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Stocks: Buy, Sell or Run for the Hills?

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These are hard times to be in or stay in the stock market. In just one week alone (September 17 to September 24), the Dow Jones Industrials had four days with price movements either up or down at least 300 points. This was followed on September 29 by the single biggest point decline (though not percentage decline) in stock market history: 778 points.

Wouldn't it be great to know ahead of time what way the market will move next? Unfortunately, we cannot predict when the market will fly and when it will tank.

It's not just hard to time the market, it's impossible, so we strongly advise that you don't attempt it. This simple warning is among the most important rules of investing. It also happens to be among the most important rules broken in investing, because many people think or hope they can do it. Unfortunately, what they usually end up doing is underperforming the market.

Not convinced? Try this simple experiment: Watch one of the financial channels for an hour, and the truth will dawn as you watch one analyst say stocks are rising, while the next predicts a plummet, and a third suggests that first they will rise, then they will fall, but overall the result will be flatline.

If you consider some of the information that flies at investors all the time, it should be no surprise that there is confusion in the market. For example, at the end of August the Labor Department said new applications for unemployment insurance rose by 15,000 from the previous week. However, that followed three consecutive weeks of a decline of more than 10,000 applications per week. Another example: On Monday, September 22, a barrel of oil ranged in price from about $100 to $130 in one day (!)—the largest absolute and percentage daily change ever.

And so it goes: the ongoing push/pull of competing information. The market is so complex, comprising so much information from so many different sources and factoring in countless unknown future events, that no one can possibly know when it is going up or down. So please resist the urge. The experts even admit they don't know how to do it, and they advise you not to do it.

Fortunately, there are some telltale signs. On September 24, legendary investor Warren Buffet invested $5 billion in Goldman Sachs. In addition to the 10 percent dividend on the preferred stock he bought, Buffett will receive warrants to buy another $5 billion worth of common stock. The warrants will be valuable only if the stock goes up, so Buffett is betting on that scenario. Also, Microsoft, Nike and Hewlett-Packard have announced that they will begin to repurchase stock—over $50 billion between these three companies alone! All together, some pretty smart money has stepped up to buy.

At the same time, many people are in a panic. Will the current downturn last another day, another week, another quarter or another year? Who knows? And how much lower can a 401 (k) go before its owner fears his retirement is melting away?

Behavioral finance teaches us that markets will almost always disappoint the majority of investors. Today that majority has run for the hills. They are likely to be disappointed that the market doesn't go down to the levels they expect and even more disappointed when they discover they have missed out on the market's next "up leg."

This brings us back to the question of timing the market. On timing, legendary investor Peter Lynch said, "The real key to making money in stocks is not to get scared out of them." Warren Buffett wrote in his Berkshire Hathaway 2004 Chairman's Letter, "Investors should remember that excitement and expenses are their enemies. And if they insist on trying to time their participation in equities, they should try to be fearful when others are greedy and greedy when others are fearful." And Philip Carret, the investor Warren Buffett admires most, said, "If you buy stocks because of what you hope will happen next week, you are trying to be a market timer. I never knew anyone who could time the market consistently, so why even try?" Benjamin Graham, Warren Buffett's mentor and the grandfather of value investing, said, "There is no basis either in logic or in experience for assuming that any typical or average investor can anticipate market movements more successfully than the general public, of which he himself is a part."

There are scores of analyses that show it's not a good idea to try to time the market. People who try it most often wind up selling low and buying high, and they miss out on the surge. Arguments against timing are simple: the market is extremely volatile and impossible to predict. It's falling-off-a-log easy to miss the best performing days, and, if you do, you will have far worse performance than if you had stayed put the entire time.

When the market moves, it often tends to move in quick bursts, so by the time you wake up to the fact an advance has begun, much of it has passed. Miss that first part and you miss out on the bulk of the gains.

Let's say, for example, that you want to believe you can beat the odds. Even if you think your ability to predict the market's next move is higher than 50/50, the odds are still not in your favor. You must predict the correct time to sell AND also the correct time to buy again, which means you need to make two concurrent predictions of where prices are heading. Your odds at the machines in Las Vegas seem better than that.

As Buffett says, "Be greedy when people are fearful" and if people aren't fearful now, then I don't know what fearful looks like. In 1998, people were greedy when they should have been fearful. It might surprise you to know that since January 1998 the market (as measured by the S&P 500) has gone up less than two percent annually! Remember how enthusiastic everyone was about buying more and more shares of the hottest tech stocks? No one would have believed then that the market would go almost nowhere for a decade. Likewise, no one believes now that the market will can go up from where we are now. I suspect that the crowd is as wrong now as they were then.

Meanwhile, we opened the doors of Fried Asset Management, Inc. in 1998. Since then we have managed client assets in the stock market through the tech wreck, the Asian Contagion, the Russian Rubble crisis, the 2002 recession, September 11, and my favorite, Y2K. Remember when people sold stocks because they thought no one's computer would work when the clock struck midnight on December 31 1999?

Somehow we have managed a return of about 11.5 percent a year since January 1, 1998. The funny thing is that had I known the market would be so bad over the ensuing decade I would have pursued a different line of work. The housing and credit crises are worse than any of the aforementioned situation. However, this too shall pass.

We can all hope that Congress will have passed the Treasury's bailout plan in some form by the time you read this. If not, then the market will have reacted to that by the time you read this as well. In my opinion, that will be the beginning of the end of our current crisis.

If you are invested in the stock market you should think twice before selling when major corporations and investors like Warren Buffett are buying. To boot, we are still the most politically stable country in the world and our markets are about 25 percent off their all-time high. You should think twice more about going with the herd. They are almost always wrong. If you are out of the market, perhaps you should consider going back in now.

Feel free to call us at (310) 459-9196. We will try and put some perspective on all of this and would be glad to help you manage your portfolio for the next decade.

(Palisadian David Fried is the editor and publisher of The Buyback Letter, the only investment newsletter devoted to finding opportunities among companies that repurchase their own stock. His asset management firm—Fried Asset Management, Inc.—offers separate investor advisory and money-management services which use the "Buyback Strategy" principles. He is an active member of the community and serves on the board of directors of LA Family Housing.)