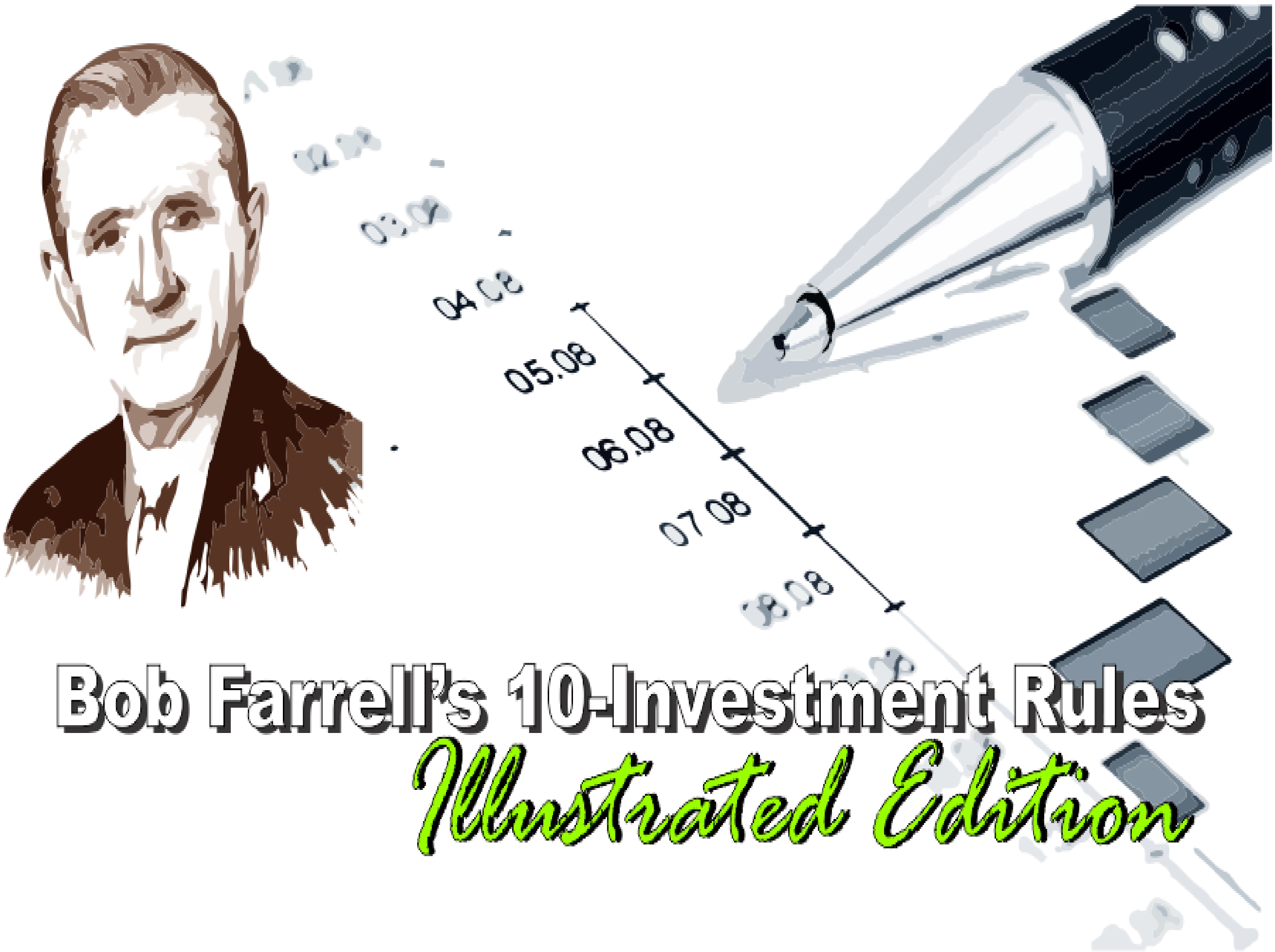
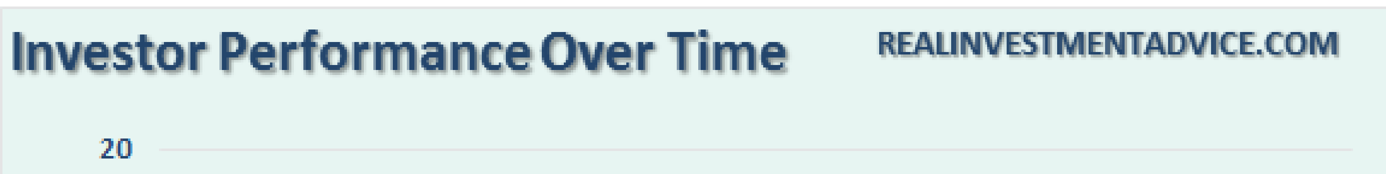


Over the weekend, it was interesting to see the number of advisors/analysts rushing to defend their *"buy and hold"* investing philosophies following the sharp decline on Friday. As I wrote this past weekend:

> ***?The downfall of all investors is ultimately•?greed? and ?fear.?•*** *They don?t sell when markets are near peaks, nor do they buy market bottoms. However, this does not just apply to individuals but many•advisors as well.When I read articles from advisors/managers promoting ?buy and forget? strategies it is for one of three reasons.* ***They either can?t, don?t want to, or don?t know how to manage portfolio risk. Therefore, the easy message is simply:*** *?You just have to ride the market out. Long-term it will go up. But hey, let me charge you a fee for holding your stuff in an account.?•* ***The reality is that markets do not return 6%, 8% or 10% annually, and spending years making up previous losses is not a way to successfully obtain retirement goals.•(Read this)*** *It is also worth pointing out that those promoting these•?couch potato?•methodologies are generally out in full force near peaks of bull market cycles, and are rarely heard of near bear market bottoms.•* ***This is why, as I discussed in 'Why You Still Suck At Investing,'•investors consistently underperform over long periods of time."•***



When markets are at, or near, *"record levels,"* those levels are records for a reason. **Throughout history, awe-inspiring bull markets are followed by devastating bear markets.** Like *"yen and yang,"* a bull cannot exist without its forever intertwined counterpart. Despite the media, advisors, and analysts' rhetoric to the contrary, **investors DO have the ability to manage the inherent risk in their portfolios. Investors can capture returns and grow their *"savings" instead of* blindly hoping that history will not repeat itself.** While I can't tell you exactly when the second half of the full-market cycle will manifest itself, **I can assure you it will, and the negative impact on retirement goals, and the time lost, will be just as damaging.** One other question to ponder. **While Wall Street tells you to *"just hold on and ride the market out,"* why are they managing•risk, spending billions on trading platforms and algorithms, and in many instances•betting against you?**With this in mind, I present **Bob Farrell's 10-Investment Rules.** These rules should be a staple for any investor who has put their hard-earned *"savings"* at risk in the market. However, they are rarely heeded in the heat of the bull market, just as they are being ignored now.

Who is Bob Farrell?

Bob is a Wall Street veteran with over 50 years of experience crafting his investing rules. Farrell obtained his master's degree from Columbia Business School and started as a technical analyst at Merrill Lynch in 1957. **Even though Farrell studied fundamental analysis under Gramm and Dodd, he turned to technical analysis after realizing there was more to stock prices than balance sheets and income statements.** Farrell became a pioneer in sentiment studies and market psychology. His 10 rules on investing stem from personal experience with dull markets, bull markets, bear markets, crashes, and bubbles. **In short, Farrell has seen it all and lived to tell about it.**

The Illustrated 10-Rules Of Investing

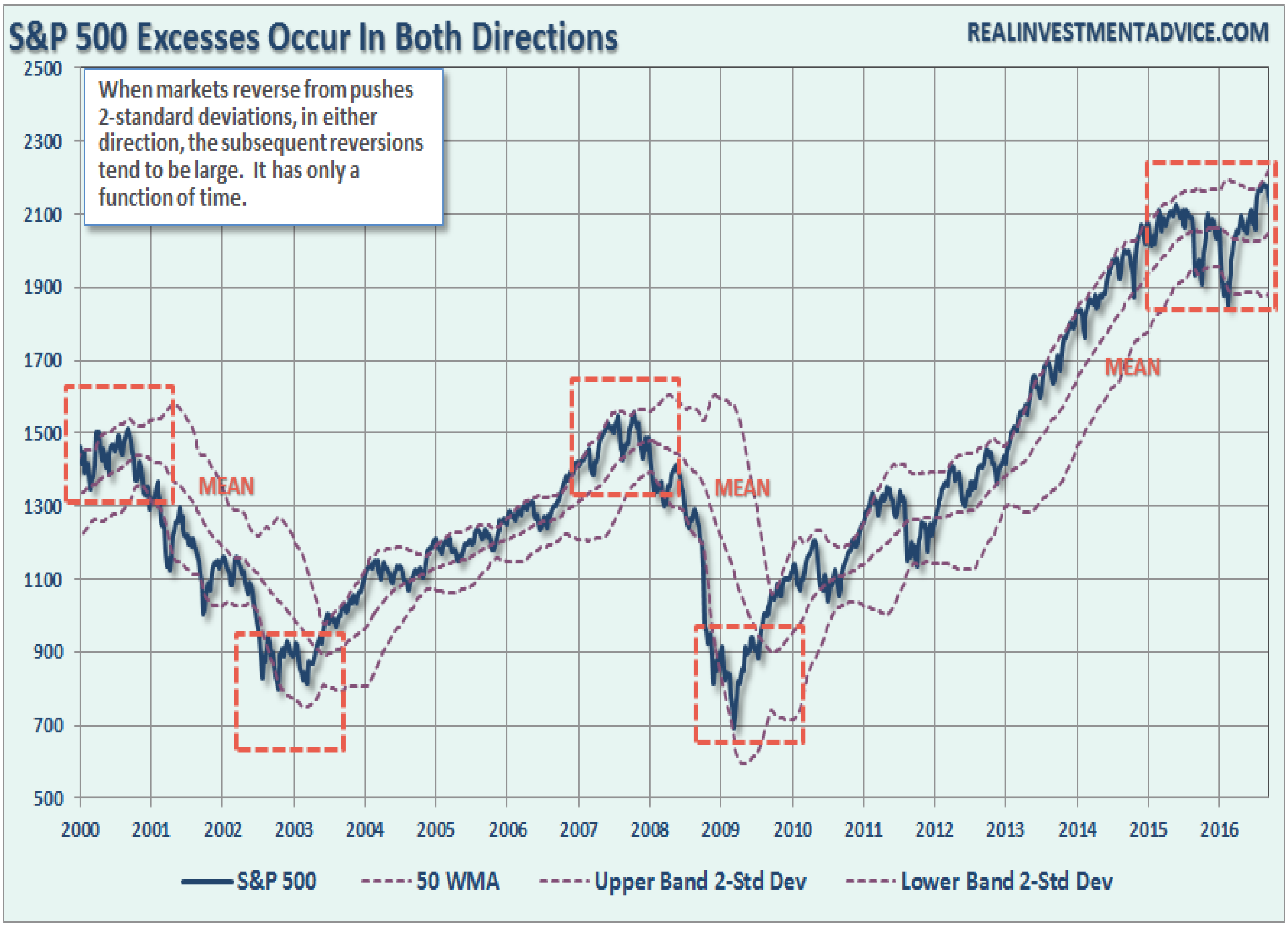
1) Markets tend to return to the mean (average price) over time.

Like a rubber band stretched too far ? it must be relaxed to be stretched again. Such is the same for stock prices which are anchored to their moving averages. Trends that get overextended in one direction, or another, always return to their long-term average. **Even during a strong uptrend or downtrend, prices often return (revert) to a long-term moving average.** The chart below shows the S&P 500 with a 52-week simple moving average.

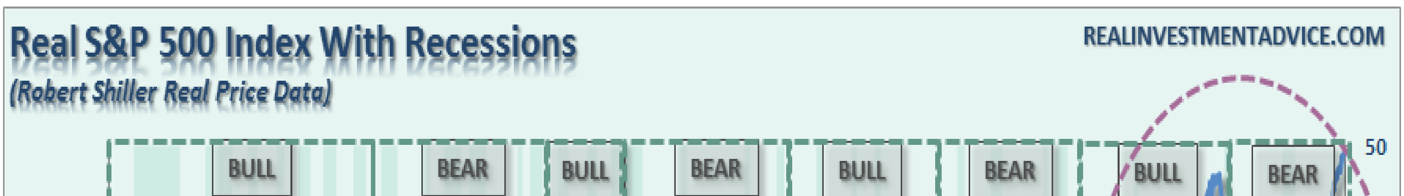
The bottom chart shows the percentage deviation of the market's current price from the 52-week moving average. **During bullish trending markets, there are regular reversions to the mean, which create buying opportunities.** However, what is often not stated is that investors should have taken profits from portfolios as deviations from the mean reached historic extremes. **Conversely, in bearish trending markets, such reversions from extreme deviations should be used to sell stocks, raise cash and reduce portfolio risk rather than *"panic sell"* at market bottoms.** The dashed RED lines denote when the markets changed trends from positive to negative. Such is the very essence of portfolio "risk" management.

2) Excesses in one direction will lead to an opposite excess in the other direction.

Markets that overshoot on the upside will also overshoot on the downside, like a pendulum. The further it swings to one side, the further it rebounds to the other side. **Such is the extension of Rule #1 as it applies to longer-term market cycles *(cyclical markets)*.** While the chart above shows prices behave on a short-term basis - on a longer-term basis markets also respond to Newton's 3rd law of motion: ***"For every action, there is an equal and opposite reaction."*** The first chart shows that cyclical markets reach extremes when they are more than 2 standard deviations above or below the 50-week moving average. Notice that these excesses **ARE NEVER** •worked off by just going sideways.



The second chart shows the price reversions of the S&P 500 on a long-term basis and adjusted for inflation. Notice that when prices have historically reached extremes ? the reversion in price is just as extreme. It is clear that the current reversion in the stock market is still underway from the 2000 peak.



3) There are no new eras ? excesses are never permanent.

There will always be some *"new thing"* that elicits speculative interest. These *"new things"* •throughout history, like the *"Siren's Song,"* has led many investors to their demise. In fact, over the last 500 years, we have seen speculative bubbles involving everything from Tulip Bulbs to Railways, Real Estate to Technology, Emerging Markets (5 times) to Automobiles and Commodities. **It always starts the same and ends with the utterings of *"This time it is different."***

> *[The chart below is from my March 2008 seminar discussing that the next recessionary bear market was about to occur.]*

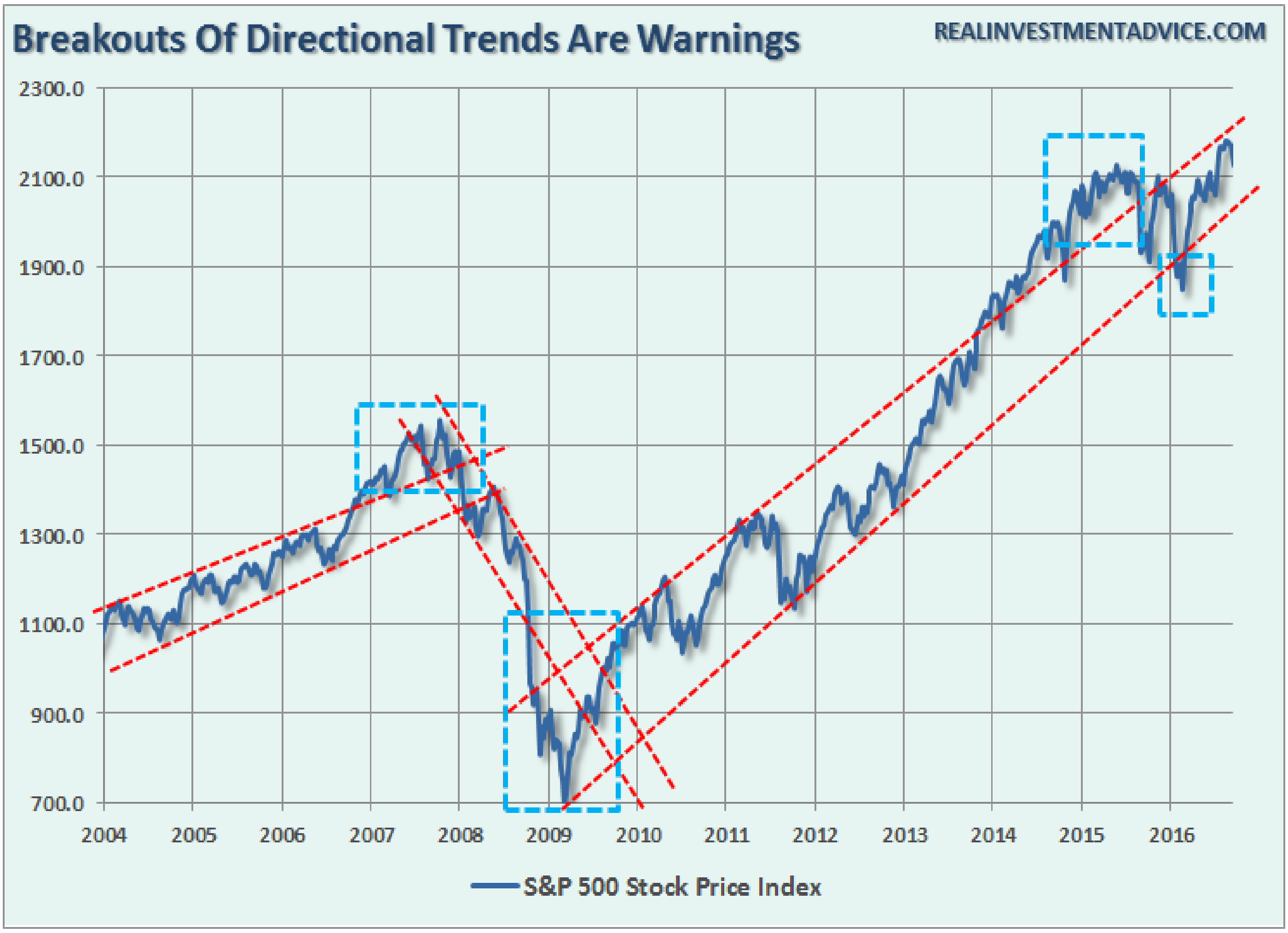
As legendary investor Jesse Livermore once stated:

> *"A lesson I learned early is that there is nothing new on Wall Street. There can't be because speculation is as old as the hills. Whatever happens in the stock market today has happened before and will happen again."*

4) Exponential rapidly rising or falling markets usually go further than you think, but they do not correct by going sideways

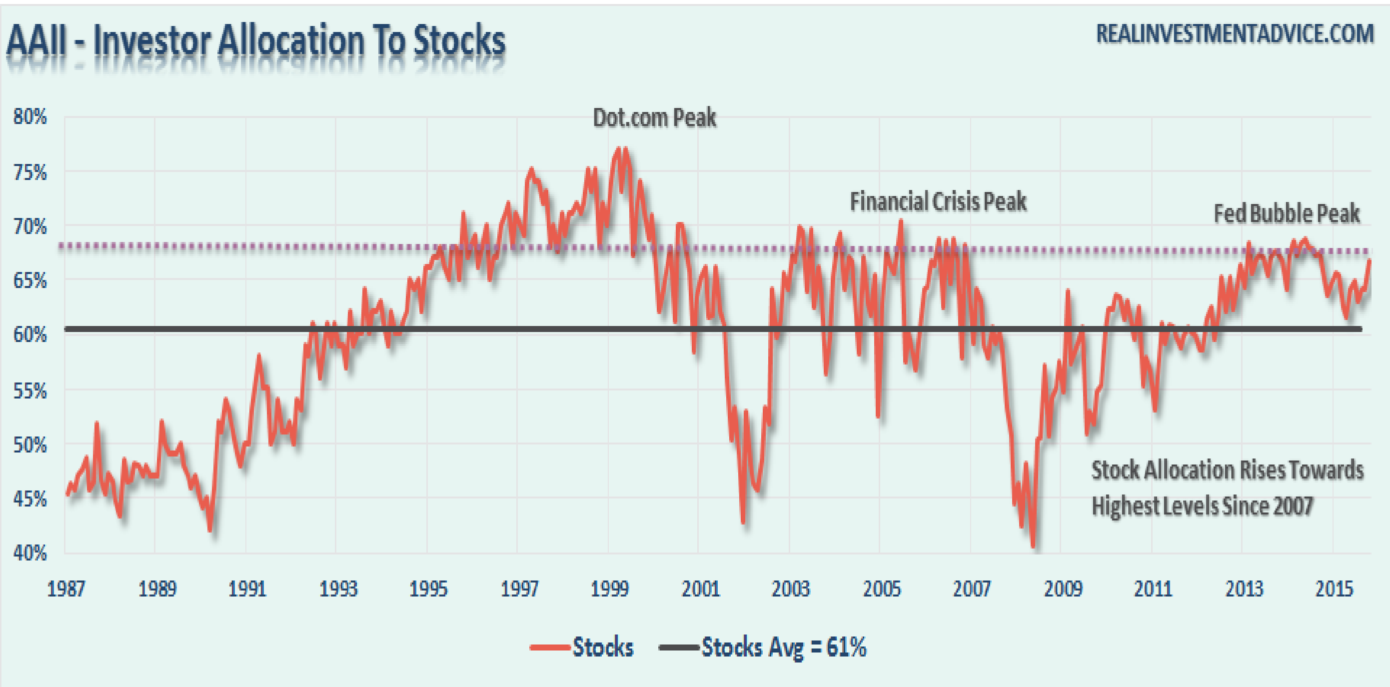
The reality is that excesses, such as what we are seeing in the market now, can go much further than logic dictates. However, as stated above, these excesses are never worked off simply by trading sideways. **Corrections are always just as brutal as the advances were exhilarating.**

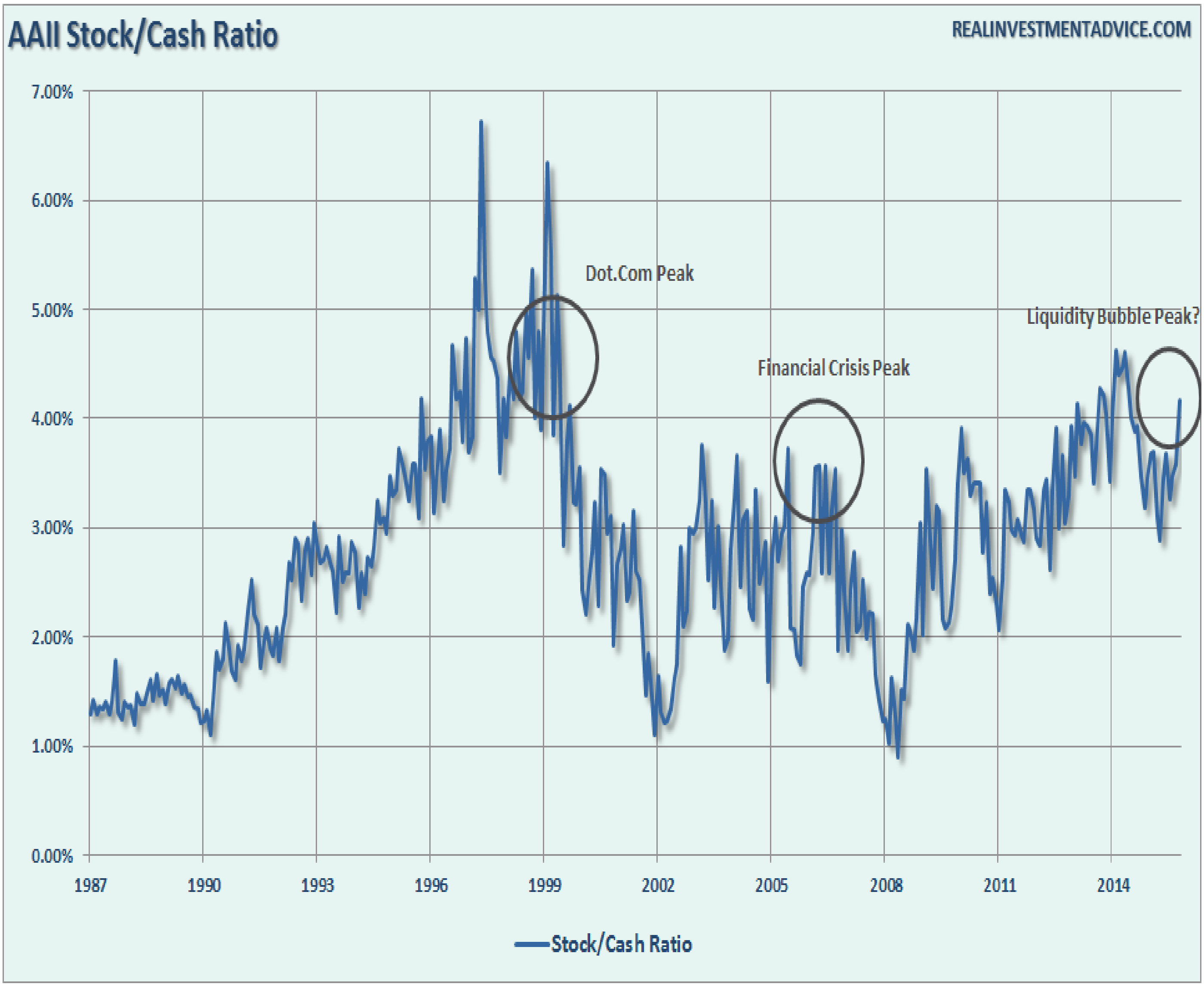
The chart below shows when the markets broke out of their directional trends ? the corrections came soon after that.



5) The public buys the most at the top and the least at the bottom.

The average individual investor is bullish at market tops and bearish at market bottoms. **Such is due to investors' emotional biases of *"greed"* when markets are rising and *"fear"* when markets fall.** Logic would dictate that the best time to invest is after a massive sell-off; unfortunately, this is the opposite of what investors do.



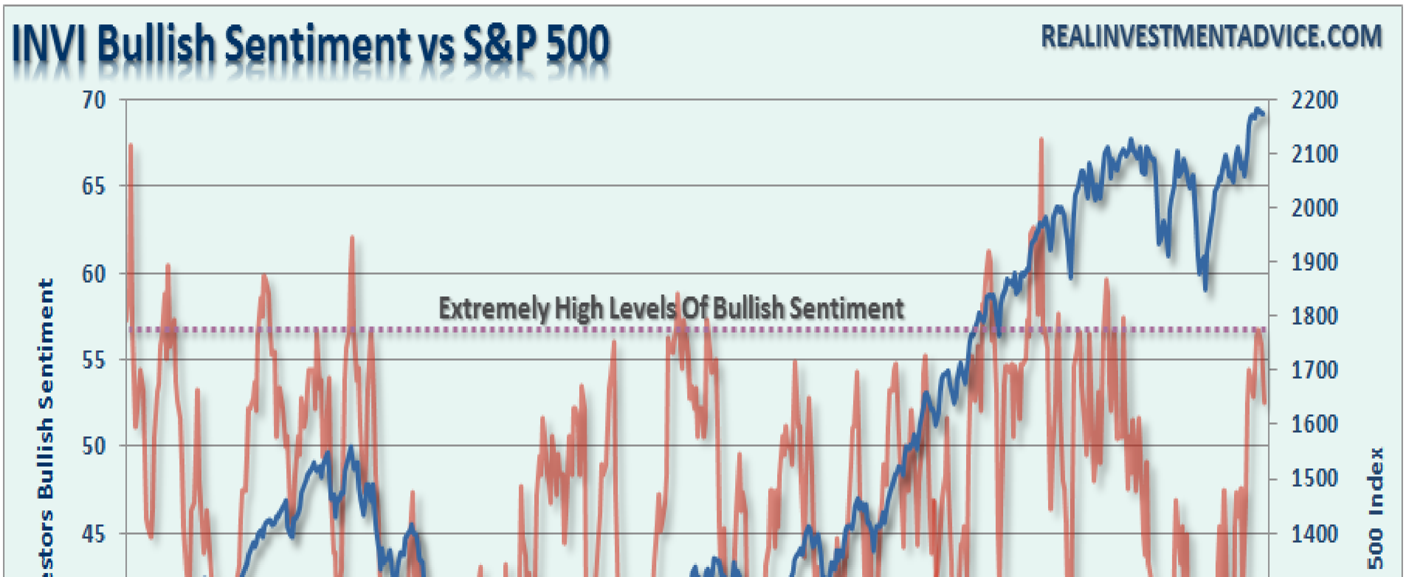


6) Fear and greed are stronger than long-term resolve.

As stated in Rule #5, emotions cloud your decisions and affect your long-term plan.

> ***"Gains make us exuberant; they enhance well-being and promote optimism,"*** *says Santa Clara University finance professor Meir Statman.• His studies of investor behavior show that* ***"Losses bring sadness, disgust, fear, regret. Fear increases the sense of risk and some react by shunning stocks."***

The bullish sentiment index shows that *"greed"* is again beginning to reach levels where markets have generally reached intermediate-term peaks.



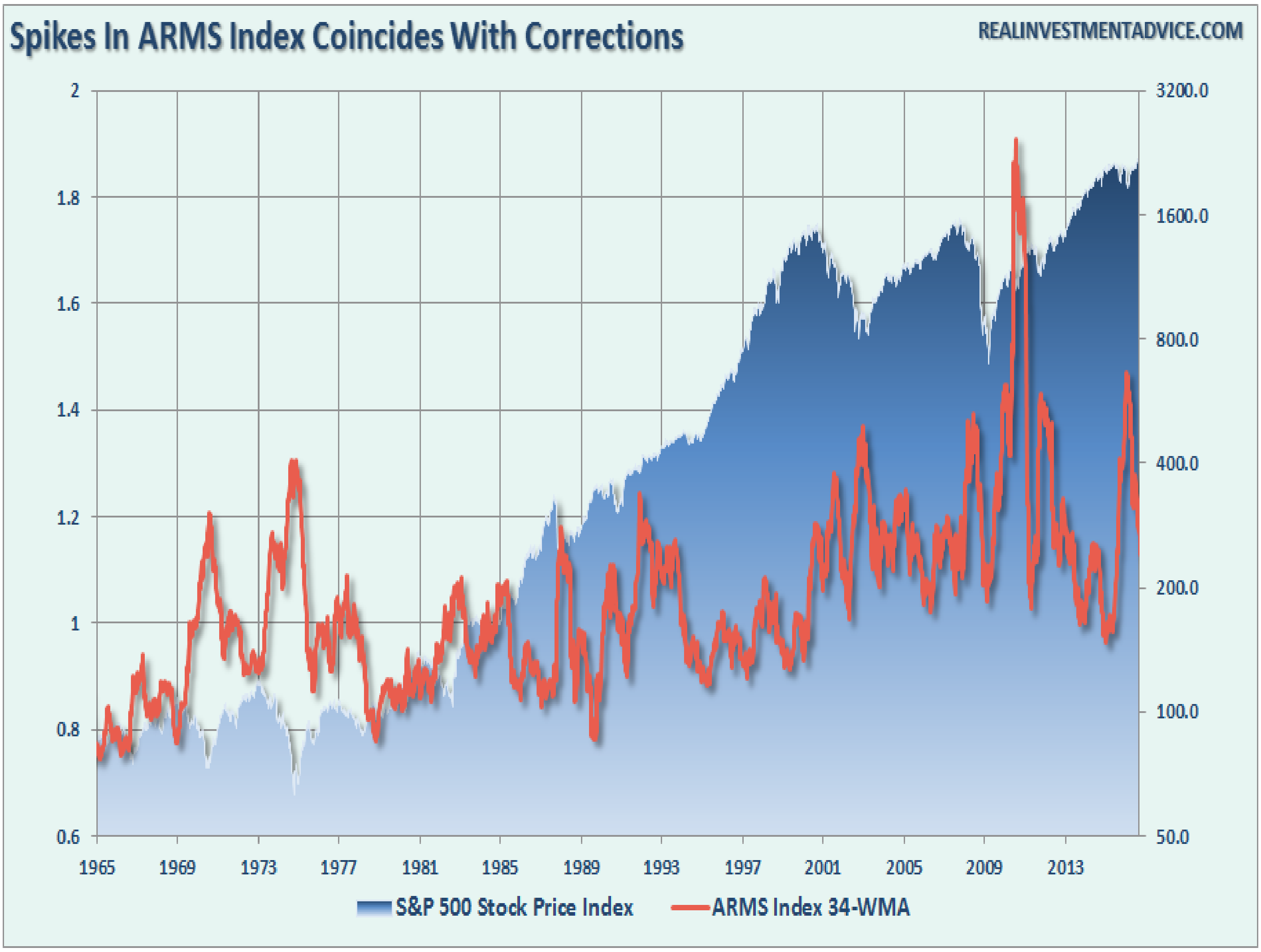
In the words of Warren Buffett:

> *"Buy when people are fearful and sell when they are greedy."*

Currently, those *"people"* are getting extremely greedy.

7) Markets are strongest when they are broad and weakest when they narrow to a handful of blue-chip names.

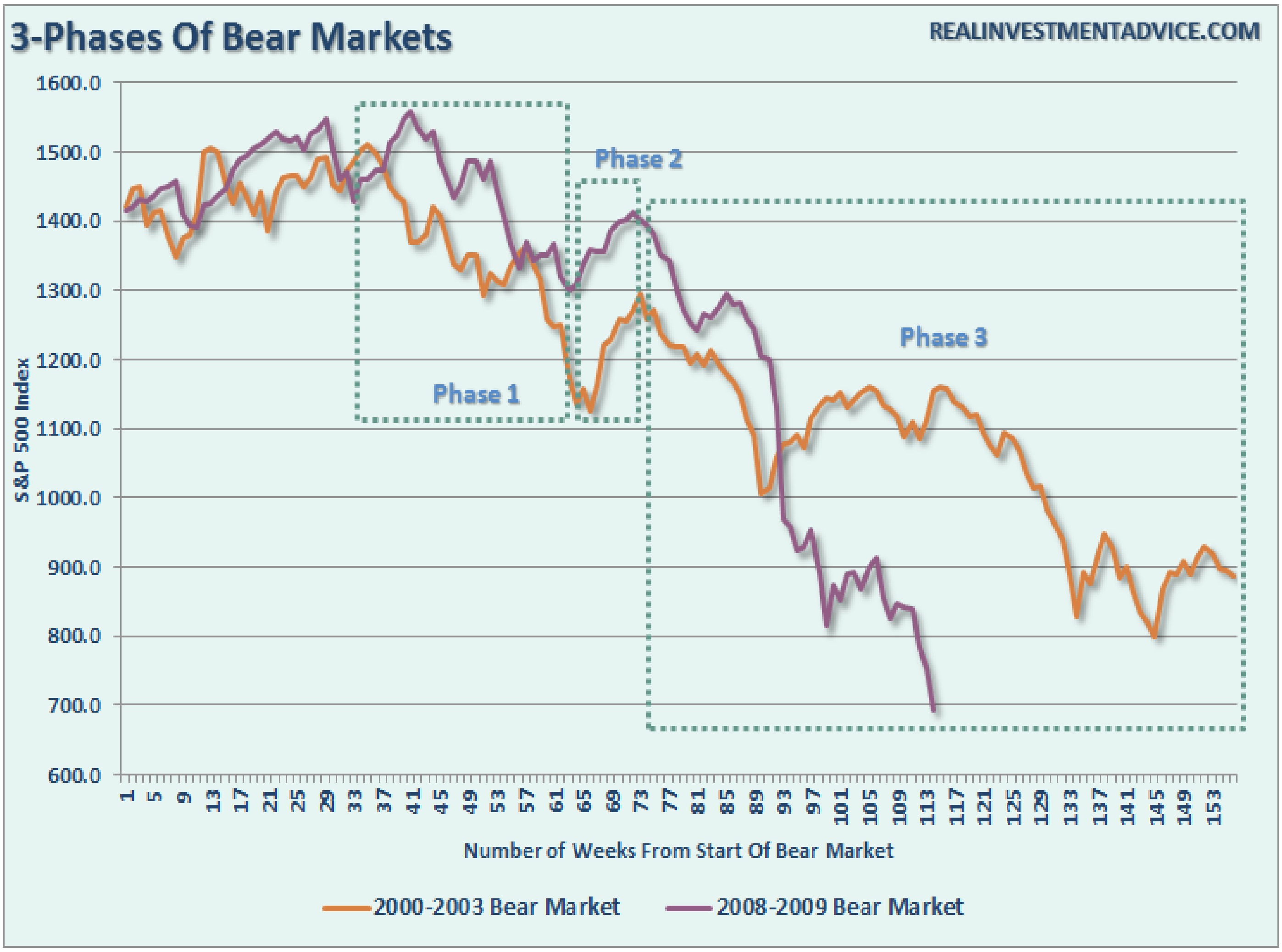
Breadth is important. A rally on narrow breadth indicates limited participation and the chances of failure are above average. The market cannot continue to rally with just a few large-caps *(generals)* leading the way. Small and mid-caps *(troops)* must also be on board to give the rally credibility. A rally that *"lifts all boats"*•indicates far-reaching strength and increases the chances of further gains.



The chart above shows the ARMS Index, which is a volume-based indicator that determines market strength and breadth by analyzing the relationship between advancing and declining issues and their respective volume. It is usually used as a short-term trading measure of market strength. However, the chart shows a weekly index smoothed with a 34-week average for extended periods. Spikes in the index have generally coincided with near-term market peaks.

8) Bear markets have three stages ? sharp down, reflexive rebound, and a drawn-out fundamental downtrend

Bear markets often start with a sharp and swift decline. After this decline, an oversold bounce retraces a portion of that decline. The longer-term decline then continues, at a slower and more grinding pace, as the fundamentals deteriorate. Dow Theory suggests that bear markets consist of three down legs with reflexive rebounds.



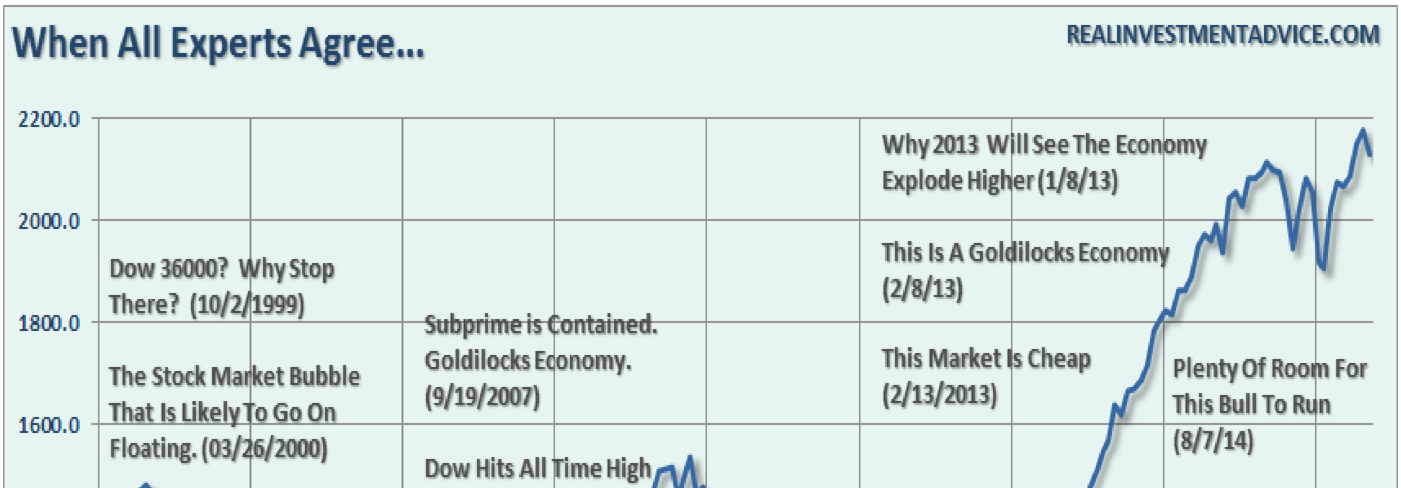
The chart above shows the stages of the last two primary cyclical bear markets. **The point to be made is there were plenty of opportunities to sell into counter-trend rallies during the decline and reduce risk exposure.** Unfortunately, the media/Wall Street told investors to *"hold on"* until they finally sold out at the bottom.

9) When all the experts and forecasts agree, something else will happen.

This rule fits within Bob Farrell's contrarian nature. As Sam Stovall, the investment strategist for Standard & Poor's, once stated:

> *"If everybody's optimistic, who is left to buy? If everybody's pessimistic, who's left to sell?"*

As a contrarian investor, along with several of the points already made within Farrell's rule set, excesses are built by everyone on the same side of the trade. Ultimately, when the shift in sentiment occurs ? the reversion is exacerbated by the stampede going in the opposite direction.

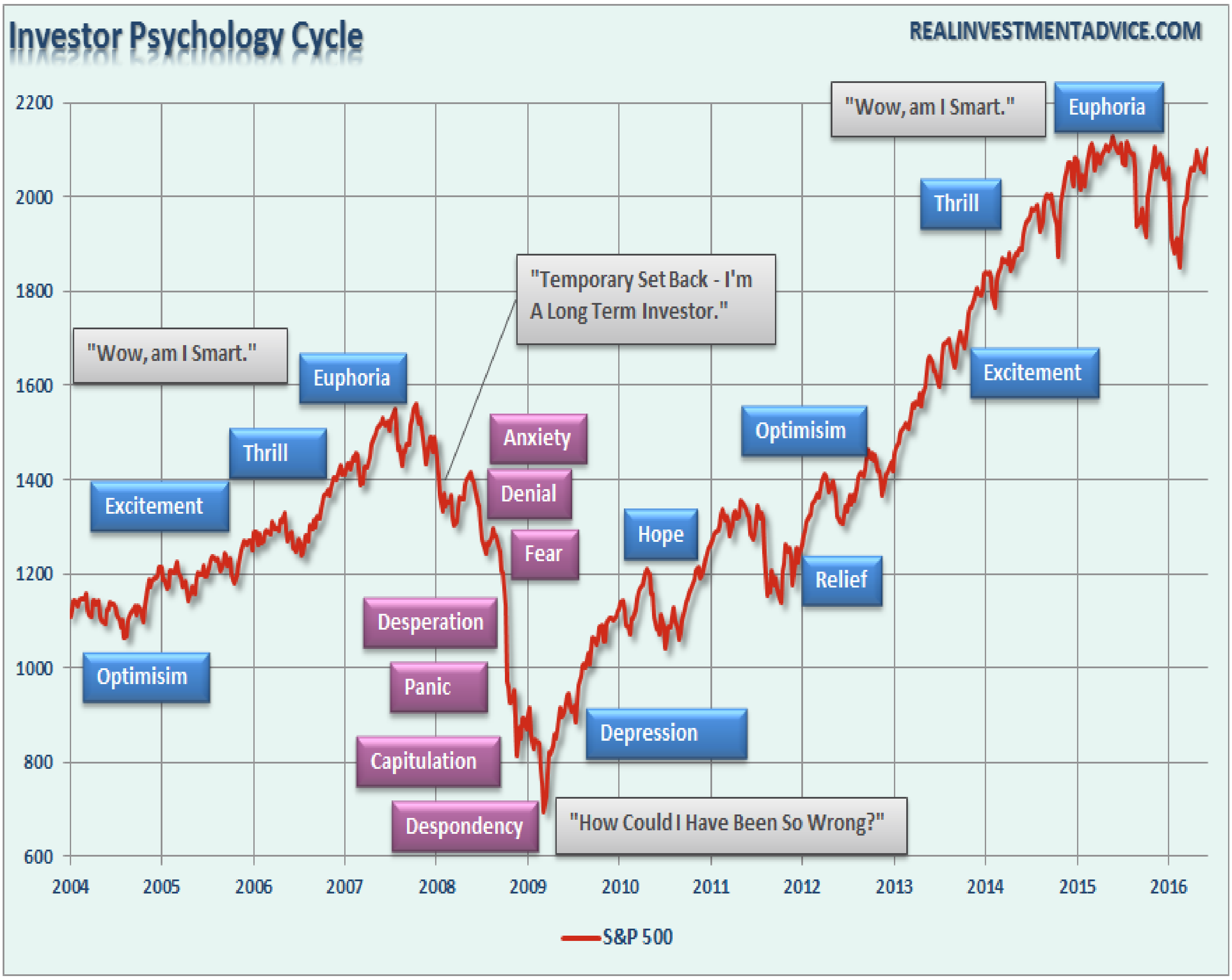


Being a contrarian can be quite difficult at times as bullishness abounds. However, it is also the secret to limiting losses and achieving long-term investment success. As Howard Marks once stated:

> *"Resisting ? and thereby achieving success as a contrarian ? isn't easy. Things combine to make it difficult;* ***including natural herd tendencies and the pain imposed by being out of step, since momentum invariably makes pro-cyclical actions look correct for a while.*** *(That's why it's essential to remember that 'being too far ahead of your time is indistinguishable from being wrong.') Given the uncertain nature of the future, and thus the difficulty of being confident your position is the right one ? especially as price moves against you ? it's challenging to be a lonely contrarian."*

10) Bull markets are more fun than bear markets

As stated above in Rule #5 ? investors are primarily driven by emotions. As the overall markets rise, up to 90% of any individual stock's price movement is dictated by the market's general direction. Such is the derivation of the saying, *"a rising tide lifts all boats."* **Psychologically, as the markets rise, investors begin to believe they are *"smart"* because their portfolio is going up.•** In reality, it is primarily a function of "luck" rather than "intelligence" driving their portfolio. Investors behave much the same way as individuals who are addicted to gambling. When they are winning, they believe their success is based on their skill. **However, when they begin to lose, they keep gambling, thinking the next *"hand"* will be the one that gets them back on track. Eventually - they leave the table broke.**



Bull markets are indeed more fun than bear markets. They elicit euphoria and feelings of psychological superiority. However, bear markets bring fear, panic, and depression. **What is interesting is that no matter how many times we continually repeat these•*"cycles"* ? as emotional human beings, we constantly *"hope"*•that somehow this•*"time will be different."*•** Unfortunately, it never is, and this time won't be either. The only questions are: when will the next bear market begin, and will you be prepared for it?

Conclusions

Like all rules on Wall Street, Bob Farrell's rules are not meant to have hard and fast rules. There are always exceptions to every rule, and while history never repeats precisely, it often *"rhymes"* very closely. Nevertheless, these rules will benefit investors by helping them to look beyond the emotions and the headlines. Awareness of sentiment can prevent selling near the bottom and buying near the top, which often goes against our instincts. Regardless of how often I discuss these issues, quote successful investors, or warn of the dangers ? the response from both individuals and investment professionals is always the same.

> *•?I am a long term, fundamental value, investor.• So these rules don?t really apply to me.?*

No, you're not. Yes, they do. Individuals are long-term investors only as long as the markets are rising. **Despite endless warnings, repeated suggestions, and outright recommendations, getting investors to sell, take profits, and manage your portfolio risks is nearly a lost cause as long as the markets are rising.** Unfortunately, when the fear, desperation, or panic stages are reached, it is far too late to act, and I will only be able to say I warned you.