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SEASONAL STOCK MARKET TRENDS

THE DEFINITIVE GUIDE TO CALENDAR-BASED STOCK MARKET TRADING

JAY KAEPPEL

Seasonal Stock Market Trends

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To Maggie, Jenny, and Jimmy

Contents

Preface

It was just about the dumbest thing I'd ever heard. And I remember it as plain as day. Like a lot of ideas that have come and gone over the years, I don't even remember the source, sadly. But the message was simple—the stock market was soon to embark on a major bull market, rising to new all-time highs in the process. It was a preposterous notion.

The time was April 1982. For the previous 16 years, the Dow Jones Industrial Average had fluctuated in a wide range between 1,051 on the upside and 578 on the downside. The Dow had approached or exceeded the magical 1,000 level on five occasions, always to be turned back. There had also been a series of painful bear markets during this 16-year stretch. The bear market of 1966 ended with the Dow plunging 969 to 744, down 23 percent in a little more than nine months. The 1969–1970 bear market was a near replay, with the Dow shedding 36 percent from its bull market high. The 1973–1974 bear market was the worst since the Great Depression. From peak to valley, the Dow fell a staggering 45 percent, and the combination of high inflation and deflated stock prices—not to mention the Watergate scandal—took a powerful toll on investors' psyches. Following a 75 percent advance from the December 1974 low to the September 1976 high, the Dow experienced another decline of 27 percent between September 1976 and February 1978. Over the next 38 months, the Dow again advanced back above 1,000, peaking at 1,024 in April 1981. And, as investors had come to expect, the rally failed to hold. By March 1982, the Dow was back under 800, 22 percent off of the April 1981 high.

So there I was, a neophyte in the market, learning the lessons of the market. The conventional wisdom at the time was pretty straightforward:

- The Dow trades in a range between roughly 600 and 1,050.
- Whenever it approaches 1,000, it is time to keep an eye on the exits, because the stock market *always* tops out when it nears that level.
- It is a given that the stock market declines during a post–presidential election year. Within the 16-year trading range, the Dow lost ground in 1969 (15 percent), 1973 (16 percent), 1977 (17 percent), and 1981

(9 percent). So looking ahead, it was pretty much a sure thing that 1985 would be a bad year for stocks.

- The good news of the day was that the stock market always makes a low every four years. The years of 1962, 1966, 1970, 1974, and 1978 had all witnessed a meaningful multiyear low.

So, sitting there in April 1982, with the Dow roughly 20 percent off of its April 1981 high, investors might have felt confident that a multiyear low was in the offing. Unfortunately, at the time, everyone knew that things were different this time around. Ronald Reagan had been in office a little more than a year, and despite the fact that he had promised to lower inflation and get the economy going, inflation and interest rates were still high (albeit declining), the economy was still struggling, and some of the leading stock market advisers of the day were extremely bearish. In fact, Joe Granville, who had called the 1981 top almost exactly—clearly a man with his finger on the pulse of the market—was forecasting another economic depression. So, when I stumbled upon a tidbit of cyclical stock market history, I almost had to laugh.

As I mentioned earlier, I don't recall where I read it. But, wherever it came from, this piece pointed out that the stock market had staged strong rallies between the end of June of years ending in 2 and the end of December of years ending in 5—get this—every other decade. In other words, we were supposed to care that between June 1902 and December 1905, the Dow had rallied 50 percent and that, 20 years later, between June 1922 and December 1925, the Dow had rallied 69 percent. And, it was supposed to hold some historical significance that between June 1942 and December 1945, the Dow had advanced 87 percent and that, another 20 years later, the Dow had rallied 73 percent between June 1962 and December 1965.

In a nutshell, we were supposed to believe that what had happened in the stock market 20, 40, 60, and 80 years prior somehow mattered a hoot in the present day. What a hoot, indeed. And we were also to ignore the fact that this trend from June of years ending in 2 through December of years ending in 5 only worked every other decade. In other words, this pattern did not necessarily work from 1912 to 1915, from 1932 to 1935, from 1952 to 1955, and from 1972 to 1975. To put it mildly, I did not put much faith in this little nugget of stock market history, especially with a leading expert like Joe Granville predicting a depression. Nevertheless, because I was still learning the ropes in the stock market, I tried to keep track of as many market tools as possible. With a chuckle, I wrote, "Every 20 years between June of year 2 and December of year 5 indicator" into my log of stock market tools. Then I quickly turned my attention back to more useful tools, like economic and earnings forecasts.

On June 30, 1982, after the stock market closed, I wrote down the level of the Dow: 811.93. This was just 2 percent above its recent low of 796, achieved a few months earlier during March. By August 12, 1982, the Dow had drifted lower to 776.92, its lowest level in more than 28 months. With the weight of negative economic and market forecasts still hanging heavy, this new low appeared to be a strong confirmation that investors needed to brace themselves for a continuing stock market decline. Then something strange happened.

Over the subsequent two days, the Dow staged a respectable 2 percent gain. Then, on August 16, 1982, something inexplicable happened. The stock market rallied 4.9 percent, in one day. And from there, it never looked back. About a month later, the Dow stood 20 percent above its August low. Some investors leaped aboard the soaring rocket ship that the stock market had suddenly become. Most others stood by with their collective jaws on the floor, unable to pull the trigger in the face of a market reality completely at odds with the conventional wisdom, or such as it was just a month prior.

On June 30, 1982 (i.e., at the end of June of year 2 of an even-numbered decade), the Dow stood at 811.93. And 36 months later, on December 31, 1985 (i.e., at the end of December of year 5 of an even-numbered decade), the Dow stood at 1,546.67. This represented a gain of 99 percent in just two and a half years. By that time, a cyclical analyst had been born.

Over the past 25 years, I have examined in great detail a wide range of seasonal and cyclical trends as they relate to the stock market. Much of the best of what I have learned is contained in the following pages. The cycle marking June of year 2 through December of year 5 has been refined somewhat and appears in Chapter 5 as the cycle of October of year 2 through December of year 5. I have written in the past about some of the discoveries I have made. In many cases, those discoveries amount to things that other analysts have already learned and made public. Some of the pioneers of seasonal stock market analysis are noted in Chapter 1 and throughout the book as the ones who deserve credit for a particular finding. In *Technical Analysis* magazine, I have published articles such as, "The January Barometer: Myth or Reality" (discussed in Chapter 2), "The 40-Week Cycle in the Stock Market" (discussed in Chapter 6), and "The Stock Market, the Calendar, and You," which incorporated a variety of seasonal trends into one comprehensive market-timing model.

Numerous studies have shown that the greatest influence on the price action of any given stock is the action of the overall stock market. A rising tide lifts all boats. In the stock market, it is a similar story. Whereas a bullish stock market in no way ensures that all stocks will participate, it is easier to make money in stocks when the overall market is rising than when it is falling. Likewise, it is often best to invest defensively, or perhaps even raise some cash, if the prospect for an overall decline in stock prices is great. The material presented throughout this book is designed to help investors weigh the likelihood of an overall stock market advance or decline during a particular time frame.

The most important thing that you can do in analyzing and considering the research presented in this book is to read with an open mind. As I described at the outset, the easiest thing to do is to laugh off ideas that seem to have no foundation in fundamental analysis, be they related to earnings and sales or supply and demand. What people think about what the stock market will do next and why has no real bearing on what the stock market ends up doing. The methods and tools presented herein provide a very useful road map for investors who seek to maximize their long-term profitability by using all tools at their disposal.

JAY KAEPPEL

Seasonal Stock Market Trends

CHAPTER 1

Introduction to Seasonality in the Stock Market

Within nature there exists an undeniable ebb and flow. The sun unfailingly rises in the east and then sets in the west. The moon revolves around the earth. The earth revolves around the sun. Trees grow leaves in the spring. The leaves turn bright colors in the fall and by winter they have fallen to the ground. The following spring the same routine starts anew. Most people go to bed at night and rise in the morning. What happens in nature affects humans, not only physically, but also emotionally and psychologically. Thunderstorms instill fear and a desire to seek shelter. A blizzard triggers an urge in people to hunker down and cocoon at home under a blanket. A dark, dreary day has an undeniable tendency to cause many people to experience—for lack of a better word—a funk, a state of mind in which virtually nothing feels right. But, ah, a warm, sunshine-filled day can all by itself suddenly make everything feel right. For millennia, the human race was a slave to the sun. And, to this day, people are drawn to bask in its glow. To better understand this phenomenon, picture opening the drapes first thing in the morning on a cloudless, sunny day following three days of dreary weather. Suddenly, almost magically, the darkest of moods seem to melt away.

So, what does any of this have to do with the stock market? The heart of the matter comes down to the fact that humans are a creature of habit and repetition, and that many, many things in life happen on a cyclical basis. And these cycles can greatly affect the way a person thinks or feels. Let's first consider the concept of seasons.

THE CONCEPT OF SEASONS AND SEASONALITY

Virtually everyone is familiar with the concept of a season. We can start with winter, spring, summer, and fall. Add in hunting season, football season, mating season, hurricane season, holiday season, and so on. Factor in "a season for all things," "now is the season of our discontent," "the seasons changed and so did I," and you start to get the idea.

In a nutshell, in many aspects of life things occur in a repetitive pattern. Spring follows winter, then summer, fall, and then winter again. Things do in fact change over time. Yet, the basic underlying idea of seasons and seasonality is that although things do change, they often return to a particular state over and over again—often in a very cyclic and predictable way. Over time, the human mind comes to understand the cyclic or seasonal nature of certain occurrences and begins to adapt. In the old days in cold-weather climates—before the advent of heat and running water—humans used to gather up provisions as the fall progressed to ensure that there would be enough food to last the winter. Nowadays, many individuals in cold-weather climates use the beginning of baseball spring training in February as something to latch onto to help get them through the remaining cold months of winter and to remind them that better (or at the very least, warmer) days are certainly ahead. Today, many people living along the Atlantic Ocean or the Gulf of Mexico make preemptive plans regarding the potential for hurricanes during the late summer and fall months.

So what, you might ask, does any of this have to do with the stock market? I mean, certainly, one might be willing to grant the notion that weather-related seasonal trends could have an impact on commodities and grains. Things that grow in the ground or that eat the things that grow in the ground clearly can be affected if the ground is too wet or too dry (or covered with three feet of snow) and does not allow for the normal planting process to proceed. But the stock market is primarily based on financial assets, not physical assets. As long as the New York Stock Exchange has electricity, the nature of the weather outside is seemingly irrelevant. And the Nasdaq market doesn't even operate a physical exchange. So, here too, the vagaries of weather and seasons would at first blush seem to be quite irrelevant. But the reality is that there is more to cyclicity, seasons, and seasonality than mere weather.

In many cases, seasons become a state of mind. As I have already described, in many instances, people prepare for certain recurring events, proceed as planned during the period in question, and then relax and redirect their energies in different directions once the anticipated cyclic or seasonal period or event has passed. In summary, human emotion becomes intertwined with cyclical trends.

So, to sum up so far, we all accept the fact that many things in life are seasonal in nature, or cyclic. Most of us recognize and accept the notion that people's thoughts, attitudes, and emotions can change with the seasons. This is an important connection, because the stock market can be thought of as the ultimate arbiter of human emotion as it relates to all things financial.

It can be argued that the stock market experiences seasons or cycles. At the very least, one can make the case that there are bull seasons, when the stock market advances, and bear seasons, when the stock market declines. In addition, one could argue that there are at least two or three other seasons in the stock market:

- A pullback in a longer-term bull market.
- A rally in a longer-term bear market.
- An extended trendless period.

Although none of these seasons are related to weather and although bull markets and bear markets certainly cannot be counted on to always begin and end on the same dates each year, the fact remains that these seasons are a fact of life for stock market investors. As such, most investors ultimately have to learn to deal with the inevitable change of seasons in the stock market.

Whereas many individuals try to deal with these seasons as objectively as possible, ultimately, much of the decision-making process comes down to emotion. As a result, the gyrations of the stock market have a direct relationship with human emotion that is deeply intertwined. At times, the fluctuations of the stock market can cause mass changes in the overall emotional state of market participants. Likewise, at other times, the emotional state of market participants as a whole can exert a direct effect on the direction of stock prices. In essence, what happens over time is that the season for investors moves from greed to complacency to fear, and then the process repeats. To better understand this change of seasons, let's consider a typical stock market cycle and how it affects investors' thinking and vice versa.

The initial stages of a bear market are generally marked by denial, as investors who have become used to making money can't bring themselves to believe that the good times have come to an end. As the bear market unfolds, more and more investors eventually bail out—often swearing never to risk their hard-earned money again—whereas others cling to every countertrend rally, hoping that it is the start of the next bull market. As the bear market reaches its low, fear typically ramps up and ever more people decide they can't stand the pain of losing money anymore. At a major stock market bottom, there is typically great despair among investors. And, at about this time, the season changes. The stock market no longer continues to make new lows but, in fact, may stage a strong rally off of a low. With human nature being what it is, many investors refuse to believe that the bottom is in. And, they refuse to be sucked into the market once again in fear that another plunge is in the offing. But, even as these former investors stand aside and get left behind, the season is changing back from bearish to bullish. As the bull market continues, optimism grows and investors flock back to the market, looking to make their money grow. Eventually, concerns of downside risk give way to fears of missing out, and money pours into stocks of all stripes and colors. As optimism and complacency reach their peak, the stock market tops out once again. It is often said that the masses are right in the middle and wrong at the extremes. In other words, the majority of investors are typically too bullish at the top and too bearish at the bottom. And, in my experience, this adage has proved to be true.

One of the key factors that drives emotion when it comes to investing is the fact that it involves the potential increase—or decrease—in one's hard-earned money. Making or losing a lot of money quickly tends to have strange effects on people. For example, in most instances, people prefer to buy something when the price is lower. If an item cost $20 yesterday and today costs only $18, most people will be more attracted to that item today on the basis that it now represents a better value than it did yesterday. When that item comes to the stock market, however, this is not always the case. This is partly because no one can ever be sure how low is low. In other words, it is possible for the stock of a given company to go to zero if the company goes bankrupt or out of business. The fear of this potential outcome always lingers in the back of investors' minds. And, as a result, a decline in the price of a stock more often is likely to persuade someone to sell that stock than it is to persuade someone to buy it. In other words, the thinking eventually changes along the following lines.

I bought it at $22 because I thought it was a value. At $20 I figured it must be an even better value so I bought some more. At $18 I started to wonder whether maybe my analysis was a bit early in selecting this stock as a value. At $16 I started to think seriously about cutting my losses. By the time the stock reached $14, I couldn't take it anymore and decided to bail out. As the stock hit $10 a share, I realized that it was one of the biggest dog companies to ever exist so I decided to sell it short. Three days later, it was back over $14 and I finally realized that I had no idea what I was doing.

And, so it goes. In some ways, buying a stock can be viewed along the lines of finding a mate. Investors first identify and become involved with an attractive stock. But, as happens sometimes, things go south. As the price of the stock declines, investors first attempt to remain convinced that the stock is attractive. Eventually, investors realize that this mate is trying to take them for all they are worth. Painfully, investors accept the fact that they were wrong and that they must terminate the relationship. After that comes the remorse and recriminations. Now, clearly this cycle does not play out just this way with every stock purchase (nor, thankfully, with every relationship). Still, it only takes one or two of these types of experiences for the pain associated with them to be permanently seared into an investor's psyche. And, this memory can strongly affect the way one looks at other future relationships.

Investors who suffer a loss beyond what they had expected will typically be gun shy for a good long while into the future, as they do not wish to repeat this unpleasant experience. They may find themselves bailing out of positions at the first sign of trouble, only to then find themselves on the sidelines when the rally starts in earnest. Likewise, investors who achieved a quick profit and then watched it vanish, never to return, may be very quick to take profits in the future. These are just two simple examples of how the market can affect an investor's thinking, and how that thinking can affect the actions that take place in the stock market. Clearly, investors' moods and outlooks change as the investment season changes. And, just as clearly, changes in the moods and outlooks of the majority of investors can affect the investment season.

So is it that much of a stretch to believe that the stock market could have seasons? That is the question that this book will attempt to answer.

WHAT IS SEASONALITY?

The Merriam-Webster online dictionary defines the words "season" and "seasonal" as follows:

> **Season**: a period characterized by or associated with a particular activity or phenomenon.
>
> **Seasonal**: of, relating to, or varying in occurrence according to the season.

For our purposes, we will use the word "seasonality" to define any number of seasonal trends that seem to exist in the stock market. We will define the phrase "seasonal trend" as a recurrent period characterized by certain occurrences—most notably, a tendency for the stock market to rise (or fall) in price. The seasonal trends that I will detail in this book will be outlined in a moment. For now, let's define what seasonality is not.

You must accept the fact that seasonality in the stock market is not a magic formula. Throughout this book we will be looking at a variety of seasonal trends, each with specific buy and sell dates. And, as you will see, the results for many of these seasonal trends have accumulated an extremely impressive track record. And, to some individuals, it might seem to make sense to use these trends on a systematic basis. But that is a determination that each investor must make on his or her own. In the end, the goal of this book is to convince you that seasonality has a place in your investment strategy. However, the goal is not necessarily to try to convince you that you should rely solely on seasonal tendencies to the exclusion of all other analyses.

The best analogy that I have heard for describing the proper way to look at seasonal trends in the financial markets came from Michael Santoli in his *Barron's Financial Weekly* "Streetwise" column from November 26, 2007. In that particular column he stated the following:

"Seasonality is climate, not weather."

Although this comment may not make intuitive sense to everyone, it very accurately sums up the proper perspective that an investor should have when considering incorporating seasonal trends into an investment strategy. Just because it is December in Chicago does not necessarily mean that the temperature will be extremely cold. On an unseasonably warm day, the high in Chicago can reach above 50 degrees even during what is considered a winter month. Seasonality tells us that it should be cold, or more accurately, that it is more likely than not to be cold on a December day in Chicago, but the weather outside can vary widely. As we will see, the same is true regarding seasonal trends in the stock market. If a given time of year has been up 60 times in the past 70 years, we would intuitively look for that period to be bullish again this year. But whether this year ultimately falls into the normal bullish category or joins that smaller number of bearish aberrations cannot be accurately predicted in advance.

So the bottom line is that seasonality in the stock market should not be thought of as an exact science. Nevertheless, the other key piece of the equation is to recognize from the data presented throughout this book the powerful trends that seasonal patterns can help you to identify in the stock market, and the fact that seasonal trends should not be ignored simply because they are not based on hard fundamental data such as earnings or on a price-based technical indicator. In essence, a given seasonal trend is a form of a psychological or sentimental indicator, as each seasonal trend is a measure of the tendency of the investment masses to act in a certain way in a certain repetitive form. Before jumping into the details of the actual seasonal trends themselves, let's first take a moment to recognize some of the pioneers in the area of seasonally related research.

THE PIONEERS OF STOCK MARKET SEASONALITY

Whereas some individuals will look questioningly upon the notion of seasonality in the stock market, the fact remains that some of the best minds in the business have spent countless hours, and even years, conducting a great deal of research in the area of seasonal trends in the stock market. In the following text, I would like to give mention to a few of the early pioneers in the area of seasonal stock market research.

Yale Hirsch

It might be appropriate to refer to Yale Hirsch as the "founding father" of seasonal trend analysis in the stock market. He was the original editor and publisher of *The Stock Trader's Almanac* (www.stocktradersalmanac.com), which has been published annually since 1967. As a result of countless hours of groundbreaking research, Hirsch became the leading analyst in the area of historical stock market behavior and cycles in different political and economic environments.

His most notable contribution to the area of seasonality is the much renowned January barometer. The premise underlying the January barometer is simply that as the month of January goes, so goes the entire stock market year. This method is discussed in-depth in Chapter 2 along with several variations. Other indicators that Hirsch has developed or popularized over the years are the Santa Claus rally (Chapter 4) and the best six consecutive months of the year (Chapter 8). In summary, Hirsch's research over the years has helped many astute investors to profit in the stock market and has effectively served to legitimize the analysis of seasonal trends in the stock market.

It should also be noted that Yale Hirsch's son Jeffrey Hirsch has followed in his father's footsteps and become another major player in the area of research of seasonal market trends. Jeffrey is now the publisher of *The Stock Trader's Almanac* and authored *The Almanac Investor: Profit from Market History and Seasonal Trends* (Wiley, 2005).

Norman Fosback

Norman Fosback authored the classic stock market book *Stock Market Logic* in 1976. Fosback was and is a serious student of the market and gained prominence in the 1970s and 1980s for implementing econometrics in his stock market analysis. He edited a newsletter titled *Market Logic* from 1975 until 1995. He also founded and was editor-in-chief of *Mutual*

Funds Magazine, one of the most widely read personal investment publications ever produced. But for our purposes, Fosback's most prominent contribution was in the area of stock market seasonality. It was from a research project that lasted from 1971 into 1975 that he developed his "seasonality switching system."

Much of what he discovered in his testing and incorporated into that original switching system is used throughout the pages of this book. The heart of Fosback's original research was the recognition that the period comprising the last trading day of the month and the first four trading days of the next month was by far the most favorable time of the month to invest in the stock market (Chapter 4). Over the years, the original system evolved and some of the rules became a bit more arcane (e.g., Fosback's Rule 5 states, "Do not own equities on the second day before a holiday closing if that day happens also to be the first trading day of the week"; Fosback's Rule 6 states, "Continue to own equities on the first day after a market holiday closing if that day is also the last trading day of the week"). Nevertheless, despite the seemingly arcane nature of some of the updated rules, the bottom line is that these changes may in fact result in better performance over the long run.

One ironic note: Although Fosback did do some research on individual stocks, the real heart of his analysis was based on the overall stock market itself. Unfortunately for him, virtually no index funds existed back in the 1970s and they became a viable investment choice only in the 1990s. Thus, whenever Fosback's methods generated a buy signal, he was faced with the task of building a portfolio or buying a stock mutual fund that would hopefully closely track the overall stock market averages. Nowadays, investors have an important advantage in that they can buy an index fund and instantly own a position that will accurately track the performance of a given stock index.

Dick Stoken

Dick Stoken authored a book titled *Strategic Investment Timing in the 90s* in 1990. In that book, he discussed something he referred to as the "investment climate." He claimed that this investment climate turned favorable on October 1 two years before the next presidential election, and that this favorable period extended through the end of the following (or preelection) year. This claim will be examined in much greater detail in Chapter 7, "Election Cycle Investing." For now, suffice it to say that Stoken did indeed speak the truth, and that this 15-month period has consistently provided investors with an above-average climate for investing in stocks.

Peter Eliades

Peter Eliades is a stock market analyst who gained prominence in the 1980s as the editor of an advisory letter titled *Stock Market Cycles*. As the name of his advisory service implies, Eliades has done a great deal of work in the area of identifying meaningful cycles in the stock market. One of his primary contributions to seasonal analysis that we will look at in this book is the 212-week cycle, which is discussed in Chapter 6, "Repetitive Time Cycles of Note."

Much of what appears in this book is either taken whole or derived from the works of pioneers such as those individuals whom we have just discussed. As a self-admitted graduate from the School of Whatever Works, I greatly appreciate the fact that so many respected analysts have refused the initial urge to scoff at seasonality in the stock market and, in fact, have not only embraced the concept but also taken the time to do research in an area that some might consider arcane. Last, they were willing to share their findings so that the rest of us might benefit also.

MEASURING MARKET PERFORMANCE THROUGHOUT THIS BOOK

This book is dedicated to the idea of highlighting a wide variety of seasonal trends in the stock market. One great thing about the stock market is that ultimately the success or failure of any idea can be quantified simply by running the numbers. If you can establish objective buy and sell rules for virtually any method you choose, you can then apply those rules and identify specific buy and sell points. From there you can simply compare the selling price to the buying price and determine whether a given trade generated a profit or a loss. You can also total and analyze for risk and reward characteristics the cumulative total of profits for all trades made according to a given method.

For the purposes of this book, we will use the performance of the Dow Jones Industrial Average (hereafter referred to as "the Dow") in almost all cases to measure the performance of each given seasonal trend. Some will argue that this index is among the most narrowly based of all, as it consists of only 30 large-cap stocks and can at times differ significantly in performance from the performance of the average stock. But, for our purposes, this is acceptable. The benefits of using the Dow as our benchmark are severalfold. First off, there are well more than 100 years of history available for analysis. Nothing is ever guaranteed to work forever. Still, if a given trend or method tests well more than a century of data, it is fair to ask, What more do you want? In other words, if 100-plus years of strong performance are not enough to convince you that a given method or trend is viable, then you are awfully tough to please.

In some ways investors today have it far better than those of just a few short years or decades ago. For example, in the discussion of Norman Fosback's analysis of seasonal historical trends, I mentioned the fact that prior to a certain time there was essentially no such animal as an index fund. Also, among the few that existed, there were some severe limitations regarding how often an investor could switch in or out of them. As a result, investors who wanted to take advantage of market movement had little choice but to buy a group of stocks that they felt would closely track the movement of the index they hoped to track. Sometimes this approach worked out fine, and other times it did not. In this scenario, it was possible to be exactly correct about one's expectation for the overall market, yet still lose money because the purchased stocks underperformed the index that one was trying to emulate.

Fortunately, for investors nowadays, it is a relatively easy task to replicate the performance of an index such as the S&P 500. This objective can be accomplished by simply buying an index fund, an exchange-traded fund, or a futures contract that tracks that particular index. Other choices include the Dow, the Nasdaq 100, and the small-cap Russell 2000 index.

One other thing that should be pointed out up front regarding the performance numbers that appear in this book is that we will use different starting points for different methods. There are two approaches that we can choose from. We can use the same starting date for each test of each different method, or we can start each test at a point where the method in question actually begins to start working. In other words, some methods might test well more than 100 years of data, whereas others might not have been of much use prior to, say, 1950. So, if we start the test for both methods 100 years ago, the first method will likely end up looking like the most effective over the entire test period. However, it is possible that the second method might have outperformed significantly over the most recent 50 years.

In a nutshell, a strong argument can be made either way regarding whether to start all tests for all methods at the earliest possible date or to choose different starting dates to test different methods. For the purposes of this book I have chosen the latter. Individuals who believe that methods tested over a shorter test period—and/or did not work particularly well prior to the chosen starting date—are less valid than other methods tested over a longer time frame are free to make their own determination regarding the reliability of the results that appear in this book.

HOW TO TRADE THE DOW

As I just mentioned, we will primarily be using the Dow as our benchmark for virtually all of the stock market performance testing to be done in this book. As I also mentioned, it is now possible to replicate almost exactly the performance of the Dow using an index fund. There are several choices, which I will detail next. It should also be pointed out that there may be times when an investor might wish to attempt to maximize his or her profitability by using leverage. Leverage simply means that your investment will fluctuate more than 1 percent based on a 1 percent price movement by the Dow itself. This can also be accomplished now using leveraged index funds. An index fund with a leverage factor of 2-to-1 will gain roughly 2 percent if the Dow rises 1 percent and will lose 2 percent if the Dow declines by 1 percent. Last, investors should also be aware that there are now inverse and leveraged inverse index funds available. The available funds for trading the Dow are listed in Table 1.1.

Investors who wish to branch out a bit more may consider using an index fund or exchange-traded fund that tracks the performance of the S&P 500 rather than the Dow. As you might guess, the S&P 500 Index is made up of 500 stocks, essentially all of the same large-cap variety as those that constitute the Dow. The correlation of the performance of these two

TABLE 1.1 Vehicles for Trading the Dow (Long, Short, and with Leverage)

Fund	Ticker Symbol	Type	Objective
Diamonds	DIA	Exchange-traded fund	Long the Dow; no leverage
Rydex Dynamic Dow	RYCVX	Open-ended mutual fund	Long the Dow*2
Profunds UltraDow	UDPIX	Open-ended mutual fund	Long the Dow*2
ProShares UltraDow	DDM	Exchange-traded fund	Long the Dow*2
ProShares Short Dow30	DOG	Exchange-traded fund	Short the Dow; no leverage
Rydex Inverse Dow x 2	RYCWX	Open-ended mutual fund	Short the Dow*2
Profunds UltraShort Dow	UWPIX	Open-ended mutual fund	Short the Dow*2
ProShares UltraShort Dow 30	DXD	Exchange-traded fund	Short the Dow*2

TABLE 1.2 Vehicles for Trading the S&P 500 Index (Long, Short, and with Leverage)

Fund	Ticker Symbol	Type	Objective
Spyder	SPY	Exchange-traded fund	Long the S&P 500
iShares S&P 500 Index Fund	IVV	Exchange-traded fund	Long the S&P 500
Rydex S&P 500	RYSPX	Open-ended mutual fund	Long the S&P 500
Profunds Bull	BLPIX	Open-ended mutual fund	Long the S&P 500
Rydex S&P 500 2x	RYTNX	Open-ended mutual fund	Long the S&P 500*2
Profunds UltraBull	ULPIX	Open-ended mutual fund	Long the S&P 500*2
ProShares UltraS&P 500	SSO	Exchange-traded fund	Long the S&P 500*2
Rydex Inverse S&P 500	RYURX	Exchange-traded fund	Short the S&P 500
Profunds Bear	BRPIX	Open-ended mutual fund	Short the S&P 500
ProShares S&P 500	SH	Exchange-traded fund	Short the S&P 500
Rydex Inverse S&P 500 2x	RYTPX	Open-ended mutual fund	Short the S&P 500*2
Profunds UltraShort Dow	URPIX	Open-ended mutual fund	Short the S&P 500*2
ProShares UltraShort S&P 500	SDS	Exchange-traded fund	Short the S&P 500*2

indexes over the years is sufficiently close enough that an investor who did not want to focus solely on the 30 stocks in the Dow index could generate similar results using the S&P 500. Just remember that at times the Dow will generate better results than the S&P 500 and at other times the S&P 500 will outperform the Dow. The key, then, is to pick an index and stick with it rather than chase the one that has performed the best over the past year, month, week, or hour. Table 1.2 displays a variety of index funds that an investor could use to trade the S&P 500 Index.

As you can see in Tables 1.1 and 1.2, there are many choices available to investors who want to trade these two large-cap indexes. In fact, there are possibly too many choices. But, ultimately, it comes down to three decisions:

Decision 1: Do you want to trade an open-ended mutual fund—typically through the mutual fund company itself—or would you prefer to trade an exchange-traded fund that you can trade through a regular brokerage account?