Selecting Rules for Investing and Trading

By James A. Andrews

There are three important differences between *investing* and *trading*. Overlooking them can lead to confusion. A beginning trader, for example, may use the terms interchangeably and misapply their rules with mixed and unrepeatable results. *Investing* and *trading* become more effective when their differences are clearly recognized. An investor's goal is to take long term ownership of an instrument with a high level of confidence that it will continually increase in value. A trader buys and sells to capitalize on short term relative changes in value with a somewhat lower level of confidence. Goals, time frame and levels of confidence can be used to outline two completely different sets of rules. This will not be an exhaustive discussion of those rules but is intended to highlight some important practical implications of their differences. Long term investing is discussed first followed by short term trading.

My mentor, Dr. Stephen Cooper, defines long term investing as buying and holding an instrument for 5 years or more. The reason for this seemingly narrow definition is that when one *invests* long term, the idea is to "buy and hold" or "buy and forget". In order to do this, it is necessary to take the emotions of greed and fear out of the equation. Mutual funds are favored because of they are professionally managed and they naturally diversify your investment over dozens or even hundreds of stocks. This does not mean just any mutual fund and it does not mean that one has to stay with the same mutual fund for the entire time. But it does imply that one stays within the investment class.

First, the fund in question should have at least a 5 or 10 year track record of proven annual gains. You should feel confident that the investment is reasonably safe. You are not continually watching the markets to take advantage of or to avoid short term ups and downs. You have a plan.

Second, performance of the instrument in question should be measured in terms of a well defined benchmark. One such benchmark is the S&P 500 Index that is an average of the performance of 500 of the largest and best performing stocks in the US markets. Looking back as far as the 1930's, over any 5 year period the S&P 500 Index has gained in price about 96% of the time. This is quite remarkable. If one widens the window to 10 years, he finds that over any 10 year period the Index has gained in price 100% of the time. The S&P500 Index has gained an average of 10.9% a year for the past 10 years. So the S&P500 Index is the benchmark.

If one just invests in the S&P500 index, he can expect to earn, on average, about 10.9% a year. There are many ways to enter this kind of investment. One way is to buy the trading symbol SPY, which is an Exchange Traded Fund that tracks the S&P500 and trades just like a stock. Or, one can buy a mutual fund that tracks the S&P500, such as the Vanguard S&P 500 Index Fund with a trading symbol VFINX. There are others, as well. Yahoo.com has a mutual fund screener that lists scores of mutual funds having annualized returns in excess of 20% over the past 5 years. However, one should try to find a screener that gives performance for the past 10 years or more, if possible. To put this into perspective, 90% of the 10,000 or so mutual funds that exist do not perform as well as the S&P500 each year.

The fact that 10.9% is average market performance for the past 10 years is all the more remarkable when one considers that the average bank deposit yield is less than 2%, 10 year Treasury yields are about 4.2% and 30 year Treasury yields are only 4.8%. Corporate bond yields approximate those of the S&P500. There is a reason for this disparity, though. Treasuries are considered the safest of all paper investments, being backed by the United States Government. FDIC regulated savings accounts are probably the next safest while stocks and corporate bonds are considered a bit more risky. Savings accounts are possibly the most liquid, followed by stocks and bonds.

To help you calibrate the safety and liquidity question, the long bond holders are comparing bond yields they now receive with next year's anticipated stock yields. Consider that next year's anticipated S&P500 yield is around 4.7% based on the reciprocal of its average price to earnings ratio (P/E) of 21.2. Yet the 10 year annualized return of the index has been 10.9%. Bond holders are prepared to accept half the historical yield of stocks for added safety and stability. In any given year, stocks may go either up or down. Bond yields are not expected to fluctuate widely from one year to the next, although they have been know to do so. It is as if bond holders want to be free to invest short term, as well as, long term. Many bond holders are thereby traders and not investors and accept a lower yield for this flexibility. But if one has decided once and for all that an investment is for the long term, high yield stock mutual funds or the S&P500 Index, itself, seem the best way to go. Using the simple compound interest formula, $10,000 invested in the S&P500 index at 10.9% a year becomes $132,827.70 after25 years. At 21%, the amount after 25 years is more than $1 million. If in addition to averaging 21%, one adds just $100 a month, the total amount after 25 years exceeds $1.8 million. Dr. C. rightly believes that 90% of one's capital should be allocated over a several such investments.

A formula to calculate the total amount of capital ***A*** one might expect to accumulate after ***n*** years at an annual fractional yield ***r*** based on an initial investment ***P*** at the beginning of the first year and subsequent annual deposits of ***d*** made at the beginning of each successive year is,

$$A = \frac{\left[P(1+r)^{n+1} - P(1+r)^{n} + d(1+r)^{n} - d(1+r)\right]}{r}$$

Now that you've allocated 90% of your funds to long term investing, that leaves you about 10% for trading. Short to intermediate term trading is an area that most of us are more familiar with, probably due to its popularity. Yet it is significantly more complex and only about 12% of traders are successful. The time frame for trading is less than 5 years and is more typically from a couple of minutes to a couple of years. The typical probability of being right on the direction of a trade approaches an average high of about 70% when an appropriate trading system is used to less than about 30% without a trading system.

Even at the low end of the spectrum, you can avoid getting wiped out by managing the size of your trades to less than about 4% of your trading portfolio and limiting each loss to no more than 25% of any given trade while letting your winners run until they decrease by no more than 25% from their peak. These percentages can be increased after there is evidence that the probability of choosing the correct direction of a trade has improved.

Intermediate term trading is based more on ***fundamental analysis*** which attempts to assign a value to a company's stock based on its history of earnings, assets, cash flow, sales and any number of objective measures in relation to its current stock price. It may also include projections of future earnings based on news of business agreements and changing market conditions. Some refer to this as value investing. In any case, the objective is to buy a company's stock at bargain prices and wait for the market to realize its value and bid up the price before selling. When the stock is fairly priced, the instrument is sold unless one sees continuing growth in the value of the stock, in which case he moves it over into the investment category.

Since trading depends on the changing perceived value of a stock, your trading time frame should be chosen based on how well you are able detach yourself from the emotions of greed and fear. The better one can remove emotions from trading, the shorter the time frame he can successfully trade. On the other hand, when you feel surges of emotion before, during or immediately after a trade, it's time to step back and consider choosing your trades more carefully and trading less frequently. One's ability to remove emotions from trading takes a great deal of practice.

This is not just a moral statement. An entire universe of what's called ***technical analysis*** is based on the aggregate emotional behavior of traders and forms the basis of short term trading. Technical analysis is a study of price and volume patterns of a stock over time. Pure *technicians*, as they are called, claim that all pertinent news and valuations are imbedded into a stock's technical behavior. A long list of technical indicators has evolved to describe the emotional behavior of the stock market. Most technical indicators are based on moving averages over a predefined time period. Indicator time periods should be adjusted to fit the trading time frame. The subject is far too large to do it justice in less than several volumes of print. The lower level of confidence involved in trading is the reason for the large number of indicators used.

While long term investors may use only a single long term moving average with confidence to track steadily increasing value, traders use multiple indicators to deal with shorter time frames of oscillating value and higher risk. To improve your results and make them more repeatable, consider your expectations of changing value, your time frame and your level of confidence in predicting the outcome. Then you will know which set of rules to apply.

James Andrews publishes the Wiser Trader Stocks and Options Newsletter. Information on selected stock market trading systems, including those of Dr Stephen Cooper, can be found at http://www.wisertrader.com/tradingsystems/stockandoptiontrading.html.