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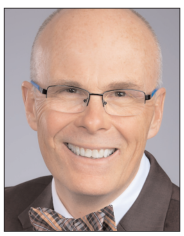
Investor's Digest of Canada

June 4, 2021 Vol. 52, No. 11

Who is 'right' and who is 'wrong' depends on what part of the chart you look at

Does today's market have a geometric problem?



Keith Richards

On May 12, I was asked to participate in the annual CSTA (Canadian Society of Technical Analysts) conference. This year, it was held via Zoom webinar. I was asked by the president of the CSTA to open the conference by relaying a story about an influencing lesson that I learned during the 2001 technology bubble and bust. There were some similarities between the look of the charts those days to the look of the charts today.

The story I told was intended to inspire some thoughts on making investment decisions that fall outside of a disciplined strategy. I relayed to the audience that In the late 1990s, I was very fortunate to have met and learned from two brilliant technical analysts when working as an advisor and studying technical analysis with Merrill Lynch Canada.

One analyst was a gentleman named Gurney Watson, who was with the Canadian side of Merrill Lynch. Gurney was a mathematical anomaly.

He understood the markets from both a traditional perspective AND from a "geometric" perspective, as he liked to put it. Gurney was the first technical analyst to introduce me to the "Smart Money/Dumb Money" concept of contrarian investing. I cover his interpretation of this indicator in one of the chapters of my upcoming book (due in late June), *Smart Money, Dumb Money: Beating the crowd through contrarian investing.*

Without going deeply into that specific analytical tool, in 1999 Gurney presented some bearish evidence using sentiment indicators like the Smart/Dumb" indicator, along with some interesting charts of the broad U.S. stock indexes. He told me on the phone one day, "The market has a geometric problem, not an arithmetic problem."

Gurney was referring to the angle of the chart. He was the original analyst to influence me in that methodology of measuring market movements by angle of ascent – and compare that angle to past moves to determine if markets were becoming overbought.

The chart on page 223 illustrates that the market had been moving at roughly a 45-degree angle (relative to the time/price scale) during most of the 1980s and 1990s. Something changed in 1998 – see the green trendline on the NASDAQ chart below.

Beginning in 1998, the market arced off of its 20-year trendline in a parabolic move. I recall in 1999 that Gurney wrote a report, saying something like, "The hour is late, partiers are growing tired. There's probably time for one last drink before the party ends." Gurney had quite a way with words!

At the same time, I was reading reports from Merrill Lynch U.S.-based technical analyst and NASDAQ specialist Don Kapetanakis (say his last name three times fast!).

Don wrote a report in or around 1999 stating that he, like Gurney Watson, saw that the NASDAQ was overbought, overvalued and ready to blow. I believe he was looking at similar chart angles to Gurney, along with the other overbought technical indicators in his toolbox.

If you take a look at the chart on the right, I note approximately where Don wrote that report.

The NASDAQ was primed for a major (not a minor) pullback, according to both of their analyses. I recall the NASDAQ was somewhere around 3,000 – although both analysts wrote further bearish reports as it moved into the 4,000 range.

But here's the thing: A few months after Don issued the first warning when the NASDAQ was hovering near 3,000, the NASDAQ went on to hit 5,000 by the year 2000. That was a 60 per cent-plus move! Don and Gurney, it appeared, were wrong!

In fact, as a retail advisor at the time, there was much criticism aimed towards Don (in particular) as his prediction proved "wrong". This was after advisors and clients watched the index climb substantially higher. Some advisors were talking trash about Don's call, saying, "I am glad I didn't listen to that guy!"

What a difference a year makes. After surging to 5,000 following Don and Gurney's original bearish call, the NASDAQ turned tail and retreated! It fell…wait for it…darned close to 1,300! So – Don said sell at 3,000 (and reiterated the sell advice at 4,000). Then the market went up a whole bunch more.

But then…it went down. Indeed, the NASDAQ settled to darned near one-third of the price when Don originally said to get out. Don and Gurney appeared to be "right" by 2002.

So, were Don and Gurney "wrong", or were they "right"? Well, hindsight tells us now that they were very wrong for a year, then very, very right for almost two years. Net-to-net, listening to Gurney and Don's advice in 1999 was painful at first, but profitable in the longer run.

Of course, people are myopic. Many will not recall Don and Gurney making the right call with a "better early than never" level of accuracy. But I do!

The interesting thing I learned from all of this is that its hard to make timing predictions based on signs of an overbought, overvalued market. The analysis might be correct…but, as Keynes once said, "The market can remain wrong longer than you can remain solvent!"

Gurney and Don's analysis taught me to respect the forward-looking indicators like sentiment indicators, chart angles, market momentum, volume and market breadth. But their early call(s) taught me to include a methodology that will keep us in the market, despite the "wrongness" of its overbought status, until the trend breaks.

At this moment in time, I am starting to see many of the signs in today's markets that I am sure inspired Gurney and Don to put on their bearish hats in 1999.

To that end, I would like to recommend that you incorporate a systematic rule-based strategy to keep you in the market so long as the trend remains in place. However, your rules should also incorporate an exit strategy that is based on quantitative sell signals upon a breakdown in trend. The key words here being "quantitative" and "trend".

I'd like to emphasize that an "opinion" on the market, even one based on sound logic, is useless. Markets trade on emotion as much as they do on fundamentals. The stock market reflects the fear, greed, opinions, AND the logical fundamental valuations of its individual holdings. It's a mishmash of crowd behaviour and analysis, where nobody really knows the future. As such, a logical rule-based system will "save you from yourself".

In my case, as Chief Portfolio Manager for ValueTrend Wealth Management, my rules are based on trend following. I'd encourage you to read my last book, S*ideways: Using the power of technical analysis to profit in uncertain times*, if you wish to incorporate such a system for yourself.

My new book on contrarian investing, mentioned above, will cover trend-following systems with some new research on incorporating contrarian investing tools. However, trend-following rules are not the only game in town. Seasonal trading and momentum strategies work as well. Again, the key is to have a rule-based system, and avoid listening to opinions (or your own emotions!).

I wish you success in your trading in today's uncertain times.

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