Wisdom from Edwin Coppock

Edwin Coppock, a US investment adviser and the founder of Trendex, invented the Coppock indicator. He designed the index to do only one thing – indicate the time to buy long term holdings at the bottom of a bear market. While we tend today to focus on his indicator, the philosophy behind his methods is equally important.

Coppock outlined the philosophy behind his view of the markets, leading to showing the calculation of the indicator and describing its use, in his paper *Realistic Stock Market Speculation*. It was published for a Trendex conference in 1967 and has been long out of print. Since it is now unprocurable, the following is a discussion of some of his main ideas.

Coppock begins his paper with the proposition that the most difficult aspect of realistic speculation is to resist the urge to act in ways that seem most natural and logical to the untrained investor. He therefore suggests that to be successful, we must change our behaviour from the apparently logical approach that has caused past losses from investing.

It soon becomes obvious to the beginner that success in stock market investing does not come easily. It also becomes obvious that forces other than rational people acting on known information drive stock markets. Thus the first step is to acknowledge this fact and realise that an approach other than simple study of the news is needed to succeed.

This is but one example of how each of the accepted principles of security analysis must be questioned and tested to see whether it works in the real world. Coppock suggests that, if the minority seem to be more successful than the majority, then the minority may be using different strategies than those commonly accepted. The reason that the commonly accepted principles remain current and continue to be promoted is because of their reasonableness. Those who may be brought to book if their advice does not turn out to be sound will protect themselves by hiding behind what is easily defended as widely accepted, rather than what they might believe actually works. This may sound cynical, but it is important to understand that investing is a pursuit where cynicism pays off.

A good example of this trap is the way stocks are sometimes touted to us as being undervalued because they are selling for less than book value. While it might be true, it also may be that there is good reason for the low price, perhaps because the company is sliding towards liquidation.

We are taught to achieve by hard work and persistence. However, mere hard work and persistence in the face of market trends is a recipe for disaster. Likewise, faith and natural courtesy are admirable qualities. However, relying upon them when an adviser is well meaning but unqualified can also lead to disaster.

Beginners also tend to be naive about company profit reports, assuming that they are seeing them at the same time as everyone else. However the facts are that some people get the news faster. Even of more importance, some are able to estimate or anticipate the results and have already acted in the market well before the news is released. Thus stock prices do not only reflect known facts, but they also discount possibilities. There is even a saying on Wall Street that earnings are usually at their best just before a price decline begins. Coppock suggests that investors watch prices before an earnings announcement is due, to gain an indication of what insiders think will be announced.

The realist does not bother to ask why prices are moving contrary to that expected from the known information. Rather, he learns to act upon what prices are telling him and expects the news to confirm it sometime later. He will then often sell to the beginners before that news is announced.

Another way that the uninitiated lose in the market is through greed. They unthinkingly buy the stock with the highest dividend yield. All too often they do not realise that the rest of the market has seen that yield and not tried to take advantage of it. Why? Often it will be because the initiated and the insiders know that the dividend on which the yield is based is very likely to be cut when the next earnings announcement is made.

Contrary to what the beginner thinks, it has been observed that many of the greatest percentage increases in stock prices have started from a situation where the company paid no dividend at all, or an insignificant one. This seems to be because the contrast between zero dividend and good growth prospects drives keen anticipation.

In learning the new concepts that are useful in investing, we need to become used to the idea of considering effect, without worrying about what the cause is. We are taught to think in terms of cause and effect and moving away from this method is bound to cause us to feel uncomfortable at first. So uncomfortable, that some people refuse to grapple with it and reject it out of hand. They prefer the comfortable losing strategy to the discomfort that has to be overcome in order to succeed.

The first thing to realise is that announced and disseminated news is out of date and can have no further effect on stock prices. Prices are driven by expectations of the future, not facts about the past. This is why stock prices can sometimes fall even in the face of generally good economic conditions and rising profits. Often this is quite reasonable, if it is appreciated that prices had already been driven too high by unreal expectations about what is now the present. The realist acts on the reality of falling prices, not the known facts of buoyant present conditions.

Coppock uses the analogy of a general who studies the information about his enemy in order to time his own strategy. Likewise, it is important for investors to get their timing right. Yet few who are brought up on a basically fundamental approach place very much importance on timing. It pays to stay aware of the actual movements in prices, as well as the underlying story.

Another area where beginners are misled is the idea that there are *normal* levels for PE ratios. Whereas it soon becomes clear to the initiated that PE ratios are related to levels of inflation and interest rates on the one hand and to expected growth rates for the company on the other. So-called *normal* rates may have applied in times of stability in prices and a stagnant economy, but students of history know that this is rarely a normal situation for long.

On the other hand, there is some relationship between earnings and prices, though not as much as many people believe. However, this does not justify using earnings in the form of a PE ratio to justify stock prices. Any chart of PE ratios over time will show that they vary widely for the market as a whole and for individual stocks.

Reactions to news is markedly different between beginners and the initiated. Beginners tend to buy good news and sell bad news. The initiated take a different tack by considering first whether the news was expected or unexpected. Expected news is ignored. Unexpected news will impact the market in the short term, but will not tend to disturb a strong trend for long. Unexpected bad news therefore can be expected to finish off a tired trend, but it will be shaken off by a young vigorous trend.

Next, Coppock turns his attention to dealing with tips and tipsters. The beginner is usually eager for inside information and pounces on tips in a most trusting way based on wishful thinking. Instead he should ask questions about how likely it is that he is the first to hear the tip, whether the tipster stands to gain from it, whether the stock has already gone up in price and how qualified the tipster is. Since the average chief executive is so often wrong about the direction of his company's stock, the beginner should ask how an outside tipster would know any better. Certainly, the tipster may be a stock market genius, but experience suggests otherwise. The real experts rarely talk about what they are doing and know that the best bargains are never the subject of rumour and have not yet started to become active price movers.

Another common mistake is to follow reports of the portfolio moves of fund managers on the assumption that they know the future. Yet most fund managers do not do as well as the market index. Moreover, they took the portfolio decision some time ago and, by the time it becomes known, the situation may have changed.

Every student of the behaviour of unrealistic novice investors eventually reaches one important conclusion: the average novice wants success without work, he wants shortcuts and he is intellectually lazy.

If it is agreed that success doesn't come easily and that among investors, the minority wins more often than the majority, then a step toward reality has been taken. Further steps depend on open-mindedness, a willingness to accept a change of method and a continuing willingness to work hard at the business of making your money work hard for you.

Coppock's paper then starts presenting a realistic program that overcomes many of the weaknesses outlined in the criticism of orthodox concepts. Coppock suggests that there are four elements to be dealt with: the problem, the participant, the media (eg stocks, bonds etc) and the method.

The problem is firstly a manifestation of greed and the thrill that comes from winning. There are always emotions involved and this is why the losers outnumber the winners.

There is also the matter of time. Everyone's objective for how long is needed to make a certain profit tends to be different. Some are more realistic than others.

Some can carry out a plan with courage and others cannot.

Some understand the risks involved in stocks and the differences in liquidity and others do not.

There is no point learning method and strategy if you do not understand the role played by your emotions in the process.

Most investors concentrate almost exclusively on method. Yet all methods will fail in some markets. Thus different methods must be used in parallel as a means of reducing risk.

Earlier, there was discussion of the need to consider the reality of price movement without being concerned about the cause. Yet if we give a beginner any sort of reasonable explanation for price movement, he becomes more assured. This points out that the average beginner is driven very largely by fear and craves reassurance. This makes them vulnerable.

The way around this is to concentrate on the one reality, which is the trend of prices. We need to consider such facts as its direction, rate of change and probable duration.

We also need to consider that there are trends within trends and that short term traders may be trading an opposite trend to the larger picture being considered by a long term investor. Yet investors, who have bought stocks with a view to holding for months, continue to call brokers to find out how the market is going within a day.

Emotions drive prices, the emotions of buyers and sellers. Thus the human factor of psychology must be considered in a complete analysis of a situation. And it is not that difficult, because people are predictable, in the sense that they tend to react in a similar way each time they encounter a given situation.

Even a superficial look at a series of long term price charts will show that from time to time there are deep valleys in price, at which time it would have been perfect to buy. Beginners never do this, but some professionals calmly wait for these times and take advantage of them.

Coppock then describes how to calculate and use the indicator to which his name is most often associated.

Calculation of the Coppock Indicator

Although some books suggest the indicator is calculated from average monthly values of an index, it is clear from Coppock's paper that the closing value is used. The steps in its calculation are as follows:

- Calculate the percentage change between the index value in the current month and its value 14 months earlier.
- Calculate the percentage change between the index value in the current month and its value 11 months earlier.
- Total the two percentages.
- Calculate a 10 month weighted moving average of the total of the two percentages. Round that number to the nearest 10 (this seemed to be aimed at eliminating minor “false” signals)

This is the indicator, which is plotted on a chart.

There is an Excel Workbook with spreadsheets for the Australian and major world stock market indices on the *Data and Other Files* page on the *Free Resources* menu, which is updated monthly.

The Coppock indicator will swing between positive and negative values. The signal for long term investors to begin buying is when the indicator turns up from below the zero line; in other words, when it becomes less negative than it has been. At this point, the market will often be some months past its extreme low, but the risk for a long term investor entering now is quite low.

Coppock's advice at this point is very interesting. He suggests dividing our capital into three equal parts and investing it in only three stocks. He pays some attention to diversification, though, by insisting that each of the stocks be from a different industrial group.

His next advice is absolutely critical. He says to buy three of the strongest stocks you can find, based on recent price increase - those making new highs for the last few months. Do not worry that you may be paying too much for them.

If this last advice worries you, then you still have much to learn. A basic observation that all experienced investors have internalised is that the leaders at the start of a bull market will tend to be the strongest throughout its course. This is often advocated today with the fancy name of relative strength. It comes to the same thing buy the strongest stocks, they tend to stay that way.

Other commentators have suggested that long term investors should complete their buying before the indicator reaches the zero line. That is, before it turns positive. However, Coppock clearly intended that purchase should be immediate upon the indicator turning up.

Another common question is whether the indicator works as well for sectors of the market or for individual stocks. His answer was in the negative - the indicator only works really well for the overall market. This is not to say it will not work for sectors and stocks some of the time, it will, but it is not as reliable.

Nor did he claim that it was a precise timing tool, simply that it signals a period of low risk for taking new positions.

Coppock claimed his indicator was only for entering the market. He used other means to exit, which were not really dealt with in the paper, because he went on to discuss techniques for dealing with the medium term. These have never obtained the popularity and following of the indicator described above and are beyond the scope of our current research paper.

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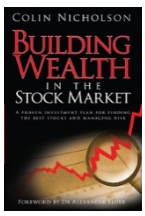

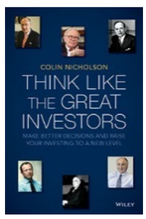

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