ASK THE Specs

BY VICTOR NIEDERHOFFER AND LAUREL KENNER

Where's the edge in the market? Holding onto your shirt while others are throwing in the towel.

Q: You two advocate the buy-and-hold philosophy, yet you often say the best way to make money in the market is to wait for a decline, buy to the extent of your bank balance, wait a week and sell out. How do you reconcile these two conflicting pieces of advice?

Laurel: The conflict is more apparent than real. We'll start with why both strategies are good, and then take up the question of how to best combine them.

Many investors gave up on buy-and-hold during the 2000-2003 market crash, and we'll no doubt take some shots for saying it still makes sense. As with all of our other trades, we base our opinion on empirical results — or, as we like to say, on counting.

The one investment book we recommend to all traders and investors, *Triumph of the Optimists*, by Elroy Dimson, Paul Marsh and Mike Staunton (2002, Princeton University Press), shows every major stock market in the world returned some 1.5 million percent during the 20th century. No other class of investments came anywhere near those results.

No comparable survey of global markets had ever been done; therefore, every trader and investor must take *Triumph* into account when formulating a basic approach to the market.

When we cite *Triumph's* results, people typically object that it makes no sense to look at market results over a century. Our response is that you may not be around in a century, but your children and grandchildren will. Furthermore, if the market's basic drift is a 1.5-million-percent upward direction, you need to factor in that powerful force in your own trading. That's why all shorts die broke.

People also argue the circumstances of the 20th century were exceptionally favorable to the market. Yet the 20th century suffered through two world wars, inflation, depression, central planning that stifled the economies of much of the world, and countless disruptions to trade. We see no reason why the market should not overcome the inevitable adversities of the present century and deliver similarly stellar results for buy-and-hold in the next 100 years.

Can you improve on buy-and-hold? Sure you can. My collaborator beats the market with great consistency when he stays out of Southeast Asia, and I'll turn the podium over to him.

The market moves between booms and busts, and the public is always leaning the wrong way during these times.

Vic: In my first book, *The Education of a Speculator*, I had a table showing what happens in the market after declines. The data covered the years 1987-1996. I have since updated the study, and extended it through 2003. Tables 1 and 2 (below) show the results.

Results from 1987 show after a decline of 7.5 points in the S&P 500 index, the average move in the S&P the next day was +1.4 points. In the subsequent seven years, from 1997 through 2003, the average move the next day was 2 points. As the typical move after any day is only 0.1 point, a trader who judiciously waits for opportunities to collect an extra point or two can substantially outperform the index.

Both results are highly significant from a statistical standpoint, with a probability of chance occurrence of less than 1 in 10,000 in each case. In both periods, 55 percent of the observations were up.

I performed the same study with Dow Jones Industrial Average data for the 70 years before 1987, with similar results.

Laurel: We can't resist quoting one of our favorite passages in market literature. It is from an 1887 book by Henry Clews, *Twenty-Eight Years in Wall Street*:

> *But few gain sufficient experience in Wall Street to command success until they reach that period of life in which they have one foot in the grave. When this time comes, these old veterans of the Street usually spend long intervals of repose at their comfortable homes, and in times of panic, which recur sometimes oftener than once a year, these old fellows will be seen in Wall Street,*

TABLE 1 S&P MOVES ON DAY AFTER DECLINES (1987-1996)

	Move in S&P next day		
	Average points	% up	Number of occasions
After decline of 7.5 points	1.39	55%	31
After rise of 7.5 points	0.88	60%	30
After any day	0.12	52%	2,154

Source: Niederhoffer, Education of a Speculator

TABLE 2 S&P MOVES ON DAY AFTER DECLINES (1997-2003)

	Move in S&P next day		
	Average points	% up	Number of occasions
After decline of 7.5 points	2.00	54%	499
After rise of 7.5 points	0.09	49%	511
After any day	0.10	51%	1,980

Source: Niederhoffer Investments

hobbling down on their canes to their brokers' offices.

Then they always buy good stocks to the extent of their bank balances, which they have been permitted to accumulate for just such an emergency. The panic usually rages until enough of these cash purchases of stock is made to afford a big "rake in." When the panic has spent its force, these old fellows, who have been resting judiciously on their oars in expectation of the inevitable event, which usually returns with the regularity of the seasons, quickly realize, deposit their profits with their bankers, or the overplus thereof, after purchasing more real estate that is on the up grade, for permanent investment, and retire for another season to the quietude of their splendid homes and the bosoms of their happy families.

Vic: The reason this kind of method holds up is the market moves between booms and busts. The public is always leaning the wrong way during these times. This helps oil the vast machinery of Wall Street: the brokers, the analysts, the market makers, the managing directors, the data vendors, the skyscraper architects, the electricians.

How to reconcile this with buy-and-hold? Everybody should keep a reserve for opportunistic investments — or, if you have no reserves, to increase the leverage of your investments at various times. The big declines provide opportunities to "expand the overplus" of your bank deposits.

However, I would disagree with Henry Clews in one respect: Rather than putting the overplus into real estate, I'd recommend putting it into a good equity index fund.

Laurel: If you can make just 3 or 4 percentage points a year above and beyond the usual buy-and-hold by buying in panics, that amounts to a tremendous increase over time.

Have a question about trading? Trader Victor Niederhoffer and financial writer Laurel Kenner, co-authors of Practical Speculation *(John Wiley & Sons, 2003), provide practical and hard-hitting answers. Send questions to gbuch@bloomberg.net.*

For more information on the authors see p. 10.