THE PERSISTENCE OF TRENDS
"Buy the Best vs. Buy the Worst"

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There are two ways to make money in the stock markets. One is by trying to follow trends as in the oft-heard phrase: "the trend is your friend." The other is by betting against trends, often called "buying straw hats in winter." A broker who helped me a lot in my early days put it another way: "Look you could buy the cream of the crop, or you could buy a dead body and hope it rises to the top after a few days." Each philosophy works at different times and over different time periods. One of the hallmarks of the process we use at Chase Investment Counsel is our reliance on data identifying trends in the markets. We constantly monitor a dozen technical and quantitative indicators to see what's getting better or getting worse in the equities markets. Why do we do this? Trends tend to persist often quite longer than people expect and identifying the right ones can result in attractive investment returns. The trend(s) then are our friends. In short, we prefer the "cream" to the "dead bodies."

The trends we watch can be broken down into fundamental and quantitative indicators.

Fundamental indicators are easy to understand. One factor we look for is how often a company exceeds the earnings expectations set for them by the analysts following the company. Not always, but often enough, a company that beats an estimate this quarter will beat its estimate for the next quarter and the quarter after that. Over time, picking stocks of companies beating estimates often leads to good investment returns.

The technical or quantitative indicators we watch are a little harder to grasp. But they basically work the same way as the earnings surprise indicator. Good news begets good news. This often results in good investment returns.

One factor we watch here is relative price action of stocks, or simply how is the stock doing compared to the overall market. Not always, but often enough to watch closely, winning stocks in one time period tend to stay winning stocks in subsequent time periods. This is often referred to as "price momentum." There is some academic support for momentum following.

Data provided by Minnesota investment guru Steve Leuthold aptly illustrates this. Looking at the S&P 500 over the past 18 years, Leuthold has come up with interesting trends. One is that the top performing stocks in year 1 have tended to be the top performing stocks in the following year. As the table below illustrates over the 1990 to 2009 time frame the prior year winners (the top decile of stocks in the S&P 500) bested the losers of the year (bottom 50 stocks) 11 of 18 times. Just as importantly, the returns from the winners were twice as good as the returns from the losers over the time period.

	Next year's Performance Prior year S&P 500 Best 50	Next year's Performance Prior year S&P 500 Worst 50
1991	45.0%	47.6%
1992	13.1%	22.8%
1993	30.3%	14.5%
1994	3.4%	-0.1%
1995	30.1%	27.8%
1996	26.9%	12.2%
1997	27.2%	24.3%
1998	45.6%	-2.7%
1999	47.5%	16.6%
2000	-24.8%	17.0%
2001	-16.7%	16.0%
2002	-13.0%	-48.5%
2003	32.4%	82.0%
2004	15.8%	9.2%
2005	29.0%	-7.8%
2006	12.0%	12.8%
2007	-7.7%	-3.4%
2008	-52.0%	-59.5%
2009	11.2%	100.3%
Avg. 91-08	9.7%	4.9%
Avg. 91-09	9.8%	8.5%

Why could this be so is a reasonable question. The best answer is probably the simplest - something is happening at those companies propelling them to strong performance in year one. That same something could well continue into year two and year three, etc.

As noted, this strategy worked quite well from 1990 to 2008. However, there have been exceptions. The biggest was 2009. And it demonstrates what an unusual market it was. The top 50 stocks from 2008 rose only 11% in 2009. The bottom 50 performers rose an incredible 100%, about nine times the top stocks return and the biggest spread by far in the Leuthold data. Ironically, it made the returns from the bottom 50 strategy just about equal to the top 50 strategy. From 1991 to 2008, the "buy the best" strategy would have returned an annualized 9.7% versus a 4.9% annualized return from the "buy the worst" strategy, or nearly 2x the returns. As noted, 2009 changed that substantially. From 1991-2009, the "buy the best" averaged 9.8% while the tremendous 2009 performance made the "buy the worst" 8.5%. So "buy the best" still wins by a respectable 1.3% over the 19 year period. To get those tremendous 2009 returns from the "buy the worst" strategy, however, probably would have required intestinal fortitude lacking in many investors, especially those with fiduciary responsibility for other people's money. So staying with the "cream" has not been proven a bad thing to do over time. After last year's comeback by the "worst," it will be interesting to see what 2010 brings.

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