The Thoughtful Investor

Active Investing Offers Sources of Profits in Sideways Markets

According to advocates of buy-and-hold investing, there's no point in attempting to actively trade the market because the market's long-term trend has always been up. The catch is that long term means just that. Studies citing long-term market trends typically encompass 70 or more years, far longer than the average investor's time frame. During that long term, some good, bad and frustrating moves take place in the market.

From March 2003 through January of 2004, the Dow Jones Industrial Average put in a period of steady gains, leading claims that the bull market was back. From February on, however, the Dow has drifted sideways with modest gains followed by losses. How long can the sideways movement last? Possibly quite a while, which makes active management essential if your portfolio is going to get ahead.

Looking at just the history of the U.S. financial markets shows us a number of lengthy time periods when the market has gone sideways, with market indices neither gaining nor losing over the period. The most recent was the 16 years from 1965 to 1982. The Dow Jones Industrials started 1965 in the neighborhood of 1000 only to bounce between a low of 607 and a high of 1020 for 16 years. It wasn't until July of 1982 that the market finally started a definitive up trend.

Never try to walk across a river just because it has an average depth of four feet.

— Milton Friedman
1912, American Economist

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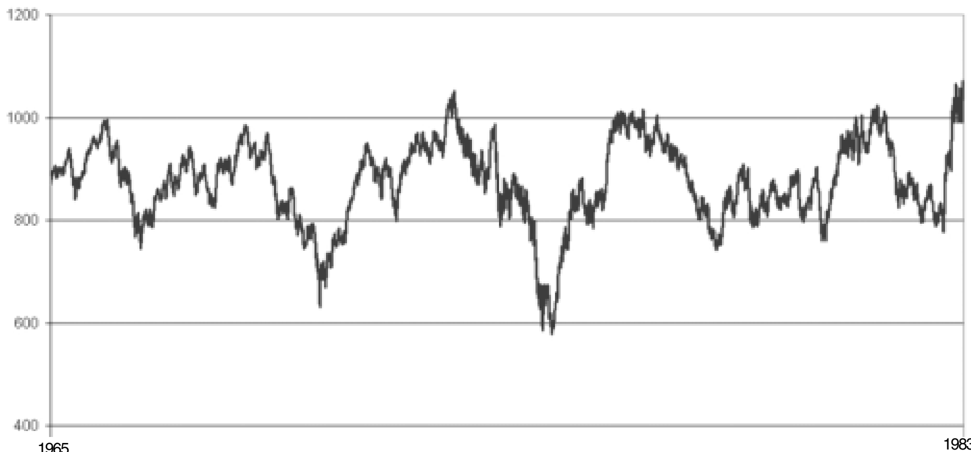
DOW JONES INDUSTRIAL AVERAGE 1965-1983



In the 16 years from 1965 to the start of 1983, the Dow Jones Industrials Average gained less than 5%, not including dividends.

AMT Impacts More Taxpayers

In late September, Congress passed the Working Families Tax Relief Act of 2004 extending the higher Alternative Minimum Tax exemption amounts through 2005 and allowing nonrefundable personal tax credits to be applied against AMT for 2004 and 2005.

While the extension resolves the immediate problem, it illustrates the patched together nature of the AMT and the tax's growing impact on middle class taxpayers. The AMT was initially designed to make certain people with extremely high incomes (above $200,000 in 1969 when the bill was originally passed) pay their fair share of taxes. Tax liability is first calculated under the "regular" rules and then using the AMT rules. The taxpayer has to file using which ever calculation results in higher taxes.

Unfortunately, no provision was made in the original bill for inflation indexing. Over the years, Congress has passed bills establishing temporary adjustments in the income levels subject to the tax. In 1997 the AMT affected a little over 600,000 taxpayers. 2.4 million taxpayers were affected in 2003. This number is expected to grow to 33 million taxpayers in 2010. Many taxpayers who do not have to pay higher AMT taxes, still pay higher preparation costs to have their taxes calculated under both rules. With the Bush Administration promising to address the tax code in its second term, this is a good time to write your congressional representatives to ask that the AMT be eliminated.

Pity the Children

If the current spate of bad news regarding the state of retiree guarantees isn't brought under control, we will be impoverishing our children to pay for retirement programs created by federal, state and local governments.

By 2035 based on current demographic trends, 20% of the American population will be over age 65, compared to 12% today. That means more people collecting Social Security, Medicare and other retirement-age programs, and fewer workers contributing to the programs. The problem is compounded by unfunded retirement liabilities at the corporate, state and federal levels and record low savings rates among individuals who will depend on those programs at retirement.

In the current Social Security statements being sent to taxpayers is a warning footnote:

"Your estimated benefits are based on current law. Congress has made changes to the law in the past and can do so at any time. The law governing benefit amounts may change because by 2042, the payroll taxes collected will be enough to pay only about 73% of scheduled benefits."

Sounding a similar warning recently was Federal Reserve System Chairman Alan Greenspan, who stated in August 2004, "If we have promised more than our economy has the ability to deliver to retirees without unduly diminishing real income gains of workers, as I fear we may have, we must recalibrate our programs."

Social Security was initially set to start paying out right about when people were expected to also starting dying out. Today, on average, people will live at least 18 years beyond age 65. The longer they live, the more inflation will erode the buying power of their savings, pensions and government benefits.

A regrettable aspect of democracy is the reluctance of legislators to deal with issues that might adversely impact their prospects of re-election. But if these issues are not dealt with now, the consequences only worsen. If the funding isn't there now to cover these liabilities, where will it come from in the future, other than from today's children?

Call me today to discuss what you can do now to assure your children the ability to retire when their turn comes.

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An individual who bought and held the stocks making up the Dow Jones Industrials during that period would have achieved a cumulative return over 16 years of less than 5%.

During that 16-year period, however, there were four definitive bull cycles when the Dow gained 27% to 65%, only to retrace its gains with one- to two-year bear markets. The well-known bear market of 1973-74 set Dow Jones Industrials buy-and-hold investors back 40%, requiring a 67% gain to get back to breakeven, only to have those gains frittered away as the market turned downward from mid-1976 through early 1978.

While past performance is not indicative of future returns and only hindsight will tell us how long the current sideways market will last, investors need to do more than just sit out sideways markets if they are going to be able to retire financially secure.

Trading Market Moves

In the midst of sideways markets there have always been opportunities for profit. One opportunity is to trade the up and down movements of the general market during the period. This means striving to buy in time for the bulk of the up move and sell when the market turns down. In volatile markets, this approach requires more frequent trading and a system that moves the investor quickly back into equities when the up move starts. For example, from the February 2004 high, the Dow dropped -5%, rose 4%, fell -4.5%, rose 5% and then dropped -6% through mid August. Capturing the gains and avoiding the losses would have required buying or selling at least once a month.

No investment system is perfect and it is possible to lose money as well as make money trading market trends. Whipsaws are one risk to this approach. Whipsaws occur when the market rebounds before an investor can reposition, leaving one on the wrong side of a move. Frequent trading can also result in additional costs, such as redemption fees or transaction fees, and taxes on gains are higher due to the often short-term nature of the trades.

Sector Opportunities

Another approach is to look for sectors that are outperforming the market. Sector funds concentrate their stock selections within a given industry or geographic sector. In virtually any market environment, positive sectors within the broader market trend offer opportunities for gains. Among the best performing Dow Jones indices for the first three quarters of 2004 were the DJ Mining Index, followed by the DJ Consumer Electronics Index, both with year-to-date gains in excess of 30%.

The challenge to sector investing is to target the right sector early in its move and to know when to move out. The narrow focus of a sector fund increases volatility and risk compared to investing in the broader market. What is in favor can rapidly fall out of favor, making an active approach essential to sector investing.

While there are no guarantees in investing, one of the greatest risks to your financial security could be just sitting still. We have no way of knowing if the current bear market has reached its low or if there is worse to come. Nor do we know how long it will be before the broad market enters a sustained rally. Just as you try to limit risk in other areas of your life through insurance and avoiding perilous situations, you need to be prepared to limit risk in your investments while also recognizing that another risk is that of running out of money.

If you haven't considered what a prolonged sideways market will do to your portfolio and how you can benefit from short-term trends in the overall long-term market, call me today and let's talk.

Mathematics and Investing

In 1225, Leonardo Da Pisa, commonly known today as Leonardo Fibonacci, took part in a mathematical tournament ordered by Emperor Frederick II. During this competition, it is said the following problem arose:

Beginning with a single pair of rabbits, if every month each productive pair bears a new pair, which becomes productive when they are one month old, how many rabbits will there be after "n" months?

Leonardo Fibonacci

The resulting answer produced a simple series of numbers named Fibonacci's numbers in his honor that play a role in finance today. To calculate the Fibonacci numbers you begin with 0 and 1 and then add the last two numbers to get the next: 0, 1, 1, 2, 3, 5, 8, 13, 21, 34, 55, 89, 144, 233, 377, 610, 987… and up to infinity.

After the eighth sequence of calculations there are constant relationships that can be derived from the series. For example, if you divide the former number by the latter, it yields 0.618 (34/55=0.6181818). Reverse that equation to divide the latter number by the former and the answer is 1.618 (55/34=1.617647).

Fibonacci numbers appear throughout nature. Flowers typically have a Fibonacci number of petals. Trees branch in Fibonacci numbers. Sunflower seeds spiral outwards in a Fibonacci number of spirals that keeps the seeds uniformly packed no matter how large the seed head.

But the quotients 1.618 and 0.618 have even more amazing applications. The distance from chin to mouth times 0.618 equals the distance from the tip of the nose to the mouth. The distance from the center of the eyes to the chin times 0.618 equals the distance from your eyes to the top of your head.

Try measuring from your shoulder to your fingertips and divide this number by the length from your elbow to your fingertips. Or measure from your head to your feet and divide that by the length from your belly button to your feet. The results will be somewhere in the area of 1.618. Sunflowers have a 1.618 ratio between the diameters of each seed rotation, and the relationships go on and on. Almost every set of "building blocks" in nature has dimensional properties that adhere to the ratio of 1.618.

In many situations where there is an absence of deliberate or rational control, the golden ratio of 0.618 seems to govern human judgment. In studies of what defines beauty, people judged a face to be more attractive if its features were interrelated by a ratio of 0.618. Financial markets appear to often follow Fibonacci ratios as well with respect to retracements, support and resistance levels and time zones in which major price movements are expected to occur. While relying on Fibonacci numbers to predict market movement is uncertain at best, the "golden rule" is used by many traders to provide a frame in which to analyze market trends and the duration of trends.

Health Savings Accounts Are a Must for Investors

There's one more tax-free account that virtually every investor should be contributing to: A Health Savings Account (HSA).

Health Savings Accounts were authorized by the Medicare Prescription Drug, Improvement, and Modernization Act signed by President Bush on December 8, 2003. The tax-free accounts are designed to help individuals save for qualified health expenses that they, their spouse, or their dependents incur. To qualify, an individual must be covered by a high deductible health plan. The act's definition of high deductible, however, is not that high. HSAs are open to individuals covered by a health insurance plan with an annual deductible of at least $1,000 for individual coverage, and at least $2,000 for family coverage.

The following are some of the major characteristics of HSAs:

- Contributions to HSAs by individuals are deductible, even if the taxpayer does not itemize.
- Contributions by an employer are not included in the individual's taxable income.
- Individuals, their employers, or both can contribute tax-deductible funds each year up to the amount of the policy's annual deductible, subject to a cap of $2,600 for individuals and $5,150 for families.
- Individuals over age 55 can make extra contributions to their accounts ($500 in 2004, increasing to $1000 by 2009).
- Interest and investment earnings generated by the account are not taxable while in the HSA.
- Amounts distributed are not taxable as long as they are used to pay for qualified medical expenses.
- HSA funds can be used to cover the health insurance deductible and any co-payments for medical services, prescriptions, or products. In addition, HSA funds can be used to purchase over-the-counter drugs and long-term care insurance, and to pay health insurance premiums during any period of unemployment.
- Amounts distributed that are not used to pay for qualified medical expenses will be taxable, plus a 10% penalty to be applied to deter the use of the HSA for non-medical purposes.
- HSAs are portable, so an individual is not dependent on a particular employer to enjoy the advantages of having an HSA.
- Like an individual retirement account (IRA), the HSA is owned by the individual, not the employer. If the individual changes jobs, the HSA goes with the individual.

Because funds invested in a HSA are tax deductible, investors immediately increase the buying power of their investment by eliminating the tax bite. In addition, the ability to compound earnings in the fund and then withdraw those funds tax free adds to the attractiveness of these accounts.

The only reason not to open an HSA if you have a qualifying high deductible health plan is if you never anticipate needing to pay health related costs. Otherwise this is a win-win for the individual. For more information on how you can open your own HSA, call us today.

Indices Don't Tell the Whole Story

There is a strong inclination on the part of the media and financial analysts to quantify market direction in terms of the movement of the S&P 500 or Nasdaq Composite. When the indices are up, investors tend to pile into equities. But, indices seldom tell the whole story and in fact, may mislead investors.

The NYSE Composite Index, Nasdaq Composite Index, Wilshire 5000, London FTSE, and MSCI Indexes are all constructed using the market value methodology. Companies with a higher market value or capitalization have more influence on the value of the index. The rationale for constructing indices this way is that large companies have larger revenues and profits and that any change in their value will have a larger effect on economic activity than a change in the value of smaller companies.

The Market-Weight Problem

The problem is that the largest companies are not necessarily representative of what is happening throughout the market as a whole. From March 1998 to March 2000 the S&P 500 rose 36%. But *Smart Money* magazine reports in its June 2004 issue that had all the stocks in the S&P 500 been weighted equally, the gain of the two-year period would have been just 7.2%. In 1998, the largest 50 stocks in the S&P 500 generated 70% of the return. Many of the other 450 stocks lost money. Even now, just 42 stocks make up 50% of the S&P 500's value.

Does that mean it makes sense to concentrate your investments in the largest stocks found in the indices? Not if you are concerned about the impact of down markets. From March 2000 through March 2004, the S&P 500 fell -25%, yet the average stock in the index was up 23%, again according to the June 2004 issue of *Smart Money*. The big cap companies were the big losers, impacting the index as a whole and investors' perception of the downturn.

One reason that large stocks led the losses for the period is that capitalization weightings can result in one hot sector dominating the performance of the index. For example, technology stocks made up more than 30% of the S&P 500 in early 2000. The Nasdaq is still very much a technology index. A comparison of the Nasdaq Composite and the Dow Jones Technology Index shows a nearly perfect fit.

An Equally Weighted Benchmark

A different view of the market is presented by the Value Line Composite Index Arithmetic Average (VLA). This market benchmark assumes equally weighted positions in every stock covered in the *Value Line Investment Survey* — which includes all the stocks in the S&P 500 and roughly 1200 more. During bull markets, Value Line tends to lag the S&P 500 but outperforms during market downturns.

If an individual had invested equal amounts in the Value Line Composite and S&P 500 at the start of 1993, the Value Line investment would have had a much lower overall drawdown and been 50% higher at the end of 2003.

As this comparison shows, the market as a whole may be considerably stronger or weaker than the major market indices. To make an investment decision purely on the S&P 500 or Nasdaq performance is rarely the best strategy.

COMPARING THE VLA AND THE S&P 500

% Price Change From Previous Year

Year	Value Line Arithmetic	S&P 500
1993	18.07%	7.06%
1994	-0.73%	-1.54%
1995	25.94%	34.11%
1996	19.78%	20.26%
1997	28.45%	31.01%
1998	5.82%	26.67%
1999	10.56%	19.53%
2000	9.65%	-10.14%
2001	10.88%	-13.04%
2002	-17.11%	-23.37%
2003	48.06%	26.38%

Past performance is not indicative of future returns. Returns are hypothetical and do not represent a real investment. The Value Line Arithmetic and S&P 500 are indices and do not take into account possible costs of investing in the stocks of the index. An investor cannot invest directly in an index.