market tops – both minor tops and major tops – tend to coincide with retail investors loving stocks – also marked with arrows.

As you will see from the chart, the level of total stock ownership by retail investors is just getting into the danger zone. If we tie seasonal trends into this observation, one might make a greater case than normal to "Sell in May and go away".

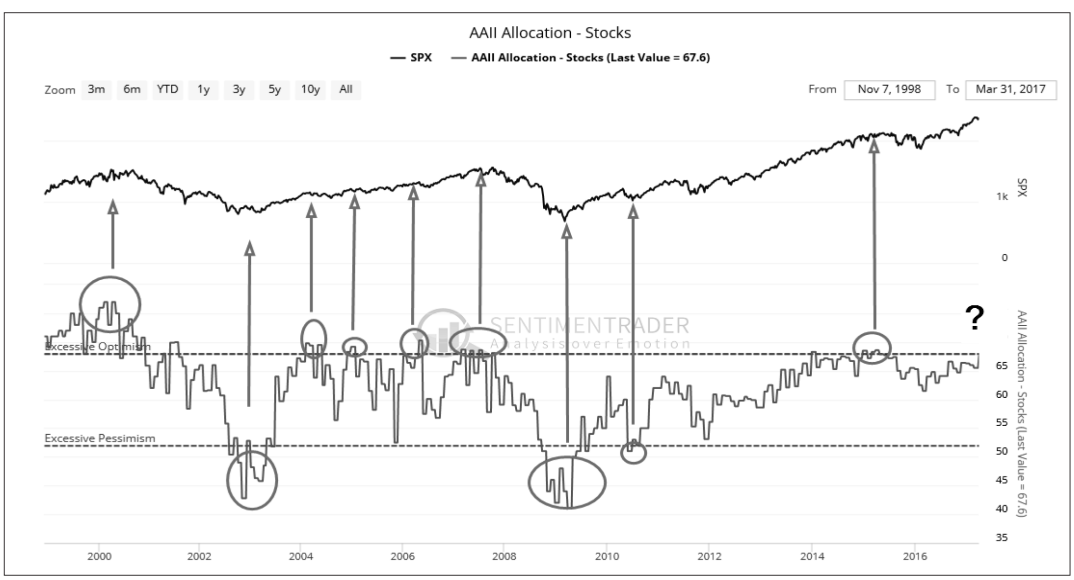
If you are a regular reader of my technical analysis blog (www.valuetrend.ca), you might be familiar with two systems that I have created to monitor short- and long-term risk-to-reward potentials for the stock market.

Nobody actually knows what the market will do. Investing in the stock market is a little like gambling. However, if we take a quantitative analysis approach to investing which includes identifying market risk-to-reward potential, along with fundamental valuation of individual companies, we can give ourselves an edge.

Thus, unlike a casino, which offers nothing but unpredictable results, we investors can have an edge amongst the randomness inherent in stock investing. We make a little more sense of that chaos through the intelligent use of technical and fundamental analysis.

As mentioned above, I utilize both short and long-term market risk measuring tools. I try to measure near-termed risk and reward potential with my "Short-termed timing system". This short-termed risk-to-reward measuring tool predicted the sell-off that we got in early March.

Right now, the system is again moving closer to a higher probability for a market pullback. Perhaps as, if, and when the market moves up between the time I have written this and the time you will read it, we will already have reached a higher risk market signal – although we're not there at



the time of writing.

That might be a good time to exit from some of your higher beta (that is, higher market sensitivity) stocks. I for one have already begun a cleaning process by raising about 15 per cent in cash within my equity model as of the third week of April.

I based this on my normal pattern of reducing stocks as the summer approaches. I'd expect to double that cash allocation by selling more stocks as, if, and when my indicators move fully into the "danger zone".

I am looking to exit several positions in the U.S. financial, energy, and industrial sectors as well as the U.S. small caps. All of these sectors face seasonal headwinds, and represent higher beta (more volatile) positions that we don't want to hold in the face of higher-risk markets. You should probably keep an eye on these sectors within your own portfolio as markets move forward.

More important than the short-termed timing signals are where the market is headed in the longer run. I'll post a long-termed risk reward signal (which I call my "Bear-o-meter") on my blog in early May. This will hopefully provide further insight into the probabilities of risk and return for the markets over the summer months.

Meanwhile- mind your neighbour. He may be telling you he's bearish (which should be a positive thing for us contrarians) - but he may also be continuing to hold his stocks, funds and ETFs despite his words. Do as I say, not as I do – as the saying goes!

Keith on BNN

Keith Richards will be on BNN's Market Call on Wednesday, May 3 at 5:30 p.m. eastern daylight time. Phone in with your questions on technical analysis for Keith during the show. Call toll free at 1-855-326-6266. Otherwise, you can email your questions ahead of time (specify they are for Keith) to marketcall@bnn.ca.

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