

PREDICTABLE INVESTING

HISTORY LESSON – April 2007.

USING INVESTOR SENTIMENT TO BET AGAINST THE CROWD.

1.0 INTRODUCTION: Warren Buffet, the legendary investor from Omaha, once said “Be fearful when others are greedy and greedy only when others are fearful”. This is great investing philosophy, but how do we gauge whether investors are fearful or greedy?

This is exactly what our Sentiment indicator measures. We start with the CBOE Put/Call Ratio, filter and process it to generate the PCR. Extreme values of the PCR indicate when most investors have thrown in the towel and run for the exits, or when they are supremely confident and wildly enthusiastic about the prospects for the stock market.

Being able to measure what the crowd is doing enables us to do the exact opposite, since the crowd is almost always wrong!

2.0 INVESTOR SENTIMENT: Investor sentiment quantifies the question “are stock market investors bullish or bearish?” When sentiment is extremely negative (bearish), the market is usually forming an important bottom. This is because bearish investors expect the market to go down even further, have already sold all their stock, and there are no sellers left to drive the market even lower.

Conversely, when investor sentiment is extremely positive (bullish), the market is usually forming an important top. Bullish investors expect the market to go up further, have already bought all the stocks they can, and there are no buyers left to drive the market even higher. ***We count on the fact that investor sentiment is almost always wrong, and therefore this is a contrary indicator.***

Let us review the definitions of “Puts” and “Calls” that are used to calculate the Put/Call Ratio (PCR). Puts are stock options that bet that the market is going down (see Ref [5] on the Links page). Calls are options that bet on a rising market. Bullish investors buy Calls, and bearish investors buy Puts. A high volume of Puts relative to Calls (high PCR) indicates extreme bearishness, while a low volume of Puts relative to Calls (low PCR) indicates extreme bullishness.

The next section reviews the historical track record of the PCR and presents data showing its ability to forecast the extreme values of the stock market.

3.0 TRACK RECORD OF THE PCR: Accurate PCR numbers have only been available since 1999, and its history and the corresponding values of the S&P500 over the last 8 years are shown in Figure 1 below (data as of March 23, 2007).

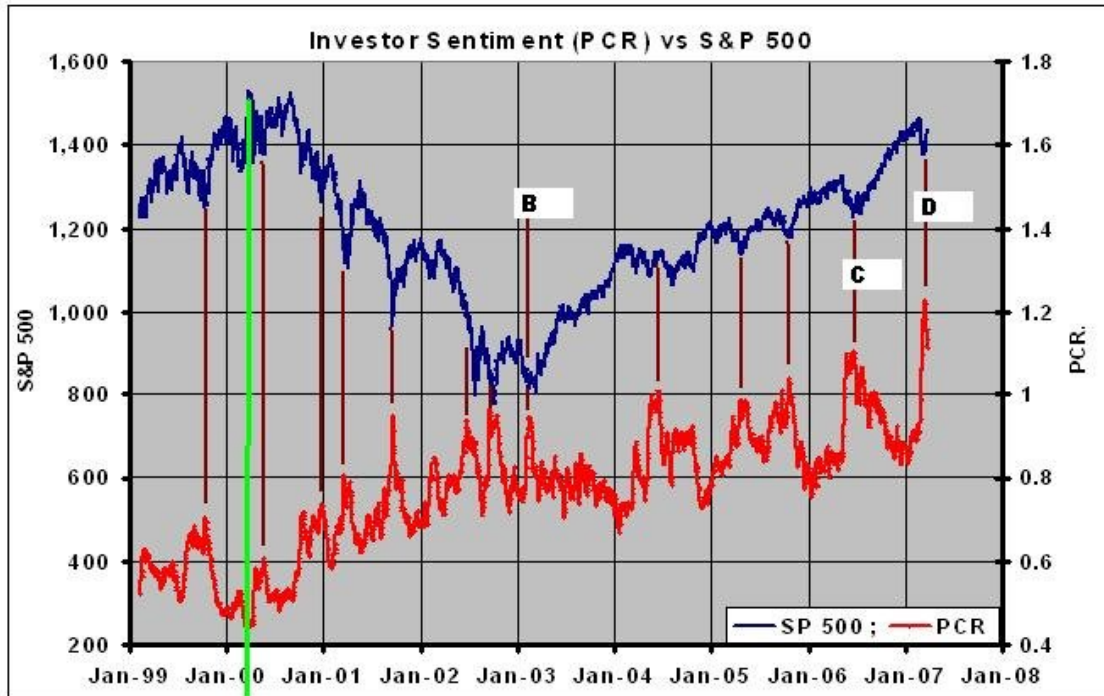


Fig 1. Peak values of PCR (red) correspond to bottom values of the S&P 500 (blue)

A

Notice how unerringly the peak values of the PCR have been able to forecast bottoms in the S&P500 (vertical brown lines). One can see that peaks in the PCR, when investors are the most bearish, correspond precisely to bottoms in the S&P500, and vice-versa. The PCR is our “investor sentiment” indicator, *which tells us what the “herd” is doing, and enables us to do the exact opposite.*

- (a) The green vertical line marked point A of Fig 1 shows the opposite scenario of extreme bullishness, where the PCR was at an all-time low. This was at the peak of the “technology bubble” in early 2000 where the S&P500 reached an all time high. Investors were at their most complacent and bullish, as evidenced by the record low PCR of 0.45. Stocks had been going up for several years and investors were making money hand over fist no matter what stock they bought. Internet and telecom stocks were doubling every few months and it seemed like the party would never end; but sadly it did.

The PCR indicator turned negative in December 1999 followed by the rest of our indicators culminating in the PI model issuing a SELL signal in October 2000. An awful bear market followed during which the S&P500 fell by almost 50%. Investors

who were highly margined and who continued to buy as the market went down pretty much lost most of their portfolio.

- (b) Point “B” marks the extreme low of the last bear market in March 2003. After the technology bubble burst, the market lost about half its value as it went down for the next 3 years (from the peak to point B).

There were six failed attempts to rally after the market dropped significantly, and all were not successful as the market kept going lower. Just about all investors who had hung on to their stocks through this period had thrown in the towel, and many sold all the way down. When there were no more sellers at the extreme bottom, the market turned around and started going back up again. The PI model generated a BUY signal a few months later in June 2003.

- (c) Point “C” on the figure is the “short –term buying opportunity” of last summer in July 2006. The PI model forecast that any closing price in the SP500 under 1243 should be used to lump-sum any new money into the market (see the discussion in the FAQ Page). There were several such occasions during this period where our readers were able to take advantage of this opportunity. The S&P500 went up 17.4% in the next 7 months, till it hit a peak of 1459.68 on Feb 20, 2007.

- (d) “D” brings us to the current situation with the recent pullback during the first few weeks of March. There has been an extraordinarily large spike in the PCR as the S&P500 dropped about 6%. The market has recovered somewhat, and is now in the process of establishing a bottom. This situation is detailed in the next section

3.0 CURRENT PCR SITUATION: Figure 2 below shows an expanded graph of the SP500 and PCR over the last year (data as of March 23, 2007).

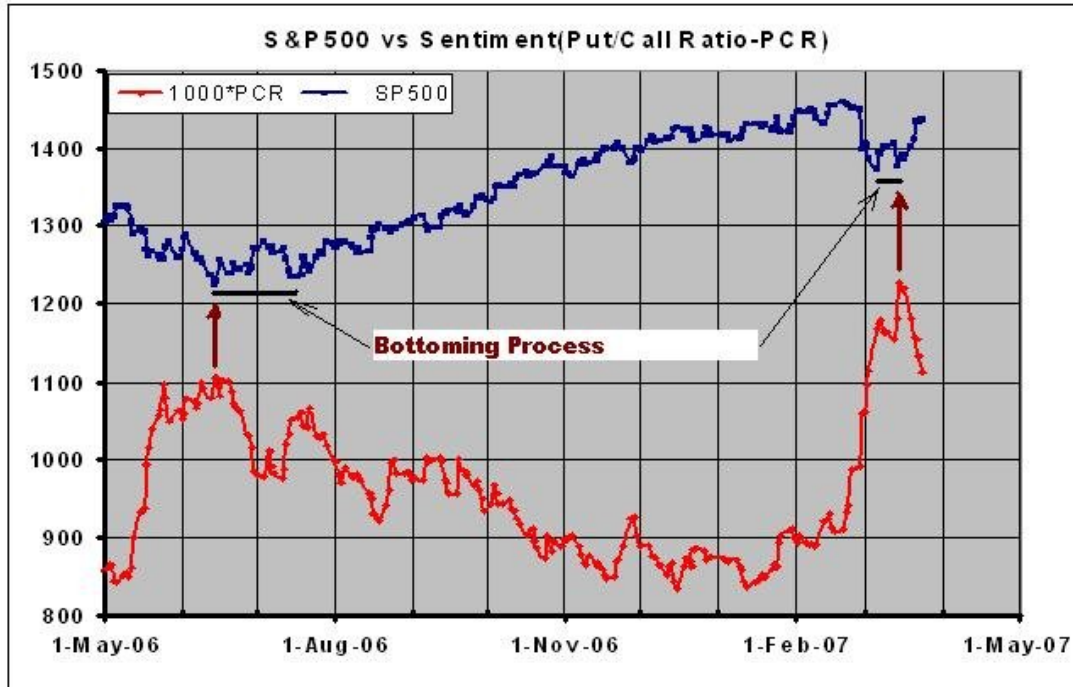


Figure 2. Expanded SP500 versus PCR as of March 23, 2007.

The PCR hit a peak value on March 8, 2007 and has started to pull back. However the action near the previous market bottom last June (brown vertical line on the left side), and other similar situations, has shown that there is usually a 3 to 4 week bottoming process where the S&P and the PCR moves sideways before a final market bottom is confirmed.

In spite of the great recovery by the market last week, it is entirely possible that we will move sideways for the next few weeks and that there will be efforts by the short sellers to see if the lows from last week will hold. Only after this process is completed will we be able to tell if the final market bottom for this correction has been established.

4.0 CAN PCR ALSO FORECAST MARKET PEAKS? Since **peaks in the PCR** accurately forecasts **market bottoms**, is the converse also true? That is, can **bottoms in the PCR** forecast **market peaks**?

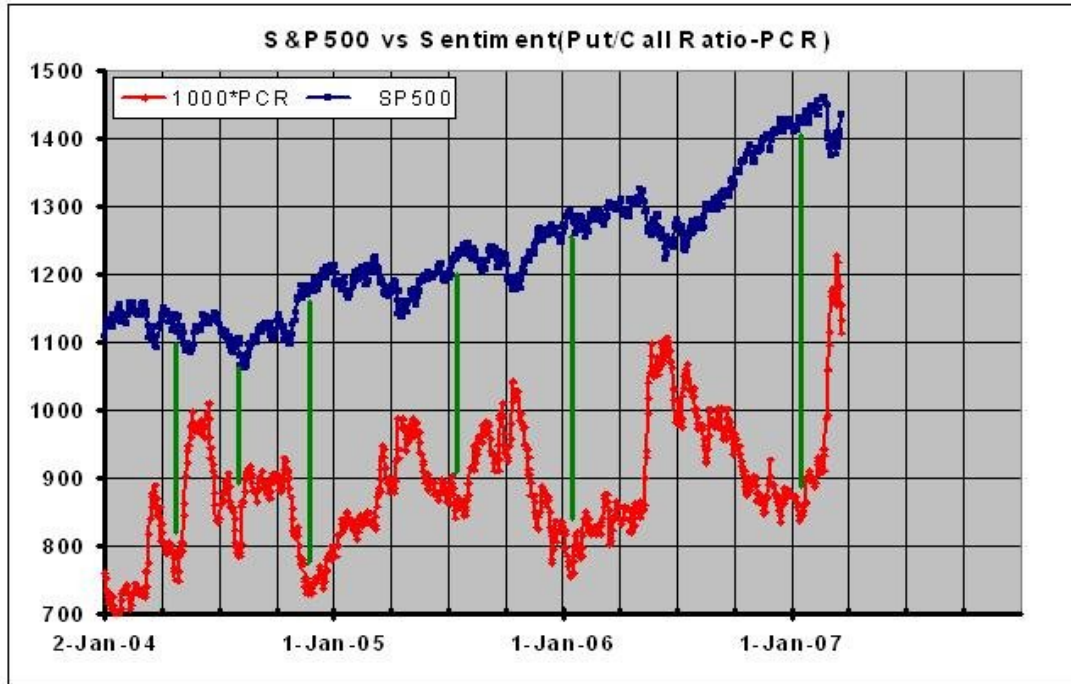


Figure 3. Vertical green lines show the low values of the PCR and the corresponding values of the SP500. Data are as of March 23, 2007.

An examination of figure 3 above shows that this is rarely the case. In most cases a bottom in the PCR (green vertical lines) seems to occur well ahead of the next peak in the S&P500, often lagging it by several months. Furthermore, the time between PCR bottoms and the following peak in the S&P500 varies considerably, so that in general this is not a good prediction tool. But as we saw from point A in Fig 1, an all-time low in the PCR with the market at an all-time high is definitely a danger sign.

5.0 CONCLUSIONS:

The main conclusion from this History Lesson is that peaks in the PCR have a great track record of being able to pinpoint bottoms in the S&P500. However bottoms in the PCR do not usually correlate well with peaks in the S&P500, and cannot therefore be used to predict an upcoming market peak.