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INVESTMENT SMARTS

Dumb money buys when the market tops

In this article I thought I would share some market statistics that I recently gathered from a few research sources.

Keith Richards

Regular readers of my columns know that I am a Technical Analyst, though we at ValueTrend incorporate both technical and fundamental data and viewpoints into our process. I offer reflections from both perspectives below.

I will admit to a "confirmation bias" here. I am bearish in the short to intermediate term (weeks to months), but bullish in the longer run (months to years). These comments point to near-termed bearish bias. At least I admit my bias!

The Smart money versus Dumb money confidence spread is something that **sentimentrader.com** tracks. "Smart" investors are those who tend to make better buy or sell decisions at market extremes. They include large, sophisticated institutions like pensions and commercial hedgers, insiders and other, better-informed investors.

"Dumb" investors, according to the spread, are those who reach the highest levels of confidence at inopportune, key-market turning points—that is, they are most bullish at tops and most bearish at bottoms.

Dumb money includes unsophisticated investors. The indicator focuses on retail-mutual fund investor moneyflow (in and out of equity funds), small traders, and small speculators. Subscribers to sentimentrader.com can track each group independently, or as a spread. The basic formula for the spread is:

Smart money per cent confidence level minus *Dumb money* per cent confidence level is equal to confidence spread.

A spread reading of below -0.25 implies that the "smarties" do not have enough confidence. It also implies that "dummies" are buying stocks hand over fist. This is the level where sentimentrader.com suggests we pay close attention, as the potential for a market top is increasing.

The current level of Smart/Dumb confidence spread sits well below the minimum warning level suggested by sentimentrader.com. As at April 25, the spread sat at -0.50.

Market sentiment specialists at sentimentrader.com note that analysts tend to upgrade or downgrade stocks in knee-jerk reactions to current market movements. If markets move up, they don't want to have mud on their collective faces, so they upgrade stock targets. If markets go down, the reverse happens – analysts lower their targets. This phenomenon often peaks prior to reversals in the market.

As a contrarian indicator, you look for a rush of increases by analysts in stock price objectives to indicate a market high. The reverse is true for market lows.

Sentimentrader notes that the recent rush by analysts to upgrade stocks on the S&P500 – reversing their downgrades made in January (a market low) may be a bad sign. They note a similar pattern as we are seeing today coming into August of 2011 - a date some readers of this article may recall as a market peak proceeding a 20 per cent correction on that index.

The company 720, Global Research, notes that equity valuations in early May were higher than average by many measures. "The current price-to-earnings ratio (P/E) is 55 per cent above the historical mean and surpasses 92 per cent of all P/E data. Only multiples from the 2000 and 2008 bubble periods were higher than today".

Bad earnings not baked in

Doug Short, another research analyst from Advisor Perspectives, created a simple model that averages four common equity valuation techniques. Based on his analysis, "The market is 76 per cent overvalued as compared to the average dating back to 1900."

Sentimentrader.com notes that we are in line for a sixth straight quarter of declining earnings. With a trailing P/E of nearly 25 in early May, they note that these poor earnings are *not* baked into stock prices and that this is the longest such streak in 140 years.

Finally, Mark Gerstein wrote in a Forbes article on April 29th that the VIX has historically been higher than 13 over 80 per cent of all days since 1990 and over 83 percent of all days over the past 12 months.

In other words, based on history the odds are on higher VIX levels at current levels. The VIX has recently risen off of a low of 13 to sit at over 16 as I write this in early May. My target remains 18 to 26.

Combining the Smart/Dumb confidence spread with pending seasonal weakness, potentially expensive valuations and pending overhead technical resistance (2135), may be the market's way of presenting unfavorable risk vs. return potential right now.

As a portfolio manager, my job is not to time the markets – I simply measure potential risk vs. potential return. Remember, risk and return are always present—stocks can go up in a high-risk environment; they can fall in a low-risk scenario.

We're only dealing with odds not absolutes. I might suggest that the odds are less favorable for greater upside in the coming weeks, while the odds for a retracement to the January lows, or lower, are becoming more favorable.

As such, I suggest three strategies that you might want to consider:

1. Raise cash. We're at about 35 per cent cash right now. This cash both reduces risk and, more importantly, increases opportunities to invest it if stock prices do indeed fall. It always makes me laugh when I hear buy and hold managers recommend buying stocks after a selloff. How can you buy stocks when they get cheap if you remain fully invested all of the time?

2. Lowering beta: We sold several of our higher volatility stocks recently. The proceeds were used to raise the cash as noted above, and to buy lower beta stocks. Beta is a measurement of a stock's reaction to market movements.

A beta of 1 implies the stock will rise or fall in line with the market. Below 1 means lower- than-market price movements, both up and down. The typical way of measuring beta is over a 3-year period, but some research services offer 5 year beta. Check with your broker, or with the TSX index (which tracks beta on all listed stocks) for the beta of your stocks.

3.Hedge: In addition to a small weighting in the somewhat negatively correlated assets of gold (3 per cent Via Horizons ETF HUG-T) and oil producers (3 per cent Via iShares ETF XEG-T), our ValueTrend Equity Platform is long a VIX ETF (Horizons HUV-T) with a short-termed trading horizon, and two bear/Inverse ETF's (HDGE-US and HIU-T) with a short to intermediate-termed trading horizon.

Our current commitment is about 10 per cent hedge ETF's. These ETF's will rise in a falling market, and vice versa. The VIX in particular can have violent movements, and I would expect to be out of this shortly – perhaps even by the time you read this column. Readers should conduct their own diligence when considering these strategies. They are more aggressive than traditional long stock strategies.

Despite my bearish outlook, anything can happen on the market. You should form your own opinion by studying the markets from many different points of view before coming to a conclusion. Risk to reward looks skewed negatively right now–but that does not imply that markets can't keep going up.

For example, look back at the years 2000 and 2007, with their high PEs, low VIX levels, high optimistic sentiment, diverging breadth, and other factors. Yet things went up for many, many months before they rolled over.

The only lesson I gain from this phenomenon is that the longer an overdone market climbs, the harder it falls.

Thus, I view interim moderate corrections as healthy. When they don't happen with a certain degree of regularity, we should all become concerned.

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