

What I've learned after 44 years of market ups and downs

Yes, it's true.

I have been doing this for 44 years now. Doing what? Trading the stock market. I started as an interest rate trader, then moved over to equities after about a year. Then I became an analyst, a senior trader, and a portfolio manager. My last stint as an investment pro was six years of running the equity trading desk at Northern Trust in Chicago. That was a real trial by fire situation. I had to please many constituents, including customers, portfolio managers, and major brokerage firms, not to mention my boss.

The market is undefeated.

During most of the market crashes I have lived through, I was trading like crazy, trying to keep up with what was happening. I had too many holdings, and it took a long time to sort everything out. Then I realized that what I needed was fewer and bigger positions. I now hold about twenty stocks in my portfolio, which is plenty for most investors. After these crashes and bear markets, things usually stabilize and trade sideways for a while. Then the market begins to move up again, just like clockwork, and always reaches fresh new highs.

A fool's errand

I learned that trying to call market tops and bottoms was a fool's errand. But when you pay attention to what is happening in the business cycle, you can cut your bear market losses in half. I do this by waiting for confirmation of a downtrend from the Treasury Yield Curve and the Employment Situation. This would add about 2% per year to your investment returns. That extra 2% has an outsized effect on your ending portfolio balance. If, for example, you invested \$1,000 today and kept it in the market for 10 years, you might go through a bear market, or not. Assuming the market

would pay you about 10% per year on your money, that would give you \$2600. Not bad. But if you earned an average of 12% per year, you would receive \$3,105. Much better. And the longer you stay in the market, the wider that spread becomes.

Recessions are the bane of an investor's existence.

One of the things I learned is that recessions are especially bad for most stocks. Everything seems to go down, no matter how much money they are making. But I figured out a few ways to mitigate the damage done to my net worth by the falling stock market. By playing defense. As the market comes down, I take money off the table. I start at 100% invested, then go to 75%, then 50% and finally 25%. That is important because my portfolio is my 'rainy day fund' that was supposed to get me through buying a house, sending kids to college, and retirement. My net worth did not increase every year. When I took money out to pay for college, for example, my net worth took a hit, but it was well worth it.

How are the economy and markets linked?

I became extremely interested in the interplay between the economy (the business cycle, specifically) and the equity market. I learned that the stock market begins to fall well before the economy enters recession. There have been many false starts, of course, but I managed to make a profit during most of the notable market declines. I did this by systematically reducing my equity exposure as the economy continued to soften. The market then starts to go up, often sharply, when we are still in a recession, but investors can see that things are about to get better.

I'm a big fan of Thomas Bayes

I developed my own models, one for the economy and the other for the market. I based these models on Bayes Law, or Bayesian Inference. This is a methodology for calculating the probability of certain outcomes. The

models begin with what is called the “Bayesian Prior” which means that the economy and market will grow at their long-term pace this year. If you talk to someone who uses Bayes’ work, they will tell you to “Never forget your priors.” Then the model makes changes to the prior probability based on current events and economic reports. It is an iterative process that gets you closer to the final real outcome. There are plenty of Bayes spreadsheets out there for you to download and use just like me. I have three examples:

1. **Statology** - This tutorial explains how to apply Bayes' theorem in Excel, including several examples. [How to Apply Bayes' Theorem in Excel](https://www.statology.org/bayes-theorem-excel/) Visit: <https://www.statology.org/bayes-theorem-excel/>
2. **Real Statistics Using Excel** - They have multiple Bayes-related resources including Bayesian Grid Approximation examples. Visit: <https://real-statistics.com/bayesian-statistics/>
3. **Fairly Nerdy** - This Excel file shows examples of implementing Bayes Theorem for a number of different problems. The problems start fairly simple, and then get into more complicated problems such as the classic German tank problem, the drug testing problem, and examples of how to handle possible errors in your input [Bayes Theorem Examples - Fairly Nerdy](http://www.fairlynerdy.com/bayes-theorem-examples/) Visit: <http://www.fairlynerdy.com/bayes-theorem-examples/>

My stock selection template keeps me out of trouble.

I also designed a template that records input from key metrics as they relate to individual stocks. It includes things like the stock’s margin of safety, the projected rate of earnings growth, and the company’s fair value ratio, which I compute as Enterprise Value/EBITDA. Having these key metrics on hand does an excellent job of keeping me out of serious trouble in the markets. I never go to 100% cash. I always keep a minimum of 25% of my assets in the equity market. But when the market is misbehaving, I

can have as much as 75% of my assets in cash, T-bills, money market funds, or whatever short-term investment pays out safely and reliably. I try to stay away from longer-term bonds that carry price risk.

What's the smart money doing?

I am a big user of charts, especially the free ones in StockCharts.com. I make many of my own charts for articles and blog posts, along with tables that track the performance of various asset classes, sectors, industries, and companies over time. By watching how the leadership changes over time, you can get a sense of where the money is flowing. For example, I have noticed a large decline in the value of the US dollar and a large increase in the price of gold and bitcoin. Could they be related? I think they might.

Alpha Monsters

I discovered that there are stocks out there that consistently generate alpha (a rate of return that exceeds the market return). These winners are not hard to find. Morningstar has a function that shows the stock return and the market return going back 10 years. It's called 'Price vs Fair Value' and it shows the annual gain of the stock or ETF, along with the gain of the benchmark used.) This is a great way to identify companies that are performing well in the market and deserve a closer look. You can do this at home with a simple Excel spreadsheet. My criteria are that a company must have captured alpha for four of the last 5 years. When I find them, I then look at their valuation and financial viability. I use Margin of Safety as a guide, along with the rate of earnings growth these companies are generating. It is a great way to find winners and avoid losers.

Final thoughts

What motivated me to spend so much time learning how the markets work? It began when my dad taught me how to read the stock tables in the Wall Street Journal. I was 10 years old at the time. I was fascinated by the

idea that anyone could make money appear out of nowhere if they really put some time into it. I knew right then and there that I wanted to work in a business that dealt with the stock market. And I did. Kemper Securities, Oakmark Funds, UBS, and Northern Trust. I have never stopped learning, and I still enjoy it today.