

Market cycles — timing is everything

By Danielle Park



Danielle Park

The investment industry exists to sell us buy ideas: Buy always, buy often, no need to question the timing. But real-life experience has proven repeatedly that timing is pivotal to investing success or failure. In this sense, financial markets are in their design an intricate pyramid scheme. He who gets in early and sells to others at higher prices wins. He who gets in late or doesn't get out loses — often heavily.

Markets have a historical precedent of rotating through long-term trends dubbed "secular cycles" that have repeated through the past 200 years. History shows that long secular cycles have averaged 15-20 years, with commodities and paper assets moving in opposite directions.

From a historical precedent, it is likely that the current secular bull in commodities began in 2000 and will remain a big-picture force until about 2017. Conversely, in the eight years since 2000, buy-and-hold returns on equities have actually underperformed T-bill rates in a secular bear cycle that could continue for another eight-nine years.

But anticipating long-term trends is not enough. Secular cycles are only the general outline of an investment theme. Winding through each secular cycle, bull or bear, are the shorter business cycles that impact individual investors more than anything else.

Stock markets are a leading indicator of the business cycle, turning down and then back up some four-five months before the overall economy. Historically market cycles have bottomed roughly every four years, averaging three years of expansion followed by one year of contraction.

Each long, secular cycle typically houses within it two to three shorter market cycles.

During a secular bull, each consecutive market cycle brings higher highs, followed by higher lows with each market contraction.

Each secular bull in history has been followed by a secular bear of similar duration. Secular bears also house within them a series of market cycles, but there are two main features that distinguish secular bears. Firstly their interim market cycles tend to move within a large trading range, not breaking out to higher highs as during a secular bull.

A second distinguishing feature of secular bears is that their market cycles tend to have contraction phases that average 17 months — about twice as long as contractions recurring during secular bulls.

In the late stages of each business cycle, consumption peaks, then slows, as revenue and profits contract. In response, stocks, bonds and finally commodity prices drop in unison around the globe.

A full market cycle is comprised of the expansion phase when prices are rising and the contraction phase when prices fall back. Failure to comprehend and manage risk exposure to cycles is the primary reason the majority of investors fare poorly over time.

Since 1926, as measured by the S&P 500, there have been 23 up market cycles, and we are presently experiencing the 23rd down market cycle, which began in October 2007. Throughout this period, market cycles have averaged 31 months with a 117 per cent gain, followed by a series of down market cycles averaging 10 months and a 26 per cent loss.

If an investor had bought the S&P 500 Index at the very start of an average up cycle and held it consistently throughout the entire 117 per cent return and without adding more capital as prices rose, then the subsequent 26 per cent loss might be considered a regrettable but relatively small consequence,

when compared to the overall gain. Following the average 26 per cent loss, the investor in this scenario would still retain a gain of 60 per cent over the full market cycle.

However, real-life experience is rarely so tidy. Typically investors are drawn or directed into a market or asset class after the up cycle has been under way for some time.

If an investor did not happen to invest until half-way through a typical up cycle, then gains enjoyed would be just 58 per cent before meeting the 26 per cent decline. In this scenario the full-cycle gain would be a more muted 17 per cent.

Where an investor happened to buy near the peak of a market cycle enjoying only a little of the up cycle before the correction phase begins, results turn negative. Where an investor buys into a peak, it is more probable there would be little or no gains before suffering the correction.

Little understood is the fact that once capital is lost, the gains needed to recover are much larger than may seem obvious. A loss of 80 per cent requires a subsequent gain of 355 per cent just to get the investor back to even.

Once large losses are suffered, it is often several years into the next business cycle and possibly the next secular cycle before prices may revisit prior peaks.

The Chinese stock market ran up an unsustainable 500 per cent over the last two years of the 2002-2007 expansion. It is not surprising then that recently investors in this market have been devastated. Those who got in during the past 18 months, or those using margin, have been effectively wiped out.

The loss of 45 per cent now requires a gain of more than 80 per cent to recover capital.

Cycles — count on them

The above examples demonstrate why risk to capital always increases as prices move longer into an expansion. Although forecasting the exact price peak is difficult in advance, cycle corrections are as inevitable as gravity. The question is not if but rather when they will begin.

Valuable perspective on present commodity prices can be gained from looking at the action of copper during the last secular commodities bull from 1963-1981.

Despite the long up trend in prices from 1963-1981, we see that copper went through a series of five peaks and troughs with each market cycle. Investors not prepared for these cycle corrections were exposed to great risk notwithstanding the secular bull over the 18-year period.

Few real life investors can or do actually hold through long market downturns. Few will hold losers for the years often needed to recoup prior prices. This is the reality of why most investors never actually earn the theoretical or historical returns of a buy-and-hold approach. There is no point saying that in-

vestors should ignore volatility and stay the course. History shows that the majority simply do not. Most investors (and their advisers!) react badly to market volatility, holding past market peaks and selling in disgust near bottoms.

Based on historical price behavior, we should expect cyclical corrections in world commodities as the current economic slowdown plays out. Those who do not plan for the reality of market cycles leave themselves overly exposed to the contractions implicit in each.

Looking at the following chart of present day copper we can see that, having increased more than 500 per cent from the business cycle trough in 2002, copper could easily correct more than 30 per cent from present levels and still remain fully within a secular bull.

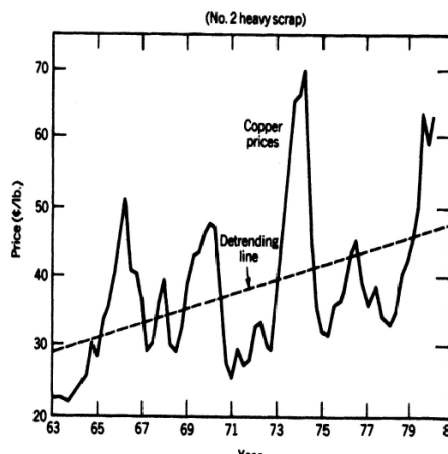


Copper price over the five-year business-cycle expansion 2003-2008

At the same time, even anticipating a continued secular bear in equities over the next several years, we should still see strong opportunities for gains in this asset class, so long as we employ a system for tactical exposure to the bulk of each cyclical expansion, while protecting against the bulk of each cyclical contraction. Data shows that where we can avoid the bulk of the cyclical downturns, we need only participate in 30 per cent of the cyclical expansions in order to outperform a buy and hold investor.

The history of investor behavior is clear. Those that invest capital early in an expansion cycle have a higher probability of making gains with the overall market. Those that buy in late or leave capital fully invested near price peaks have a high probability of losing capital with the overall market. Those that use leverage near market tops with no prescribed sell discipline, have a high probability of permanent capital impairment.

Once losses are suffered, it is often several years into the next business cycle and sometimes the next secular cycle before prices may reclaim prior peaks.



A secular bull in commodities: copper price per pound 1963 to 1981

Think of the gold investors who bought into its secular peak in 1980, having to wait 28 years to recover their capital. Think of those who invested in the Japanese market in the late 70s or the NASDAQ market in the late '90s, who, if still holding even years later, are nowhere near back to entry points. Protecting capital from cyclical down markets must be our primary focus.

The math of loss shown above is all the more magnified once we realize that real-life people typically receive the bulk of their life savings later in life and in lump sums, as they sell property or business, receive settlements or inheritance.

For us to ignore the significance of the market cycle in asset-management strategies is a form of reckless abandon. And yet this is precisely what the investment industry and the majority of its advisors and managers routinely counsel clients to do.

In reality, few investors have more than a couple of secular cycles and a handful of business cycles to grow and preserve capital within their relevant life span.

Valuable risk-management strategies must navigate profitably within bear and bull markets, using objective rules about when to buy and when to sell investment assets. Few individuals can afford to let their capital blindly ride up and down market cycles. Individuals are not pensions or foundations, they do not have infinite time horizons over which to make and retain profits.

Exchange traded-funds and index units are an excellent tool to help investors focus on big-picture risk to capital and the macro factors that matter most. But more than a passive strategy is needed to profit and protect in the series of market cycles running through secular trends. Technical analysis is one of the most useful tools we have found to help quantify and monitor market cycles. Longer- and medium-term technical charts allow us to focus on relative price risk and time to prepare for probable pullbacks within longer secular trends.

Having sold banks more than two years ago, we were able to avoid large losses over the past 12 months at the end of this cycle. Now we are watching for a favorable re-entry point on the iShares Dow Jones U.S. Financial Sector Index Fund (IYF-AMEX, \$84.32) and the iShares CDN Dow Jones Canada Select Dividend Index Fund (XDV-TSX, \$20.43). While we do not yet have a buy on our rules, we anticipate a possible re-entry point in the weeks ahead.

Danielle Park is Portfolio Manager and President of Venable Park Investment Counsel Inc., an independent money management firm specializing in tactical asset allocation and ETFs. Ms. Park is also the author of a best selling new book: *Juggling Dynamite: An insider's wisdom about money management, markets and wealth that lasts*, and a popular financial blog called www.jugglingdynamite.com.

"[Rogers's] insight . . . is a commodity that's always in demand."
—Barron's

THE NATIONAL BESTSELLER

"Hot Commodities opens a window on the contrarian investor mind."
—The Wall Street Journal

JIM ROGERS
Bestselling author of *Investment Biker* and *Adventure Capitalist*

RANDOM HOUSE TRADE PAPERBACKS