The CJ Investment Newsletter

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February, 2015 206th Month

The Greater Fool Theory

Quick Look

Market	Next Expected Move

	Month	YTD
DJI	**<3.69%>**	**<3.69%>**
COMP	**<2.13%>**	**<2.13%>**
SPX	**<3.10%>**	**<3.10%>**
Gold	8.03%	8.03%

- We explore the meaning of the Greater Fool theory and how it might play out in the coming months.
- The stock markets appear to be topping, suggesting a correction or bear market will happen soon.

The Greater Fool Theory

As a beginning broker many years ago, I heard about an *unproven* theory that purports to explain why bull markets top and become bear markets. Of course, there are many of these "theories" and, to my knowledge, none is proven, nor are they accurate as to predicting market highs and/or the timing of market tops. That is not to say these theories are worthless, however.

One of these unproven theories was called the Greater Fool Theory (*GFT*). It's not complicated: a bull market will run until the last fool has bid up the price of a security (or collectively a basket of stocks comprising an index) up to its maximum price. Once done, there are no greater fools willing to pay more for the security. Therefore, the bull run is over and the security (or index) must decline.

While this "theory" obviously provides no benchmarks or means of using it practically, it dovetails into a few others, more complete and quantifiable, "theories" regarding market behavior. Besides, many consider what the theory does say to be consistent with observable human behavior. So, while not predictive except in the most general sense, it provides a means of understanding at least one aspect of market behavior. Surely, that has at least *some* value.

One consistently observed market behavior is: In bull markets, the price to earnings ratios (P/E) *expand*. Also observably, P/E's *contract* during corrections and bear markets. Not to get too basic here, but P/E's are one of the most commonly used measures of *relative value* when comparing different securities, providing objective measures to assist in deciding buy, sell or hold decisions.

When P/E ratios expand, the group of investors (purchasers) involved feel that the security in question has improved future earnings potential, and are therefore willing to pay more than the current price to participate in that future. Conversely, if the owners of a security feel its future earnings prospects have diminished sufficiently, they would become willing sellers in order not to participate in the anticipated less profitable future. This is certainly the case for *value investors*, but the metrics of P/E are used by virtually all professional advisors, even if they incorporate other criteria in their decision-making processes.

One thing should be made clear at this point: *in order for the P/E to expand, the price relative to actual and/or expected earnings must appreciate faster than the security's earnings.*

Continued on page 2)

"We must beware of trying to build a society in which nobody counts for anything except a politician or an official, a society where enterprise gains no reward and thrift no privileges." - Sir Winston Churchill

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(Continued from page 1)

The price of a security can appreciate without the expansion of the P/E ratio if the price merely appreciates at the same rate as the earnings themselves. In such a case, the price would increase, but the P/E ratio would not (perhaps not precisely, depending upon the actual stock price and earnings, but for all meaningful purposes).

Therefore, *in a bull market, securities appreciate faster than any increases in their earnings*. Therefore, investors (as a group) are "betting on the come" (the next roll of the dice in a game of craps). Since they are "betting" on an uncertain future, *i.e.* better than consensus opinion, those investors have now become "greater fools."

How Some Investors Become Greater Fools

The power of a bull or bear market run on most investors' emotions is hard to overstate. Even professional investors are not immune to the pull of apparently easy profits in the middle of a bull market run – or, especially, near the end of one. In a bull market run, some investors only think about return, ignoring the risk involved in achieving that return. That is, until the risk makes itself apparent through losses incurred when the market changes direction.

In the late 1990's, P/E's reached ridiculous heights relative to earnings growth, especially on the NASDAQ, where many, if not most, of the tech stocks were traded.

A "rule of thumb" I was taught in the late 1990's regarding P/E and stock price went as follows: a security is "fairly valued" if the percentage growth rate of earnings is expressed as a multiple to those earnings. This would be practically applied as a range (fair value range [FVR]) with the exact calculation being the midpoint of that range.

Example:

EPS	\$ 1.00
EPS Growth Rate	20%
(year over year prior quarter)	
Implied multiple	x 20
Midpoint of "fair value" range:	
20 x 1.00 =	\$20.00

I have never seen any kind of conceptual or mathematical proof of this rule of thumb, but experience indicates this concept and its application are pervasive and used by many investors, including many professionals. Part of the appeal is likely the simplicity of its application and the calculation of an apparently reasonable "benchmark" of value for the security in question.

What is being described here is actually an application (misapplication?) of a method of determining relative value between *bonds and dividend paying stocks*. One can calculate a P/E "ratio" for a bond by dividing the percentage yield on a bond into 100. Therefore, a bond yielding 5% would therefore have a "P/E" of 20. If a particular dividend paying stock also yields a 5% dividend, the investor would likely choose the bond over the stock, given relative risk, dividend payout ratios on the stock, the quality of the stock company and other factors. If the stock yielded 6½%, the investor might choose the higher yielding stock, given his/her assessment of the same factors.

The big difference between the two applications of this method? The latter application deals with real cash return to the investor from two different sources. Applied to "growth stocks," there is virtually never a cash dividend to investors. Such growth stocks are often cash strapped, needing virtually all net earnings to be applied to growing the capital and labor bases of the growing business to keep up with increased demand and to fend off competitors. There is *no* guarantee that a growth stock will *ever* provide an actual cash return to an investor.

Returning to the rule of thumb, decisions regarding the width of the FVR would depend upon the person. Below the FVR would be considered "undervalued," within the range "fairly valued," and above the range "overvalued." Remember, there are many ways to measure value and this is just one – and unproven at that. But, it was used in the heady days of the 1990's bull market.

Now that you understand this example and the concept, we can return to the emotional pull of a bull market and how this fair value concept was altered and applied in the late 1990's prior to the 2000-2003 bear market.

Then, as in now, quarterly earnings reports were watched by the investing world. Large investing firms and some famous investors regarded as "experts" on a particular company or industry would issue earnings estimates for some stocks, as well as "whisper numbers." Whisper numbers were generally estimates in excess of the "official" estimated earnings numbers. For a company to beat its whisper number, especially for several quarters was the Holy Grail that would pull in a number of "greater fools."

(Continued on page 3)

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(Continued from page 2)

Eventually all traditional measures of fair value were exceeded, especially for successful tech stocks. Did that slow down the P/E expansion? No. Instead, some enterprising investment firms and analysts began to use *estimated future* earnings per share (EPS) numbers in order to determine the price multiples. These estimates were based upon company statements regarding their internal estimates of growth modified by the firm or analyst using EPS "beats," whisper number "beats," and by how much, and what the government calls *hedonic* adjustments when applied to government statistics. Basically, *hedonic* means whatever adjustment, founded or not, the analyst wishes to apply.

Sadly, some of these techniques are in use today, although probably not as much as in the late 1990's. In a roaring bull market, it's very easy to forget the classic warning: *Past performance may not be indicative of future results*. Thus, human emotions can create greater fools and propel a bull market way beyond any sort of reasonable metric – until, of course, the tide changes direction towards the bear side. Then, in retrospect, most reasonable investors will wonder how the value metrics of that bull market reached such heights. After all, *didn't they know those stocks couldn't possibly be worth that much*?

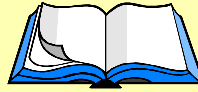
One final note/warning. I wish I remembered the name of the financial firm that did this TV commercial, but it appeared in the late 1990's, in a era of wild stock market enthusiasm. The basic message could be summed up in these closing lines:

> *Announcer*, "Do you believe we have entered into a new era of investing, where some of the old rules don't apply anymore? (Pause) So do we."

That is *still* the most spot-on perfect contrarian call for a bear market to appear soon that I have ever seen. Until human behavior changes, the old rules will *always* apply. As Richard Russell, the famous Dow Theorist says, "The market always does *what* it is supposed to – just not always *when*."

Chart Review

Please study the weekly charts of the DJI and SPX (right) before continuing. These are simplified versions of *CJC2 Indicator* (*CJC2*) charts I use for timing decisions. The math that generates the bands is somewhat complex, but understanding how they are generated isn't necessary for understanding how to use them. The charts are designed to draw attention to cyclic tops and bottoms that occur near the edges of the bands. The bands are nested (a common technique) with the widest bands being generated by

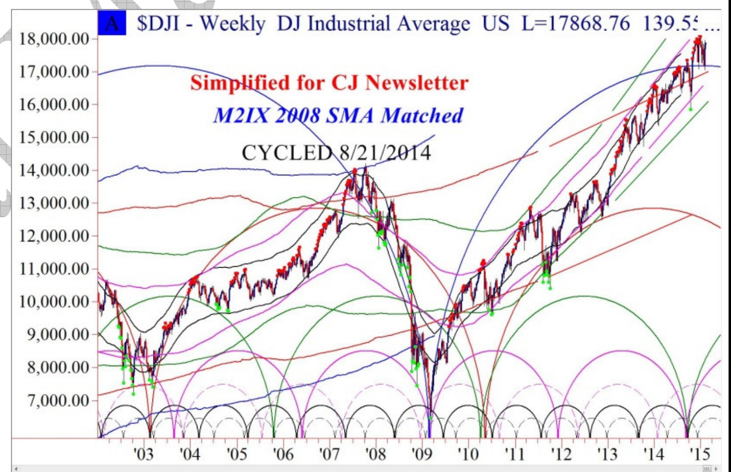


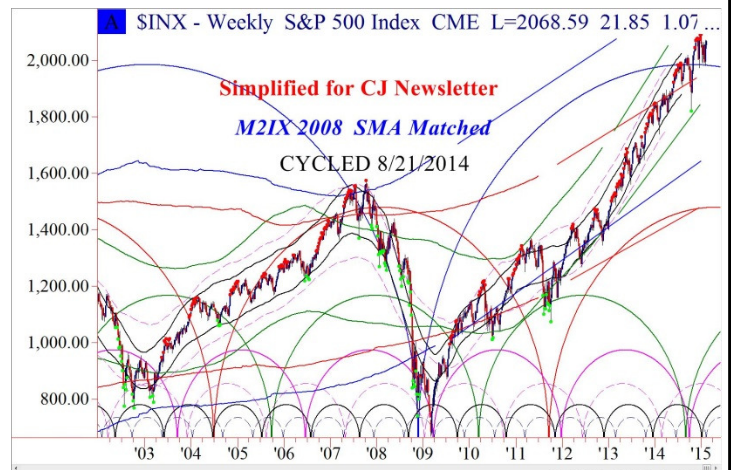
Recommended Reading

Q3 GDP Jumps 5%; Ha! The Crap Behind the Numbers, *Connecting the Dots*, Tony Sagami, 12/30/2014
http://www.mauldineconomics.com/connecting-the-dots/

Some of you may recall my CJ Newsletter from 10/2013 entitled "Government Obscuro," which presented key points from Chapter 13 of Chris Martenson's seminal book, The Crash Course. This chapter recounts the history of how US government statistics, especially *economic* statistics, are manipulated to provide palatable lies regarding the health of the economy in order to keep the public positive on whomever are the current occupants of the White House.

Here, Tony Sagami details the factors that provided such a robust 5% growth rate for the 3rd quarter of 2014. Short but not too sweet, I seriously suggest you read this article and think about its implications to you and your families and to our country in general.





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(Continued from Page 3)

the longest moving averages (*cycles*) and the narrower bands being generated by progressively shorter cycles.

As you study the charts, notice how the index amounts generally move within the confines of each band in a cyclic manner from bottom to top to bottom, *etc*. Please also notice how similar these charts are in the stories they tell. What do see as the most likely next direction these indices will take from looking at these charts? From observing the previous government/Fed induced bull market (2003-2007) and its subsequent bear market (2008-2009) do you see any similarities to our current situation? Finally, what is the position of the major cycles telling you? Are we near a bottom where we can expect to see future gains or a top from which we can expect future declines? Are we near the bottom bands where we would expect to see future appreciation or near the top bands, which indicate future declines are likely?

An Investing Giant's Point of View

Robert Prechter is the greatest living expert on an esoteric technical analysis called Elliott Wave Theory (*EWT*). He could be the greatest Elliott Wave theorist of all time, even more so than R. N. Elliott himself, who created the theory. Prechter is in the Trader's Hall of Fame for his results and has been for a very long time. He created his company, Elliott Wave International, Inc. (*EWI*) to teach and to further the study of EWT and to provide considered Elliott Wave opinions to those who would seek those opinions.

In the January, 2015 issue of *The Elliott Wave Theorist*, Prechter opines and teaches:
"The economists who say that deflation can be a good thing have mis-defined deflation. Deflation is *not* a period of generally falling prices; it is a period of *contraction in the total amount of money plus credit*. Falling prices in an environment of stable money is indeed a good thing. In fact, in a real-money system, it is *the norm*, because technology makes things cheaper to produce. But when debt expands faster than production, it becomes overblown, then wiped out, and prices rise and fall in response. The US government and its law-imposed, debt-based banking system have encouraged debt growth for 100 years, and now the piper has his hand out. Periods of debt implosion bring recession and depression. That is what the world is facing, not "good deflation."

"Figure 8 [not shown] updates our famous "Pluto" chart, showing the insane valuation that investors place on US stocks in March 2000 based on the S&P 500's dividend yield and the S&P 400's price to book value. *To this day, that extremity remains uncorrected. Instead, the stock market has meandered in historically overvalued territory ever since.* [Italics mine – CBJV] At the close of 2014, these indexes registered their highest year-end overvaluation since 1998-2004."

"What sustains a major overvaluation is optimism. Figure 9 [not shown], based on the percentage of advisors bullish, shows that stock market optimism has been relentless for an unbelievable 17 years, with only a 13-month interruption (from March 2008 to April 2009)."

"We admit to being stunned when the widely held bullish expectations for 2014 were borne out. But one of these days, this euphoric state will melt away and lead to the opposite."

Sobering thoughts indeed, built upon sound theory and containing logical conclusions.

Purpose

The *CJ* Investment Newsletter deals with most of the spectrum of securities investing, including cash (money market funds), bonds, equities and derivatives. It will evaluate the overall investing environment and, from time to time, discuss the relative allocations (including avoidance) of these asset types, as well as strategies to implement them (individual stocks or bonds, CEF's, ETF's, open-end mutual funds, and derivatives). Essentially, it reflects what I'm actually doing with my clients.

However, that's not its only purpose. Even if you never become a client, if you want this information, I want you to have it – for a while, anyway. My hope is that providing this information and teaching you what I consider important when investing may help you. I'd also love to hear any questions or comments you may have about my letter.

These letters are not sent "cold." Either I know you or someone you know gave me your name. Yes, this letter *is* a sales tool. It communicates how I analyze the markets and economy, as well as how I apply my investment strategies, so that you can decide, without any sales pressure, if my thinking is compatible with how you want your money invested. If you're not already a client, I would like to discuss your *becoming* a client. Please contact me for more information.

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