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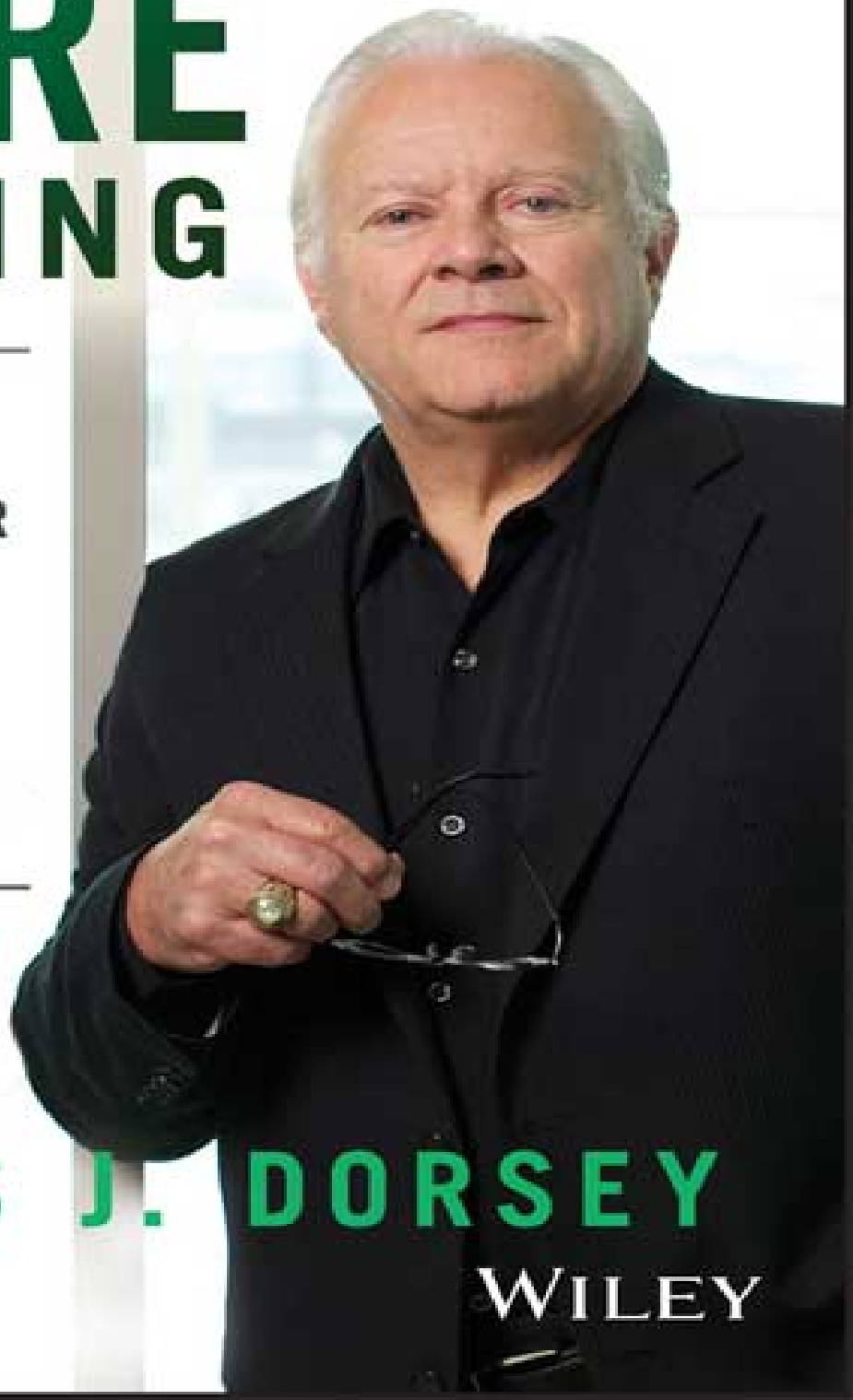
POINT & FIGURE CHARTING

THE ESSENTIAL
APPLICATION FOR
FORECASTING
AND TRACKING
MARKET PRICES

FOURTH EDITION

THOMAS J. DORSEY

WILEY



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POINT AND FIGURE CHARTING

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**POINT AND
FIGURE
CHARTING**

The Essential Application for
Forecasting and Tracking
Market Prices

FOURTH EDITION

Thomas J. Dorsey

WILEY

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ACKNOWLEDGMENTS

It's been 17 years since the first edition of *Point and Figure Charting* was printed and 26 years since Watson Wright and I walked down Main Street in Richmond, Virginia, to our new quarters to launch Dorsey, Wright & Associates (DWA). Watson and I were together for the better part of 32 years in total, almost as long as I have been married to my wife, Cindy. Watson and I found a way to make $1 + 1 = 3$. Our partnership worked well for 25 years. In 2011 Watson decided a 32-year career on Wall Street was enough and he retired. Bravo to you, Watson. May your golf handicap approach zero!

The first edition of *Point and Figure Charting* was a labor of love. I knew it had to be written if for no other reason than to express my gratitude for having been shown my manifest destiny to help others become great at investing, and giving me a vision to develop DWA with Watson. The second I learned this method of investment management I knew I had to pass the word to any and all investors who are searching for a more secure financial future. The success of the first edition and the consistency of sales told me this was the right method for the majority of investors. When John Wiley asked me to write the second and third editions I knew we would be here for the long haul. We have developed many new concepts for Point and Figure analysis over the years similar to the spokes extending from the hub of a bicycle wheel. My two top analysts, Tammy DeRosier and Susan Morrison, joined in with me in writing the second and third editions and I roped them into proofing a few chapters of this book. Tammy and Susan have been with DWA since the beginning and are like family to me. They have accumulated 25 years each in experience in this method of investment analysis. Tammy is now my COO and Susan is head of Research, two very important jobs. In my opinion, they are the best on the planet when it comes to our little slice of Wall Street. The third-longest employee here, and also like family to me, is Jay Ball, who heads up all of our technology. This is a massive job as we have the largest portfolio charting system on the Internet today. Our DWA Database, which I like to call the Dorsey, Wright Productivity System, has expanded and evolved over the years to reflect our cutting

edge research. Jay has been the key architect in the web site's design and development, and has done a yeoman's task, sacrificing many nights and weekends to be sure this system keeps running to service our clients' needs. Over the years we have had a great group of analysts join us; Steve Raymond, Paul Keeton, Jay Gragnani, Chuck Fuller, Ben Jones, Amy Kemp, Sydney Seik, and a group of interns that are second to none. James Fisher, the newest addition to our team, does a fantastic job as our VP of Finance. Without Nancy, our office manager, the office does not function.

In 1994, we formed Dorsey, Wright Money Management in Pasadena, California, under the guidance of Mike Moody and Harold Parker. Andy Hyer and J. P. Lee do a great job in marketing and client services for this division; and our portfolio managers (John Lewis, along with Mike and Harold) have developed excellent asset management products and services, such as our fantastic Technical Leaders line-up of ETFs. At this writing we have approximately \$2 billion in assets under management—and in my mind, the sky's the limit!

One of our newest, oldest employees is Sara Giegerich. She is one incredible lady. She first became an intern at DWA during her high school career. She graduated and went on to the University of Virginia, still working at DWA on all holidays and summers. When she graduated from UVA she went to the University of Georgia School of Law and continued to work here all holidays and summers. It was amazing to me to watch her develop not only as an analyst, but also an all-around person who knows everything about the workings of DWA. This was the perfect training ground for her new position as our corporate attorney. She is not unlike all analysts at DWA who have worked here through college, but Sara has the most accumulated time at the job working in many different positions. I look over at her each day and all I can do is smile. Sara was my driving force in writing this fourth edition. Her organizational and English skills pushed me forward to the end. She has proofed every chapter not only as a project manager, but as an analyst who understands every facet of this book. Having been around me all these years, she knew exactly how to use the “cattle prod” to keep me moving. It is difficult to work full time and devote your spare time to a book like this. Both she and I have spent many weekends immersed in the construction of this fourth edition. Thanks so much, Sara, for your dedication to DWA and your dedication in helping make this edition a success.

As with everything we do at Dorsey, Wright, this book is a family affair. I hope you enjoy the book; our heart is in it.



PART I

**LEARN THE POINT
AND FIGURE
METHODOLOGY**

Introduction

■ Point and Figure Charting: A Lost Art

I would never have thought we would be embarking on the fourth edition of this book when I wrote the first edition. I know now that this will not be the last edition either. Technology has significantly changed the way we approach technical analysis and the way we implement the art of portfolio management. The Internet has provided a delivery system we could not have imagined when I was a stockbroker at Merrill, Lynch, Pierce, Fenner & Smith in the 1970s. What I mean by that statement is that computers can now do most of the work for you. We have taught the computer to do exactly what we used to do by hand 25 years ago. The operative word there is *taught*. The computer can only do what we tell it to do. Somewhere in the future it might do its own thinking, but at this writing, it has to be told. Think about medical technology for a second. I have a friend who is going to be operated on next week by a robot. To me this is *The Jetsons* revisited. *The Jetsons* was an animated sitcom that debuted in 1962. It was about a Space Age family living in the future (the exact opposite of the animated sitcom *The Flintstones*, which was a family living in the Stone Age). Much of what was depicted in that weekly show has come to pass. Think of how automobiles can now parallel park by themselves. Robots can perform operations on humans but only under the eye of a trained surgeon. We have gotten to the point where a surgeon-guided computer can actually perform the operation with more skill than an unassisted human, just like computers can outplay world-class chess players as “Big Blue” did against Gary Kasparov and later the computer “Watson” outplayed the best contestants on the TV game show *Jeopardy*. The computer does exactly what it is told with no emotion and no mental or physical fatigue (if you don't think mental and physical fatigue come into play with

regard to portfolio management, think again). Google has transformed how we deal with ordinary medical conditions that used to require us to see a doctor for advice. Today, most people simply “Google” the symptoms and thousands of informational pages instantly appear. It still amazes me. Naturally, if the online remedy didn't work, you would go to your doctor, but only after you searched the Internet for a solution. Investing is the same today. On our system you could search for, say, a list of high-dividend stocks in the Oil Service and Utility sectors. Then you could simply click a button and the DWA Matrix system would perform an extensive “relative strength arm-wrestling contest” among all the stocks, and then order the list from best relative strength to worst relative strength in the group. It would only take a matter of minutes to perform these tasks. Then an investor could click a button to buy at the market the top 5 or 10 on the list. After that, a program could be set to sell any stock that dropped to a certain level on that relative strength list and replace it with a purchase of the next strongest stock. Think I'm kidding? The technology is already here at Dorsey, Wright & Associates (DWA). It is amazing to me that we have this capability relative to where we were only 10 years ago. In a matter of minutes you could create a good income-producing portfolio ready for investing. But without reading this book carefully, you would not understand the underlying concepts used in this computer search. This book is the first rung of the ladder on your climb to becoming a world-class investor. Questions you will learn to answer before you take full control of your investments include:

- Which asset classes are in favor?
- Did you search the right sector?
- Is the market in a mode to support higher prices?
- What countries are the best places to invest?
- What mix of bonds and stocks should you have in your portfolio?
- Should you use stocks, exchange-traded funds, or mutual funds to populate your portfolio?

There are many questions that need to be answered to stack all the odds in your favor, but once they are answered, let technology do the driving. You see, you are still an integral part of the equation. This goes for professionals and individual investors alike. There are two kinds of investors—those who want to use the quarter-inch drill and those who simply want the quarter-inch hole. Harvard marketing professor Theodore Levitt illustrated this difference with this straightforward analogy: “People don't want to buy a quarter-inch drill. They want a

quarter-inch hole!” You know what? I so believe in the quarter-inch hole concept that I had my niece Meghan Hartsoe, who is an artist, paint me a black hole on a canvas—nothing else but a creatively drawn hole. I want Dorsey, Wright Analysts to always keep this concept in their minds as we write research and develop new products to serve the investment advisory business.

Over the years, we have all experienced many medical difficulties and have learned from them. When we have a cold, we automatically know what over-the-counter medication to take for it. If we have a scratch that becomes infected, we know exactly what to do for it. We have many years of hands-on knowledge about simple health problems we all encounter on a daily basis. In the investing world, you don't have these basic life skills we acquire just by being alive. You have to learn them. What were the telltale signs that 2008 was going to be a terrible year for investor portfolios? How did anyone know that the banking sector was in deep trouble and the stocks underlying it were about to fall? You certainly didn't learn it from the financial newsprint or financial TV. If investors could learn anything from reading or watching these forms of media designed to give investors a heads-up, there would not have been 13 trillion dollars of American household net worth lost in the meltdown. These are the things you will learn in this book that will eventually become intuitive to you. When you have a working knowledge of the material in this book, you will then be ready to let the computer do the work. Just like doctors let robots do the work today and airline pilots allow planes to land with no human assistance, you, too, will be ready to let technology do the work and have it delivered to you on your mobile device. One of the largest deterrents to successful investing is encapsulated in one word: *emotion*. Computers don't have emotion; they only do what they are told to do. They don't watch CNBC or read the *Wall Street Journal*.

In learning this method it is always best to maintain some charts by hand. Nothing will give you a better feel for it. Even though the computer is updating the same chart automatically, when you put that one extra “O” in the chart as you update it by hand, and that “O” completes a certain pattern you know has statistical significance, it's an “aha” moment you won't forget. So, yes, it is important to learn the craft before you allow the computer to take over. Take the time to read this book carefully, underline, take notes, take it page by page, and in the end you will be well rewarded. Remember, “life's a cinch by the inch; life is hard by the yard.” I live by this saying, and it's how I will complete this book. At the end of the financial

accumulation road, the goal is to have more money than when you started on that road. This is financial planning. I have often said the best financial plan is a stock that goes up. Over the years, we have been able to develop new and interesting ways of implementing Point and Figure analysis. But you know what? Nothing has changed in the basic principles of this method in 140 years. Here's why. The irrefutable law of supply and demand has not changed since first introduced in the caveman days. If you understand and embrace the concept of supply and demand, you are at the right place.

When we first started DWA, we used a Tandy 3000 computer that was considered to be state of the art. We did not have enough money to buy it outright, so we leased it. When it was all totaled, that computer cost \$3,000 in rent. That was probably twice the cost of buying it. My guess is today this computer would be in the Smithsonian Institute if it were still around. It performed only a small fraction of the tasks computers perform today. I'm writing this on a computer that cost \$400 and has more computer power than the astronauts had when they reached the moon. Twenty years ago, there was no such thing as an online charting system. It was around 1994 when we went live with our Internet-based portfolio management and charting system. We updated 2,500 stock charts by hand for close to a decade. Our relative strength charts were updated by hand once a week. It was a rite of passage for each intern to maintain the relative strength charts each week. Distribution of our research each day was done by fax machine. The machine we used to fax out our 20-page report each day cost \$1,800. This fax machine was state-of-the-art technology, and we borrowed it from friends. Since we had no money, only debt in the beginning, we had to go downstairs to another company that magnanimously loaned us the use of their fax. Each day we faxed out our report by hand, page by page. This machine could fax to only one phone number at a time. This was in 1987. I think we paid seven cents a page to use this fax. I can't quite remember the cost. When you start a business with nothing, you do whatever it takes to make it work. By 1994, we were on the Internet; however, our clients were not up on that technology curve yet and still wanted our reports by fax. This is a great example of the "technology gap." Those who wanted to take down stock charts did so through the outdated DOS (disk operating system) system. Today, in 2013, it feels like we are working with *Star Wars* technology. I am continually amazed by what we can teach the computer to accomplish. I am continually amazed because I am among the few today who can remember the first computer programs written for public use

back in the 1960s. People today grow up with technology I did not. Maybe this is why I feel like I'm living in a fantasy world. Today, the iPad 4 was released. Amazing! Remember when you used eight-track tapes in your car to listen to music? Heck, I remember a friend in high school who had a 45 rpm (revolutions per minute) record player in his car, attached to springs to keep it stable. We use to bring stacks of 45 records to play as we drove around in his little Spitfire sports car in Germany where I went to high school. This was technology at its best. How could it get any better than that? Most of you reading this are far too young to remember the in-car record players, but you do remember the CD. People use CDs today, but they are yesterday's technology. What most of you use is iTunes. iTunes allows you to download music from the Internet. I'm not telling you anything new here. I'll bet most of the cars you drive still have the CD sound system. More than likely you kept using the CD for a while before you adapted to music download on the Internet. Most of us will hold on to the old way of doing things until we are forced to switch. It's more comfortable to stick with the old because we're familiar with it. This is the technology gap I keep talking about. I want to keep that concept firmly in your mind because this book will teach you some things that are disruptive to your way of looking at the stock market. We all have preconceived ideas on how the market is supposed to work. Get ready for a ride that will take you "back to the future." Rest assured, technology never sleeps. It keeps advancing, and you too must keep advancing to stay up with it. Examples of the technology gap are everywhere. I remember one of the largest brokerage firms on Wall Street saying the Internet was a "flash in the pan," and they were not putting any significant resources into it. Incidentally, this firm went bankrupt and had to be bought by a major bank in 2009. We knew from the start how important this new technology would be and put all our resources into it. With this new technology, we were able to deliver our product to a much larger population of investors. The Internet did not change what we were already doing—it just facilitated the delivery of it. It was the massive leaps and bounds in computer technology in general that allowed us to push past the boundaries of Point and Figure analysis as it had been known for 100 years prior. We were able to create new and important indicators that stemmed from the basic Point and Figure analysis simply because of the speed of calculations. Productivity is about doing more with less. As computers became more efficient and faster, the Internet allowed us to deliver our product almost instantaneously to anyone, anywhere in the world. Take, for instance, the speed of calculations today. This speed allows us to compare and contrast on a relative strength basis millions of charts overnight. Think

about this for a second. It took us a week to update 200 relative strength charts 25 years ago. Until April 2012, we had the capability of updating millions of charts overnight. Today, we can do the same number in 10 minutes using “cloud technology.” We now, almost instantaneously, follow the world. To Dorsey, Wright, the world is open for business. We continue to push the envelope with technology, and every few years we have new and innovative things we have created to help investors and professionals become more successful at the investment process while at the same time we give them their life back. Much of what professional advisers used to do can be done by computer today. This is why I am sure that at some point in the future there will be a need for *Point and Figure Charting*, Fifth Edition. For now, we have more than enough new things to discuss in the fourth edition.

■ **Beginning with the Basics**

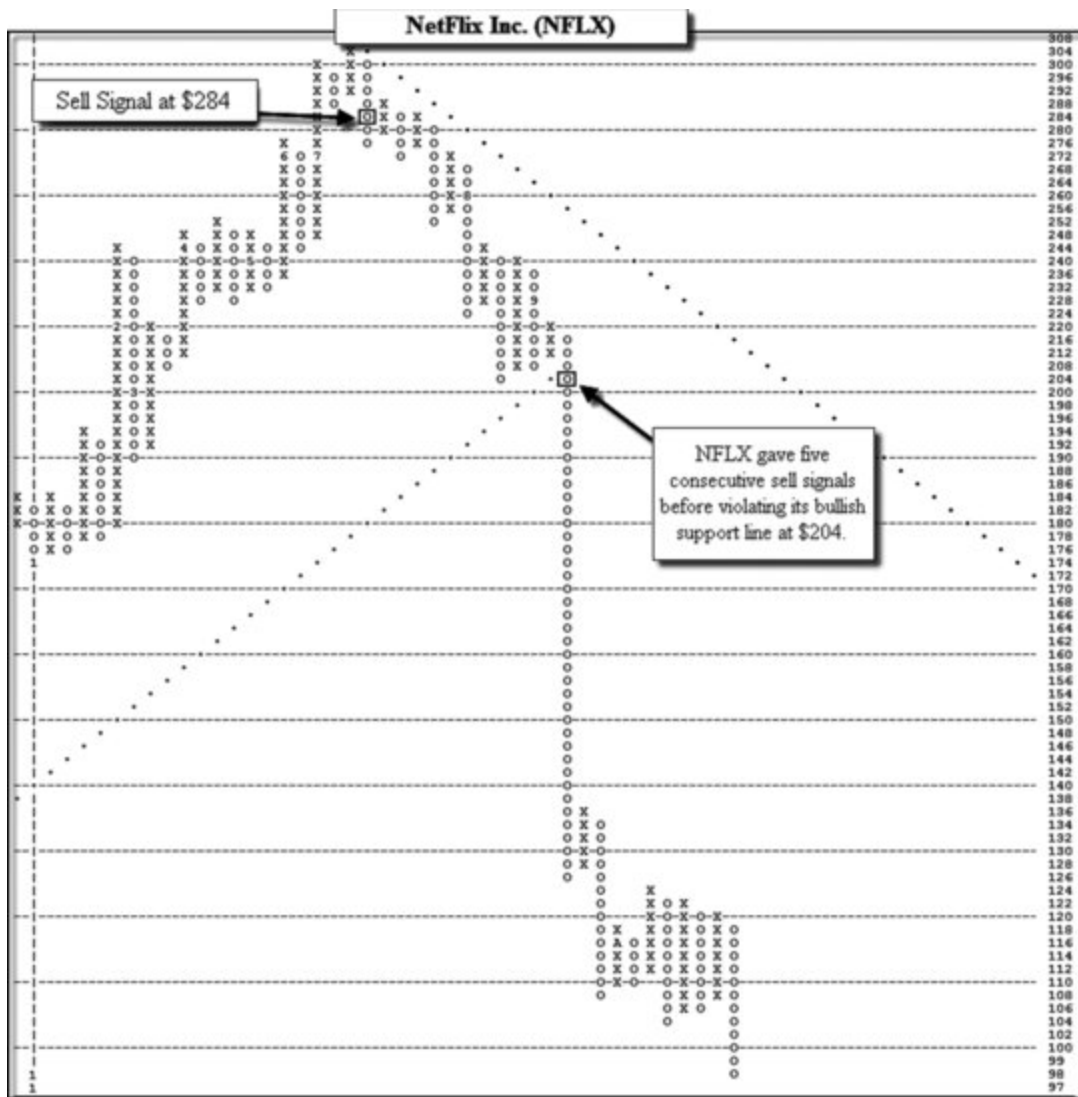
Let's start with the basics of how this stock evaluation and portfolio management system was developed. The Point and Figure method is not new by any stretch of the imagination. It is, however, a lost art simply because most investment professionals and individual investors have lost sight of the basics that cause fluctuations in the prices of securities. Even though we have been championing this method of analysis for 25 years, we have barely made a dent in the 80 million investors in America. We've only scratched the surface; that's about all, and our business has grown every year for 25 years. We have a lifetime of work ahead of us. In today's rapidly evolving technologies, the irrefutable law of supply and demand remains the same. In the end, the only thing that will outlive technological change, that is truly sustainable, is the transcendent competence of an individual's workmanship. New methods of security analysis continue to crop up, capturing the ever-expanding curiosity of the investment public. It seems everyone is searching for the Holy Grail, and it's been sitting right under their noses. Economics 101 is the way the world works. Schools don't teach it unless you choose, on your own, to take courses in it. In its most simplistic form, the “Irrefutable Law of Supply and Demand” reigns supreme. If there are more buyers than sellers willing to sell, the price must rise. If there are more sellers than buyers willing to buy, the price must decline. If buying and selling are equal, the price must remain the same. Embrace the simplicity of this because it is all there is. The rest is all fluff designed to make you feel good.

A long time ago, when I was a stockbroker at a major firm on Wall Street, I learned there is no easy ticket to riches. The key to success in this business—and any

business for that matter—is confidence. According to my dictionary, confidence means “firm belief or trust; self-reliance; boldness; assurance.” In the securities business, the key term in that definition is *self-reliance*, and it is the one trait most investors and stockbrokers lack. Investors today are increasingly averse to making their own decisions, which is why the mutual fund business has grown to record levels. Investors even look to the television to provide them with guidance on where to invest their hard-earned money, not realizing that the business model for TV is advertising, not helping investors. Conversely, there are some investors who take the time to learn how to become more involved in their investments. Most investors look to professionals to guide them when the irony is that 75 percent or more of professional money managers never outperform the broad stock market averages. The typical response from a professional is that they do much more than manage money—they do financial planning, insurance, trusts, wills, and so on. But those are one-time things. Ask them where the real money is made for them and the answer is fees charged for money under management. So let's get real. It appears that looking for professional help has proven ill-fated in many cases. Investors are no further ahead today than they were a decade ago. In the past 12 years, from 2000 to 2012, investors doing modern portfolio theory have earned money market returns, exactly, with much more volatility and much more cost. Investors seeking an adequate retirement have experienced a lost decade. Today, computers have been programmed to handle much of the investment process. In fact, at DWA we have automatically managed portfolios. What is interesting is that although the portfolio construction and management are computerized, the computer only does what we program it to do. So, in essence, the portfolio is constructed and managed exactly as if we had managed it by hand. This computerization of our “rules-based portfolio management system” allows us the ability to handle an infinite number of portfolios. The most important thing the computer does not bring to the equation is emotion. This one word, *emotion*, is responsible for the destruction of assets like no other word in our vocabulary. Most investors look at the stock market as an enigma. It confounds them that the market reacts in what seems to be an illogical pattern. Increased earnings expectations should result in price appreciation of the underlying stock, right? Not necessarily. In many cases, the opposite happens. In the meltdown of stock prices in 2008, great companies as well as less fundamentally sound companies collapsed. How can that happen if fundamentals drive stock prices? Apparently, they don't. There had to be something else that caused the 2008 meltdown if good stocks and bad stocks went down together. That something else

was the imbalance between supply and demand. There simply were more sellers than buyers willing to buy in 2008. In the year 2000, we saw exactly the same thing happen, only the collapse was restricted to technology companies, the very companies the fundamental analysts guaranteed would never go down. At the same time in 2000, those same analysts wrote Apple's death notice. Stocks with questionable fundamentals rose to a price level where the fundamental analyst group had to come up with a new way of valuing companies. This new method of fundamental analysis was called "pro forma." The *Financial Times Lexicon* says this about pro forma earnings: "... the use of pro forma earnings, which are published alongside GAAP (generally accepted accounting principles) numbers, is controversial since it gives companies greater freedom to present their figures in a way they choose, and the figures are not audited. However, investment analysts often assess a company based on its pro forma numbers, giving greater validity to the practice." It was joked about as EEBS: earnings before bad stuff. Then reality began to set in as investors began wondering what in the world TV and Wall Street pundits were talking about. It was a veritable love fest with dot-com stocks. Then without any introduction, the "Invisible Hand of Economics" stepped in and brought sanity back to the markets. All of a sudden, supply began to overtake demand, and companies like Lucent Technologies declined from 80 to the single digits. Major firms on Wall Street were in love with the company at a price of 80. The fundamentals justified the price, but Lucent's only problem was not in the company itself but in its customers' ability to pay for the products they had purchased. Who would have guessed that? Certainly not the three-piece-suited analysts on Wall Street. This information did not show up in the fundamental research until the stock collapsed. It did, however, show up in the Point and Figure chart. Those investors who were well versed in evaluating the supply-and-demand relationship of the stock (Point and Figure chart) saw trouble early on. It is the same reason that on page 100 in *Point and Figure Charting*, Second Edition, I said to sell Worldcom short before it became evident there was trouble with their fundamentals. Fast forward to 2011 and look at the chart of Netflix ([Figure 1.1](#)).

FIGURE 1.1 Netflix



The stock was \$304, Wall Street loved it, and everything was coming up roses. Then they made a fatal error in judgment. They raised prices in an economy that was in a recession and, I would say, in many ways in a deflationary environment. People were not willing to accept a price increase no matter how it was presented. The stock collapsed and is trading at \$110 after hitting a low of \$63. The CEO realized what a mistake it was as their customer base dwindled but it was too late. Supply had already overtaken demand in the stock. The Point and Figure sell signals began at \$284 and continued unabated until the stock hit \$120. It rebounded four points, then collapsed again. As Yogi Berra once said: "You can observe a lot just by watching." This quote is the epitome of what the Point and Figure method of analysis is all about. You can choose to either watch your stocks on a daily basis or let our computer system do it for you. Over the past 17 years, since the first edition of this

book was published, my confidence in this methodology has increased tremendously. While nothing in the method has changed, how we use it has expanded and grown significantly. We have developed a number of new ways of creating and managing portfolios, using the same relative strength concepts covered in the first edition of this book. We have also found new ways to use old indicators. Often, it's not a matter of creating something new but using the old in new and creative ways. One of the most interesting and useful products that was just coming into existence when the last edition was published was the exchange-traded fund. This class of investment vehicle is growing by leaps and bounds, and I think it is the most important new product to hit the market in my 37-plus years in the business. Hint: learn it well while reading this book.

In the past five years, we have gone through some of the most volatile markets anyone has seen. I don't think 2008 will be forgotten by many investors, and I don't think many of our professional clients will forget that our relative strength work prevented us from owning any equities the whole year. Our Dynamic Asset Level Investing (DALI) platform did not suggest that we own equities for all of 2008. To me this was amazing and a real tribute to what our rules-based portfolio management tools can accomplish. Human emotion is totally taken out of the equation. I think of it as an "operating system" not unlike what a computer must have to operate. Without an operating system, like Windows 7, which I am working with right now, the computer is worthless. Try accessing Google on a computer wiped clean of any operating system. It ain't happening. Now think of investing in the stock market without an operating system in your head, guiding your approach to stock selection and subsequent management of that portfolio. This book provides that operating system. Think of it as Windows Point and Figure 4. The old paradigm of buying quality stocks with real products and visible earnings went right out the window with the crash of 2008. We knew its fallacy for 26 years; it just took 2008 for investors to finally believe us. Those stocks go down, too, without the fundamentals changing before the collapse. In the late 1990s, the mantra on Wall Street was: "Forget earnings, they aren't important, only revenues are important." We heard 22-year-old CEOs suggesting that the old-line companies like Procter & Gamble, the backbone of the United States, "just don't get it." Well, the crash of the dot-com companies clearly demonstrates that the 20-something CEOs were the ones who didn't "get it." Not only that, no one realized until 2008 that all asset classes can become correlated at the same time. Oops, there went modern portfolio theory

(MPT). Here is what is confounding. MPT is still being pushed by brokerage firms simply because they have too much tied up in facilitating the failed strategy. Slowly but surely, investors are coming to realize there is another way and it isn't buy and hope. There is no question that real wealth can be made in the stock market, but this wealth can be wiped out just as quickly as it is made. There is an old market adage that goes like this: "Bear markets return money to its rightful owners."

Attention to the bottom line is now back in vogue as investors recognize that net earnings are, in fact, important—a company has to make a profit or it's out of business. In the latter part of the 1990s, firms attempted to create brand names by simply throwing millions of dollars into advertising. Companies were trying to create solid brand names in one month that took companies like Procter & Gamble 40 years to create. Some companies even sold products below cost, with the expectation of making up the difference in advertising revenues.

This all came to roost in the second quarter of 2000, when the Nasdaq stocks literally melted down in a matter of a few weeks. In 2008, another treacherous year, the margin clerks took over and, in a mad attempt to raise capital anywhere they could, sold anything and everything, totally blowing the concept of diversification. If it could happen once, it can happen again. It was the first experience most investors had with a margin clerk at banks and brokerage houses selling everything they could to raise capital as the banks moved closer to bankruptcy. That old concept of some asset classes being noncorrelated to other asset classes (commodities to equities, for example), providing a cushion in a portfolio when all hell is breaking loose in the market, vanished. The high-flier Priceline.com (PCLN) was as low as \$6 in 2000, and is now at \$630 in September 2012. Are we back in the dot-com days again? I said three years ago I thought the United States was the next emerging market, and it might just be playing out. The high fliers were not the only ones that were hit in 2000. Some stocks, many New York Stock Exchange names, hit their peaks in 1998. Many of these stocks are just beginning to show signs of life again, 14 years later. It was an interesting market from April 1998 to March 2000, in which the indexes did fairly well while the stocks underlying them were killers. This is very instructive in understanding capitalization versus equal weighting (discussed later in this book). From 2000 to September 2012, the Dow Jones has risen only 14 percent, not including dividends. Here's the problem with guesses advisers use in their algorithms to determine what the market will do going forward. In 2000, brokers were promising investors an 11 percent return each year to retirement. It wasn't that they

had a gut feeling their investor clients would experience those returns. It was MPT, and it's Monte Carlo simulations with mere guesses on input to the computer program. One thing MPT always does is overweight large-cap growth stocks. That was the wrong thing to do in 2000 and in 2012; it's still the wrong thing to do. The preferred overweight in the asset class U.S. equities has been and still is small-cap stocks. You see, we aren't talking about trading here. Since January 2000 the Standard & Poor's (S&P) 500 Large Cap index we all look at as “the market” is down 4.3 percent, while the S&P 600 Small Cap Index is up 131.5 percent, not including dividends or costs to purchase in either one. Which would you have preferred to own since January 1, 2000? Nothing else needed to be done during this period other than own the S&P 600 Small Cap Index. Although the companies that comprise the S&P 600 Small Cap Index are considered small cap, they are billion-dollar companies. This is where it gets real interesting knowing which hand to fold and which hand to hold. That belongs to the chapter on relative strength. Hang on for the ride—it's going to be fun. I'm having fun just writing this, and I know how it ends. I'm like a kid in a candy shop right now. I can't go on without bringing to your attention the fact that during this same period the S&P 500 Equal Weighted Index was up almost 81 percent. That is an 85 percent outperformance on two indexes with the *same* 500 stocks in them. Yes, the same 500 stocks just weighted differently had totally different returns. Would you have liked to have an adviser that could have simply guided you into the S&P 500 Equal Weighted Index (RSP), instead of what everyone thinks is the market, the S&P 500 Capitalization Index (SPX)? I almost want to jump to the relative strength chapter right now. But don't. Push on, slowly but surely.

■ Finding the Safe Harbor

What do investors have in common with an 18-year-old bungee jumper?

The answer is no fear. During the decade of the 1990s investors came to believe that buying the dips is the key to success: Stocks always come back—don't panic, just buy more. MPT suggests that if you just don't worry, things will be fine in the long run. John Maynard Keynes once said, “In the long run we're all dead.” As home prices rose during this period, some people leveraged their homes to put money in the stock market. This kind of situation never ends well, and 2008 was no exception. The meltdown in the market for many was not as bad as the meltdown in the value of their houses. For the first time in many people's lives, they saw real

estate prices plummet. I know it was the first time in my lifetime that this happened. By the end of 2008, a substantial amount of individual investors' wealth had been wiped out. The second I saw this happening early on, when one of our good corporate clients went bankrupt directly due to the AAA subprime mortgage bonds they were selling, I turned to Tammy DeRosier, my chief operating officer at Dorsey, Wright, and said: "We're going back to *Leave It to Beaver* days." In other words, my vision at that moment was that Americans would put themselves under a self-imposed austerity plan that would ultimately increase savings, wipe out credit card debt, and in essence get their fiscal house in order. This is exactly what is happening in Mr. Jones's household. Investors are wondering if there is a safe haven anywhere on the investing landscape. This year dividend stocks have become the rage as the Federal Reserve's artificially low interest rates have forced investors back to stocks that pay relatively good dividends.

The "buy every dip" mentality is what I call false courage. False courage is confidence you may feel when under the influence of alcohol or drugs. It dulls the senses and gives you the confidence to do things you otherwise would not consider. A friend of mine, the late Cornelius Patrick Shea, used to say, "My pappy used to tell me the 'sauce' makes ya say things ya don't mean and believe things that ain't true." The "sauce" for investors consisted of the seemingly never-ending rise in high-flying tech stocks and, prior to 2008, the parabolic rise in real estate prices. It was so intoxicating that investors were "saying things they didn't mean (buy 1,000 more) and believing things that weren't true (revenues are increasing with no end in sight)." This would be the definition of an *investaholic*. Similarly, during the latter part of the 1990s and first quarter of 2000, investors were enamored with the seemingly never-ending ascent of the stock market and in particular the Nasdaq. The media aided this belief with the ceaseless chant of zero inflation and endless increases in worker productivity due to technological advances. Because of their intoxication, investors kept taking more risks through leverage in high-volatility stocks beyond any rational measure. I even had a broker call me with a story of how her aunt was not allowed to use margin at her firm because of her advanced age (she was 80). Do you know what she did? She took a second mortgage out on her house, put the money in her stock account, and continued trading. In essence, she skirted the brokerage firm's margin requirement and margined the account anyway with the money the bank loaned her when she margined her house. I wonder how she fared after the crash of March 2000, May 2000, November 2000, and 2008. She may have lost her house.

The decline in stocks from 2000 to 2002 certainly woke many an investor up to the fact that markets go both ways—up and down. The dot-com crash was confined to technology and was not as widespread as the meltdown of 2008. In 2003 through 2006 the markets lulled investors back to sleep. From July 1998 to present, someone who bought and held the S&P 500 is finding him- or herself with an annualized rate of return of about 1 percent per year. You might first think, “That's not too bad—at least I didn't lose any money.” But the fact of the matter is for a great many people that means you have lost, although maybe not in actual dollars. But when adjusted for inflation, you are a loser. When you consider that so many investors were made to believe that they would get 11 percent a year rate of return on equities, dropping to a return of 1 percent a year can really put a dent in your retirement planning. Not only did you not make much headway, you lost a decade. In our short lives, one decade of investing can make the difference between a comfortable retirement and no retirement. Many investors have forgotten that having a logical, organized, well-founded method of investing in the markets is the only way to success. Haphazard, overleveraged, methodless investing will always lead to disaster, just as it has twice since 2000. For example, if an investor loses 50 percent of his portfolio value, that portfolio will have to rise 100 percent to get back up to even. How long will that take at an average 10 percent per year, which is the long-term average going back 80 years? About seven years. If an investor bought at the top in 1973 and rode the market down, it took seven and a half years to get even. Can you wait seven and a half years to get your money back if you ride a bear market down as the media and mutual funds suggest you should do? If your answer is no, then you are ultimately interested in risk management, which is what this book is all about.

I was in a store the other day purchasing a new laptop computer. I got into a conversation about investing in the market with the head of the computer department. He was having a hard time understanding what I did for a living. I have always had a hard time explaining it to those not familiar with Wall Street. I told him that successful investing requires an operating system like the one in every computer. The computer's operating system allows it to effectively read and run software products. Operating systems like Windows 7, which I'm currently using, simply provide a set of instructions that tell the computer how to run. Without an operating system, software cannot run on the computer. Investing is the same.