

Greedy versus Fearful

**Portfolios heavy with under-performing stocks almost never outperform the market.
Ignat's Law**

Surveys of investor attitudes reflect what investors have already done, not what they plan to do. You can bet that if an advisor turns in a bearish response to a survey, he has already made his sales of stock. It also indicates that he is holding cash that will return to the market at some point in the future. Importantly, it also means that as long as he is fearful, he will refuse to cover his shorts until those shorts start to lose money.

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Market Dynamics

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The advice from the Sage of Omaha is to be "greedy when others are fearful." This advice has a solid grounding in stock market history, particularly at major bear market lows.

It seems that the current condition of the stock market confirms that most investors are now quite fearful. Other than stocks having gone down in price by almost 20% as measured by the broad market averages over the past eight months or so, how can we know that the majority of investors are fearful of investing in stocks? There are various statistical tools that are called sentiment indicators that provide strong signals that the majority of investors are fearful and they usually only show their readings of fear right at the bottom of a major bear market when the majority of investors "throw in the towel."

Many of the sentiment indicators are flashing their fear signals right now. The Chartcraft survey of investment advisors that are bullish and bearish is showing readings for the most recent week of 43.3% bears and only 31.1% bulls. This sort of lopsided fearful outlook only appears at major stock market bottoms. The last time these readings were this upside down was right at the low in October of 2002.

Another important indicator of investor sentiment is the short interest ratio. The level of shares that have been sold short on the New York Stock Exchange is compared to the average daily share volume on the exchange. This ratio for the most recent report, as of the end of February 2008, was 10 to 1. The amount of shares that have been sold short represents ten full days of trading on the New York Stock Exchange. The important thing about the short interest ratio is that it represents shares of stock that must be repurchased in order to close

out the trade. The ratio was in the range of 5 to 6 up until mid-year 2007 when it started to rise sharply. A rise in the ratio from 5 to 10 represents an enormous increase that could only be the result of the anticipation of significant downside, primarily by institutional investors. This also reflects a near record level of bearishness among short-sellers.

The willingness to go short has not been limited to the professional investors who run hedge funds, but has been mirrored by the activities of the small investor as well. Although trading by odd-lot investors is miniscule when compared to the daily volume on the major stock exchanges, the trading patterns of odd-lot investors do reveal the sentiments of small individual investors. As of last week's data, odd-lot short selling represented over 38% of total odd-lot selling and that is at a near record level. This bearishness is also confirmed by the withdrawals of funds from mutual funds by individuals.

The OEX 100 Put/Call ratio reported by the CBOE for the most recent week stands at about 108, which is not a record, but does portray a negative bias among option traders.

It seems that almost everyone is so fearful of the current debt crisis that commentators in the media are suggesting that the recent steps that have been taken by the Federal Reserve Bank to provide liquidity and stabilize the financial situation will be ineffective and are doomed to failure. A recent magazine cover confirmed this fear with a headline that the "Housing crisis is worse than you think." These kinds of financial input from a magazine cover almost always appear toward the end of a market trend. For example, a popular news magazine carried a headline on its cover last summer that the stock market was "Up, Up and Away" and "The Dow jumped over the moon" and that was coincident to the top in the market that preceded the current bear market.

It seems reasonable to conclude that the vast majority of investors are now extremely fearful and have probably already acted to sell their investments in stocks.

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