FOREWORD BY
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BEING RIGHT *or* MAKING MONEY

NED DAVIS

Ned Davis Research Group

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Being Right or Making Money

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Third Edition

Ned Davis

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Foreword

TIM HAYES, CMT
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We knew nothing about sleepy Venice, Florida, and only one of us knew about the investment research company that Ned Davis started in 1980. Tucked away on a quiet street near a tired strip mall that had been ravaged by a tornado a year earlier, NDR's two small houses appeared sparsely occupied when we started in 1986. The company employed about 15 people.

As we gradually learned about computer-threatening lightning strikes and other surprises of working in southwest Florida, we also started to learn more about the founder's philosophy and approach to investing. Knowing little about market behavior, we listened to Ned carefully as he pored through his chart pile at weekly research meetings, anxious about the inevitable market questions that he would fire our way.

It wasn't long before our minds started filling with phrases that to this day remain crucial to successful investing: *Don't fight the tape*, *don't fight the Fed*, and *beware of the crowd at extremes*. We learned about behavioral finance long before it became a common term in the investment world.

While Ned would employ his red pen to raise questions about our research, he would also use it to circle data points in the past with similarities to market conditions of the present, in the process demonstrating the importance of understanding history. Along with his emphasis on clean data and historical analysis, Ned stressed reliance on indicators and composite models to support an investment approach that's objective, flexible, disciplined, and risk aware. His tenets would come to be known as Ned's Nine Rules of Research, which he discusses in the first two chapters of this book.

Ned has always encouraged independent thinking. Even early on he was open to whatever market calls we wanted to make as long as they were supported by the objective weight of the evidence. As the firm expanded, Ned encouraged and enabled us to expand our respective research areas and develop our strategy teams, all the while producing commentary and research tools based on his research guidelines. These guidelines helped us navigate through three decades of bull and bear markets, economic expansions and recessions, peacetime and war, euphoria and panic, and bubbles and crashes. We learned that market survival requires humility and respect for an entity—the market—that demonstrates an amazing ability to surprise, time and time again. Ned has often called investing "a game of making mistakes," adding that "the difference between the winners and the losers is that the losers make the big mistakes while the winners cut their losses short."

In terms of size and global recognition, the NDR of today bears little resemblance to the NDR of 1986. Now in a bigger facility, the Venice office employs more than 100 people, with nearly half in research. Sales offices can now be found in Boston, San Francisco, Atlanta, and London, and service a client base of more than 1,200 client firms in 43 countries around the world. From the early days when the product consisted of a printed chart book and Ned's comments on a recorded call, it has expanded to include a custom research team that builds indicators and models for clients, plus nearly 20 different authors covering macro and market conditions, commodities and currencies, sectors and sub-industries, ETFs, and individual stocks in countries around the world.

The breadth of topics and depth of coverage are exemplified by the last two chapters of the book, in which Alejandra Grindal discusses the implications of demographic changes and John LaForge focuses on prospects for U.S. energy independence. Loren Flath, who joined NDR even earlier than we did, explains in Chapters 3 and 4 how NDR's technology developments have supported the evolution of our modeling and research efforts.

Certainly a lot has changed since we started in 1986, such as the proliferation of data available over the Internet. But what hasn't changed is the time-tested research philosophy that Ned discusses in the pages that follow. It has continued to underpin the product development and analysis that has kept us on the right side of major market moves and investment themes.

Preface

Why write a new edition of *Being Right or Making Money*?

The short answer is that I always feel that I can improve my work. However, though I have updated the philosophy chapter from the previous editions with some new facts and quotes, the only major change is the evolution of my belief that the most successful money managers are risk averse. While it might seem that many of the big winners since 2000 have been risk takers, I still contend that those who consistently succeeded were successful risk managers.

This book is mostly about making money, but that is not my only focus. I try to understand the world and educate myself about the issues affecting it. I have thought about a quote from Eleanor Roosevelt many, many times. She said, "Great minds discuss ideas, average minds discuss events, small minds discuss people." In that spirit, I spend much of my time researching and learning about ideas. Among my current passions: new research data, techniques and indicators, energy fracking, health care and biotech, demographics, the Middle East and other areas of geopolitical conflict, the implications of fascinating new technology in cars and electronics, secular trends, the European Union, debt problems, and domestic politics. So many factors can impact the economy and investments.

I'm fortunate that I no longer need to work to make a living, but I still find it exhilarating to be paid to continue my education and stimulate my mind. I am so grateful. This is a fascinating business! My hope is that this book will inspire discussion about important issues, such as demographics, the energy revolution, and potential investment risks.

Acknowledgments

While the 45 years I have dedicated to my work have been very fulfilling, much of my joy comes from my family: Mickey, Evan, Ben, Brody, Dylan, Connor, and Lisey.

I am fortunate to be surrounded by talented and dedicated colleagues at Ned Davis Research, but I want to offer special thanks to my extraordinary team: my executive assistant Leslie Kahoun; my senior research assistant, Loren Flath, who was largely responsible for building the models described in Chapters 3 and 4; my research assistants Stephanie O'Brien and London Stockton; and Julie Meyers, who also helps edit my work.

Thanks to two of our outstanding up-and-coming strategists—senior international economist Alejandra Grindal and commodity strategist John LaForge—for authoring Chapters 6 and 7.

There are now more than 100 employees at Ned Davis Research. We are dedicated to quality products and customer service. I appreciate all their efforts and support.

Being Right or Making Money

CHAPTER 1

Being Right or Making Money

NED DAVIS

Bad News about Forecasting (Being Right)

Later in this book there are several chapters about factors—including a potential cyclical bear market, demographics, and the U.S. energy renaissance—that could be game changers, and might help forecast the future. I hope you will find the perspectives useful, even though after studying forecasting for over 40 years I realize I do not always know what the market is going to do.

You may have heard of the Texan who had all the money in the world but who had an inferiority complex because he felt he wasn't very bright. When he heard about a brilliant doctor who was offering brain transplants, he immediately consulted him to find out if it were true and how much it would cost. The doctor told him it was indeed true that he could boost intelligence quotient (IQ) levels. The doctor had three types of brains in inventory: lawyer brains for $5 an ounce, doctor brains at $10 an ounce, and stock-market guru brains for $250 per ounce. The Texan asked, "Why in the world are the stock-market guru brains so much more expensive or valuable than those of doctors or lawyers?" And the doctor replied, "Do you have any idea how many gurus it takes to get an ounce of brain?"

People laugh at that joke because unfortunately there is a lot of truth to it. I don't know in what direction the markets will go, and neither does Janet Yellen or Barack Obama. Even George Soros, whose modest $1 billion take-home pay of a few years ago qualifies him as a bona fide market guru, says in his book *The Alchemy of Finance*,[1] "My financial success stands in stark contrast with my ability to forecast events . . . all my forecasts are extremely tentative and subject to constant revision in the light of market developments."

While 95 percent of the people on Wall Street are in the business of making predictions, the super successful Peter Lynch, in his book *Beating the Street*,[2] says, "Nobody can predict interest rates, the future direction of the economy, or the stock market. Dismiss all such forecasts. . . ." And as Mark Twain once observed, "The art of prophecy is difficult, especially with respect to the future."

I think it was Alan Shaw, one of the more successful practitioners of technical analysis, who said, "The stock market is man's invention that has humbled him the most." Fellow legendary technician Bob Farrell warned, "When all the experts and forecasts agree—something else is going to happen."[3]

Economist John Kenneth Galbraith put it this way, "We have two classes of forecasters: those who don't know and those who don't know they don't know."

Financial theorist William Bernstein described it similarly, but with an even darker message: "There are two types of investors, be they large or small: those who don't know where the market is headed, and those who don't know that they don't know. Then again, there is a third type of investor—the investment professional, who indeed knows that he or she doesn't know, but whose livelihood depends upon appearing to know."[4]

Despite my realization that forecasting is difficult, I haven't become a spoilsport and turned away from predicting the market's course entirely, because I've had my share of really good forecasts. Perhaps recounting how I came to distrust "being right" and instead embraced techniques that allowed me to make money consistently will be helpful.

Like nearly all novice investors and analysts, back in 1968 I was convinced that all I had to do was discover the way the investment world worked, develop the best indicators available to forecast changes in the markets, have the conviction to shoot straight, and gather my profits. And my record of forecasting stock prices from 1968 to 1978 was so good that during a *Wall $treet Week* broadcast in 1978 Louis Rukeyser said, "Ned Davis has had an outstanding record in recent years . . . and has been absolutely right about most of the major ups and downs. . . ."

The only problem was that at the end of each year, I would total up my capital gains and unfortunately I would not owe Uncle Sam much money. Before someone else could question me, I asked myself, "If you are so smart, why aren't you rich?" It was about that time (1978–1980) that I began to realize that smarts, hard work, and even a burning desire to be right were really not my problems, or the solution to my problems. My real problems were a failure to cut losses short, a lack of discipline and risk management, letting my ego color my market view (which made it difficult to admit mistakes), and difficulty controlling fear and greed. *It was thus a lack of proper investment strategy and good money management techniques, not poor forecasting, that was holding me back.*

I dealt with those problems, and by 1985 *Barron's* magazine was interviewing me and saying on its cover: "No Bum Steers from This Raging Bull: Ned Davis Has Been Dead Right on the Market."

Over the years I have seen scores of very bright investment advisors turn into hugely successful gurus who blaze into the investment business with spectacular forecasts. Yet, I've watched each and every one of them crash back to earth when a big subsequent forecast inevitably proved wrong. The Bible says, "Live by the sword, die by the sword." As my late friend Marty Zweig and I watched these forecasting gurus fail, we often said to each other, "Live by the forecast, die by the forecast."

Before examining indicators, I'd like to discuss the record of some professional forecasters. Perhaps the biggest myth in financial markets is that experts have expertise or that forecasters can forecast. The reality is that flipping a coin would produce a better record. Therefore, relying on consensus economic forecasts to provide guidance for investment strategy is almost certain to fail over the long run.

What is my evidence? Consider forecasts from the Survey of Professional Forecasters released by the Federal Reserve Bank of Philadelphia and shown in Figure 1.1 (solid line). The dashed line shows real GDP. The chart shows seven recessions (shaded zones) since 1970. As a group, professional economic forecasters did not correctly call a single one of these recessions. In fact, they have never predicted a recession, period. Since the first edition of *Being Right or Making Money* was published in 2000, on average economists have been 59 percent too high in their 12-month forecasts (predicted growth: 3.1 percent; actual growth: 1.9 percent).

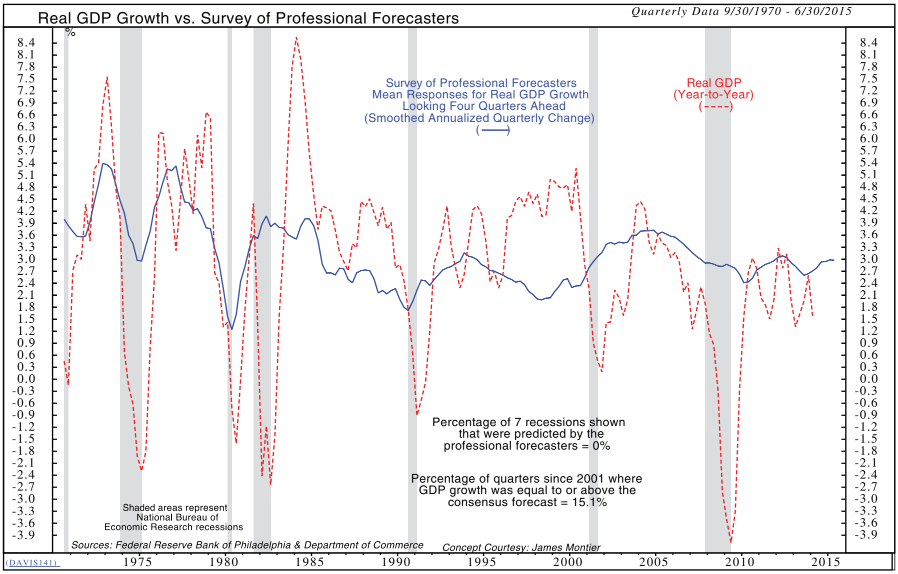

FIGURE 1.1 **REAL GDP GROWTH VERSUS SURVEY OF PROFESSIONAL FORECASTERS**

Well, what about the experts at the Federal Reserve? They are supposed to be independent. They have a lot of money to spend on research, a full professional staff, and they have expanded their projections from a year or so to five years ahead. Two years ago the initial projection for 2013 was 4.15 percent real growth. In Figure 1.2 we plot the wide range of projections by the Fed (not the central tendency or specific point forecast) and then see how real GDP performed since 2000. And as shown, the Fed was actually correct (actual GDP fell within the Fed's wide range) just 26.3 percent of the time!

The last word I'll offer on predictions is from the Fed's leader during much of the period covered by the chart. In October 2013 Alan Greenspan said, "We really can't forecast all that well. We pretend we can, but we can't."

Forecasting the economy and the investment markets consistently and reliably is very difficult. In fact, consensus predictions often contain the seeds of their own destruction by altering human actions. Most crowds are usually wrong at sentiment extremes as I will discuss later in this chapter.