

Forecasting Short-term Moves in Stock Prices: An Update

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For the past 9 years I have included an estimate of investor psychology in my weekly financial reports. My indicator is presented on a scale of 0 to 10. Numbers greater than 5 correspond to positive psychology and suggest that the odds favor rising stock prices. Numbers 5 or less correspond to a relatively high degree of uncertainty and suggest the market is vulnerable.

A Real-Time Record

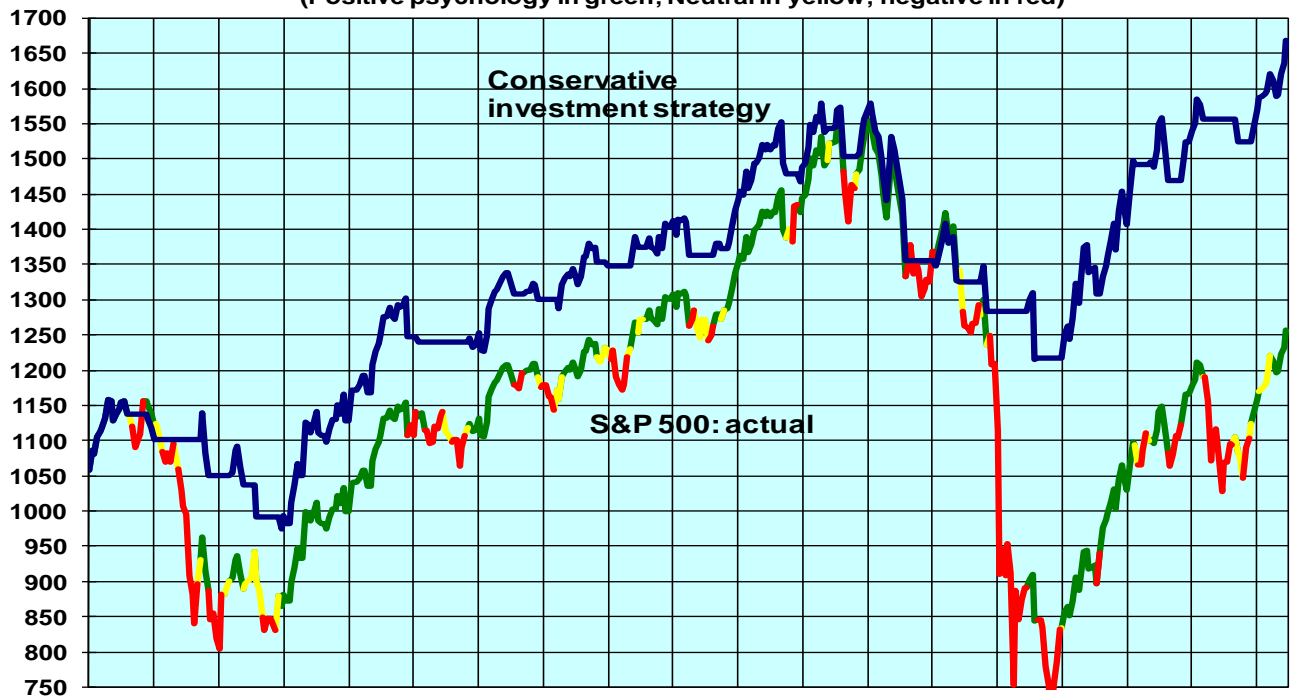
The chart below shows the S&P 500 with a color code reflecting the *actual* readings presented in my weekly reports. My relatively conservative personal investment strategy during this period has been to be almost fully invested in stocks whenever psychology is positive (green). I sell almost all stocks whenever sentiment turns either neutral (yellow) or negative (red).

Over the entire period that I have provided this indicator the S&P 500 has gained 19%. My strategy (shown by the solid blue line) has produced a gain of 58%. The value of correctly gauging investor sentiment comes entirely from being out of stocks during down markets. This is when the gains relative to the S&P were made. In contrast, losses relative to the S&P 500 occur whenever the portfolio is in cash while stock prices are increasing. During bull markets, the best this approach can do is to match the gains in the S&P 500 by consistently maintaining a fully-invested position.

During 2010 the S&P 500 was up 12.8%. My strategy produced a gain of 10.3%. Decisions to hold cash at several times during the year reduced the gains that would have been achieved by continuously holding an all stocks portfolio. At year end, my portfolio was fully-invested in stocks.

Investor Psychology & Subsequent S&P 500 Moves

(Positive psychology in green; Neutral in yellow; negative in red)



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Investor psychology as it appeared in Dr. G's weekly update and subsequent moves in S&P 500.

Should We Always Be Fully-Invested?

Different investors have different objectives and a different tolerance for risk. For younger investors my advice has always been to keep your retirement account fully invested in stocks, preferably in an index of smaller company stocks. My preference for small companies is due to their tendency to increase profits at a faster rate than larger companies.

For older investors (those nearing retirement), it's important to place a premium on protecting assets. One way to do this is to hold relatively large positions of fixed-income securities. However, holding bonds can be more risky than holding stocks if inflation were to soar. And holding shorter-term fixed income securities may yield little in the way of returns.

My personal approach (as an older investor) is to hold stocks to attempt to take advantage of the market's potential for gains, but to be prepared to move to cash when conditions appear less favorable. With this strategy it's important to recognize that it's clearly a mistake to be out of the market when stocks are moving higher. If the long-term market trend is up, holding stocks all the time makes sense.

However, if economic fundamentals turn negative, stock prices can suffer for an extended period of time. Moreover, negative psychology and monetary policy mistakes can send markets lower even during the best of times. It's also possible that a shift toward negative psychology can provide advanced warning of an upcoming negative change in either economic fundamentals or monetary policy mistakes. This is what appears to have happened in the recent bear market when the possibility of a negative shift in these factors appeared first in the market's technical indicators.

Gauging Investor Psychology

Determining investor psychology involves analyzing technical factors as well as economic fundamentals and monetary policy. The idea behind technical analysis is that markets in motion tend to stay in motion until a contrary force sends them in another direction. In assessing the market's direction, moving averages can provide useful information regarding shifts in investor psychology. In addition to moving averages, trends in daily trading volume can also signal shifts in momentum.

It's also important to determine the appropriate market index that provides the best assessment of the market's momentum. After analyzing daily stock movements for almost two decades, my main choice is an equal-weighted index of more than 8,000 stocks produced by vectorvest.com. Determining investor psychology can be somewhat subjective. This is particularly true when factors such as the economic fundamentals and Fed policy come into play.

It's my belief that stock prices incorporate the collective wisdom of all investors. My objective is to respect and interpret this wisdom so as to profit from gains when conditions are positive and get out of the way and protect assets when those conditions turn negative.

Over the past decade my approach has been personally rewarding. It has also been reward to those who have followed my strategy. However, you should be aware that I have never made a major decision to buy or sell with complete confidence. Predicting short-term moves in stock prices is a lot like playing golf. These are humbling endeavors. Embarrassing moments are inevitable. I advise anyone with a large ego to avoid either of these activities.