

Defining Punditry Down

Investment professionals constantly predict what is going to happen in the financial markets. They may sound smart, but their statements are not worth considering unless they use terms that are clear, in propositions that are true, in arguments that are logically valid. Because most of us are easily bored, our minds tend to race ahead to consider the truth or falsity of their propositions or the validity or invalidity of their overall argument. We tend to skip the essential, but possibly boring, step of considering whether the terms they use convey any useful meaning. In many instances, they do not.

What, after all, is a “blue chip” stock, a “high quality” company or “excellent” management? Has anyone on *Wall Street Week* ever vowed to seek out low quality companies with bad management? Is there a reason to believe the current market price does not reflect the quality of the company or its management, excellent or not? When someone says this is a time to be “selective,” is she drawing a contrast to previous times in which she was unselective and just threw money at anything with a stock symbol?

We discuss “bull” and “bear” markets, but there are varied definitions of even those basic terms. Students of the market get in furious arguments about characterizing *past* market cycles. The average U.S. stock peaked in the spring of 1998, but most major market indexes that give more weight to large companies did not peak until almost two years later. While the market indexes declined in 2000 and 2001, the average stock actually rose. So was it a bull market in 1998-99? Was it a bear market in 2000-01? What are we in now? Between its low in October 2002 and its high in February 2004 the Standard & Poor’s 500 index rose 490 days with a gain of 47 percent. This is certainly a healthy advance, but is it a bear market rally or a new bull market? It has only been three months since the high – can we even be sure that the cycle, however characterized, has ended?

For the purposes of our discussion, we will use the complicated but precise definitions of bull and bear markets (too long to delineate here) developed by Ned Davis Research, Inc. While we believe the NDR definitions are better than the alternatives, they have had to add additional rules over time to explain market anomalies that pop up, much as the believers in the Ptolemaic astronomical system added new rules to keep the earth the center of the universe. NDR also distinguishes between “cyclical” bull and bear markets and “secular” bull and bear markets, with the cyclical swings being components of longer term secular movements.

The market advance from October 2002 to February 2004 lasted longer and was bigger than any previous bear market rally, so it seems likely that this move was a bull market. We cannot be certain, however – with any set of rules, some rally has to be the biggest or longest. Assuming it was (is) a bull market, is it in the context of a secular bull market or a secular bear market? If we are in a secular bear market, the recent cyclical bull market gain lasted longer than the typical cyclical bull with about the average magnitude of gain. In actuarial terms, February was about when the cyclical bull was due to die. On the other hand, if we are still in the secular bull market of the 1980s and 1990s, the typical cyclical bull market would have a lot farther to run, both in terms of time and size.

“The social object of skilled investment should be to defeat the dark forces of time and ignorance which envelop our future.”
– John Maynard Keynes

Ned Davis believes we are in a secular bear market that started in early 2000, but nobody can know with certainty. There are long bear market rallies that last longer than short bull markets. There are long cyclical bull and bear markets that last longer than short secular moves. You only really know in retrospect whether a market move was a rally,

cyclical swing or secular bull or bear market, and even then you can get in an argument over the characterization. If it is so hard to be descriptive, why are market pundits repeatedly magnifying the potential error by using these terms to be predictive?

If all this seems somewhat vague and pointless, you have gotten our point. Even if you can finally determine that you are in a cyclical bull swing, and even if you can finally determine that it is in the context of a secular bull market, by that time both may be so long in the tooth that the risks of chasing the move may be uncomfortably high. All the blathering from the “experts” about whether this is a bull market or a bear market, even if they are being careful about their definitions (which they almost certainly are not), will not help make you money.

People in the investment profession persist in behaving as if they have a crystal ball that provides them a view of the future superior to that of their competitors. The industry acts this way because its prospective customers seem to want to believe that predictive ability exists and is perhaps even common. They believe the alternative is to admit that the dark forces of time and ignorance are enveloping our future. The use of invalid arguments, untrue propositions and sloppy, vague terms, however, increases the darkness. Rather than pretend to predict the future, we prefer to try to add light by applying rationality in an all-too-often irrational world. If you believe this makes sense, call us at (503) 419-3938. Just don’t ask us to define “rationality.”