



MARKET OUTLOOK

A publication of Strategis Financial Group and MarketOwl.com

Renewed volatility uncomfortable, but not unusual

In a newly released song, country singer Brad Paisley reveals his true nature. Titled "I'm Still a Guy," the song's lyrics note that while he might occasionally walk his wife's sissy dog or hold her purse at the mall, eventually he will revert to behavior more typical of a male.

In the past few weeks, we've seen the major stock indices revert to more typical market behavior.

In mid-July 2006, major market indices began a powerful advance. One of the unique features of this rally is that with the exception of a small pullback in February 2007, it has been a smooth, sustained rise.

Much of the volatility that normally accompanies market movement was absent. Intraday trading ranges were tight as the markets marched steadily upward.

Fast forward to mid-July 2007, Not only does the market endure a correction, but daily volatility increases dramatically.

It is uncomfortable for many investors when major indices have daily swings of 1%, 2% or even more. This most recent episode has seemed particularly difficult because we haven't seen this kind of volatility for more than a year.

The chart at the top of the page makes it easy to see how market behavior has changed.

The black vertical lines show the daily price activity of the



Nasdaq over the past six months. On the left side of each line is a tick that marks where the index opened on that day. The line itself shows the trading range during the session. A tick on the right side of each line shows where the index closed.

Notice that everything appears pretty even and regular until the Nasdaq peaked in July. Then those black vertical lines start growing longer, signaling much greater intraday trading volatility.

Most ordinary investors do not like volatility because it makes them uncomfortable. But it is important to understand that volatility is an inherent feature of the financial markets.

We like volatility when it works in our favor. Most of us would be thrilled to own an investment that

gained 5% in a single session. But when an investment we own loses 5% in a day, our feelings are totally different.

Volatility, risk, and reward are inseparably connected, even though most investors wish that were not the case.

As I write this, the Nasdaq is about 50 points (2%) higher than the prior week. But that isn't necessarily comforting, because it is also 30 points lower than its close the previous day.

It is still too early to know whether this correction has reached its lowest point. But we can forecast with a high level of confidence that the markets' are likely to maintain their increased volatility for several more weeks.

Enjoy the ride.

Technical analysis useful, but flawed

First let me start with a shameless plug. I write a weekly market blog: www.MarketOwl.com. It is **FREE and I encourage all Strategis clients to sign up.**

Long time readers know that when it comes to trying to forecast what stocks are likely to do, I use charts and technical analysis to help. But in spite of the fact that I rely on technical analysis, I am also aware that it has many shortcomings.

Let's start with a definition of technical analysis from Wikipedia:

"Technical analysis is the study of past financial market data, primarily through the use of charts, to forecast price trends and make investment decisions.[1] In its purest form, technical analysis considers only the actual price behavior of the market or instrument, based on the premise that price reflects all relevant factors before an investor becomes aware of them through other channels."

In other words, technical analysts attempt to forecast future market activity by studying what has occurred in the past. Technical analysts use a wide range of tools and philosophies. These include everything from moving averages to candlestick charting.

Some proponents rely on a single tool or methodology while others com-

bine a number of tools to make investment decisions. That brings us to one of the major weaknesses, which is actually not a weakness of technical analysis but of technical analysts.

Many believe too strongly in the infallibility of their tools or systems. There is no tool or system that can accurately forecast every market top or bottom and there never has been.

Over the past 20 years I have met or talked to at least a couple of dozen technical analysts who are convinced that they have found the Holy Grail tool or system that is essentially perfect at predicting market turning points.

The common factor is that they all eventually fail. In most cases these analysts have mistaken luck for perfection. It's kind of like the guy who flips a coin that comes up heads 20 times in a row.

After 10 times he is convinced that he can control the flip of the coin and after the next 10, he believes he is the most skilled coin flipper of all time and is willing to wager ever increasing amounts on each flip.

So what are the odds that the coin will come up heads on his 21st flip? Fifty percent. Just like the odds on every one of the previous attempts. While his run of luck is unusual, it has nothing to do with his ability nor does it matter what he believes.

Studying chart patterns is about as reliable as looking for images in the clouds. Seeing the same fluffy bunny formation that you saw a month ago is not necessarily predictive.

One reason that these analysts all eventually fail is that no system can account for all of the variables that impact the financial markets. For example, no technical tool foresaw the 9-11 attacks and their impact on the financial markets.

On that day every foolproof system got fooled. Such unpredictable events are called "black swans." This refers to the fact that when a when swan is hatched, we expect that it will be white and in almost every instance it is. But on rare occasions a black swan is born, taking everyone by surprise.

Events the magnitude of 9-11 are rare, but smaller unpredictable events happen with regularity. They can range from unexpected comments from a Federal Reserve chairman to a currency meltdown in Indonesia.

The opposite weakness is technical analysts who develop a good trading system or rules and then don't stick with them or constantly second guess their own systems.

I specifically recall an investment manager several years ago who had developed a reliable technically based trading system. Yet in spite of an impressive back-tested track record and of real trades in his own account, once he started to manage other people's money he kept second-guessing and overriding the signals.

Invariably his decisions proved wrong. At one point he even started

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seeing a psychiatrist to try and help him figure out why he couldn't adhere to his own methodology. He never could resolve the problem and he eventually failed as a money manager.

Another manager had few very simple, but solid rules. These included things like: never buy a stock that isn't in an uptrend. Or, don't buy a fund unless it is trending above its 50-day moving average. As simple as these rules were, he could not make himself stick to them.

Anytime an investment moved sharply upward for a few days, he worried about missing the move and would jump in even if it were in a long-term downtrend. He also often sold funds in long-term uptrends if they had a few days of correction.

One of the most amusing areas of technical analysis is the attempt to forecast the movements of investment vehicles based on chart patterns. There are many books devoted to the study of chart patterns.

Most investors have heard phrases like "double bottom" or "head and shoulders." Studying chart patterns is about as reliable as looking for images in the clouds. Seeing the same fluffy bunny formation that you saw a month ago is not necessarily predictive.

When it comes to charts, there is some value in identifying areas of support and resistance. Because so many investors and traders watch these levels, they often become self-fulfilling.

The main value of charts and the main value of technical analysis, in my opinion, is to identify trends. Remember that law of physics that says "an object in motion tends to stay in motion"?

While an investment is not generally considered an object, this rule seems to hold true. The best indicator available for forecasting market movement is long-term trends. I don't worry much about short-term trends. I like trends that have been in place for at least six months to a year. Longer is better.

Most of the technical tools I rely



on—moving averages, MACDs, RSIs, momentum, stochastics, etc.—are all helping me to try to answer a single question: Is the trend intact?

As long as a long-term trend has not been violated, I can hold through some corrective action without much worry. For example, the black line on the chart above shows the performance of Fairholme Fund (FAIRX) compared to the Nasdaq (gold line). The blue line is a 200-day moving average of FAIRX. Notice that in spite of the greater volatility of the Nasdaq, FAIRX remains in a strong, steady uptrend.

When a long-term trend breaks down, it is usually a signal that the underlying instrument is going to be in serious trouble for some time.

In addition to technical tools, I also consider cyclical tools and fundamental analysis when making investment decisions. Once again, these elements primarily help me determine whether or not a trend is likely to remain in place.

In spite of many years experience and reliance on some pretty good and sophisticated tools, I'll be the first to admit that I have no ability to predict what the markets will do.

I've made my share of investing blunders through the years. On one of my very first forays into investing I bought the Japanese market when the Nikkei peaked at 42,000. Unwilling to admit my blunder, I held on to the position until it dropped to about

17,000.

I've learned a lot since then. I still make mistakes—just like every other manager or investor I know. But I've learned to be more conservative and to accept my losses when I am wrong.

—Flint Stephens

Mr. Stephens is marketing director for Strategis Financial Group. He has been a writer and editor for numerous investment publications. He has a masters degree from Brigham Young University.

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August 2007

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By:
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Date: _____

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