

Investing: Alternative Theories

Introduction

There are numerous theories and approaches to structuring an investment portfolio. Some theories are relatively contemporary; others, though no longer followed today, can serve as an introduction to more modern trading practices. Some are criticized for having no real forecasting value, but are sometimes used as a way to monitor trends. Keep in mind that none of these theories can guarantee the future performance of any investment.

Modern portfolio theory

Modern portfolio theory, first publicized by Nobel prize-winning Harry Markowitz in the 1950s, is based on the idea that not all investments behave the same way at the same time; some may be doing well when others are doing poorly. Correlation is a measure of how much you can expect one investment (or asset class) in your portfolio to change in price relative to another. For instance, the price of wood might go up, which is great for the lumber industry but bad for the building trades because homebuilders will have to pay more for materials. As a result, you could expect investments in these two areas to move in opposite directions. These investments have a low, or negative, correlation. In contrast, one might expect an investment in the tire industry to closely track investments in the automobile industry. This is a high or positive correlation.

Advocates of modern portfolio theory contend that a portfolio's performance can be improved through diversification: selecting a variety of investments with a negative correlation. MPT advocates attempt to offset downward movements by one investment with upward movements by another, trying to minimize portfolio volatility and maximize total returns. Though diversification alone cannot guarantee a profit or ensure against a loss, it creates a framework for attempting to take advantage of the unique attributes of multiple types of investments.

Random walk theory

The random walk theory asserts that changes in securities prices are random, thus making it impossible to accurately forecast market direction. In other words, changes in securities prices are unpredictable, and any patterns or trends in securities prices are merely coincidence. This is not to say that security prices are randomly determined. On the contrary, they are determined by such factors as earnings, interest rates, and the overall economic climate. The random walk theory stipulates that, although security prices are the result of a variety of predetermined factors, changes occur haphazardly.

The random walk theory, popularized by the book *A Random Walk Down Wall Street* by economist Burton Malkiel, operates on the premise that in an efficient market, investors are highly informed and have access to all sorts of information regarding a company and its securities. As a result, securities prices reflect all or most of the information obtainable about companies and their securities. Consequently, those security prices quickly change in response to the new information, following a random walk pattern over time. If an investor thinks that a company's security is priced too high, he or she will either sell it or choose not to buy it. However, if an investor feels that a security is underpriced, he or she will most likely purchase it or hold it if he or she already owns it. The competition between investors results in security prices reflecting what these informed investors collectively think a security is worth.

Dow Theory

The Dow Theory is a technical method for analyzing security prices. The Dow Theory is based on the assumption that three movements are operating simultaneously in security prices: (1) the primary, (2) the secondary, and (3) the daily movement. The primary movement (also known as the major or primary trend) can last anywhere from 28 weeks to 33 months and depicts the long-term trend of the stock market (i.e., the major bull or bear market). The secondary movement (also known as the secondary reaction) can last anywhere from 3

weeks to 3 months and depicts a rally in a bear market or a reaction in a bull market. The daily movement (also known as the day-to-day movement) depicts the day-to-day fluctuation of stock prices.

The Dow Theory forecasts stock prices under the assumption that over time security prices develop patterns, illustrated in turn by stock indices. Furthermore, these stock indices often move together. The Dow Theory uses two Dow Jones averages to measure security prices: the Dow Jones Industrial Average and the Dow Jones Transportation Average. An investor can forecast security prices by following the direction of these averages. If the Dow Jones Industrial Average is rising, then the Dow Jones Transportation Average should, too. This simultaneous movement indicates a strong bull market. In contrast, a decline in both averages would imply a strong bear market. When the two averages move in opposite directions, the market is uncertain.

Is the Dow Theory used today?

The Dow Theory evolved at the turn of the century based on a series of *Wall Street Journal* editorials by Charles H. Dow (though Dow himself never promoted it as a trading system). Its accuracy and forecasting power have been the subject of much debate. Although the theory still has followers, its popularity has decreased in recent years. Some have suggested the theory's forecasting ability is no more accurate than flipping a coin. Its proponents are quick to point out that the theory was never meant to be a system for beating the stock market, simply a way to predict changes in primary bull and bear markets. Others feel that even if no longer useful, the Dow Theory can serve as an introduction to more modern trading plans.

Odd-lot theory

The odd-lot theory, a technical method for analyzing security prices, focuses on the buying and selling behavior of the odd-lot public; basically, small investors who buy in small quantities (i.e., less than 100 shares).

Tip: Generally, there are two basic units of trading on the Nasdaq and New York Stock Exchange (NYSE): odd lots and round lots. Round lots are for orders of 100 shares or multiples thereof. Odd lots are orders for fewer than 100 shares. Odd-lot trading data is published in the financial press.

The odd-lot theory is based on the belief that these odd-lot or small-time investors often misjudge the market, most frequently just prior to a change in market direction. That is, small investors will get caught up in the excitement of a bull market and increase their purchases while the market reaches its top. Conversely, those same small investors will tire of experiencing losses in a declining market and will sell as the market reaches its bottom. The crux of this theory is that small investors are incapable of making informed investment decisions. As a result, the odd-lot theory suggests that you determine what the market "losers" are doing and do the exact opposite. In other words, the larger, more knowledgeable institutional investors should sell when small investors buy, and buy when small investors sell.

Is the odd-lot theory a reliable method for analyzing security prices?

Like most methods for forecasting security prices, the odd-lot theory is not without controversy. Although research has shown that odd-lot purchases increase in rising markets and odd-lot sales increase in declining markets, detractors of the theory feel it has no real forecasting value.

If the odd-lot public is wrong at times, so are larger institutional investors. Both small and large investors have sold at the market bottom and bought at the top. Consequently, there is no reason to believe that the buying and selling habits of the odd-lot public form an accurate way to monitor the stock market. In addition, reliance on odd-lot trading to indicate the behavior of small-time investors is skewed by the movement of investors from the odd-lot to the options market, which allows investors to make small trades in options that represent round lots. As a result, many now feel the odd-lot theory is more properly utilized as a way to monitor trends--not as a crystal ball to predict market change.

Industry selection

There are many factors to consider when purchasing securities for your investment portfolio, such as the type of investment and the risk involved. Another factor to consider in creating and designing your portfolio is industry

selection, in which an investor targets a particular industry for investment.

If you can accurately predict which industry will rise or fall during any given period and invest accordingly, your investments may outperform the market indexes. For example, someone who underweighted the energy industry in their portfolio just before the industry experienced one of its periodic surpluses of oil or natural gas may have fared better than those who increased their investment during the same time.

Industry life cycles

Most industries have life cycles that closely mirror one another. For example, when an industry is expanding and many firms enter the field, the industry will normally grow at a very rapid rate. However, once that industry becomes inundated with market participants, its growth rate may slow to a more moderate pace. During this time, some firms will fail while others will survive. As a result, the remaining firms in that particular industry are likely to have a larger market share and a greater potentially greater opportunities for continued growth. Generally, a more mature industry will have fewer participants that share a somewhat stable existence and a moderate growth rate. Some industries eventually die off as new technology or changing consumer needs make them obsolete.

Types of industries

In addition to going through life cycles, industries will react to the prevailing economic climate. Certain industries are cyclical and move with the economy, while others do not. These industries are not influenced by business cycles but by the growth expectations of investors. When selecting an industry for investment purposes, an important factor to consider is whether you want to invest in a cyclical, noncyclical, or growth industry.

Noncyclical industries

Noncyclical industries produce goods or services in constant demand by consumers (e.g., food, drugs, and utilities). Generally, these industries are resistant to changes in the economy. They remain relatively stable, even during an economic recession. As a result, noncyclical industries have traditionally been considered less risky than industries whose sales and revenues are closely tied to the economic climate.

Cyclical industries

Cyclical industries produce goods and services not constantly in demand by consumers. Instead, demand for their products may vary from one year to the next, depending upon the economic climate. This class includes the automobile and building industries. Sales here are heavily influenced by fluctuations in the economy and are thus less stable and more risky than their noncyclical counterparts.

Growth industries

Growth industries are dominated by companies experiencing rapid expansion of markets (often younger, less mature companies). Innovation and the pursuit of leading-edge developments often are their hallmark. They typically exhibit considerable growth expectations and high P/E ratios, and may have little or no history of dividend payments to investors. These companies can ride business cycles to impressive heights or aggravating depths. Technology is typically considered a growth industry.

Other factors to consider in industry selection

When making your investment decisions, in addition to life cycle or type of industry considerations, you should also take into account other factors, such as government regulations, labor conditions, and the financial requirements of the industry.

Formula investing

Formula investing, or relying on formulas for your investment timing decisions, is a way to take the guesswork out of deciding when to invest in stocks or mutual funds. Formula plans fall into two categories: current investment strategies, such as dollar cost averaging and dividend reinvestment plans; and historical formula plans no longer in widespread use, such as constant-dollar plans, constant-ratio plans, and normal-value plans.

Constant-dollar plan

The objective of a constant-dollar plan is to keep a nonvarying number of dollars invested in stock, regardless of stock price fluctuations. Under a constant-dollar plan, an investor would invest a fixed dollar amount (e.g., \$50,000) in stock and maintain that same level of investment despite upward or downward movements in pricing. If stock prices rise, the investor would sell any surplus in order to reduce the value of the investment to the original amount. Conversely, if stock prices fall, the investor would invest in enough stock to bring the value of the investment up to its original level.

Constant-ratio plan

A constant-ratio plan attempts to maintain a fixed percentage of a portfolio invested in stocks and a fixed percentage in bonds. Under a constant-ratio plan, the investor would put a fixed percentage of his or her portfolio in stocks (e.g., 40 percent) while investing the remaining percentage in bonds (e.g., 60 percent). If stock prices rise, stocks are sold and converted into bonds to bring the percentage of stocks in the portfolio down to its original level. Conversely, if stock prices fall, bonds are sold and the proceeds are used to purchase shares of stock, bringing the percentage of stocks in the portfolio up to its original level.

Normal-value plans with variable ratios

In general

All normal-value plans with variable ratios split portfolios into two parts. One part is a defensive component consisting of bonds and high-grade preferred stocks; this part protects the value of the portfolio against declining stock prices. The other part is an aggressive component consisting of common stocks that move with the market averages; this part provides the portfolio's growth potential. The ratio between the defensive and aggressive components may vary with an investor's risk tolerance and need for current income, and will also change as stock prices rise or fall.

The objective of normal-value plans with variable ratios is to help investors minimize investment timing mistakes. To accomplish this, the plans attempt to establish rules that mechanize buying and selling decisions, thus eliminating emotional considerations that may cloud an investor's judgement. First, for each stock included in the aggressive component of the portfolio, a normal or median stock value is established. The stock is sold when its value exceeds this normal value, and bought when its value falls below the normal value.

These plans are not expected to yield the high profits that could be gained by buying at the market's bottom or selling at its top, nor can they protect an investor against a loss. However, because the plans are designed to assure that stocks are bought when the share values are low and sold when high (compared to the stock's normal value), their proponents defend them since their returns--although smaller--are more certain, with less risk.

There are two types of normal-value plans with variable ratios: (1) normal-value plans that use price as the normal value, and (2) normal-value plans that use an intrinsic value to determine the normal value.

Normal-value plans based on price

Normal-value plans based on price arrive at a stock's normal price by determining the median point on either a long-term moving average (120 months is considered optimal) or a trend line for the price of the stock under consideration. To determine buy or sell action points, zones (often determined as a percentage of the stock's normal value) are calculated above and below the normal value. According to historical trends, the stock's price will fluctuate between the bottom and top zones. As the stock's price moves through successive zones, the stock is bought or sold. A rising stock typically isn't sold until its price reaches or exceeds the normal value. Likewise, a declining stock isn't bought until its price reaches or falls below the normal value.

Normal-value plans based on intrinsic values

Normal-value plans based on intrinsic values presume that the value of a stock is not based solely on its price. Instead, normal-value plans based on intrinsic values use factors such as a stock's earnings, dividends, or yields to arrive at the stock's normal value. Detractors of intrinsic-value plans argue that, since there is no agreement on what makes up a stock's intrinsic value, they cannot accurately forecast a stock's value.

Dollar cost averaging

Dollar cost averaging is an investment strategy that systematically invests the same amount of money at regular intervals, thus buying more shares when the price is low and fewer shares when the price is high. Followed faithfully, especially over a long term, this strategy can result in purchasing a greater number of total shares at a lower average cost per share. To achieve these benefits, however, the investor must be willing to invest continually, even through periods of market decline. The strategy cannot assure a profit or protect an investor against a loss, particularly if he or she chooses to sell at a time when the share's market price is below the average cost per share.

Dividend reinvestment plan

Dividend reinvestment plans allow shareholders to purchase additional shares of stock or stock mutual funds by reinvesting the dividend. Reinvestment plans are a form of dollar cost averaging--you periodically invest money in stock over the long term.

Fortuitous investment selections

While many investors use theories to help in their selection of investments for a portfolio, others feel they would have just as much success by throwing darts at a dartboard. These investors feel that successful investment selection comes down to luck, and those who invest successfully do so by chance. Of course, some people believe that proper investment selection requires a mixture of both luck and theory--and that, by striking the proper balance between the two, you can achieve investment success.

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