Bull Market Lessons

All bull markets begin in an atmosphere of doubt and uncertainty. They begin slowly and most investors do not perceive that anything much has changed. One reason for this is that many investors are nursing losses from the bear market that is ending and have lost interest in the stock markets, perhaps not even actively following it any more.

Those who do see the first rally have been conditioned by the bear market to distrust any rally. Each of the previous rallies has brought hope, only to see them peter out and the market fall lower. Most investors therefore tend to see the first rally in the bull market as another of the traps that had been set for them all the way down the slope of the bear market.

This rally will be different. It will continue and with slight corrections, the bull market will be born. Disbelief will gradually bring in more and more investors as they fear they are missing out on the new bull market. Other stale investors see they are making money in the market and join in. Like a stone thrown into a pond, the circles of winning investors widen, bringing in more and more investors hoping to join in the action.

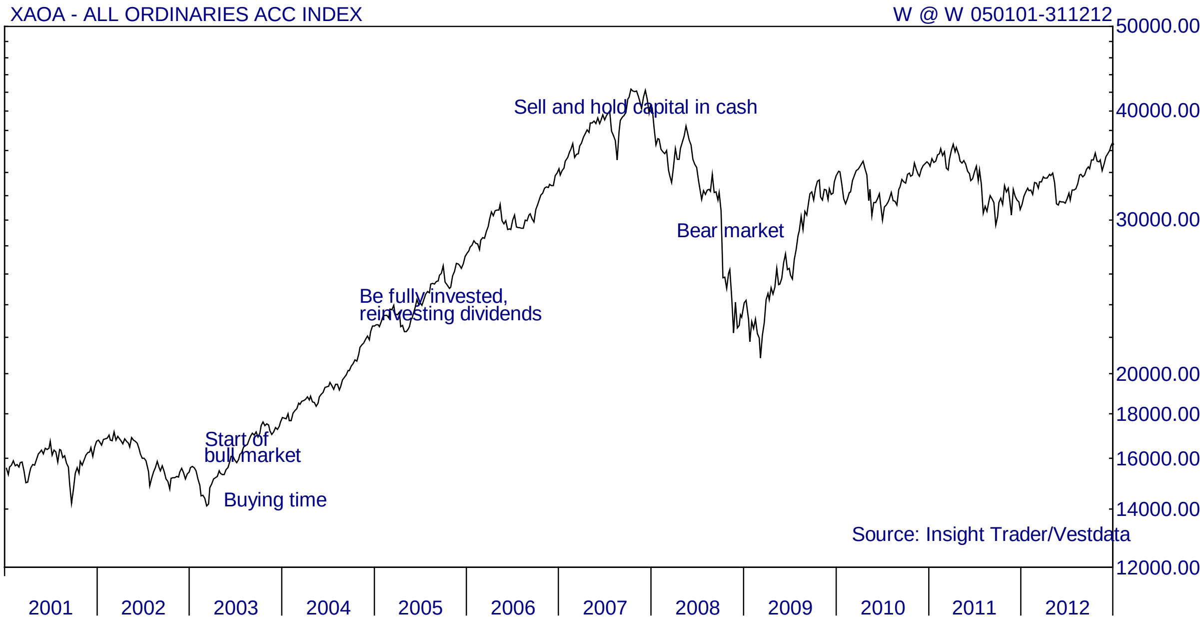
Stock markets always turn up or down ahead of the real economy. This is because investors buy stocks not simply on past profits, but on their expectation of future profits. This anticipation can typically be anything from six to twelve months, depending on the level of confidence felt about the future earnings environment for companies.

Companies listed on the stock market are not only leveraged to the local economy, they may also be strongly affected by overseas economies where they do business. They may also be very strongly leveraged to commodity market cycles, interest rates and to movements in exchange rates for the Australian dollar and the currencies in which their products trade internationally.

Most bull markets begin benignly enough and unfold slowly in a sound manner. However, as the real economy picks up, earnings rise strongly and consistently, leading to increased dividends and strongly rising prices for stocks. These rising prices are turbocharged by increases in the price earnings ratio, reflecting greater confidence.

By this stage, it is not just investors in the market. Short term traders become more numerous and more active. Advertisements for trading systems begin to flood the media claiming sure ways to make big profits. Of course, if these claims sound too good to be true, they always are, but new suckers are born in each bull market. There are always those who are willing to tell them what they want to believe: easy ways to make big profits trading stocks. Not just stocks, either: the lambs are led to margin loans, Contracts For Difference, Exchange Traded Funds, Hybrids, options, futures, currencies all of which are likely to be their financial executioners when the bull market ends, as it always does. Maybe a seemingly sound financial adviser will suggest they take out a large mortgage on their house and gear that up with a margin loan to put a rocket under their investments or trades. ASIC warns that high promised returns always indicate higher risk of loss, but by now nobody is listening.

While investors and traders are multiplying their firepower with debt, so are companies. Directors are under constant pressure from analysts to increase their profits through capital management. Capital management is a jargon term for higher debt or gearing. If a company takes on more debt and uses it to buy back some of its shares, the result is two-fold: earnings per share rise, promising increased dividends, which boosts the share price. The reduced equity that has been replaced with debt will increase the return on equity, which promises increased earnings and also tends to increase the share price. The fund managers are happy because their portfolio returns are boosted. However, the debt level in the company has been increased. Debt magnifies returns in good times, but magnifies losses in the bad times and could lead to an otherwise viable firm going bust.



Around this time what I call the seminar indicator will have swung from gloom to euphoria. This is how it works: In a bear market and into the early part of a bull market, speakers at seminars about investing and trading are faced with a room that has a scattered audience and a great number of empty seats. This is the gloom reading. As people begin to notice the bull market has been running for a year or so, our seminar presenter finds the room is fairly full. This is the neutral reading. When the bull market is in full cry and racing towards its inevitable end, there are people jostling to even get into the seminar just to sit on the floor in the aisles or stand at the back. There may be almost as many standing outside trying to hear as there are in the room. This is the euphoria reading.

The way to interpret the seminar indicator is this: when the reading is gloom, investors should be very busy analysing stocks and buying bargains for long term appreciation. These are the successful investors. Then as the reading swings to neutral, these smart investors are fully invested and reinvesting their dividends into the market as their stocks rise steadily in price. When the reading swings to euphoria, these smart investors are selling their overvalued stocks to the late arrivals and moving heavily into cash. They complete their selling as the bear emerges and prices plunge. The key thought to take away here is that smart investors buy when stocks are cheap and sell them when they are expensive. The uninitiated only become involved and buy when prices are at silly levels and most ride them down with the bear. That is if they can meet the margin calls, otherwise they are sold out by their margin lender.

The last bear market from late 2007 to early 2009 was particularly severe because of another extreme form of debt in the corporate world loosely called financial engineering. Sounds as though it is a smart idea that has good connotations, doesn't it? What it really means is extreme leverage or super-high debt levels, usually hidden in almost impenetrable structures described in arcane jargon terms. Warren Buffett keeps warning us not to invest in things we do not understand. Smart investors already knew this, but the newcomers, blinded by greed, plunge in and lose huge amounts of their capital when the bear roams the financial heart of our economy.

Anyone, even a child, can learn how to avoid being caught in the stocks that crash and burn taking investors' capital with them in a bear market. I have taught this for many years and in my book *Building Wealth in the Stock Market.*

This article was originally written for Money magazine in December 2012, but the lessons are timeless, so I have added it to the Educational Articles page of the free website.

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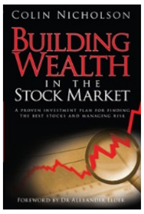

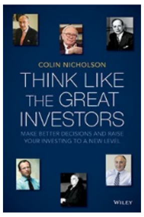

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