

Revisiting Isaac Newton: The Coming Golden Age of Market Timing?

We last mentioned Isaac Newton in our June 2000 newsletter (available with other past newsletters in the archive section of our new website at www.sigmainvestment.com). Newton, the inventor of the calculus and developer of the laws of motion, lost six times his original investment, the modern equivalent of a million dollars, in the speculative frenzy of South Sea Bubble of 1720. He mused “I can calculate the motions of the heavenly bodies, but not the madness of people.”

Our thoughts traveled again to Sir Isaac recently as we spent too much time listening to investment pundits predicting the near term course for the stock market. Despite claiming to rely on all manner of economic, financial and psychological models, the pundits appear to be unwitting slaves of Newton’s laws of motion. Those expecting the market to go up were relying on Newton’s third law, that for every action, there is an equal and opposite reaction. In other words, the market has to go up because it has gone down so far for so long. Those expecting the market to go down were relying on Newton’s first law of motion, the law of inertia that a body in motion tends to stay in motion unless acted upon by a countervailing force. In other words, they just extrapolate the past -- the market will continue to go down because it has been going down. The majority of “experts” seem permanently wedded to their bullish or bearish viewpoints. There are also probably people applying Newton’s second law (force equals mass times acceleration) to the markets, but we have enough of a headache already to consider them here.

Market pundits appear to be slaves of 300 year old theories about physics.

While the permanent bulls and bears are fixed in their market views, they are flexible in which of Newton’s laws they choose to apply. In the late 1990s boom, it was the bulls citing the law of inertia to conclude that the bull market would continue forever, while the bears were converts to the third law, believing that the higher the market rose, the more severe and righteous the inevitable fall. Another small but hardy group, however, are true market timers, alternating their market predictions between bullish to bearish. Since the Newtonian achievement has been demoted to a mere subset of “modern” physics, should we be paying attention to these market timers? To see, let’s engage in a thought experiment.

Imagine a group of market timers with no skill -- academics will tell you this should not take much imagination. In contrast to holding a fully invested position, market timing means you are out of the market sometimes. Our no-skill timers will sell their stocks and be out of the market at random times. In a long bull market (e.g. between August 1982 and early 2000, when the stock market

went up 1,400 percent), the market will likely go up while they are randomly out of the market, so the timers will look stupid. In a long bear market (e.g. between January 1966 and August 1982, when the market declined 20 percent), the market will likely go down while they are out, so the no-skill timers will look smart. If Newton's law of inertia holds and the market continues to remain "volatile," Wall Street's euphemism for "disintegrating," market timers as a group will look smart and gain respect.

***"Firmness cannot show itself,
of course, if a man keeps
changing his mind."
-- Carl von Clausewitz***

Is it fair to assume no skill among market timers? Going through a thought experiment in which you assume away skill doesn't mean such skill is unlikely.

Let us examine evidence from Ned Davis Research, Inc. with respect to the market timing calls by Wall Street strategists -- think of this group as being the talking heads from leading investment firms that you see on the TV news pontificating about where the market is headed. Ned Davis has aggregate data on the market timing by the strategists dating back to 1985. The strategists are often extremely optimistic, which should have produced good results during the huge bull market of the late 1980s and 1990s. But the Standard & Poor's 500 index actually *fell* during periods when the strategists were optimistic. The strategists were seldom extremely pessimistic, but the S&P 500 index rose about 30 percent per year when they were. Clearly, we were being exceedingly optimistic in our assumption that market timers simply lacked skill -- the strategist/timers do far worse than what random chance would dictate. It is hard to imagine a record that awful could be generated even by someone purposely trying to shoot wide of the mark.

Someone who is nearly always wrong is just as valuable as someone who is nearly always right, as long as you get the direction right. This is why Ned Davis uses the strategist/market timers as a contrary indicator -- you wait and see what they think and then do the opposite. Unfortunately, the strategist/timers are currently bloodied but unbowed, remaining doggedly optimistic. Which means, based upon the Ned Davis indicator, that the market is likely to go down... which means, based upon the results of our thought experiment, that bearish market timers are likely to be perceived as geniuses, *raising public respect for the concept of market timing*. If you are beginning to share our headache, you are starting to understand the bizzaro world of market timing, and why we are interested in it primarily for entertainment purposes. Come to think of it, it does remind us of modern physics.

Until proven otherwise, we will assume that nobody is likely to consistently guess future market movements correctly (or even consistently incorrectly). Tempting as the market timing game is, we hope to focus our efforts on something more useful, like applying a rational approach to investing for our clients. If you would like our help, call us, e-mail us, or visit us on the web. You can reproach us if you catch us attempting to apply Newton's second law of motion to the markets.