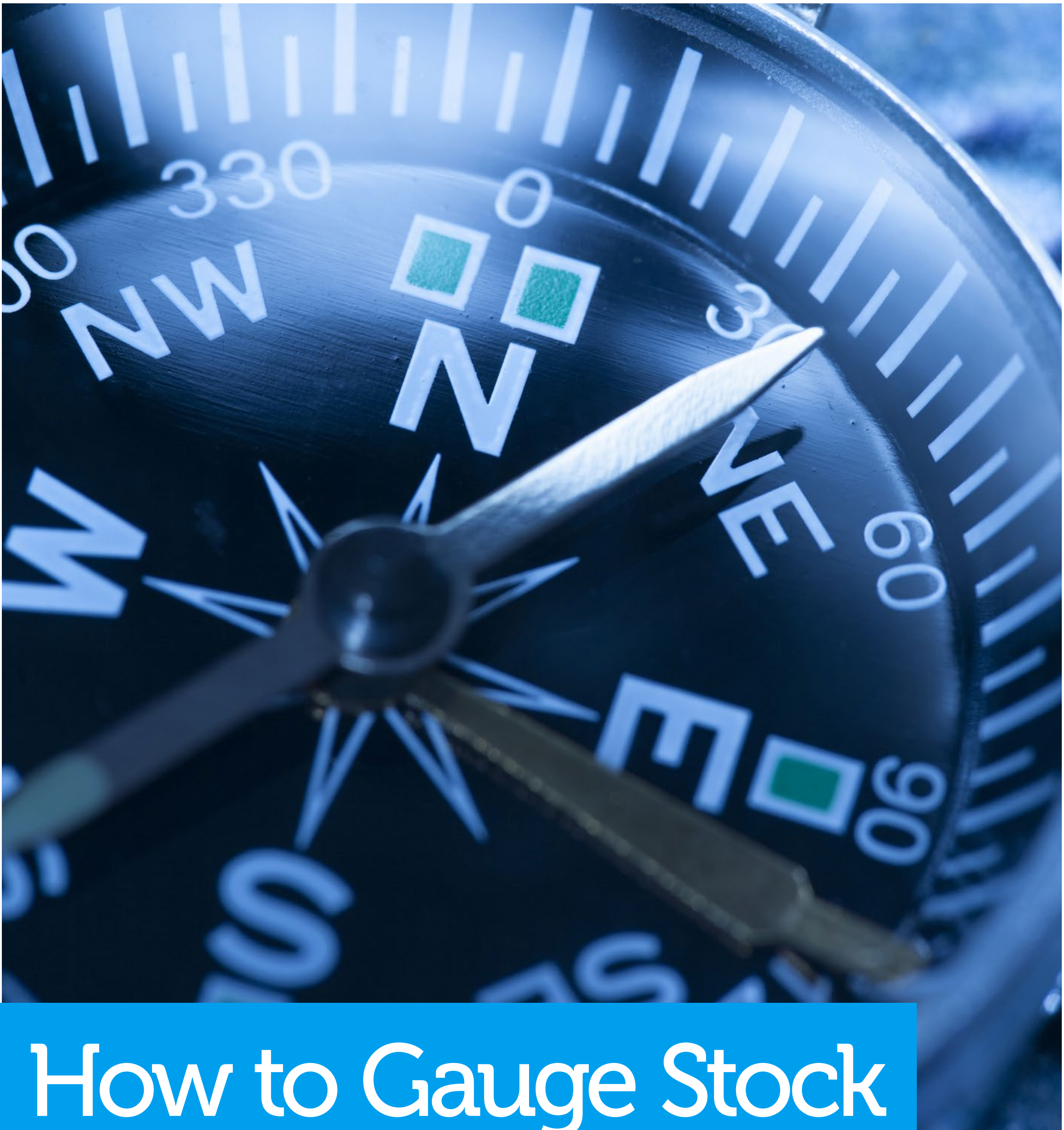

How to Gauge Stock Market Direction

ISACO

LET'S GROW WEALTH TOGETHER.

Contents

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Introduction

Stephen Sutherland.
ISACO's Chief Investment Strategist and author of *Liquid Millionaire.*

My name is Stephen Sutherland and my passion in life is investing. I was fortunate enough to have instant success when I first got serious about the stock market. That success early on in my trading career made my love and curiosity for the market strengthen. It's now in my blood and I live, eat and breathe the market 24/7. Some would say I'm obsessed and maybe they are right.

Even if you have a real knack for picking the best fund, if you are wrong about the trend of the market, your portfolio is going to suffer. This happened to thousands of uninformed investors in the great bear markets of 2000–2002 and 2007–2009.

This means it's essential that you have a reliable method of determining which way the market is heading. Throughout your investment journey, you will ideally need to know if we are in a bull (up) or a bear (down) market. In this report we'll look at how you can get in sync with the market's trend and direction.

In case you are wondering, our clients are ISA and SIPP investors who buy funds for their portfolios and most of the people we work closely with have over £250,000 actively invested. If you are an ISA or SIPP investor with over £250,000 actively invested, this report was written especially for you.

Happy fund investing!

Stephen Sutherland
Chief Investment Strategist and author of *How to Make Money in ISAs and SIPPs*.

Is the market healthy or unhealthy?

We've found that to win with investing, you have to watch what the market is doing and interpret what it means. For example, is the market behaving well? Or is it weak and acting out of character? To achieve investment success, it helps if you have a good handle on the market's current health and likely future direction.

The best way we've found of achieving this is to watch what the general market averages are doing on a daily basis. We do this by tracking and analysing the following US indexes:

- The NASDAQ Composite
- The NASDAQ 100
- The S&P 600
- The S&P 500
- The S&P 400

Even though we like to keep an eye on all the world exchanges, our main focus has always been on the US markets and there are four reasons why we do this:

1) The US is the world's largest economy
2) The US is the leading market to watch for clues of future direction
3) The US stock market indexes long-term growth exceeds other world exchanges
4) Our philosophy involves watching the behaviour of US institutional investors

The other indexes around the world that we watch closely are the FTSE 100, the DAX, the CAC 40, the Nikkei 225, the Hang Seng, the Shanghai Composite, the SZSE Component and the BSE SENSEX. As well as watching those five US indexes, we believe it's crucial to watch the behaviour of the US's leading stocks and leading sectors. By studying these five indexes, plus the action of leading stocks and sectors, each and every day, you can keep a close eye on the market's character and quickly notice any significant changes in the market's 'personality', which can help you to spot market tops and bottoms.

Is buy and hold broken?

Buy and hold is an investment strategy that only tends to work in long-term upward trending markets, such as the super bull market that occurred between 1980 and the year 2000.

A buy and hold strategy may work, but only if you buy when the market is low and just before a bull market begins. But what about during bear markets? Adhering to a buy and hold program during significant correction periods can be very painful, particularly if retirement is approaching.

Why we prefer being active

Every buy and hold program has to start with an initial buy. You have to decide when to get in and if your decision is based on emotions, which it usually is, you may encounter problems. For example, if you had used a buy and hold strategy and bought at the peak of 2000, just before the 2000–2002 savage bear market, or at the 2007 top, just before the 2007–2009 financial crisis, you may have experienced losses of 50–90%.

Did you know that dropping 50% requires a 100% gain to get you back to even? Yes, it's true and that's why you have to do all you can to try to limit your downside during bear markets.

In the 2000–2002 bear market[1], our ISA account dropped 10.9%, the FTSE 100 fell 17.2% and the NASDAQ Composite lost a hefty 67.2%. And in the most recent bear market of 2007 to 2009[2], our account fell by 5.3%, the FTSE 100 lost 8.6% and the NASDAQ Composite 14.4%.

[1] December 31st 1999 - December 31st 2002.
[2] December 31st 2007 - December 31st 2009.

But others who experienced significant losses during 2008 won't have been as lucky. Some investors who took heavy falls will be sitting in those losses for up to a decade. Imagine what it must be like for those investors who took a loss of 90% in either of those two bear markets. For them it would mean their portfolio having to rise 900% to get back to where they started. That could take some time! The table explains how this works.

Size of loss (%)	Gain (%) needed to get back to even
33	50
50	100
90	900

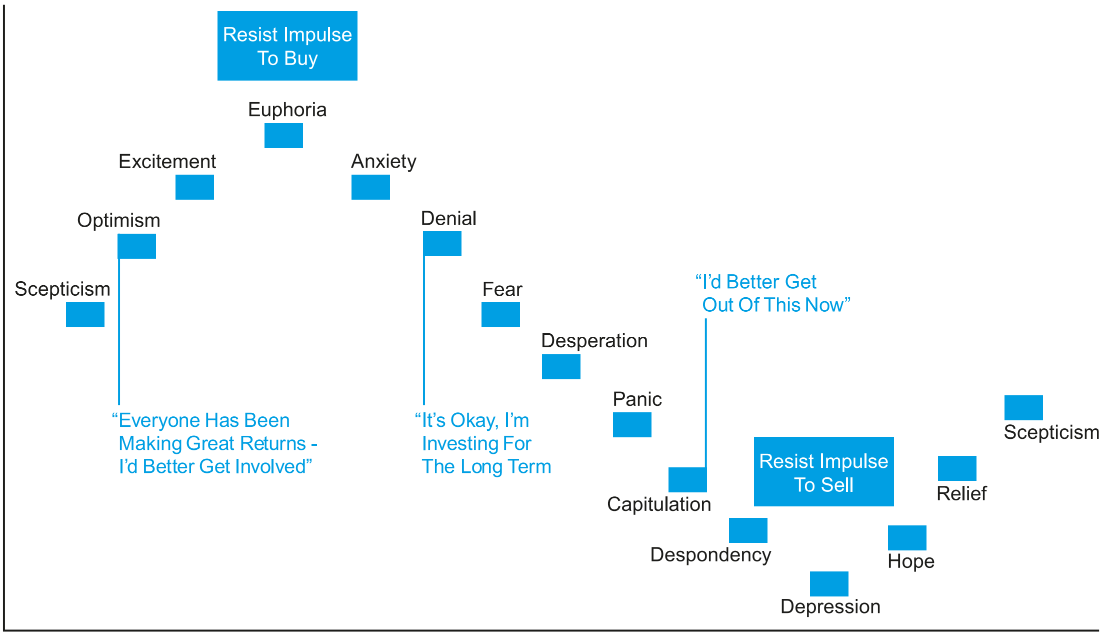
Courtesy of ISACO.co.uk.

This is why it is so important for you to be active and aim to preserve your capital when you see the first signs that the market has changed from healthy to unhealthy. Whenever I see behaviour that suggests a 'change' in the personality of the indexes and my investments, suggesting that something may be wrong, I immediately become more defensive, exiting from those investments that are no longer performing well and raising cash if necessary.

Most investors buy at the wrong time

You might be thinking that you'd have to be extremely unlucky to buy right at the top of the market, however, as you will soon see, unfortunately most investors do buy at the wrong time. The perfect point to start a buy and hold program is right at the bottom of the market and the point to exit would be right at the top.

The challenge we all face is that when the market is at its bottom, not many people feel like starting their buy and hold program. Most investors want to start their buy and hold strategy when the market is at its top – again because of how they feel. Unfortunately, all too often investors are influenced by short-term market movements rather than focusing on the longer term trend.



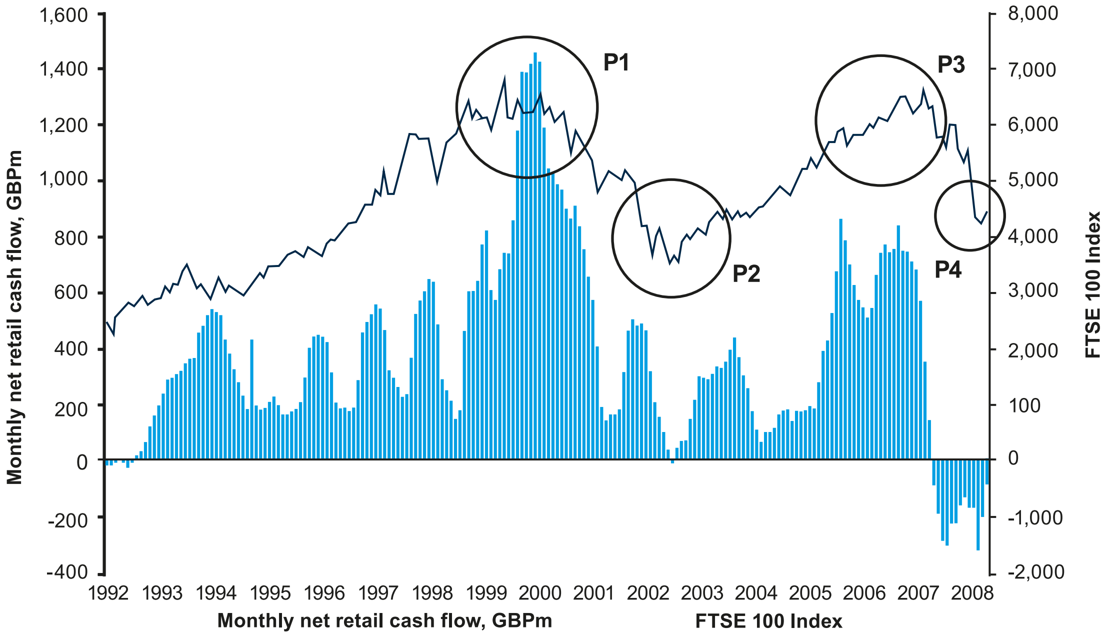
Courtesy of ISACO.co.uk.

As the chart illustrates, many investors go through a range of emotions at different points in a market cycle. All too often this can result in them entering or exiting the market at precisely the wrong time.

As markets peak, investors experience emotions of excitement, thrill and euphoria. This tempts unsuspecting buy and hold investors to start their programs when the market is highly priced. But, as markets dip, negative emotions of panic, despondency and depression lead buy and hold investors to give up on their plan, exit the market and realise a loss.

Buying high and selling low

To support this theory, the next chart shows historic net investment flows (investment purchases minus investment sales by retail clients) into equity funds by UK investors, alongside movements of the FTSE 100 Index, between 1992 and 2009.



For illustrative purposes only.
Source: IMA, MSCI. Monthly cash flow data shown reflects 6 month moving average.

As can be seen, investment flows increase significantly as markets peak, especially during P1 in 2000 and P3 in 2006/2007, and conversely decrease during market dips, especially during P2 in 2002 and P4 in 2008, when we see net outflows (i.e. more sales than purchases by investors) from funds.

The dangers of buy and hold

Let's now look at the dangers associated with buy and hold, using a real life example of a fund we bought back in 2005 and what would have happened to our clients' accounts if we hadn't taken a more active role. The fund we bought was called the Legg Mason Japan Equity A.

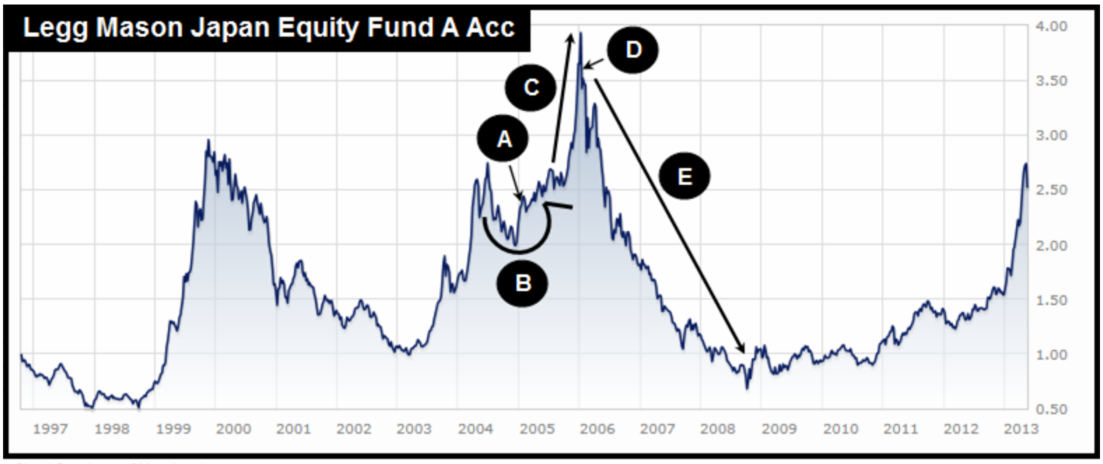


Chart Courtesy of Morningstar

We bought this fund at a price of 2.32 on January 11th 2005 (Point A), just before it broke out of a bullish cup-with-handle formation (Point B). Soon after purchase, this fund really took off, eventually hitting a peak at 3.93. We recognised this behaviour as climax topping (Point C) and, soon after it hit this high, we decided to exit at a price of 3.32 (Point D) on January 5th 2006. This helped us net a 43.1% gain in twelve months. As you can see from the chart, just after getting out, the fund fell like a stone, dropping 71.4% (Point E) over the next three years.

More reasons for being active

Buy and hold could work if you started your program at the right time but as you've seen, unfortunately most investors don't buy at the optimum point. You could of course decide to adopt a pound cost averaging strategy, a strategy we use for investing capital outside an ISA and SIPP.

I'm sure you already know this but just in case, pound cost averaging is the practice of investing a predetermined amount of money at regular intervals, regardless of market conditions. The amount you invest is constant, so you buy more shares when the price is low and fewer when the price is high. Adopting such an approach could help you avoid the risk of mistiming your initial buy. Even though this is a better approach, it makes more sense when investing using ISAs and SIPPs to consider becoming more active.

Let me be clear, being active does not mean frequent trading. Personally we don't like to make too many trades because first of all it's a faulty strategy and secondly the trading costs can eat into your returns. During a typical market year, we'll normally make no more than six trades each year and our changes are triggered when we see underperformance from a fund we own. This happens due to sector rotation, which is when money moves from one sector into another.

Watching where the big money is flowing

For example, technology may be the hot sector for a while but eventually it has to cool off. As it cools, the big money flows into the next hot sector, for example, financials. These hot sectors are known as leading sectors and all leading sectors eventually become laggards. This is why it's important to keep a close eye on which sectors are leading and which ones are lagging and never to fall in love with an investment you own.

The aim is to keep track of the money flow and to try and always be positioned right in the middle of the money flow during a bull phase. This is easier said than done of course, but it still should be your aim.

Making better and more accurate investment decisions starts with understanding how the stock markets operate in cycles and how the majority of the daily trading volume is created by institutional involvement – large investors who have a significant influence on the market's trend and direction.

Do fundamentals still matter?

In 2003, the FTSE 100 bottomed at 3392 and in 2009, it hit a low of 3461. Who would have thought that the FTSE 100 would revisit a similar price point again? Between 2008 and 2009, some of world's most respected companies lost as much as 90% of their share value and that's the reason why we all may need to look beyond fundamentals. Technical analysis is different to looking at fundamentals. It looks at chart trends and asks the question, is the market in an uptrend or a downtrend?

Is technical analysis the solution?

While technical analysis is not a perfect solution, it can often provide an effective way to help you gauge market direction. It can also remove the emotional element of stock market investing. Fundamentally, you can look at corporate profits, GDP growth, unemployment, inflation and price/earnings ratios to try to determine if the general market is under or overvalued.

Adding technical analysis to your tool box aims to keep you fully invested when trends are up. On the other hand, it also aims to help you become more defensive when major downtrends have been triggered. Before you decide to invest, you could ask – is the market and the fund I'm thinking of buying in an uptrend? If the trend is up, you would have more confidence issuing a buy order.

Why it pays to watch indexes more than economic data

Did you know that the market is six month forward-looking? This means that you are going to struggle gauging future market direction if you use the news headlines and economic indicators to guide you. Using the news headlines and economic data to guide your investment decisions doesn't work because the market will have already factored all the news and data into its current price.

If you find the countless economic indicators confusing, join the club! How are you supposed to know if an industrial production figure is good or bad? How should you interpret the jobs report? We've found that economic gauges reflect the past or, at their best, the present. They won't really tell you the future. Often, by the time the economy starts cooling, stocks and investment funds will have already suffered a downturn.

Likewise, a new uptrend can emerge while economic activity is slumping, or even as the economic cycle is at its worst point. There are two headlines that we pay attention to. The first is 'Federal Reserve Raises Rates' and the second is, 'Federal Reserve Lowers Rates'. The Federal Reserve is the US's equivalent of the Bank of England and one of the Fed's jobs is to decide if interest rates need to be changed. Interest rates are crucial to economic activity, and to the stock market. The stock market loves rate cuts and hates rate increases.

Did you know that the stock market has a personality?

The stock market can behave in different ways. Sometimes its personality is friendly and the market's the best friend you could ever ask for. Other times however, the market's like the bully from hell who beats you up and steals your lunch. Funds have a personality and so do stocks. In bull markets, they tend to act well. In bear markets, they turn tail and drop like stones from the sky.

The only way to know if the behaviour of the market, stocks or your fund is normal is by watching their activity extremely closely. For indexes and stocks, this means watching the action whilst the market is open and analysing the market once it's closed. Funds don't trade in real time and so their behaviour needs to be analysed after the market is closed. You have to put in the time to really get to know the personality and character of the market so that when something changes you'll know and you'll be able to react quickly.

Market indexes always eventually move into higher ground

Did you know that the market indexes always eventually move into higher ground? Sometimes they don't make any price progress for very long period, a decade or even longer in exceptional circumstances, but this is simply classed as a resting period for the market before it takes its next major leg upwards. Eventually the stock market ALWAYS breaks into new high ground and that means making brand-new price highs. The most popular market index in the UK is the FTSE 100, which you are probably familiar with but have you heard of the S&P 500? The FTSE 100 is an index that contains the hundred largest publicly traded companies in the UK and the S&P 500 is the United States equivalent, and contains five hundred of the largest US businesses.

S&P 500

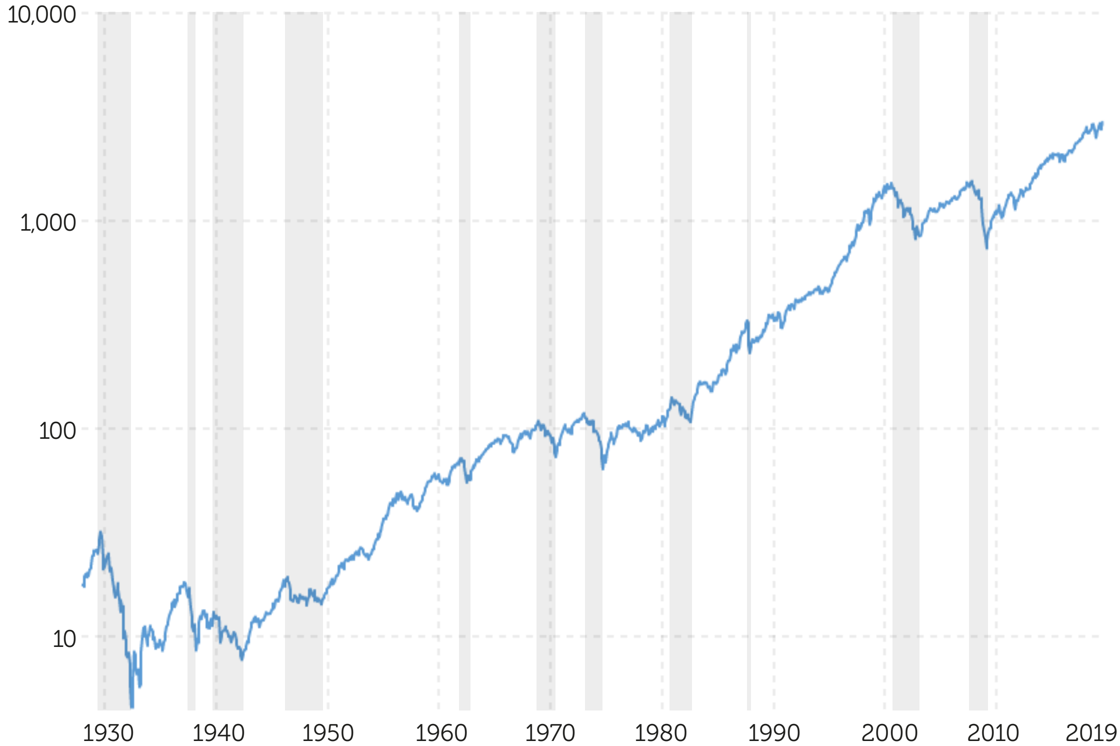


Image courtesy of Macrotrends.com

As you can see from the illustration, the long-term trend that the S&P 500 has formed is up. Look closely and you'll notice that the chart features grey vertical shaded areas and these represent the bear markets. The white areas on this chart are the bull markets. If you take another look, you'll also notice that the market has always recovered after significant correction (resting) periods and proceeded to move into new higher ground.

The market works in cycles

Bull markets typically tend to last between two and four years. Bear markets last approximately nine to eighteen months. Because bull markets last longer, the stock market over the long term forms an uptrend. In a typical cycle, you'd normally have three years up and then one year down. The bull/bear cycle then starts again and keeps repeating.

Bear markets tend to end when businesses and the economy are still in a downturn and bull markets often end way before a recession sets in and usually when all the business and economic data looks positive. The market's action is determined by millions of investors and its daily activity is a result of the investors' general consensus about what they like or don't like and what they foresee happening in the world. For example, what governments are doing or about to do and what the consequences of those actions could be.

Make money by asking the audience

Rather than trying to work out where the market is likely to head by reading reams of economic data, reading the newspaper or listening to the latest financial news, we would rather see what institutional investors think and more importantly, closely watch what they are doing. We can very easily see what they are thinking by looking at charts. We can tell if they are bullish and aggressively buying stock or if they are bearish and aggressively selling.

Each and every day we simply analyse what has happened and what it means. We look to see if it is positive, neutral or negative. If, over several weeks, the activity is positive, it would tell you that the market is behaving well and therefore more likely to head north than south. If, however, the behaviour is negative, it would suggest that the market is more likely to head south.

How to analyse the market's health

Institutions, not individuals, account for nearly 75% of the daily trading activity on the exchanges[3]. That's why it's important to watch their activity carefully. The large institutional investors have the greatest influence on the stock market and consist of investment funds, banks, pension funds and insurance companies.

[3] Investors.com.

If these 800lb gorilla investors are buying, smaller, more nimble investors like you and us can jump onto their coat-tails. And if these institutional investors are selling, you could quickly take a more defensive stance. Here is how it works. Picture the market as a large tree and try to imagine institutional investors being woodcutters. If institutional investors are selling heavily it is as if they are taking a cut out of the tree and this of course, makes the tree weaker.

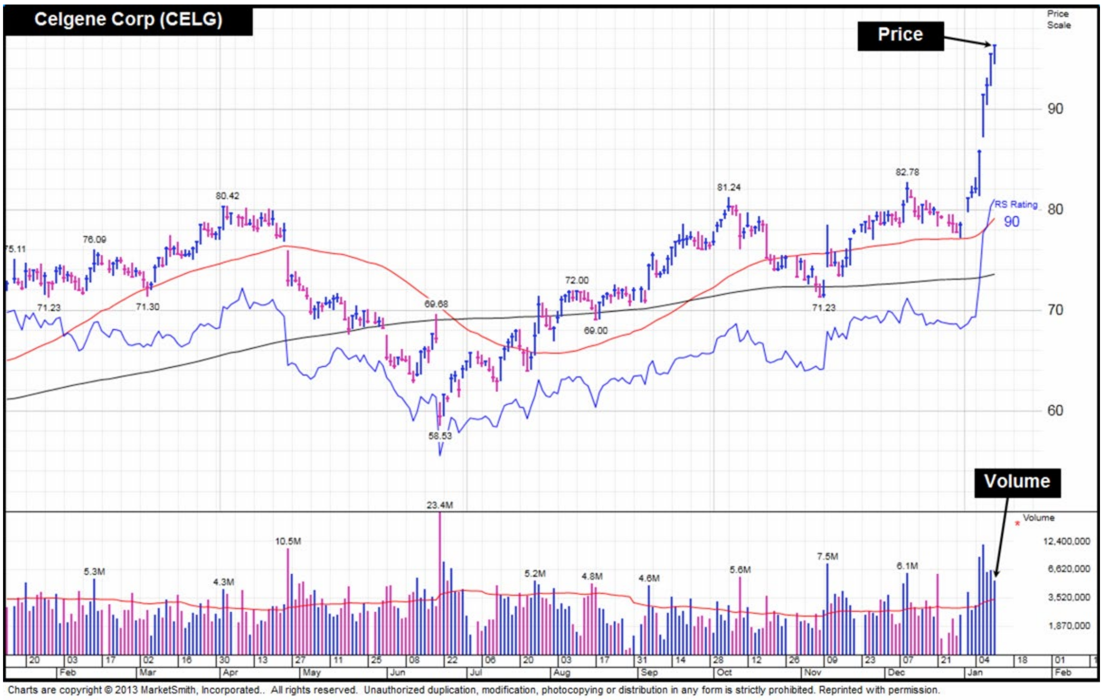
If they take too many swipes at the tree in a short space of time, what is going to happen? That's right, the tree will fall over. This means that the market gets weak when it succumbs to excessive selling, which results in a red flag being raised.

When heavy selling occurs, especially over a short period of time, it's often a sign to say that it's probably the time to become more defensive. On the other hand, when institutional investors are buying heavily over a short period of time, it makes the market healthy and extremely strong, and this is the time we like to be invested.

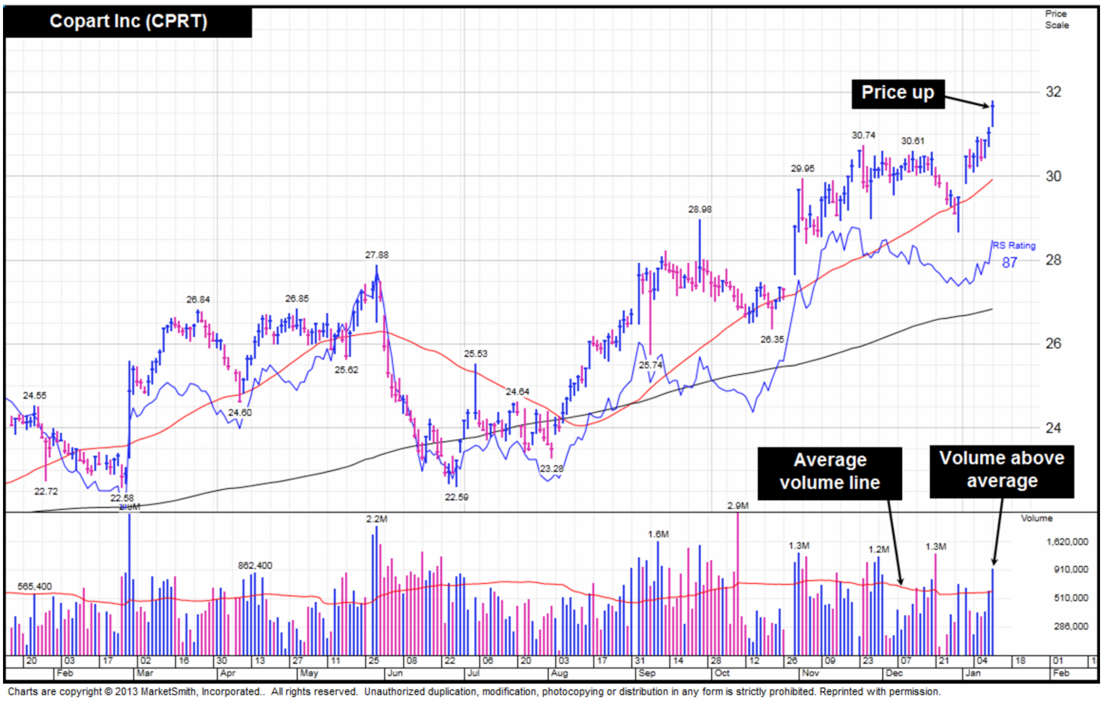
Why it pays to watch the price and volume action

One of the best ways of reading the market's health and gauging its likely future direction is to look at charts. A stock chart is a graph that displays the price and volume history of a given security or index over a period of days, months or years. Price and volume charts help you to see what the professional investors are doing; allowing you the opportunity to follow in the large investors' footsteps.

Institutional investors cannot hide their tracks. Think of an elephant getting into a bathtub. Whether they are buying or selling, through a chart you can clearly see what the big players are doing. Price action is how a stock or index changes in price. Volume action is the number of shares traded.

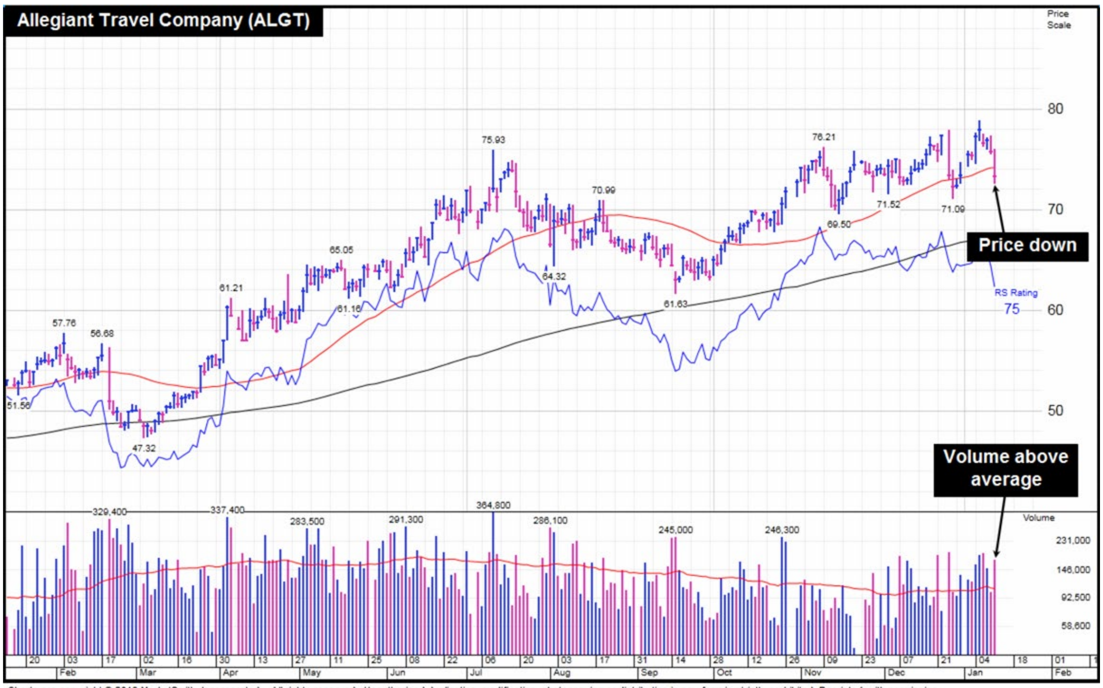


In the volume part of the chart, notice the red horizontal moving line.

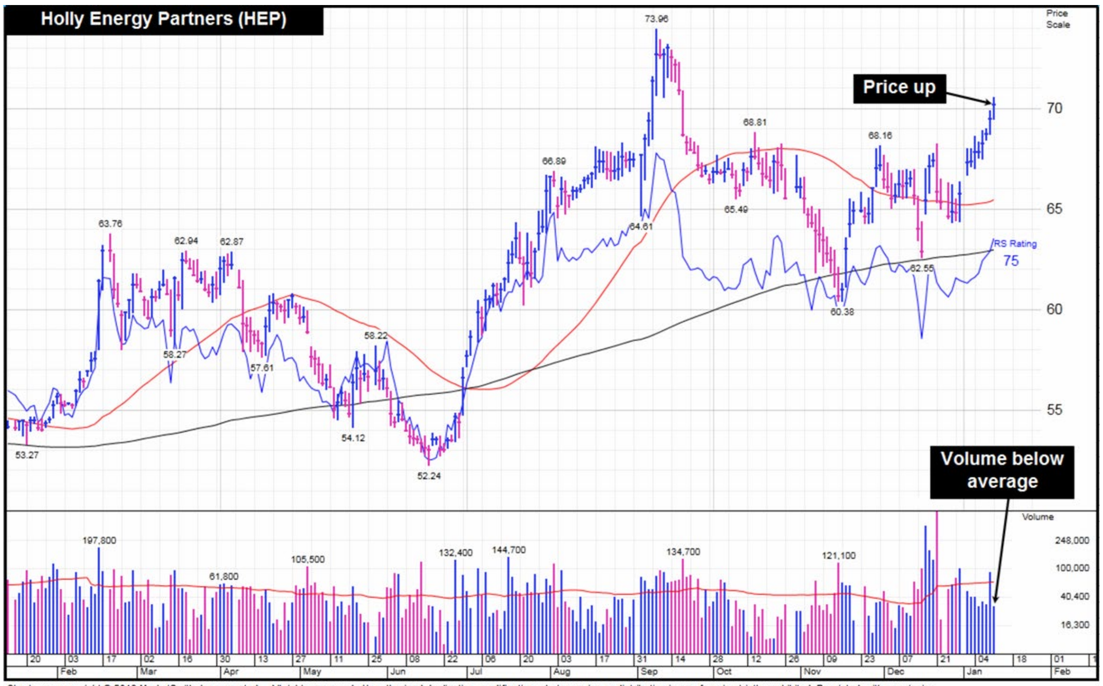


This represents the average volume levels over the previous 50 days. If trading volume is above average and price action is up, institutional investors are buying. That's good. This is classed as healthy behaviour.

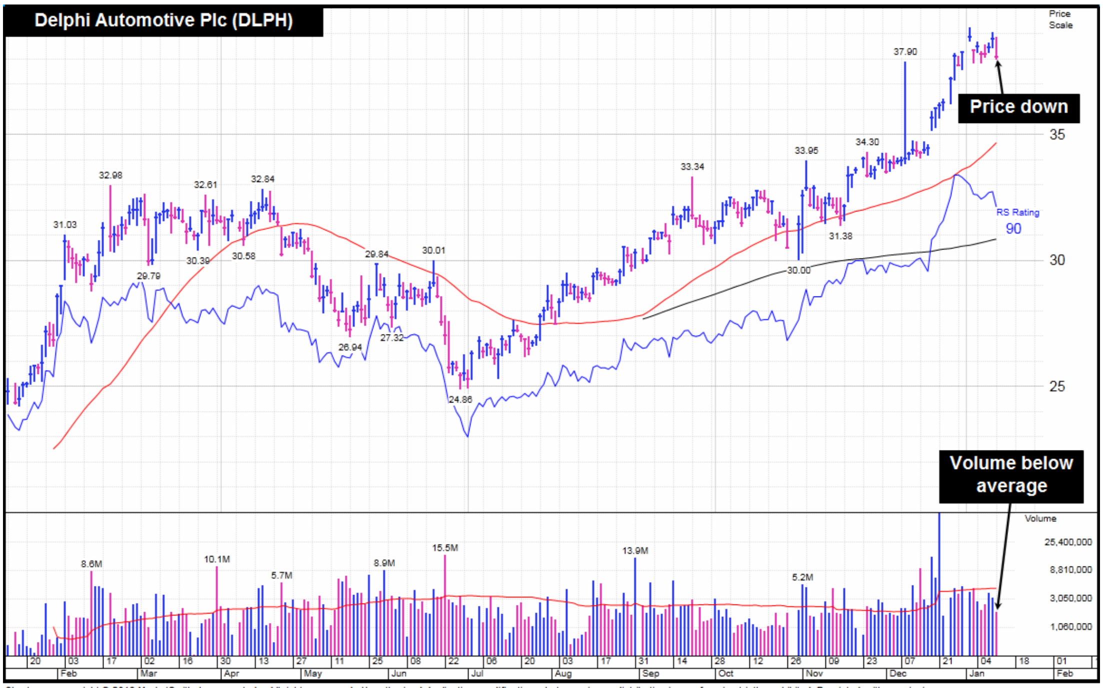
On the other hand, if volume is above average and price action is down, it means institutional investors are selling. That's not good. This is classed as unhealthy behaviour.



If volume is below average and the price action is up, it indicates little demand from institutional investors. That's also not good. This is seen as unhealthy behaviour.



And finally, if volume is below average and the price action is down, it indicates that institutional investors are reluctant to sell. This type of action is good. This is seen as healthy behaviour.



It does take a lot of buying or selling to change an established trend. By carefully analysing the market's behaviour on a daily basis, it can assist you in trying to determine whether the trend has changed. If you believe it has, you can act accordingly. By watching the trading activity closely, you can see exactly what institutional investors are doing with their money – effectively allowing you to get in sync, and trade with the trend, instead of against it.

Reading the market every day could reap you a fortune

We suggest you aim to make it a habit of reading the market day in, day out. It's important to read and analyse the market regularly because a piece of positive or negative news could change the whole market dynamic in just a single day. How the market responds to the news will ultimately govern how you react. The market's health and direction could alter in the space of 24 hours, which is why you should remain vigilant at all times.

When you watch and analyse the market on a daily basis, you have the potential to profit from exciting investment opportunities. Another reason to read the market every day is to avoid being invested in the wrong investments when a downtrend has been triggered. This could result in unnecessary loss – that could have been avoided by being a more diligent follower of index, stock and sector activity.

Why it pays to watch what the big players are doing

By making it a habit to read the market every day, five days a week, you'll be able to make a good call on its health. By reviewing the behaviour of the market over the previous several weeks, and the activity that day, you'll be able to decide if it is healthy and acting right.

The stance you take on the market can be created by daily analysis of the market indexes and leading stocks. Your in-depth intraday look at the market could be followed by a thorough after-market check up. The concluding results could then be reported in your own personal trading diary.

Stock market tops

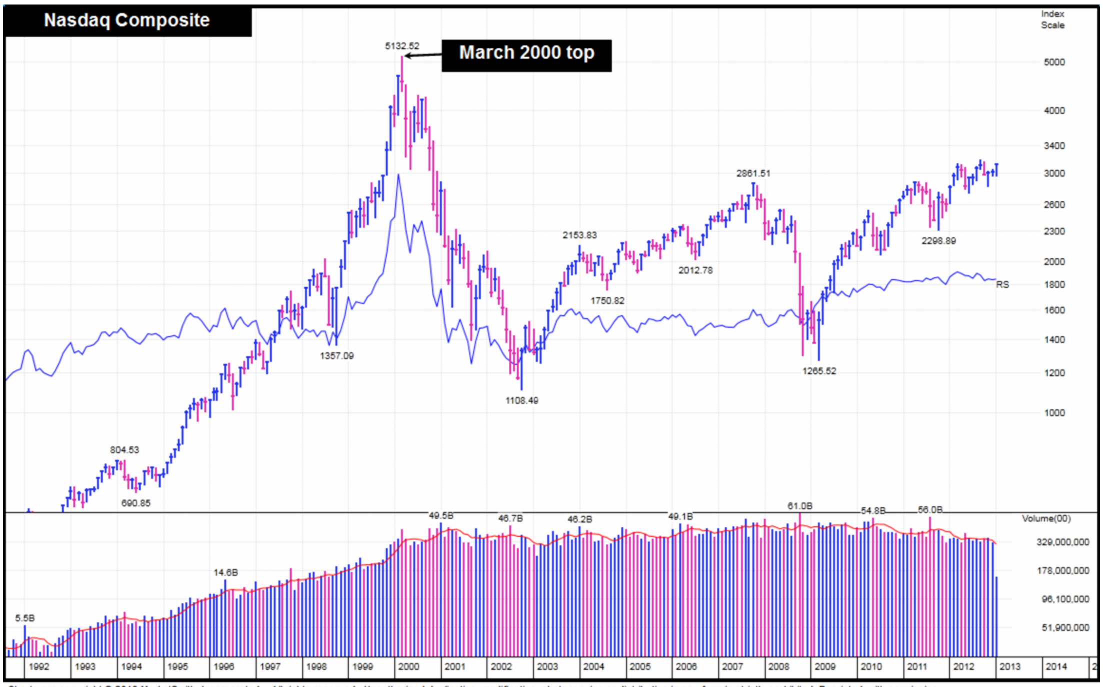
Historically, market tops occur after the averages move into new high ground and show several days of large and increased volume, with either very poor price progress or actual declines in the averages. A series of distribution days (institutional selling) mark the end of a bull market.

A distribution day occurs when one of the major stock indexes falls on above average volume. When the market piles up four or five distribution days in just a few weeks, and the uptrend seems to have stalled, chances are it's heading into a correction, especially when you notice many top stocks falling heavily in great volume.

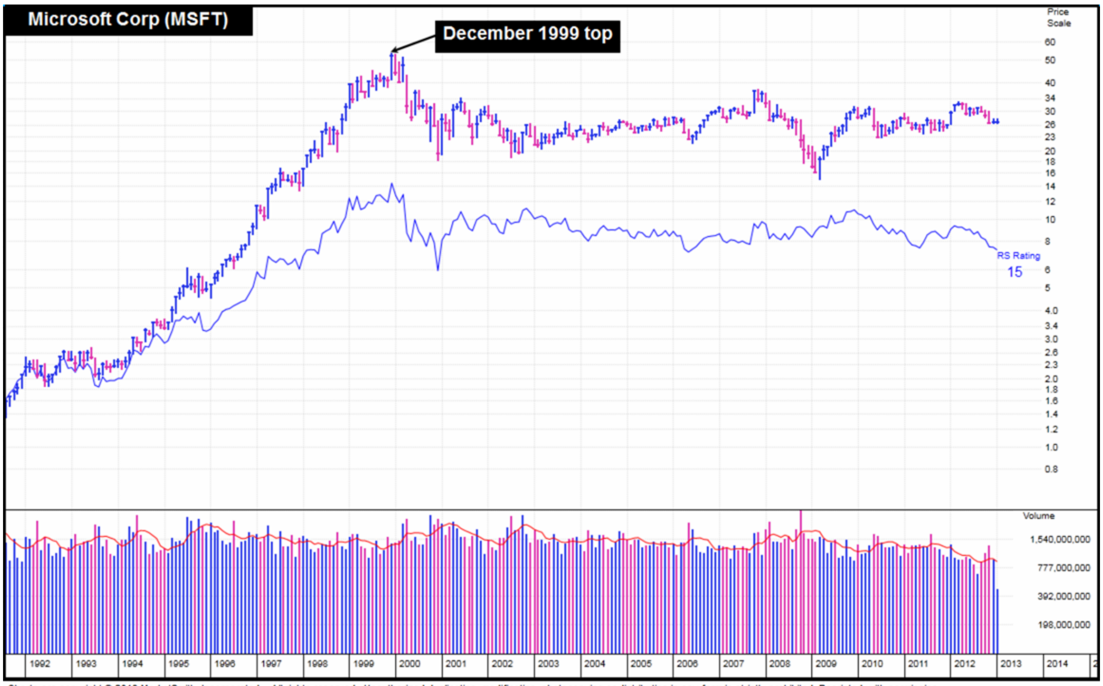
Why it's smart to keep a close eye on leading stocks

Throughout the year, come rain or shine, we love to watch the daily activity of the market's best stocks. The reason we watch them like a hawk is because they tend to lead the market higher or lower – before the general market catches on.

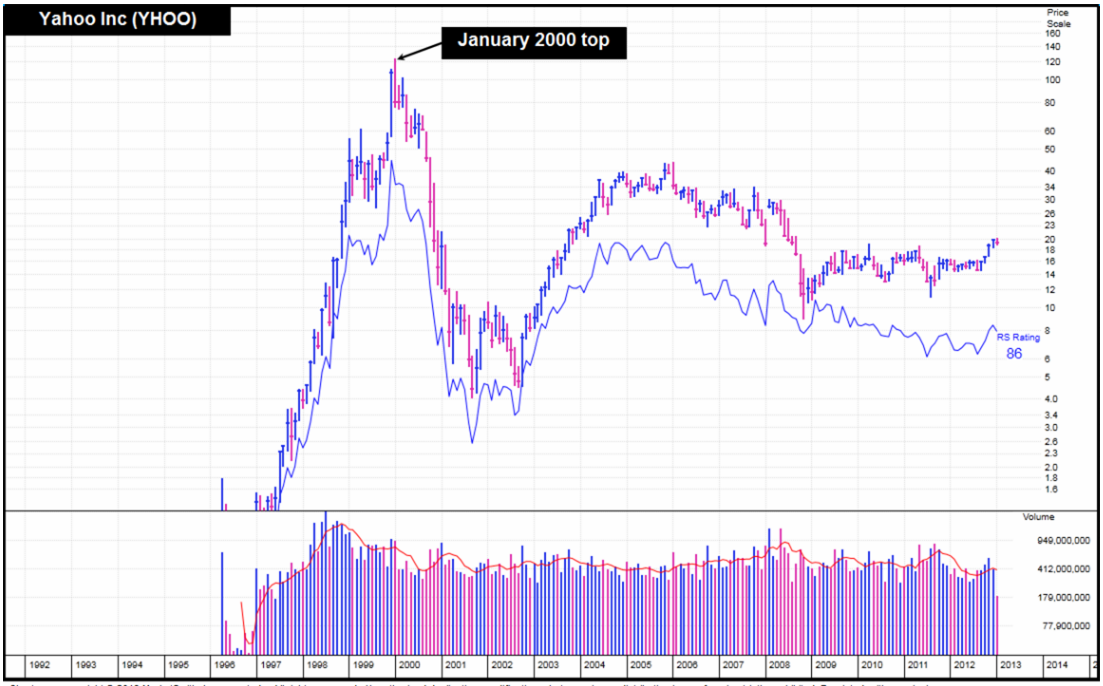
This means that they are a very good indicator of which direction the market is likely to head next. For example, back in 1999 during the technology bubble, leading stocks at the time were equities such as Yahoo! and Microsoft. As you can see on this 20 year chart of the NASDAQ Composite, the general market topped in March 2000.



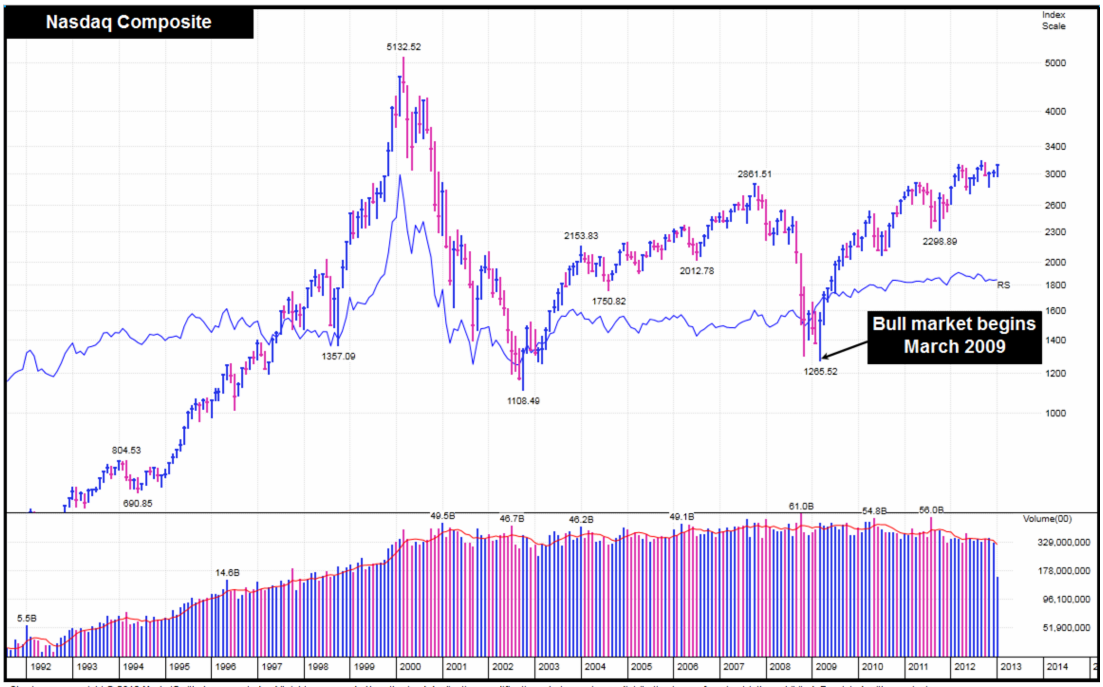
The market may have topped in March 2000, however Microsoft (ticker symbol: MSFT), a leading stock at the time, topped in December 1999, giving investors a signal that the bull market might be close to a top.



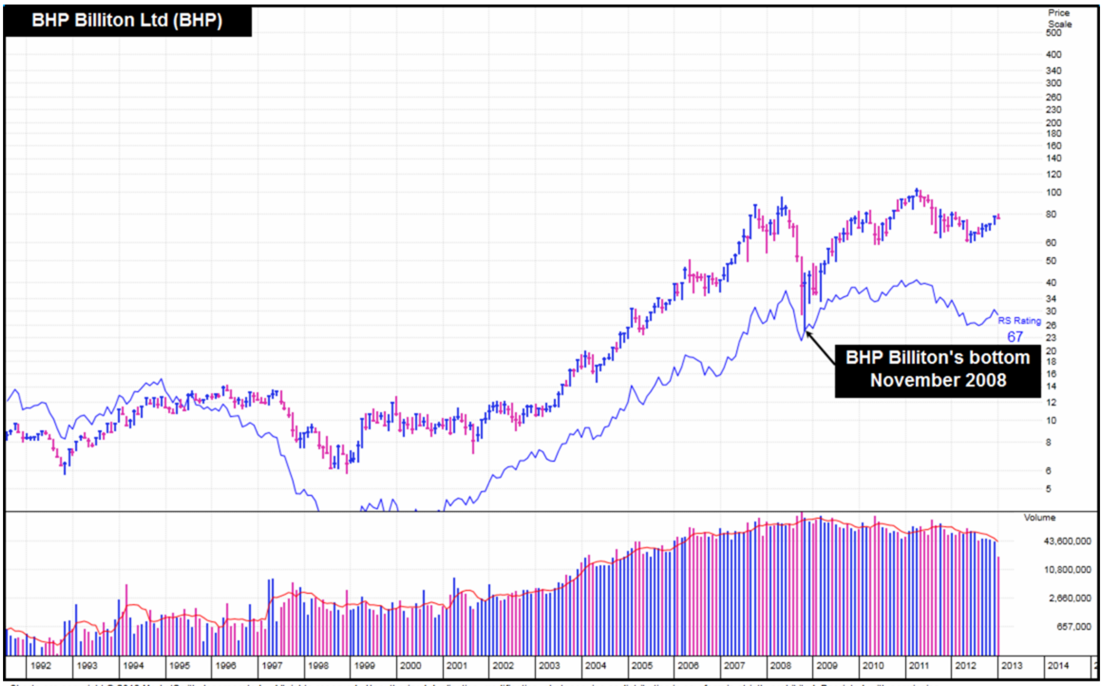
Yahoo! (ticker symbol: YHOO), another leader at the time, topped in January 2000, which was another clue that a top was coming.



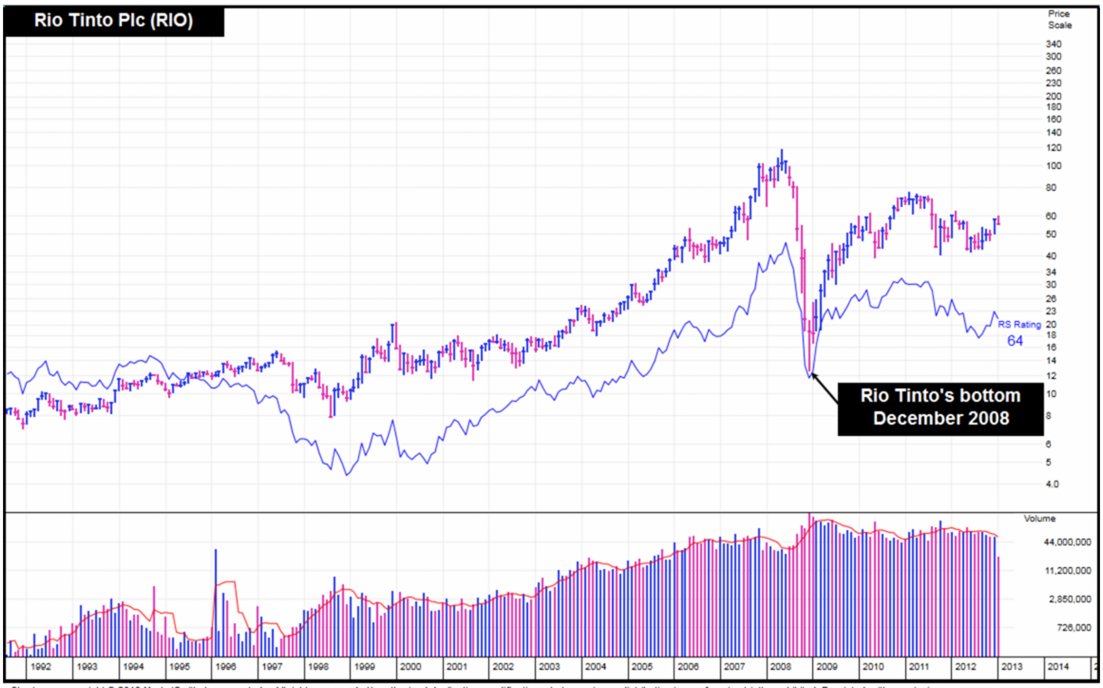
As we mentioned, it also happens on the flip side too. Stocks such as Rio Tinto (ticker symbol: RIO) and BHP Billiton (ticker symbol: BHP) were two of the leading stocks at the start of the bull market that began in 2009.



It's interesting to note therefore, that BHP Billiton bottomed in November 2008, four months before the market turned around.



It's also interesting to see Rio Tinto (another leader in 2009 and 2010) bottoming out in December 2008, which was three months before the 2009 bull market began.



It's also good to know that a leading stock can become a laggard stock. Personally, we class a leading stock as one that has an RS (relative strength) rating on MarketSmith of 80 or above and an EPS (earnings per share) rating of 80 or above.

Stocks' ratings change on a daily basis, which means it's probably a good idea to always have a list of stocks that you class as leaders and continually work on adding new members to the list and removing stocks that no longer match your leading stock criteria.

Stock market bottoms

So, how do you know when a market correction has hit bottom? We keep our eye on a number of things, such as the behaviour of the US indexes, the activity and personality of leading stocks and we also look for a follow-through day. This is a day that helps to confirm that institutional investors are going all in. The follow-through is a concept coined by William O'Neil and can be summarised as follows: you look for an increase in total market volume from the day before and substantial price progress for the day, up at least 1.7% or more in any index.

We like to see a follow-through occur on either the NASDAQ Composite, the NASDAQ 100, the S&P 600, the S&P 500 or the S&P 400. The phenomenon of a follow-through day has occurred in every new bull market throughout history, though not all follow-through days result in a new bull market. A follow-through on the fourth day or later of an attempted rally is likely to be an indicator of follow-through buying from institutions with conviction. A first, second, or third-day rally attempt off a market bottom can often be little more than short-covering.

Gold nuggets

As you've discovered, observing how the general averages are acting is essential in helping you gauge the market's future trend or direction. However, there are some key indicators that can give you a head start when spotting market turning points. One of the things that we like to see happening to confirm that the market is strong and vibrant, is the way that the NASDAQ Composite, the NASDAQ 100 and the chip sector are acting.

We refer to the NASDAQ 100 as the NASDAQ Composite's big brother. The NASDAQ 100 is formed of the 100 largest stocks listed on the NASDAQ Composite and includes giants such as Microsoft, Google and Cisco Systems. Chips are a common term for semiconductors. The main index for chips is the PHLX Semiconductor and is commonly known as the SOX.

A giant magnet

If the market is rising but being led by the Dow or the S&P 500, meaning that the NASDAQ Composite, the NASDAQ 100 and the chip sector are lagging, it means that the rally (uptrend) is more prone to fail. But if the NASDAQ Composite, the NASDAQ 100 and the chip sector are leading the market higher, it tells you that the rally is more likely to succeed. By watching the market every single day, we've noticed that these three key indicators act like a kind of giant magnet.

In other words, when they are weak, they tend to pull and lead the market down, but when they are strong they tend to pull and lead the market up. We like to watch the NASDAQ 100's action in two ways. We look at the chart of the NASDAQ 100 and we look at the chart of the QQQs, which is the exchange traded fund (ETF) that tracks the movement of the 100. By watching the QQQs, we can carefully study the behaviour of the NASDAQ 100.

With chips, we like to watch the SOX and the SMH, which is the exchange traded fund that tracks the performance of a number of major semiconductor companies. Included in the SMH are Intel, Texas Instruments and Applied Materials. The NASDAQ Composite, the NASDAQ 100 and the chip sector are three key indicators that can give you early signals to act. We watch them very closely and we suggest you do too.

How to read the market like a professional

The market has worked in exactly the same way since it began in the late 1800s. It is always about supply and demand, and the way to analyse supply and demand is through looking at price and volume behaviour on charts. Institutional investors can be bullish one minute but then discover some new information that overrides their optimistic outlook. At the end of the day, to read the market effectively, you have to remember that it really does not matter what is happening news wise. Regardless of what the news or any market commentator is saying, if the price and volume action is positive, then that's good, period. And that goes for the downside too.

At the end of the day, to read the market effectively, you have to remember that it really does not matter what is happening news wise. Regardless of what the news or any market commentator is saying, if the price and volume action is positive, then that's good, period. And that goes for the downside too. The lesson here is simple. Do not look to the news or economic data to tell you what is going on or going to happen. Instead, find out what is really going on by studying the daily market activity using stock charts.

Final thoughts

I hope this report helps you get in sync with the market's direction and so helps improve your investment returns.

If you would like some one-to-one help and guidance, feel free to get in touch. Our clients kindly say that my brother Paul and I are incredibly friendly, caring and highly responsive to their questions and requests for help, support and guidance. What's more, if you call or get in touch, I promise that you won't be charged a penny and you won't be passed on to a junior associate. Instead you will speak to me or my brother Paul, the founders of ISACO and two directors of the company.

Email me direct at Stephen@ISACO.co.uk

Or call me on my private line: 01457 831 642.

Your friend,

Stephen Sutherland
Chief Investment Strategist and author of *How to Make Money in ISAs and SIPPs*.