



▶ Introduction

To make it easier for our busy readers to scroll directly to the items they are interested in without having to read through all the material, we list the issues covered in this module:

- **Market conditions on the stock exchange**
- **Market rallies and corrections**
- **Investor sentiment and behaviour**
- **The single element dilemma**
- **Some useful portfolio guidelines**
- **Greatest wins and losses on the stock markets**

If you are interested in accumulating useful information about stock market investments you may want to copy this module and add it to the others published in order to build your own manual of useful tips to assist you with successful investments in the equity markets.

The statistics and historic performance used in the examples are based on historic averages as it applied to the JSE and we attempted to be as accurate and fair as possible in each scenario or illustration.

■ Market conditions

* Bull Markets

Bull markets refer to favourable trading conditions where stocks generally for at least two quarters showed a fairly strong upward or positive trend.

When investors are optimistic and positive towards the markets they are said to be "bullish" or they are referred to as the "bulls".

During this market cycle one may find that "smart" investors tend to sell their holdings to the optimists in the market, hence the phrase ... *sell into greed*.

During bull markets many of the stocks listed may become fully priced and overbought.

The PE ratios of stocks will also tend to become too high (above 16.0) which indicate that investors are probably expecting too much from the company's future performance or that they simply are paying too much for the stock considering its current enterprise fundamentals or earnings potential.

* Bear Markets

Bear markets refer to unfavourable trading conditions where stocks generally for at least two quarters showed a fairly strong downward or negative trend.

During bear markets stocks may become more fairly priced and even oversold.

During this market cycle one may find that "smart" investors tend to buy stocks from the pessimists in order to add to their holdings, hence the phrase ... *buy into fear*.

Unlike the “old days”, these days many investors see bear markets as great opportunities for profitable trading by using leveraged derivative instruments available in order to benefit from falling markets.

There is also a strong historic trend for bull markets to last considerably longer than bear markets.

If we look at some of the prominent bull and bear markets during the past 50 years or so, the above trend can clearly be seen in the table below:

Bull Market Periods	(Move)	Bear Market Periods	(Move)
Apr 1961 to Apr 1969	+ 462%	Apr 1969 to Nov 1970	- 56%
Aug 1976 to Oct 1980	+ 387%	Aug 1987 to Feb 1988	- 44%
Oct 1983 to Aug 1987	+ 233%	Apr 1998 to Aug 1998	- 40%
Sep 1998 to May 2002	+ 152%	May 2002 to Apr 2003	- 30%
May 2003 to May 2008	+ 362%	May 2008 to Mar 2009	- 44%

It is a well-known fact that the “smart money” investors actually welcome bear markets, mainly because many stocks return to realistic values and the less experienced investors often dump their holdings at prices way below the real value of those stocks. Another benefit is that many companies “cut the fat” from their operations in difficult times in order to survive and therefore become more lean and effective as a business enterprise.

On average, the bull markets each lasted approximately 5 years whilst the bear markets on average lasted less than a year.

It also took, on average, approximately 18 months for the market to again reach its previous high after the crash period ended and the recovery started.

* Volatility in the markets

Volatile markets occur when there are considerable price movements taking place over very short periods of time. There is even a volatility index to measure the extent of such volatility.

Many stock analysts and fund managers become anxious when markets become highly volatile and one often observes panic trends amongst them under such circumstances.

Volatility generally creates uncertainty amongst investors and as many investors still believe the “*trend to be your friend*” concept, it makes them nervous when the trend becomes uncertain, obscured or distorted.

Whilst volatility is regarded by most investors as a negative situation many day traders and jobbers actually welcome it as it considerably enhances their daily trade gain margins.

A day trader is someone who considers a full day as a long-term investment. They often buy in the morning and sell before they leave for home that same day.

Let us face it, if they show a net 1% profit for the day they would probably be quite happy and consider it a good trading day.

Just imagine how pleased they will be if they showed a net 3% profit during a volatile day, which on only R1m traded during that day would leave them with a neat little profit of R30,000 for the day.

* The impact of hedge funds and derivatives

During the past few years, hedge fund instruments and other derivatives have become much more prominent and popular. Many market experts are of the opinion that these players may even be responsible for much of the volatility we experienced in the markets during recent times.

Example:

During 2008 the Volkswagen motor company was generally perceived by most investors as a bad bet for good performance mainly because the motor trade across the globe was in serious trouble.

So, many investors went "short" on Volkswagen shares (which is what you do when you think you can buy those shares much cheaper somewhere in the future).

However, when Porsche announced its intentions to start buying more shares to obtain a controlling interest in Volkswagen, all those investors who went short now had to get out of those short positions as soon as possible. They did this by buying Volkswagen stock before the price went any higher where margin calls could destroy them and of course, the more they bought it, the higher the price went.

(Margins are the security deposits required to cover some short positions and if things go wrong the increase in margins demanded could be really bad for the person who shorted the stock. In fact, the margins could become much higher than the original investment made).

This buying frenzy resulted in Volkswagen stock rising more than 100%, all in a single day.

This unfortunate incident resulted in many hedge funds getting into trouble and just once again proved that even a "perceived certainty" can get you into serious trouble with geared derivative instruments.

■ Market rallies and corrections

A market rally is an upward swing during a bear market and should not be confused with a recovery.

Market recoveries come in three formats:

The *V-shaped* recovery where the recovery is fairly quick and strong

The *U-shaped* recovery where the recovery is slow and more gradual

The *W-shaped* recovery where the first recovery may be nothing more than a rally

Market rallies are probably responsible for the greatest losses suffered by novice investors on the markets. The reasons are twofold, *firstly* they invest more and more to try and make up for the losses suffered just before the rally and *secondly* they often take some serious leveraged "long" positions on some stocks, believing it will keep on going up.

If this improvement turns out to be just a rally and not a recovery they could then soon be in serious trouble.

It is estimated that probably more than 80% of the people who "went under" during the 1929 market crash in the USA did so because they confused the rally in 1930 with a proper recovery. Therefore, many borrowed money to invest in order to recover their losses, just to see the real crash following the rally destroy them.

The actual recovery following the above crash took nearly 23 years for the markets to again reach the pre-crash highs.

Fortunately, the modern day global financial environment makes it very unlikely for such a market disaster to occur again.

A correction is a general drop in share prices on the markets and such a drop could be as high as 20% before it is deemed to be a crash.

Most astute and experienced investors welcome the occasional correction as it tends to bring stock prices back in line with its true embedded value, hence the word *correction*.

The important thing to remember is that over time the trend will be upward irrespective of the up and down movements in the short-term.

Since 1961 to date the JSE All Share Index on average gained more than 17% compound growth per annum.

During the past 30 years the USA markets gained on average 13.4% compound growth per annum.

We are not aware of any other asset class that could maintain such a return over such an extended period of time.

If one looks at the past 10 years from 1998 to 2008 and selected the worst scenario where one includes the full negative effect of both the serious market crashes that occurred during this period, the JSE still would have given a positive return of 8.4% per annum and that does not include the tax-free dividends received during that time.

■ Investor sentiment and behaviour

* The human factor

There are many investors who steer away from the stock markets because they still firmly believe that stocks move and perform in a random manner and that it is not really possible to predict what the markets will do in future.

One should never lose sight of the fact that it is people who buy and sell stock on the markets and therefore designing mathematical models to select good stocks may not be as reliable as the "number fundis" experts with numbers would like to believe.

Very few people have the ability to act only with logic, common sense and rationale. We mostly act on emotion, perceptions, beliefs and other unreliable stimuli.

If we acted on logic and rationale all of us probably would have bought a Volkswagen Kombi, mainly because it is good German engineering, it is versatile, it has great passenger capacity, it has a good trade-in value, it is nice to drive, it is fairly priced, etc, etc.

For this reason, a method with its focus on what people are going to buy or sell such as used by Valana will almost always have an advantage over more traditional "number" models.

* The role of fear and greed

The two primary drivers of activity on the stock markets are probably fear and greed and to become a successful investor one must master the art of ignoring all the market hype and other unsubstantiated market noise daily contained in the many media and news sources.

Often rumours or perceptions could lead to a selling frenzy on the markets which in turn may cause share prices to go into "free fall".

The reason for this peculiar behaviour is because most people *fear losing much more than they enjoy winning*.

The “smart money” investors, of course, love these “suckers” who respond so easily to rumours and market noise, because they create great opportunities for these “smart money” investors to pick up really good stocks, often usually then at bargain basement prices.

■ The single element dilemma

* The PE (price/earnings ratio) illusion

As previously mentioned, nothing should ever be considered in isolation if one wants to assess investment value in companies listed on the equity markets.

There are still many investors who put far too much weighting on the PE ratio of a stock when deciding whether such a stock is fairly priced or not.

PE ratios can be very misleading and should be treated with great caution by the unwary.

The only thing one can safely say about PE ratios is that over time good quality stocks with low PE ratios (under 10) may probably do better than stocks with high PE ratios (above 16).

However, it is not a certainty and it will be foolish to make investment choices simply because you rely on such a trend.

In fact, a low PE could simply indicate that the stock is "rubbish" of poor quality and one should probably stay clear of it.

One should also understand that a PE ratio of 16.0 for a *high quality stock* may be more acceptable than a PE of 8.0 in an *obscure stock* with little performance history.

The PE ratio of a stock actually reflects the expectations investors have of the company. If they expect the company to do very well they will push up the price which will raise the PE ratio (earnings multiple) and if they have low expectations, they will sell the stock which will lower the PE ratio of the stock.

Therefore, one could say that a company where the stock has a high PE of say, 20.0 such a company is expected to do much better than one with a PE of only 8.0. In such a scenario the higher expectations are already built into the price of the stock.

The important thing to understand about these PE ratios is that if the expectations are not matched with the eventual outcome these investors will probably be disappointed and then over-react, as they often do, by dumping such stock on a grand scale.

The above is the reason why we often find a stock price falling even though the earnings on the face of it seemed to be very good.

Whilst earnings maybe important the problem lies in the fact that share price movements look at forward earnings and none of us really know what the expectations for earnings are amongst the big players in the markets.

We already, in Module 2, mentioned Warren Buffet's view on risk taking in the markets and that is probably the reason why he once said he will tend to avoid stocks with PE ratios above 16 ... *the risk of the future outcome not matching the expectation is simply too high.*

As with PE ratios, one should also not consider any other element in isolation such as Headline Earnings (HEPS) Return on Equity (ROE), Return on Assets (ROAM), Net Asset Value (NAV), Profit Margin, etc.

In fact, the only factors that could to some extent be considered in isolation would be the verifiable skills and quality of the management team and cash generating abilities in a specific company.

■ Some useful portfolio guidelines

Have at least one-third of your holdings in solid high quality "Jewel" stocks.

A good dividend paying stock means you are probably getting such a stock at a discount.

Avoid having more than 10% of your assets invested in property (excluding your own home).

Avoid having more than 10% of your stock in any single sector of the market.

Avoid having more than 10% of your holdings in companies listed for less than 3 years.

Avoid pre-listing offerings of new companies no matter how great the prospectus sounds.


Never wager more than 10% of your portfolio worth (value) on derivative instruments.

If trouble looms, first get rid of all your recently listed small cap stocks.

■ The greatest wins and losses ever recorded

The greatest gain ever recorded by an individual was during the 90's when a Wall Street "whiz kid", named Andrew Carlson, with an initial investment of only \$800, within two weeks, made 26 correct geared derivative calls in a row to end up with a portfolio worth more than \$350 million.

The greatest loss ever recorded by an individual was when Nick Leeson, a trader for Barings Bank, within three months lost more than \$1.3bn with reckless derivative trades.

 To really appreciate how much \$1.3bn is the following simple example may explain it. If you earned an incredible R8,640 each single day, you would have had to start earning it more than three thousand years ago - as it would have taken you approximately 3,280 years to actually earn \$1.3bn (based on R8 to US\$).

It should be noted that both the above examples involved geared derivatives.

In our next module we will deal with some of the different trading approaches that may be used to trade successfully with stocks on the Securities Exchange.