

## EPIC ADVISORS, LLC

Weekly Market Commentary

July 1, 2009

Sean Hannon, CFA, CFP

---

As I often discuss in my weekly newsletter *EPIC Insights*, I prefer simple technical patterns such as trendlines and moving averages over elaborate systems. By examining clear price points, I can dedicate more time to forecasting than interpretation.

When using moving averages (MA) to forecast the future, we often look for ways in which time series relate to one another. A popular technique is the double crossover method, which involves watching two different MAs. When the shorter time period crosses over the longer time period, it indicates a reversal is occurring and investors should alter their approach.

For example, consider the current status of the Dow Jones Industrial Average (Dow). When the Dow reached an interim peak of 8,574 on May 8, the 50-day MA was nearly 1,600 points below the 200-day MA. With the shorter time period below the longer, it indicated that the trend remained bearish. By June 30 the Dow declined to 8,447, but the 200-day MA is only 39 points above the 50-day MA. As the stock market has enjoyed its best quarter in nearly a decade, the 50-day will move above the 200-day MA in a matter of days.

Were we to follow simple rules, this reversal would indicate the markets are preparing to resume an upward move, signaling us to buy.

Unfortunately, following set rules often leads to disappointment. To understand the ability of a double crossover to predict market direction, I examined the Dow from January 1, 2000, until June 30, 2009. During that period, someone who invested in the Dow with a buy-and-hold mentality would have suffered a loss of 26%. Conversely, an investor who bought the Dow when the 50-day MA crossed above the 200-day MA and shorted the Dow when the 200-day MA fell below the 50-day MA would have gained 4%.

Does this mean we should rush to buy stocks at the pending cross? Not so fast.

A more detailed look at this time period shows that an investor who followed the mechanical trading program would have done 13 trades. Of these only four were profitable. As the Dow attempted to determine future moves, a mechanical trading program would have had a maximum drawdown of nearly 40% at the same moment at which the Dow buy-and-hold approach faced a loss of 10%. In fact, only by capturing the bulk of the bear market decline was the trading approach able to generate positive returns.

From all this data I draw a simple conclusion. The double crossover may have an impressive track record, but that record is built on the ability to capture wide moves. As the crossover occurs, we

## **EPIC ADVISORS, LLC**

Weekly Market Commentary

July 1, 2009

Sean Hannon, CFA, CFP

---

must assess whether this is a moment in which the broad market will immediately move higher, or if it indicates a sideways movement with little progress. Forced to choose, I pick the latter.

With a market that has consolidated since early May, we now enter an uncertain time. The strong rally from the March lows was driven in part by an oversold market, but hope of the recession ending was a significant factor as well. Second-quarter earnings are around the corner and the market will quickly determine whether the rally is valid. I continue believing the foundation of this move higher is shaky and that any indication of fear will send investors to the exit door. Those expecting the 50-day MA to signal that all is right with the market should consider these factors prior to plunging into stocks.