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COURSE GUIDE

Professor Peter Navarro
UNIVERSITY OF CALIFORNIA, IRVINE
Paul Merage School of Business

Big Picture Investing

Professor Peter Navarro
University of California, Irvine
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COURSE GUIDE

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#UT020 ISBN: 978-1-4025-4780-5
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Course Syllabus

Big Picture Investing

Photo courtesy of Peter Navarro

About Your Professor

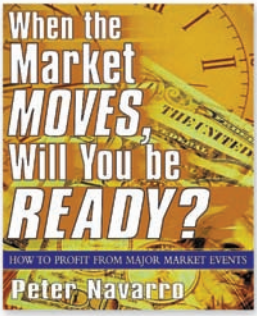
Peter Navarro

Peter Navarro is a business professor at the Paul Merage School of Business at the University of California, Irvine. He holds a Ph.D. in economics from Harvard University and is the author of *The Coming China Wars: Where They Will Be Fought and How They Can Be Won,* the best-selling investment book *If It's Raining in Brazil, Buy Starbucks,* and *The Well-timed Strategy: Managing the Business Cycle for Competitive Advantage,* which illustrates how a knowledge of macroeconomics can be used to improve executive decision-making.

Professor Navarro's articles have appeared in a wide range of publications, from the *Harvard Business Review, Sloan Management Review,* and *Wall Street Journal* to the *Los Angeles Times, New York Times,* and *Washington Post.* He has made frequent guest appearances on major financial news stations, including Bloomberg Television, CNBC, and CNN.

Professor Navarro's weekly stock market newsletter, the *Big Picture Investor,* is distributed to several thousand readers and available free of charge at www.peternavarro.com.

You will get the most out of this course if you have Peter Navarro's *When the Market Moves, Will You Be Ready? How to Profit from Major Market Events* (New York: McGraw-Hill, 2003).



Three Golden Rules	
1	**Buy strong** stocks in **strong** sectors in an upward trending market.
2	**Short weak** stocks in **weak** sectors in a downward trending market.
3	**Stay** in cash when there is no definable market or sector trends.

Introduction

Welcome to this course on Big Picture Investing! This course is a very hands-on companion to my two books on investing. In the best-selling *If It's Raining in Brazil, Buy Starbucks,* I introduced the revolutionary concept of Big Picture Investing as a way to not only profit, but also protect your portfolio from heavy losses. Since the publication of that book, I have received countless requests to illustrate, in a very detailed way, just how to apply Big Picture Investing to the day-to-day management on individual portfolios. Hence, this exciting audio course and its companion textbook—*When the Market Moves, Will You Be Ready?*

Over the next fourteen lectures, I will walk you step-by-step through the Big Picture Investing method. Each lecture will be followed by some review questions as well as a set of very important and interesting exercises. I offer these questions and exercises because I believe that to truly master a set of ideas, you must do much more than simply, and passively, listen. Instead you must also *actively* apply that comprehension to very practical applications. So let's get started!

~Peter Navarro

Lecture 1:
An Introduction to Big Picture Investing

COURSE OBJECTIVES

1. Understand both how and why big macroeconomic forces like inflation and recession and war and terrorism and interest rate hikes by the Federal Reserve can all move the stock market.
2. Show you how to harness these market-moving macroeconomic forces by following the Three Golden Rules of what I call "Big Picture Investing."
3. Illustrate some of the most modern techniques of picking successful stocks.
4. Show you how to better manage both your money and your risk to maximize your gains and minimize your losses.
5. Teach you the nuts and bolts of what's called "trade execution," which involves how to buy and sell your stocks most efficiently.

Introduction

In this introductory lecture, we will describe the five major objectives of the course, and we will examine a brief summary of the three additional objectives of this lesson.

1. Show you how and why a big picture view is essential to profiting in the stock market, within the context of one of the biggest market booms and busts in history.
2. Illustrate some of the most common and costly mistakes that investors typically make.
3. Talk very frankly and candidly about the kind of commitment and temperament that it takes to be a successful investor.

"Four Market Movers" Affect Stock Prices

1. The corporate earnings news can affect particular companies but such news for big "bellweather" companies like GE and Intel can affect the broader overall market.
2. Exogenous shocks that range from war and terrorism to earthquakes and oil price shocks likewise move the markets in both systematic and predictable ways.
3. The fiscal and monetary policies of the government have an enormous impact on stock prices because they affect economic growth and potential earnings.
4. On a daily basis, both government agencies and private institutions regularly release reports on all phases of the economy—from production and capacity utilization to inflation, recession, and productivity, and this macroeconomic calendar likewise moves the market.

The Broad Market Rises and Falls Because of Big Macroeconomic Events

1. As an example, we shall see how the bear market of 2000–2003 was caused by a series of negative macrowaves that included rising interest rates, oil price shocks, war, terrorism, presidential election uncertainties, and accounting scandals.
2. The point: big macroeconomic forces—from war and terrorism to inflation and recession—ultimately determine stock prices and the profitability of your investment portfolio.

The Most Common Investor Mistakes

- Buy good companies in a bad market.
- Practice bad money management, particularly failing to cut your losses.
- Practice bad risk management, particularly not diversifying your portfolio properly.
- Have poor stock-picking skills and succumb to "impulse buying."
- Engage in poor "trade execution" and wind up paying too much for trade commissions and failing to get the best prices.

The Kind of Commitment and Temperament You Will Need to Succeed

1. You must devote at least five to ten hours a week on your investment portfolio.
2. You must become an intelligent speculator rather than a reckless gambler.
3. You should not only want to make money. You should also enjoy the investing process and beauty, elegance, and satisfaction in a well-executed investment strategy.

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You Will Need Adequate Resources

1. A fast computer with a fast Internet connection.
2. At least $25,000 to $50,000 in investment capital to begin.
3. If you don't have that much capital, don't worry. You can begin the investment process by simulating your investing on the Internet.

Go to page 8 for exercises to help you get started

FOR GREATER UNDERSTANDING

NOTE: As part of the exercises in this course guide, I will sometimes ask you to recall from memory some of the key points of each lecture. This is a good way to test your listening comprehension. If you can't answer the questions, you may want to re-listen to the lecture.

Exercises

1. Please write down the Three Golden Rules of Big Picture Investing.
2. Please write down the four major market movers.
3. Please write down at least five of the major negative macrowaves that led to the prolonged bear market of 2000–2003.
4. In this course, I will be recommending that you regularly read two particular publications. One is *Investor's Business Daily,* www.investors.com. The other is *Barron's* weekly magazine, www.barrons.com. I strongly urge you to order your subscriptions now so these publications will be available as you complete the remaining lectures.
5. Get a silver dollar (or quarter) and flip it thirty times. If it's heads, you win. If it's tails, you lose. Did you win more times than you lost in those thirty flips? Chances are it was pretty close. Now if you add in the House's advantage in games of chance, it should be pretty clear that over time, you will always lose in gambling. That's why we want you to become an intelligent speculator, not a gambler in the stock market.

Suggested Reading

Lefevre, Edwin. *Reminiscences of a Stock Operator*. New York: John Wiley & Sons, Inc., 1994.

Edwin Lefevre writes a thinly veiled biography of one of the most successful stock speculators of the 1920s, the legendary Jesse Livermore. This book is an exclamation point to the importance of seeing the Big Picture when investing.

Navarro, Peter. *If It's Raining in Brazil, Buy Starbucks*. New York: The McGraw-Hill Companies, 2001.

In this book, I introduced the concept of "macrowave investing," what we call in this lecture course "Big Picture Investing." The *Brazil* book is not a substitute for this course but rather a very nice complement.

Lecture 2:
The Three Golden Rules and Four Stages of Big Picture Investing

LESSON OBJECTIVES

1. Present the Three Golden Rules of Big Picture Investing and come to understand just what these rules imply as to the skills you will need to become successful Big Picture investors.
2. Provide you with an overview of the four stages of Big Picture Investing and, in doing so, give you an overview of the remaining lectures in the course.

Three Golden Rules

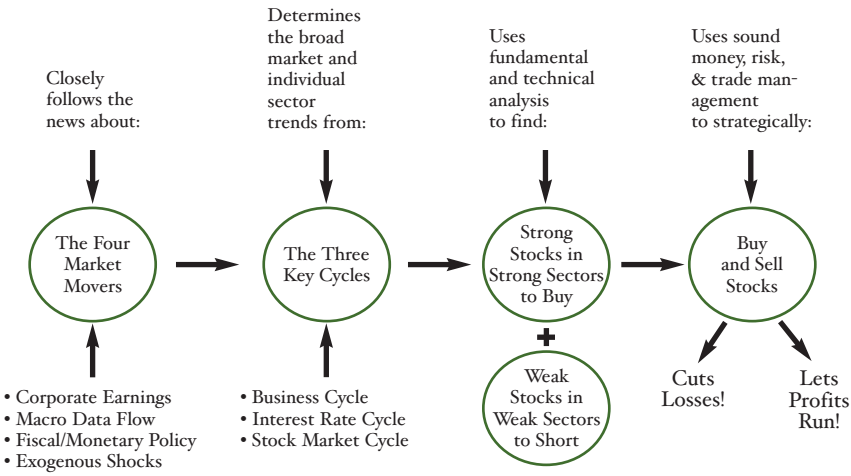
There are Three Golden Rules we will discuss in this course. You will see these rules reinforced in each lecture along with useful advice on how to implement them in your personal investing program.

Three Golden Rules	
1	**Buy strong stocks in strong sectors in an upward trending market.**
2	**Short weak stocks in weak sectors in a downward trending market.**
3	**Stay in cash (and out of the market) when there is no definable market or sector trends.**

What These Golden Rules Imply

1. You must be able to pick both strong and weak stocks.
2. You must be able to correctly determine the direction of the broader market trend.
3. You must also be able to pick strong and weak sectors.
4. Once you have picked your strong and weak stocks in your strong and weak sectors and have determined the market and sector trends, you must learn how to both enter—and exit!—the stock market with discipline.

The Savvy Big Picture Investor:



The Four Stages of Big Picture Investing

1. Stay abreast of all the latest news regarding changes in the Four Market Movers—the earnings news, the macroeconomic reports, fiscal and monetary policies, and any new exogenous shocks.
2. Use a keen awareness of the business cycle, the stock-market cycle, and the interest-rate cycle together with a careful monitoring of the news about the Four Market Movers to constantly assess and reassess the likely direction of the market and sector trends.
3. First uncover possible stocks to buy and short using an array of sophisticated stock-picking tools and then put each of these stocks through both a Fundamental Analysis and Technical Analysis screen.
4. Use solid risk-management, money-management, and trade-execution skills to buy or short sell stocks, with the broader goal of efficiently entering and exiting positions so as to cut losses and let profits run.

Stage One:

Following the Four Market Movers

1. An intelligent speculator seeking to make money in the stock market must keep daily track of any changes in the Four Market Movers—corporate earnings, macro data flow, exogenous shocks, fiscal and monetary policy—because it will be the changes in these factors that will move the markets.
2. This means reading key newspapers like *Investor's Business Daily* and the *Wall Street Journal*, perhaps watching financial news shows like Bloomberg Television and CNBC, and certainly surfing key Internet Web sites for the latest-breaking news and analysis.

Stage Two:

Determining the Market and Sector Trends

1. The stock-market cycle is a leading indicator of movements in the business cycle.
2. Patterns of sector rotation within the stock-market cycle provide essential clues to identifying both strong and weak sectors.
3. If the economy is going to be sliding into recession any time soon, chances are the stock market is going to be bearishly falling well in advance of that recession.

The Business Cycle

1. The business cycle charts the course of the economy as it moves from an expansionary phase and some inevitable peak to a recessionary phase and some equally inevitable trough.
2. As the business cycle moves through its recessionary and expansionary phases, the stock-market cycle moves right with it through six clear phases of its own. In the early-bull, middle-bull and late-bull phases, both the market trend and the prices of most stocks are moving up. Then, when we get to the early-bear, middle-bear, and late-bear phases, the market trend is clearly down—along with the prices of most stocks.
3. The savvy Big Picture investor seeks to capitalize upon these patterns of sector rotation with a strategy of buying into strong sectors and short selling into weak ones.

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The Interest-Rate Cycle

1. The interest-rate cycle charts the progression of Federal Reserve policy from a series of rate hikes to dampen inflationary pressures during an expansion to a series of rate decreases to stimulate an economy out of a recession.
2. Like the stock-market cycle, the interest-rate cycle is likewise a leading indicator of movements in the business cycle, and one of the clearest warnings of the danger of the collapse of any bull market comes when the Federal Reserve begins to actively raise interest rates in response to budding inflationary pressures.

The Yield Curve

1. The Yield Curve describes the highly dynamic relationship between yields on short- and longer-term Treasury securities.
2. History has repeatedly taught us that an inverted yield curve almost always signals recession while a steepening of this curve often signals the start of a new bull market.

Stage Three:

Picking Your Stocks

1. Stock-picking techniques range from the "buy low, sell high" approach of so-called value investors like Warren Buffet to the "buy high, sell higher approach" advocated by the likes of *Investor's Business Daily* guru Bill O'Neil.

Read the investment pages and watch the news!

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2. Regardless of what your style and stock-picking technique are, every potential stock you find must be put through both a fundamental analysis and technical analysis screen.

Technical versus Fundamental Analysis

1. Technical analysis focuses purely on the price action of a stock—and it cares not whether the stock is for computer chips or potato chips.
2. The fundamental analyst believes that a stock's price simply reflects its underlying fundamentals, and key fundamental characteristics range from a company's growth prospects, market capitalization, and earnings per share to its sales-to-profit ratio, leverage, institutional ownership, float, and even its labor-management relationships.

The Fundamental Analyst's Two Traps

1. Investing in a fundamentally strong company in a bad overall market.
2. Investing in a great company in a bad market sector.

Stage Four:

Managing Your Risk, Money, and Trade Execution

1. Managing your money and your risk arguably are the two most important keys to successful, long-term investing. There are some great stock pickers who still go bust simply because they don't know how to manage their money or risk.
2. Learning the techniques of sound money management will help you answer critical questions like: How many shares of each stock should I buy or short? How much of my total cash should I allocate to all of the trades? At what point should I sell any one of the stocks to cut my losses if the trade goes against me? And how much of my total portfolio am I willing to lose if all of these trades go against me?
3. By executing your trades efficiently, you get the best prices and the lowest commission and transaction costs. While the difference in costs for any one investment may not add up to much, when you sum the costs of poor trade execution up across your portfolio, the burden can add up very quickly.

Portfolio Simulation

1. Portfolio simulation involves taking what is essentially "play money" and investing it in the market in real time using any one of a number of simulation softwares.
2. Both new and experienced investors can benefit from using this approach.

FOR GREATER UNDERSTANDING

Consider

1. Please write down from your listening memory the four stages of Big Picture Investing.
2. Visit www.nber.org. This is the website for the National Bureau of Economic Research. Find the appropriate link for reviewing the history of the American business cycle. After reviewing this history, use the website to pinpoint where the business cycle currently might be.
3. Visit www.stockcharts.com. See if you can find a link for the "Dynamic Yield Curve." It should provide you with an animated "movie" of how the yield curve has changed over time relative to the S&P 500 index. Alternatively, you can try the "Economy and Bonds" link at www.smartmoney.com for a picture of the "Living Yield Curve."
4. Visit my website at www.peternavarro.com and read the latest edition of the *Savvy Macrowave Investor* newsletter. This will get you into the flow of current market conditions if you've been out of the stock market.

Suggested Reading

Navarro, Peter. *When the Market Moves, Will You Be Ready?* New York: McGraw-Hill, 2003.

In this book, I further honed the concept of Big Picture Investing. This textbook serves as the text for this course.

Niederhoffer, Victor. *The Education of a Speculator*. New York: John Wiley & Sons, Inc., 1998.

Victor Niederhoffer had one of the most distinguished trading careers on Wall Street—as well as one of the spectacular trading wipeouts. This is another great book to help tune you in to a Big Picture perspective.

Lecture 3:
How the Corporate Earnings News and "Exogenous Shocks" Move the Markets

LESSON OBJECTIVES

1. Understand how and why the corporate earnings news moves the markets and identify the different types of news, from quarterly earnings and guidance to ad hoc reports.
2. Discuss the direct versus bellwether effects of the earnings news and explain the critical difference between the consensus estimates, whisper numbers, and actual earnings reports.
3. Illustrate how to trade stocks around earnings activity and especially learn how to avoid falling into the earnings announcement trap.
4. Come to understand both how and why exogenous shocks move the market and illustrate how such an understanding can be used with an important investment strategy called the "macroplay" to profit from such shocks.
5. Illustrate in greater detail the effects of war, terrorism, oil price spikes, and other shocks on both the market and individual industry sectors.

The Nature of Stock Prices

Stock prices reflect nothing more nor less than investor expectations about a future stream of corporate earnings. Any news that changes these expectations will move stock prices.

The Earnings Effect

1. In parsing the earnings news, the savvy Big Picture investor wants to answer three major questions:
   a. Is the company's earnings for the quarter likely to meet, beat, or fall short of the consensus estimates?
   b. More subtly, is the company likely to meet, beat, or fall short of its earnings whisper number for the quarter?
   c. Most broadly, is the company likely to prospectively change its earnings guidance for the next quarter or next several quarters?

The Two Ways to Profit from Owning Stock

One

Investors can benefit from both the stream of dividend income and the capital appreciation that come from a stock's price rising; and all stocks offer some combination of dividend income and potential capital gains to attract investors.

Two

As an investor, you must choose what mix of stocks to own based on your need for dividend income versus your desire to see longer term capital appreciation.

In general, the older you are, the more you should invest in more conservative dividend-yielding stocks.

The Earnings Season

1. All publicly traded corporations file both quarterly and annual reports, and there is a very well defined "earnings season" that the financial press ritually follows on a quarterly basis. Corporations also periodically issue ad hoc reports regarding new developments.
2. There are three readily definable categories of earnings news: current earnings, guidance for future earnings, and revisions of previously published reports.
3. In the stock market, good current earnings news can be more than offset by lower guidance and vice versa. At the same time, ad hoc reports can either bolster or batter a stock price. For example, a chief executive officer might announce a major new product at a big industry conference, and the company's stock may soar.

The Bellwether Effect

1. Some companies like Intel and GE and General Motors are so big that the earnings news of these companies can move not just the stock but the whole market or market sector. This is called the Bellwether Effect.
2. Intelligent and successful Big Picture Investing requires you to follow the earnings calendar very closely. The reports of the various companies during each quarterly earnings season provide an important mosaic of the future stock-market picture, and any Big Picture investor who ignores this mosaic does so at his or her own peril.

The Earnings Announcement Trap

1. Sometimes a stock price runs up in advance of the earnings news. When the news actually hits, the stock can sell off—even if it is good news.
2. To understand the subtleties and nuances of the earnings season, we must learn about three gap openings or closings, consensus versus whisper numbers, and a well-known phenomenon on Wall Street known as "buy on rumor, sell on the news."

Gap Up or Gap Down Openings

1. Companies typically release their earnings reports either in the afternoon after the market closes or in the morning hours before the next day's opening. The clear danger from the timing of this earnings news is what's called a "gap down" opening if you're long on the stock or a "gap up" opening if you're short.
2. With a gap up or down, the opening stock price is significantly higher or lower than the previous day's close. In such a case, you have absolutely no chance of exiting the stock with a small loss. You have essentially been trapped by the gap.

Consensus Estimates versus Whisper Numbers

1. The consensus estimate is provided by a company called First Call and relies exclusively on professional analysts.
2. These estimates can be unreliable because companies have an incentive to understate their earnings to analysts.
3. Because consensus estimates are unreliable, a whole new industry has arisen that produces so-called "whisper numbers," which are regularly posted on several Internet websites.
4. A stock price can fall when the announced earnings meet the consensus estimate but fail to meet the whisper number, which can be higher.

The Broader Lesson

1. Follow the earnings calendar very closely and be aware of the next earnings report for every stock you hold.
2. Check the earnings calendar for other key companies in the sector and related sectors. This will be particularly true if the stock you are looking at is a relatively small player in the sector.
3. Be careful buying or shorting a stock during an earnings announcement move.

Exogenous Shocks

1. These include natural disasters like earthquakes, floods, and hurricanes as well as disease and pestilence, from the AIDS virus and ebola to man-made "diseases" like computer viruses.
2. These also include political events such as war, terrorism, assassinations, and oil price shocks.
3. There are also beneficial exogenous shocks like so-called disruptive technologies—from electricity and the gasoline engine of a hundred years ago to the Internet and computer.

How Exogenous Shocks Move the Market

1. A shock may merely affect a sector or a cluster of sectors in the economy and perhaps only a region of a country. For example, hurricanes regularly wreak havoc upon Florida and the insurance companies, but have little lasting impact on the broader economy.

2. In some cases, exogenous shocks are quite capable of knocking the entire global economy off its path. Oil price shocks almost always trigger recessions while new technologies can work the other way and spur a higher rate of economic growth.

Oil Price Shocks and the Markets

1. Oil price shocks are bearish because they are effectively a large tax on the global economy.
2. When the government taxes us, it recycles that money back to us in the form of government services like defense and highway construction. As it does so, the contractionary effects on the economy are muted. However, when oil prices rise, the shock also acts like a tax but with a huge difference. Rather than these tax revenues being recycled, the revenues are simply exported to oil-producing countries.
3. With oil price shocks, some sectors do even worse than the broad market, while others do much better. Energy-intensive sectors like the airlines, chemicals, and utilities obviously suffer. On the other side of the ledger, however, oil drilling and equipment stocks always do well.

War and the Markets

1. Both World War II and the Korean War acted as an important stimulus to economic growth and bolstered the stock market.
2. However, the Vietnam War actually triggered inflation and eventually stagflation and was decidedly bearish.
3. Likewise, the 1990–1991 Gulf War ultimately triggered a recession, while the 2003 Iraqi war created uncertainties for the stock market.
4. Certain sectors will always do well in wartime, and those sectors, of course, will be those clustered around the defense sector.

The Art of the Macroplay

1. To profit from exogenous shocks as an investor, you must be a chess player thinking several moves ahead rather than a simple checkers player.
2. As an example, when the Chernobyl nuclear reactor caught fire in 1986 and spewed radiation over a thousand square mile stretch of the most fertile Russian grain land, the checkers' investment move was to try and short sell companies like General Electric and Westinghouse, both manufacturors of nuclear reactors, and utilities like the Long Island Lighting Co. that use nuclear reactors.
3. The chess move was to short sell grain companies like General Mills and Quaker Oats. Fears over a global grain shortage from the catastrophe in the Russian breadbasket caused the stocks of grain processors like General Mills and Quaker to fall.

FOR GREATER UNDERSTANDING

Consider

1. For every stock you are considering, you must be aware of its next earnings announcement date. One way to do this is to visit the website http://yahoo.finance.com and click on the link “Site Map.” In the “Calendars” section under the column “Tools & Community,” find the link “Earnings Calls.” Click on the link and take a look at some of the companies that might be announcing earnings in the current week and in some of the weeks that follow.
2. This exercise will show you how to research not only a company’s earnings calendar but also its consensus estimates and whisper numbers. Compile a list of the stocks in your portfolio and be sure to have their stock symbols ready. Then go to www.earningswhispers.com. Take a few minutes to peruse the site and look at some of the latest earnings news reports. After you do so, find the “Get Whisper” box and look up the latest whisper numbers for your stocks and compare them to the “Analysts’ Estimate.” Determine how you can actually put in your own estimate of earnings for a stock or two. [If you don’t have any stocks at this time, use Cisco (CSCO), General Electric (GE), and Applied Materials (AMAT).]
3. Visit the New York Mercantile Exchange at www.nymex.com. Here, billions of dollars worth of futures contracts for oil, precious metals, and other commodities are traded. At the markets link, go to “Energy” and then “Light, Sweet Crude Oil.” Click on it and learn a little bit about the world’s largest oil futures market.
4. Write down from memory as many exogenous shocks that you can think of from the lecture. Choose one and think about how the shock might affect different companies in the stock market.

Suggested Reading

Visit your local bookstore and peruse a copy of the Massachusetts Institute of Technology’s *Technology Review* for the latest in disruptive technologies. If you are a “dyed in the wool” Internet surfer, alternatively visit sites like www.changewave.com and www.redchip.com.

Lecture 4:
How Fiscal and Monetary Policy Move the Markets

LESSON OBJECTIVES

1. Learn about the four components of economic growth: consumption, business investment, government spending, and net exports.
2. Examine the two different types of inflation: demand-pull and cost-push.
3. Introduce the tools of fiscal and monetary policy, illustrate how they are used to stimulate economic growth and control inflation, and compare the strengths and weaknesses of fiscal and monetary policy.
4. Illustrate the use of "macro scenario building" to show how the stock market may react to the application of government policies.

Goals of Fiscal and Monetary Policy

1. Robust economic growth with a low unemployment rate and low inflation.
2. The stock market hates either slow economic growth or inflation and is especially fearful when the two occur together to give us "stagflation."

	Monetary Policy	Fiscal Policy
Most appropriate for	Fighting inflation or trying to cure a minor recession.	When the economy is in a deep recession or depression.
Upside	The best "fine-tuning" instrument; works relatively quickly; easily reversible.	Provides a very powerful stimulus to a recessionary economy; can choose either tax cuts or spending increases.
Downside	Can't "push on a string" so may be ineffective in periods of significant or severe recession; hits some sectors like autos and housing much harder than others; potential negative effects in international currency markets.	A much blunter tool. Any stimulus takes much longer to work its way through the economy; much greater danger of "missing the target" and being inflationary; harder to reverse; increased government spending may crowd out private sector investment and harm productivity; tax cuts may be ineffective in times of increased uncertainty.

Measuring Economic Growth

1. Economic growth is measured by the rate of growth of the "gross domestic product" or GDP.
2. The GDP equals consumption plus investment plus government spending

plus net exports, where net exports is simply the difference between exports and imports.

The Importance of Consumption

1. Consumption is a very critical part of the economic formula, accounting for almost 70 percent of GDP growth. Falling consumer confidence may trigger a recession.
2. One way to stimulate consumption is for the government to lower taxes—that's fiscal policy. Another way is for the government to lower interest rates so that people might want to buy big ticket, interest-rate sensitive items like cars and houses—that's monetary policy.

Business Investment

1. This involves the purchase of new equipment, machinery, technologies to modernize and expand production and service facilities, and is about 10 percent of the GDP.
2. Lower taxes and lower interest rates can be used to coax business investment back to expansionary levels.

Government Spending

1. This accounts for 15 to 20 percent of the GDP equation and has traditionally been seen as a way of directly stimulating a recessionary economy.
2. Such spending can cause budget deficits, inflation, and higher interest rates and actually cause a recession rather than cure one.

Net Exports and the Dollar

1. When we make products in our factories and sell them abroad, that contributes to the GDP and economic growth.
2. Fiscal and monetary policy can't directly affect net exports, but both have a very big effect on the value of the currency.
3. Expansionary fiscal and monetary policy can weaken the currency and make exports easier to sell abroad. A weak currency also contributes to inflation because it makes foreign goods more expensive.

Demand-Pull versus Cost-Push Inflation

1. Demand-pull inflation comes with economic booms and "too much money chasing too few goods" and is bullish. It is easiest to cure by using contractionary fiscal and monetary policies like raising taxes or raising interest rates.

2. Cost-push inflation results from "supply shocks" like oil price hikes or drought-induced food price spikes and is very bearish. This inflation is much more difficult to cure because in trying to cure it, the result can be recession.
3. As Big Picture investors, we must be able to spot the difference between the two types of inflation, because the Federal Reserve is going to react quite differently to each kind of inflation—with very different implications for the stock market.

Fiscal Policy

1. Involves the use of increased government expenditures or decreased taxes to stimulate a recessionary economy. A reduction in government expenditures or an increase in taxes can also be used to contract an overheated and inflationary economy.
2. Fiscal policy—and its effects on the stock market—have a long and mostly successful place in U.S. economic history. It has helped lift the US economy and stock market on numerous occasions dating back to the Great Depression.
3. However, as the twenty-first century started, fiscal policy was much less successful in stimulating the economy out of a recession.

Men Waiting Outside Al Capone's Soup Kitchen

Notorious gangster Al Capone attempted to help unemployed men with his soup kitchen "Big Al's Kitchen for the Needy." The kitchen provided three meals a day consisting of soup with meat, bread, coffee, and doughnuts, feeding about 3500 people daily at a cost of $300 per day.

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The Problems with Fiscal Policy

1. It takes a long time for a fiscal stimulus to work through an economy. The economy may have already recovered and the stimulus may not only be unnecessary, it can cause inflation.
2. Tax cuts are quicker than using government expenditures, but in a recession where workers fear being laid off, consumers might simply use the tax cuts to pay off debt or save them rather than spend it.
3. Fiscal policy causes budget deficits, which can lead to higher interest rates and the crowding out of private investment, which is anathema to the stock market.

The Role of the Federal Reserve

1. The nation's central bank and "lender of last resort."
2. The Fed helps prevent "bank runs" and insures the stability of the system.

3. It also conducts monetary policy, which involves raising interest rates to contract the economy and lowering them to stimulate the economy.

Monetary versus Fiscal Policy

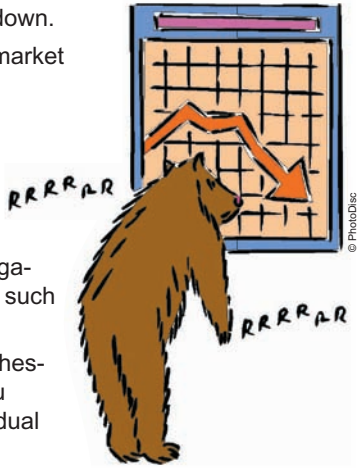
1. Monetary policy is faster acting than fiscal policy, and unlike fiscal policy, it is more easily reversible.
2. Monetary policy is better at slowing down an overheated and inflationary economy than stimulating a recessionary one because "you can pull on a string, but you can't push on string" (that is, consumers and businesses may not take advantage of lower interest rates if they believe the recession will continue).

The Fed and the Stock Market

1. Once the Fed starts raising its rates, it will often do so three or six or even twelve times over a period of months or perhaps even more than a year.
2. The Fed has often triggered a recession and bear market with its rate hikes.
3. The Fed also typically kills a bull market and sends the market on a bearish binge once it starts raising rates.

"Don't Fight the Fed"

1. Once the Fed starts to raise interest rates, it's time for you to carefully consider the possibility that the bull market will soon be over and that it will be time to cash in a lot of your long stock positions and begin to consider the short side.
2. Remember our golden rules: we buy strong stocks in strong sectors when the market trend is up. But we short weak stocks in weak sectors when the market trend turns down.
3. There is perhaps no faster way to turn the market trend down than a series of Fed rate hikes.

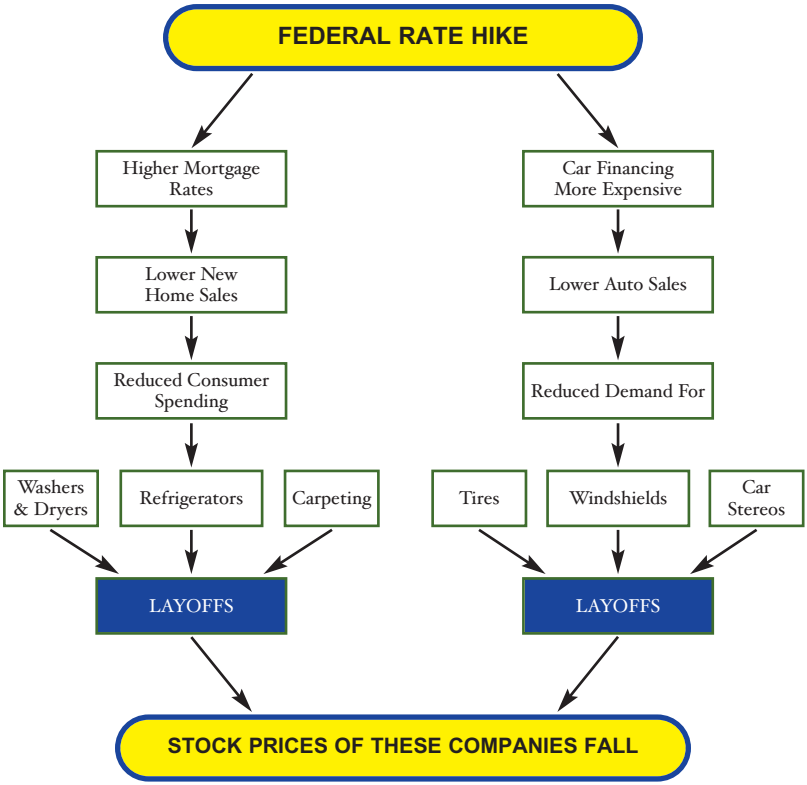


The Casualties of a Fed Rate Hike

1. Interest rate-sensitive sectors such as autos, banking, brokerage, financials services, home finance, and construction.
2. A Fed rate hike will have much less of a negative impact on so-called "defensive sectors" such as food, tobacco, and drugs.
3. An awareness of the Federal Reserve's orchestration of the interest-rate cycle will help you determine both the broad market and individual sector trends.

Macro Scenario Building an Interest Rate Hike

1. A Fed rate hike can lead to higher mortgage rates, a fall in new home sales, and a decline in new home construction. This means reduced consumer spending on appliances such as washers and dryers, dishwashers and refrigerators, and so on. Carpet manufacturers and other home improvement businesses likewise suffer. Stock prices and sectors fall accordingly.
2. Fewer people buy automobiles, as car financing becomes expensive and job prospects become uncertain. This hurts sectors that make tires, windshield glass, car stereo systems, and the like. As layoffs mount, other sectors—from gaming, leisure, and retail to various technology sub-sectors—are affected.
3. Higher interest rates may make the dollar more expensive versus other currencies. That's why stocks in export industries such as agriculture, pharmaceuticals, and steel are likely to react more sharply to Fed policy.



FOR GREATER UNDERSTANDING

Consider

1. What's the difference between demand-pull and cost-push inflation? What kind did we have as the result of the Vietnam War, and what kind was caused by an El Niño weather condition in the 1970s? Which is more difficult to tame?
2. Democrats and Republicans have very different views of fiscal policy. For example, Democrats generally favor increased government spending to stimulate the economy while Republicans favor tax cuts. For a flavor of this debate and to learn more about fiscal policy, check out these websites: The Progressive Policy Institute at www.ppionline.org (go to the "Economic and Fiscal Policy" link). The Cato Institute at http://www.cato.org (go to "Research Areas" and click on "Budget and Taxes"). Which of the two sites is liberal, and which is conservative?
3. Visit the website of the Federal Reserve at www.federalreserve.gov. Click on the "Monetary Policy" link and click on the link for "Open Market Operations." Review the history of the Fed's rate changes, as demonstrated by the changes in the "Intended federal funds rate."
4. Spend some additional time perusing some of the other links at www.federalreserve.gov. Read some of the chairman's speeches, for example, under the "Testimony and Speeches" link in "News and Events."

Suggested Reading

Schwager, Jack. *Market Wizards: Interviews with Top Traders*. New York: HarperBusiness, 1990.

Jack Schwager interviews some of the best investors in the business. As you read the interviews, note how many of the investors take a very broad view of the markets.

The *Wall Street Journal* editorial page provides insight into the conservative approach to fiscal policy.

Lecture 5:
How the Macroeconomic Calendar Moves the Market

LESSON OBJECTIVES

1. Discuss the difference between so-called leading, lagging, and coincident indicators.
2. Identify the "Big Six" macroeconomic problems that plague the stock market and explain the macroeconomic calendar within the context of these problems.
3. Analyze how the market moves in response to the recessionary and inflationary indicators, the productivity numbers, and the budget deficit and trade deficit reports.
4. Show you how to think very systematically about how to follow the economic news to gauge the broader market and sector trends within the context of our GDP.

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"The economy begins to slow, consumer demand falls, and business inventories begin to build. In response, businesses begin to cut back on the hours their employees work and they may begin to lay people off. With less money in their pockets, workers spend less, sales fall, more inventories pile up, and soon, businesses start laying even more people off. But this means even less money gets spent by consumers, even lower sales, less production, and still more layoffs. This circling around the recessionary drain hits the bottom line of almost every business very hard, and (as we never tire of observing in this course), stock prices are ultimately driven by earnings, stock prices must inevitably fall during a recession."

~Peter Navarro

Leading, Lagging, and Coincident Indicators

1. Leading indicators like housing starts and building permits provide us with a signal of what is to come and are most valuable because they allow us to anticipate movements in the stock market and business cycle.
2. A lagging indicator such as the unemployment rate only changes directions after business conditions have changed. They can be important in confirming changes in a trend in the economy and stock market.
3. Coincident indicators like personal income and industrial production rise and fall with the trend and indicate the current state of the economy. They are useful to confirm market trends but not predict them.

The Big Six Macroeconomic Problems and Their Impact on the Stock Market

1. Corporate earnings fall in a recession and drag down stock prices.
2. Rising inflationary pressures are likely to compel the Federal Reserve to hike interest rates.
3. Falling productivity drives earnings and stock prices down and inflation up.
4. Budget deficits can drive up both interest rates and the inflation rate and trigger a recession.
5. Trade deficits can signal weakness in the global economy, weaken the currency, and put downward pressure on the stock market.
6. The slower the rate of economic growth, the worse the stock market will do.

The Recession Indicators

1. Along with housing starts and building permits, automobile and truck sales are important leading indicators of recession and recovery, because consumers typically stop spending money on these durable goods as the economy slows.
2. When the economy is in a recession, the weekly Jobless Claims report is followed very closely because it provides a pretty good indication of the direction of the economy.
3. The monthly jobs report helps set the macroeconomic tone on Wall Street for the month—and therefore the stock market trend.

The Inflation Indicators

1. The Consumer Price Index measures inflation at the retail level while the Producer Price Index measures inflation at the wholesale level.
2. Any sign of demand pull inflationary pressures is likely to trigger an interest-rate increase by the Federal Reserve and the beginning of a new interest-rate cycle.

The Productivity Report

1. The higher the rate of productivity growth, the faster the economy can grow without fear of inflation, so higher productivity is very bullish.

2. Rising productivity is also the only way that workers can enjoy increases in their real, inflation-adjusted wages.

The Treasury Report and Budget Deficits

Any emerging picture of a severely increasing budget deficit will be bearish because budget deficits must be financed in ways that are likely to raise the inflation rate and interest rates.

The Trade Report and Trade Deficits

1. Assessing the impact of the trade report on the market is a very complex task for the Big Picture investor.
2. When the U.S. economy is growing faster than both Europe and Japan, it sucks in more imports and the trade deficit rises. The stock market is unlikely to react to this and may even rally because of U.S growth.
3. The deficit may rise because of recession in Europe and Japan and fewer exports from the U.S. are sold. This is much more bearish for the stock market.
4. The trade deficit may rise because of an oil price shock. This acts as a tax on the U.S. economy and on the broader global economy, and is likewise bearish.
5. The trade deficit may rise because the Federal Reserve has raised interest rates and this makes exports harder to sell and imports cheaper to buy. This can be very bearish.

The Dollar and the Stock Market

1. When the dollar weakens, this lowers the value of foreigners' investments even if stock prices don't initially change.
2. If these foreign investors want to take their profits from the market and export them to their home country, they will have to exchange their dollars back into their original currency. If the dollar is weak, they can buy fewer yen or euros and thus foreign investors lose on U.S. investments when the dollar falls.

Tracking the Macroeconomic Calendar

1. When you want to provide a broad assessment of the economy for the purposes of determining what the broad stock market trend might be, you can look at some of the most important indicators bearing on each of these four components:
   a. The most important economic indicators relating to consumption are consumer confidence and retail sales.
   b. One of the most important reports to watch each month to track business investment is the ISM index.
   c. The Treasury Report and Trade Report are important in tracking government spending and net exports.
   d. For a solid expansion and strong bull market, you need all four components of the GDP hitting on all cylinders without any inflation.

Macroeconomic Calendar

Indicator (Quarterly reports in *italics*)	Rating	Source	Time of Release
Construction Spending	*	Department of Commerce	First business day
Institute of Supply Management Index	* * * *	National Association of Purchasing Managers	First business day
Personal Income & Consumption	* *	Department of Commerce	First business day
Auto & Truck Sales	* *	Department of Commerce	Third business day
The Jobs Report	* * * *	Department of Labor	First Friday
Index of Leading Indicators	*	Conference Board	First week
Consumer Credit	*	Federal Reserve	Fifth business day
Productivity & Costs	* * * *	Department of Labor	Around the seventh of the second month of the quarter for the prior quarter
Retail Sales	* * * *	Department of Commerce	Between the 11TH and 14TH
Product Price Index	* * *	Department of Labor	Around the 11TH
Industrial Production & Capacity Utilization	* * *	Federal Reserve	Around the 15TH
Business Inventories	*	Department of Commerce	Around the 15TH
Consumer Price Index	* * * *	Department of Labor	Between the 15TH and 21ST
Housing Starts	* * *	Department of Commerce	Between the 16TH and 20TH
International Trade	* * *	Department of Commerce	Around the 20TH
Consumer Confidence	* * *	Conference Board University of Michigan Survey Research Center	Last Tuesday of the month Second and last weekend
The Treasury Budget	* *	United States Treasury	Third week
Durable Goods Orders	* *	Department of Commerce	Third or fourth week
Factory Orders	*	Department of Commerce	About a week after the Durable Goods report
Employment Cost Index	* * *	Department of Labor	Near the end of the month of the quarter for the prior quarter
Existing Home Sales	* *	National Association of Retailers	Around the 25TH
New Home Sales	* *	Department of Commerce	Around the last business day
Gross Domestic Product	* * *	Department of Commerce	Quarterly—Third or fourth week of the month

Source: Navarro, Peter. *When the Market Moves, Will You Be Ready? How to Profit from Major Market Events.* New York: McGraw-Hill, 2003.

FOR GREATER UNDERSTANDING

Consider

1. Write down five different categories of macroeconomic indicators and try to remember at least one indicator in each category.
2. To become more familiar with the "Macroeconomic Calendar," visit http://www.economy.com/dismal or, alternatively, www.dismalscience.com. This is the platinum standard when it comes to information on the macroeconomics calendar. I will use this website in many of the exercises that follow in this book so I strongly urge you to sign up for the free trial subscription. Once you do so, please then go to the front home page. Where it says "View All Indicators," hit the go button, and see what's on tap for the month.
3. On Saturday, read the "Review and Preview" section of the latest *Barron's* to see which of the key economic indicators are coming up for review in the coming week as well as to see some of the estimates of these indicators.
4. Go to www.peternavarro.com and read four of the old newsletters in the archives over a one-month period to get a flavor of how the macroeconomic indicators can affect the markets.

Suggested Reading

Navarro, Peter. *If It's Raining in Brazil, Buy Starbucks*. New York: The McGraw-Hill Companies, 2001.

To really get a handle on the macroeconomic indicators, read part three of my book *If It's Raining in Brazil, Buy Starbucks*. You will find all you need to know (and maybe a little more).

Lecture 6:
How Stock Prices Move Over the Course of the Business and Stock Market Cycles and the Patterns of Sector Rotation

LESSON OBJECTIVES

1. Describe the key phases of the business stock market cycles and illustrate how the stock market cycle leads the business cycle.
2. Show how an awareness of the business and stock-market cycles can help you better anticipate the market trend.
3. Explain how "exchange traded funds" can be used to follow the market and sector trends.
4. Illustrate the patterns of sector rotation that occur during the course of the typical business and stock-market cycles.
5. Contrast pure sector investing with "basket trading."

The Business and Stock Market Cycles [See Figure 6-1]

1. Every business cycle moves from peak to trough to peak as the economy contracts, expands, and contracts.
2. As the business cycle moves, the stock-market cycle likewise moves through early, middle, and late bull phases when the market trend and most stock prices are moving up and early, middle, and late bear phases when the market trend and most stock prices are moving down.
3. The stock market clearly peaks well before the business cycle and is the leading indicator of movements in the business cycle.

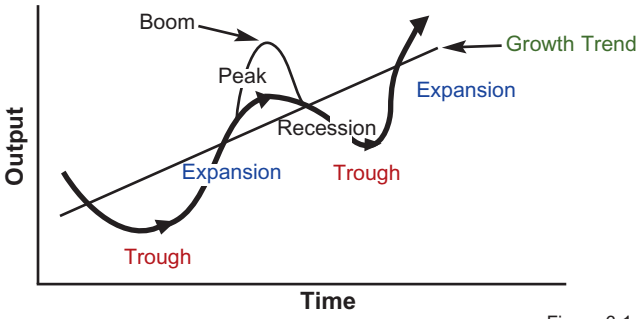


Figure 6-1

Following the Broad Market

1. The Dow Jones Industrial Average includes thirty of the largest corporations like GE and Dupont. It significantly underweights technology, which is a critical part of our modern economy and provides a skewed picture of the market's movements.

2. The Standard and Poor's 500 index reflects stock price movements of the 500 largest corporations listed on the American exchanges and is a much better measure of the stock market than the Dow.
3. The Nasdaq market index is heavily weighted toward technology and is much more volatile than either the Dow or the S&P 500.

Exchanged Traded Funds or ETFs

1. ETFs allow you to trade the three market indices exactly like stocks.
2. You can both buy AND short sell ETFs and they are not subject to the "up-tick" rule, which prevents you from short selling a falling stock.
3. You can use DIA to trade the Dow, SPY to trade the S&P 500 and QQQ to trade the Nasdaq market. Following these three ETFs will help you keep track of the market trend.

The Importance of Sector Awareness

1. Over half of any individual stock price movement is typically driven by events in the company's sector rather than by the company's own earnings performance.
2. If you define your sectors too broadly, you will also miss a lot of great investing opportunities. But if you define your sectors too narrowly, you can get lost in a blizzard of sub-sector minutia.

Categories versus Sectors

1. Broad sector categories of the stock market analysts include consumer cyclicals, consumer non-cyclicals, energy and utilities, financial, health care, real estate, technology, and transportation.
2. These categories are far too broad because many of the sectors within each of these categories are often moving in the opposite direction from one another.
3. For example, within the cyclical category, retailing stocks may be rallying in the stock market even as the leisure sector is taking it quite literally in the shorts.

What Makes a Sector a Sector?

1. The question boils down to things like who the customer is, whether the industry is more labor-, energy-, or capital-intensive, and whether the industry is cyclical, rising and falling with the business cycle, or non-cyclical and therefore more sheltered from recessionary forces.

2. Some sectors, such as computers and leisure, rely heavily on sales to consumers, but sectors like chemicals and environmental services target industrial buyers. These differences matter when it comes to gauging the full effects of indicators like consumer confidence and durable goods.
3. Some sectors, such as retailing, are very labor-intensive; some, such as the utilities, are very capital-intensive; and some, such as transportation, are very fuel-intensive. This matters in the stock market when it comes to assessing how different kinds of macroeconomic shocks like wage inflation, interest-rate spikes, or energy prices hit the economy.

The Patterns of Sector Rotation [See Figure 6-2]

1. In the transition from late bull to early bear, investors start to defensively rotate funds into the health care sector and consumer non-cyclical sectors like cosmetics and food and pharmaceuticals.
2. In the middle to late bear phase after the Fed has lowered interest rates and energy prices have softened, utilities become attractive because they are both capital-intensive and energy-intensive.
3. Housing, autos, and financials lead us out of the late bear to early bull phase on the wings of lower interest rates and pent-up demand.
4. Transportation and technology do well in the early bull phase.
5. Capital goods—from agricultural equipment and industrial machinery to machine tools and basic electronics—do well in the middle bull phase.
6. Basic industry and basic materials such as aluminum, chemicals, paper, and steel do well in the middle to late bull phase.

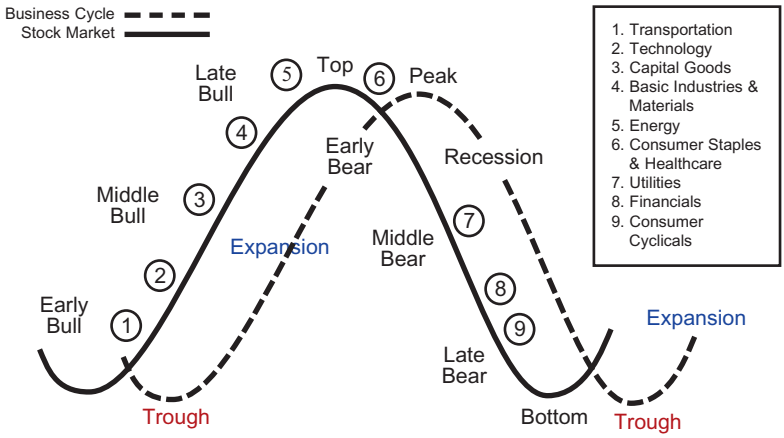


Figure 6-2

Using ETFs to Track the Sectors

1. Just as there are ETFs for the broad market indices—the Cubes, the Spiders, and the Diamonds—there are also ETFs for tracking the various sectors.
2. A representative list of these sector ETFs is presented in Table 6-1. For example, SMH for semiconductors, PPH for pharmaceuticals, and BBH for biotechnology.
3. Just as with your market trend ETFs, you can use these sector ETFs for tracking the various sector trends.

Sampling of Market and Sector Exchange-Traded Funds (ETFs)

	Exchange-Traded Funds (ETFs)
NASDAQ 100 Index	QQQ
S&P 500	SPY
Dow Jones Industrial Average	DIA
Biotech	BBH
Chemicals	IYD
Energy	IYE
Financial	IYF
Healthcare	IYH
Internet	HHH
• Internet Architecture	IAH
• Internet B2B	BHH
• Internet Infrastructure	IIH
Pharmaceuticals	PPH
Real Estate	IYR
Semiconductors	SMH
Software	SWH
Telecommunications	TTH
• Telecom—Broadband	BDH
Utilities	UTH

Table 6-1

Sector Investing versus Basket Trading

1. You can use ETFs to invest at the sector rather than company level. The big advantage is that you don't have to worry about individual company risk.
2. With the alternative, basket trading, you find the top three or four stocks in the sector and buy shares in each. If your speculation was wrong and all stocks in the sector move against you, you sell them accordingly to cut your losses. But if the investment goes in your direction, you can gradually wean out one or two of the stocks in the basket that perform less well than the others—even as you buy more shares of the others.
3. Basket trading can lead to higher profits than sector investing because you don't have weak stocks in the sector acting as a brake or drag on the sector ETF.

FOR GREATER UNDERSTANDING

Consider

1. Go to www.bigcharts.com, enter “QQQ” in the “Enter Symbol or Keyword” box, and click on the “Interactive Charting” link. Check that the time frame is for “1 year” with a frequency of a “Daily” chart. Click on “Draw Chart.” Study the resultant chart carefully. See if you can spot any trends over the period. Look for both Up and Down trends as well as any trading ranges.
2. Go through the same exercise for SPY and DIA as in Exercise 1 at www.bigcharts.com. Explore different time periods to study the various trends.
3. Go to www.ishares.com and spend some time learning more about just what an “iShare” is. Find the list of all of the different kinds of iShares that are offered on the market (for instance, IYH for health care and IYE for energy). Note that besides sector iShares, there are others like “International.”
4. Find the iShare for one of your favorite industry sectors at www.ishares.com and then go back to www.bigcharts.com and appraise the trends for its one-year chart.
5. Go to www.holdrs.com and read up on this particular kind of ETF. As you read about HOLDRS, try to figure out the key difference between a HOLDR and an iShare. You will see that one reflects a very broad index, while the other is based on a smaller number of companies. Which one is which? Think about which one would be a little less risky.
6. At www.holdrs.com, find the list of all the HOLDRS. For a specific HOLDR, such as RTH or SWH, look at all of the individual companies that make up the HOLDR.

Suggested Reading

Gonzalez, Fernando, and William Rhee. *Strategies for the Online Day Trader*. New York: McGraw-Hill, 1999.

I don’t encourage you to become a day trader. But it is important to understand this world, because day traders can move the markets. This book by Fernando Gonzalez and William Rhee is the rare day-trading book because it emphasizes the importance of a macroeconomic, Big Picture perspective on the markets.

Lecture 7:
The Interest Rate Cycle and Yield Curve as Leading Indicators of Stock Price Movements

LESSON OBJECTIVES

1. Explain what interest rates are and how they function within the economy and the stock market.
2. Introduce the concept of the "term structure of interest rates" and show how both time and other forms of risk determine interest rates over the short and longer term.
3. Provide you with some "bond market basics" after which I will explain the often complex relationships between the bond market and stock market prices.
4. Examine the relationship between interest rates and the stock market and interest rates and the currency markets.
5. Look at how a change in Federal Reserve short-run interest-rate policy affects longer-term mortgage rates.
6. Discuss the four shapes of the so-called yield curve and explain why it's a very powerful signal of a coming bull market and an approaching bear market.

The Definition and Function of Interest Rates

1. An interest rate is the price a lender charges to borrow money. It is used to allocate financial capital in the economy across consumption and investment.
2. For consumers, interest rates determine how many cars or houses they can buy collectively and how much debt they can carry on their credit cards.
3. For businesses, interest rates determine how much new plant and equipment they may be purchasing to expand their companies.
4. For the government, interest rates are crucial in determining how the government is going to finance the budget deficit.

The "Term Structure of Interest Rates"

1. The interest rate is typically set higher for a longer-term loan than a shorter-term loan.

	No Risk	Low Risk	Med. Risk	High Risk
Term	Treasury Securities	Aaa to Aa	A to Baa	Ba to C
Short (1 year or less)	1.75%	3.43%	3.99%	5.21%
Medium (1 to 10 years)	4.36%	4.66%	5.75%	8.19%
Long (10 to 30 years)	5.75%	6.36%	6.99%	10.07%

2. The interest rate is typically set higher for riskier investments like junk bonds than for safer investments like treasury bonds.
3. The different interest rates we observe in the capital markets for shorter- and longer-term bonds and safer and riskier bonds defines the term structure of interest rates.

Who Sets Interest Rates?

1. The Federal Reserve sets short-run interest rates.
2. Long-run interest rates are set by the expectations of investors in the market.

An Inverse Relationship Between Interest Rates and Bond Prices

1. As interest rates rise, bond prices go down, so if you buy a bond today for a certain price and interest rates begin to rise, the price of that bond in the marketplace will actually go down and you can lose money on that bond.
2. Bonds can be quite risky because of this inverse relationship to interest rates. And they can also be quite profitable too because the inverse relationship can work in reverse.

A Typical Matrix of Treasury Securities

T-Bills		Current Price	Current Yield
3-Month	--	1.62	1.65
6-Month	--	1.62	1.66
Notes/ Bonds	**Coupon Rate**		
2-Year	2.125	100–04+	2.05
5-Year	3.250	100–29+	3.05
10-Year	4.375	102–31+	4.01
30-Year	5.375	108–11+	4.83

Why the Bond Market Is Important to Stock Investors

1. The amount of money in the bond market is large relative to the amount of money invested in the stock market.
2. When money leaves the bond market and moves into the stock market, that is going to drive up stock prices—and often dramatically.
3. If you have a lot of money going into bonds, very often it's a lot of money coming out of the stock market being used to buy the bonds, and the stock market is going down.

The Flight to Quality

1. Stock market risks are many and varied, and range from recession to war and terrorism.
2. When investors perceive any kind of grave risk, they pull money out of the stock market for fear the economy is going to be collapsing and put that money into the bond market.
3. In such a flight-to-quality scenario, you will observe stock market prices falling, perhaps dramatically.

Asset Re-allocation

1. As the economy expands and investors see bigger profits for corporations, they will begin to move some of their funds out of bonds and into stocks, seeking a higher return.
2. This asset re-allocation from the bond market to the stock market provides the stock market with the fuel it needs to become a new bull market.

Interest Rates and the Currency Market

1. When the Federal Reserve raises interest rates in the United States, this attracts more foreign capital into the country—from, say, Europe, Japan, or Korea.
2. In order for a European investor to invest in the U.S. market, the European has to exchange euros for dollars—just as a Japanese investor has to exchange yen for dollars or a Korean investor has to exchange won. This drives up the value of the dollar.

Why the Currency Market Is Important to Stock Investors

1. When the Fed hikes interest rates, foreign investors funnel money into the U.S., and the dollar strengthens.
2. This stronger dollar lowers U.S. exports and therefore production and earnings of U.S. companies whose exports are lost. Everything else being equal, that's bearish for the stock market.
3. The strong dollar is also inflationary because Americans have to pay more for imports. That is bearish too.

The Scenario of Falling Interest Rates and a Weakening Dollar

1. Falling interest rates are often a symptom of a weakening economy.
2. When the dollar begins to weaken, this causes foreign investors to begin to pull money out of the stock market.
3. As foreigners sell their dollars and expatriate their euros and yen, this further bids the dollar down, more foreigners pull money out of the stock market, and stock prices fall further.

The Beggar Thy Neighbor Scenario

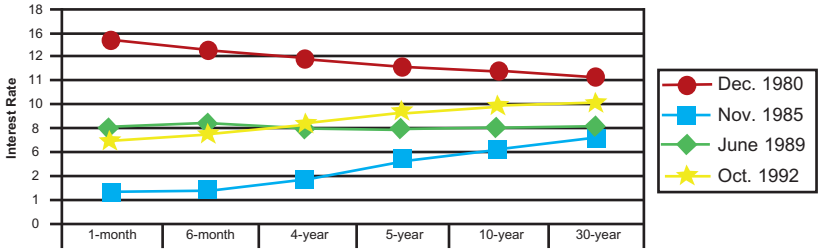
1. In order to stimulate their economies, some countries may purposely devalue their own currency as a means of boosting exports.
2. When these exports are sold at the expense of jobs created in another country, these kinds of devaluation policies can create economic instability and rising political tensions.
3. When you see countries starting to devalue their currencies, as we observed in the Asian financial crisis of the 1990s, the stock market may be headed for troubled times.

The Mortgage Market

1. The Federal Reserve only determines short-run interest rates. Longer-term interest rates, such as mortgage rates, are determined by investor expectations in the market.

2. If investors believe a Fed rate cut will be very effective at bringing the economy out of the recession, longer-term mortgage rates will raise expectations of future inflation.
3. If investors believe a Fed cut will be an ineffective stimulus, mortgage rates will fall on expectations of recession and deflation.

Four Shapes of the Yield Curve



The Normal Yield Curve

1. The Yield Curve describes the highly dynamic relationship between yields on short- and longer-term Treasury securities.
2. The Normal Yield Curve slopes nicely upwards and is defined by an interest rate spread of several hundred basis points, where one hundred basis points equals one percentage point on the interest rate.
3. It is typically observed during the middle expansionary period of the business cycle and the early to middle bull phase of the stock-market cycle when the Federal Reserve is holding interest rates steady, inflation fears are muted, and the economy is expanding nicely.
4. In such times, the market trend is typically up, specific interest-rate sensitive sectors like banking and brokerage are performing well, and this is a very, very profitable time to be buying and holding stocks.

The Steep Yield Curve

1. This usually signals what will be a major change in the market trend and the onset of a new bull market.

2. It is typically observed at the start of an economic expansion—just after a recession ends. At this point, interest rates are relatively low and recovery is on the horizon.
3. Increased capital demand and the first stirrings of inflationary expectations after a recession drive the long end of the Yield Curve up in anticipation of expansion.

The Inverted Yield Curve

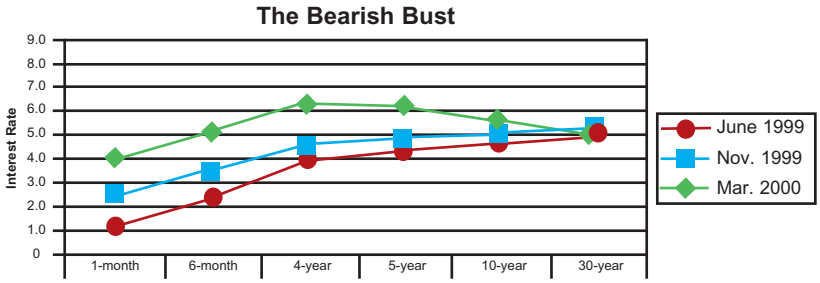
1. It arises because of two inter-related bearish forces and is a very powerful signal of recession and the onset of a new bear market.
2. At the short end, the Federal Reserve has begun to raise interest rates to fight inflation.
3. The long end may also start to fall if bondholders believe that the Fed's contractionary medicine will trigger a recession and associated deflationary pressures.

The Flat Yield Curve

1. Results when yields are roughly the same for both short- and longer-term securities. This can happen for the same reasons that the Yield Curve inverts.
2. A flattening of the curve signals slowing economic growth and a possible recession. But not every flat curve leads to an inversion and the predictive power of a flat curve is less than that of an inverted curve.

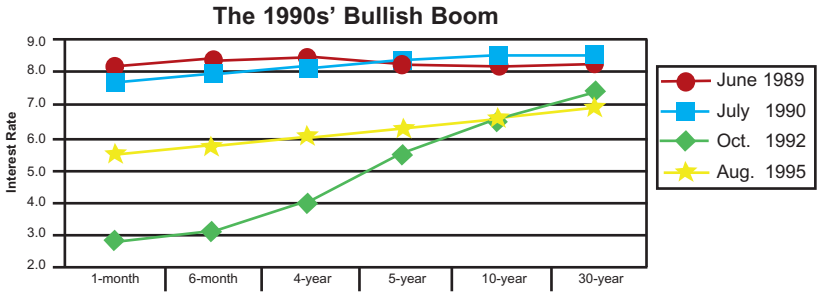
The Yield Curve and Bearish Bust of 2000

1. The June 1999 curve offered a normal shape and represented the calm before the Fed storm.
2. The November 1999 curve began to flatten as the Fed raised interest rates to fight growing inflationary pressures and was a strong early signal of recession.
3. The March 2000 curve took on an ominous "hump-backed" version of the Inverted Yield Curve and marked the absolute height of the Nasdaq boom—and the ensuing Bearish crash.
4. Within exactly a year of this inversion, the economy would officially be in recession—just as the curve forecast.



The Yield Curve and the 1990s Boom

1. The 1992 Steep Yield Curve presaged one of the longest economic expansions in U.S. history—as well as one of the most robust bull markets ever recorded.
2. The Flat Yield Curve of June 1989 correctly forecast what eventually would be dubbed the "Bush recession," which officially began in July of the following year.
3. By that recessionary time, the July 1990 Yield Curve was already fighting its way back to a reasonably normal shape.
4. With the October 1992 Steep Yield Curve, the spread between the short and long ends of the curve climbed to over 450 basis points. Clearly, the bond market was anticipating a very strong recovery—as was indeed the case.
5. The result was an unprecedented stock-market boom.



FOR GREATER UNDERSTANDING

Consider

1. Tune in to CNBC or Bloomberg TV as the stock market is opening and watch the show until one of their bond market analysts comes on to discuss that day's market movers. Note during the discussion whether the bond market is "up" or "down" and what that implies for bond yields.
2. Please take out a pad and paper and try to draw the four different shapes of the yield curve. Which shapes are bullish and which are bearish? Try to think about why this would be so.
3. After you complete exercise 1, go to www.bloomberg.com and see if you can find a picture of the current yield curve as well as a chart of current yields on Treasury securities. (If you are unsuccessful, you can also try www.bondsonline.com.) Observe the yield curve's shape. What does it augur for the stock market?
4. Take a tour of www.stockcharts.com. You should be able to see a nice animated movie of the "Dynamic Yield Curve," which shows how it has changed over time.

Suggested Reading

Thau, Annette. *The Bond Book: Everything Investors Need to Know About Treasuries, Municipals, GNMAs, Corporates, Zeros, Bond Funds, Money Market Funds, and More*. New York: McGraw-Hill Companies, 2000.

This is Bonds 101 and Bonds A to Z all in one volume.

Lecture 8:
How—and How Not!—to Find Winning Stocks

LESSON OBJECTIVES

1. Learn about the "buy low, sell high" method pioneered by value investors like Warren Buffett.
2. Contrast "buy low, sell high" with the perhaps counterintuitive "buy high, sell higher" method pioneered by the publisher of *Investor's Business Daily*, Bill O'Neil.
3. Work our way sequentially through a number of other methods that will range from the high volume movers and "buy what you know" approach of Wall Street legend Peter Lynch to the ratings game played by a number of Wall Street analysts and the division of your stock picking into various asset classes—from small cap and medium cap stocks to large cap stocks.

Buy Low, Sell High

1. This intuitive method of stock picking is also one of the most dangerous, at least in a bear market.
2. "Buy low, sell high" seems to fly directly in the face of our First Golden Rule of Big Picture Investing, which says, buy strong stocks. However, a stock that has fallen significantly in price isn't necessarily a "weak stock."
3. It may simply be that this is a very strong stock, but it is a stock that has found itself in both a very weak sector and a significant downward market trend. In this case, "buy low, sell high" may well work, but only if both the market and sector trends are going to go back up.
4. This strategy is absolute suicide when both the sector and market trends are continuing to move down.

Buy High, Sell Higher

1. The counter-intuitive element of this strategy is simply that if you have a stock that's been going up, isn't that the time to sell and take your profits?
2. It is precisely those stocks that are building strength that have the best chance of blasting off into an even stronger upward run. So look for stocks that have put in a strong base of support and have begun to move upward. Then, when they get at or near their recent highs or "resistance," look for them to try and break out above those highs.
3. Once a stock breaks through resistance, it has a free run. There are lots of people wanting to buy the stock but nobody really wanting to dump it. That's what makes "buy high, sell higher" work.

When to Use—And When Not to Use—the Buy High, Sell Higher Strategy

1. This strategy works very well in an upward trending market. Once a stock gets above a resistance point, very often it will have a nice run.
2. You can get pretty roughed up in the stock market using this strategy if the market is either falling or is in what is called a "trading range." In both cases, there is a high probability of what's called a "failed breakout."
3. You can use the Internet to find stocks that are hitting new 52-week or 26-week highs. It is this universe of stocks hitting new highs that is worth screening if you are looking to implement the "buy high, sell higher" strategy.

BUY HIGH, SELL HIGHER

Bill O'Neil's "buy high, sell higher" theory is based on fifty years of historical studies that show stocks making new highs tend to go higher, while stocks making new lows tend to go lower, negating the myth of "buy low, sell high."

These studies are the basis for the highly successful CAN SLIM™ investment strategy. Independent studies of over fifty well-known systems (by the American Association of Individual Investors) found that CAN SLIM™ consistently outperformed with a 350.3 percent result during both bull and bear markets (1998 to 2003). CAN SLIM™ is the acronym for the seven common characteristics of winning stocks, before they make their price highs.

High-Volume Movers

1. If a stock is moving on very heavy volume, then it's clear that Wall Street is showing some very strong interest.
2. When I see a stock moving up on high volume, that becomes a stock that I may possibly want to buy and will put through my appropriate stock screens. Conversely, when I see a stock moving down on heavy volume, that may well become a good short candidate.

The Underlying Logic of the High-Volume Mover

1. Well over half of the money that comes into the stock market to purchase stocks is money that is provided by institutions like mutual funds and pension funds.
2. When an institution gets interested in a stock and begins to buy large blocks of shares, that can really move a stock price. The same is true when these institutions are bailing out of a loser.

The Wall Street "Ratings Game"

There are literally thousands of analysts who regularly publish ratings about stocks. Very often, if a well-known analyst changes the rating on a stock, you can actually see the stock price move very quickly in the direction of the rating—up for an upgrade and down for a downgrade.

The Problems with the Ratings Game

1. Wall Street analysts have a strong bias toward buying stocks. This leads to ratings that almost always overestimate the potential of a stock.
2. Wall Street analysts are also notorious for their refusal to downgrade stocks and particularly, not downgrading them in a timely manner.

3. Because they do business with some of the companies that they rate, analysts are reluctant to lower the ratings of these companies for fear of losing their business.

Peter Lynch's Buy What You Know

1. Find the latest products that are likely to be a big success, get to know a lot about them by trying the products yourself, and then make stock bets accordingly.
2. I'm always looking for new products that are going to capture the public's imagination—like the Polaroid camera did in the 1950s, the video cassette recorder did in the 1980s, the palm pilot did in the 1990s, or fill in your own blank.
3. Beware: You can buy the stock of the company with the hottest new product in the world, but if the economy is soft and the stock market is heading downward, you will still be swimming against the tide.

Segmenting by Asset Class

1. Small capitalization companies or small-cap companies are typically new and emerging companies with a total capitalization of between $250 million and one billion dollars.
2. Middle capitalization or "mid-cap" companies have a market value of between one and five billion.
3. Large-cap companies are the biggest companies in America and many of them are so-called blue-chip companies.
4. Small-cap companies tend to be a lot more risky than large-cap companies.
5. Small-cap stocks tend to outperform other asset classes in the early to middle bull phases of the stock-market cycle as the economy is coming out of recession.
6. You can also use exchange-traded funds to trade asset classes.

Dividends versus Capital Gains

1. One way to profit from buying a stock is to receive dividend income.
2. The other way to take a profit or "capital gain" is when you sell a stock above the price you pay for.
3. Together, you can think about the dividends and the capital gains from the stock as being your total return from the stock.

Blue Chips versus Growth Stocks

1. Blue-chip stocks tend to offer you more of your total return in the form of dividends, while growth stocks tend to pay little or no dividends. For growth stocks your total return must come in the form of capital gains.
2. A company that pays dividends will be less risky than a growth stock.
3. The older you get and the less risk you want to bear, the more your portfolio should be oriented toward dividend-paying, blue-chip stocks.

4. If you are at a young age and really want to maximize the possibility of a big retirement nest egg, you should be more oriented toward growth stocks.

TV Hype and Touts

1. On CNBC, you might see some young nerdy-looking guy announcing his retirement at the tender age of twenty-nine years old on the basis of his making a fortune using a technique like so-called "channeling."
2. This particular method is nothing more than a variation on the "buy low, sell high" theme.
3. Please don't fall for any of this and keep your checkbook safely tucked away. Any computer system of stock picking that works will simply not be for sale.

ChangeWave Investing

1. What Tobin Smith and his organization did very effectively was identify emerging-market leaders with dominant positions in select market niches in key sectors of the economy, particularly the tech sector.
2. Smith and his followers made an absolute killing using the ChangeWave method right up until March of 2000, when the bear market began.
3. During the bear market, the ChangeWave website continued to tout various tech stocks even as the broader market was disintegrating. The result was often financial disaster for those acting on the picks.
4. While I love to read newsletters, I am also absolutely adamant that when it comes to investing—particularly in tech stocks—you must follow the Golden Rules of Big Picture Investing.

The Cutting Edge

1. *Technology Review* is a magazine that will keep you on the cutting edge of technology developments and point you in the direction of new and emerging stocks.
2. *Investor's Business Daily* is an investment tool that will help you find winning stocks before they break out. *IBD* is filled with stock lists, ratings, unbiased market analysis, and more. IBD's website, www.investor.com, provides a "Stocks on the Move" that lists stocks experiencing unusually high volume—both up and down.

FOR GREATER UNDERSTANDING

Consider

1. Please write down at least four of the stock-picking methods we discussed in the lecture.
2. Find the stock-screening engine at http://finance.yahoo.com in the "Investing" section and "Stock Research" link. Take a look at some of the "Preset Screens" and determine whether any might be useful in implementing some of the stock-picking methods we discussed in the lecture.
3. Visit www.moneycentral.com. Click on the "Investing" link and then click on the "Stocks" link. Go down to the "Stock Screener" and try some of the various stock searches they have available.
4. Play the "ratings game" by visiting http://my.zacks.com. See what the analysts think about some of your favorite stocks.
5. Visit www.peternavarro.com and browse the latest edition of the *Savvy Macrowave Investor* newsletter for the stock picks of the week.

Suggested Reading

O'Neil, William. *24 Essential Lessons for Investment Success: Learn the Most Important Investment Techniques from the Founder of* Investor's Business Daily. New York: McGraw-Hill Trade, 1999.

This book by William O'Neil—as well as *Investor's Business Daily* published by O'Neil—will be two of your most valuable tools in the trading trenches. [Might as well see exactly how the "buy high, sell higher" guru does it.]

Go down to your favorite bookstore and buy the latest issues of the Massachusetts Institute of Technology's *Technology Review*. Today's innovations may be tomorrow's monster stocks.

Lecture 9:
How to Properly Screen Your Stock Market Picks Using Both Fundamental and Technical Analysis

LESSON OBJECTIVES

1. Explain the basics of fundamental analysis.
2. Talk about the two basic traps that investors who rely solely on fundamental analysis often fall into.
3. Show you how to use the four major tools of technical analysis: the basic price chart to identify trends and trend reversals, volume indicators that measure the degree of interest in a stock, moving averages to measure strength of a trend, momentum indicators for strength and weakness, and sentiment indicators.
4. Talk about how to use these basic indicators to conduct simple fundamental and technical screens of your stocks on the Internet.

Two Important Assumptions of Fundamental Analysis

1. Every company has an "intrinsic value."
2. In the short run, the stock market may undervalue a company relative to its intrinsic value, but over the long run the company's stock price will always reflect its intrinsic value.
3. If you, as a fundamental analyst, can determine a company's intrinsic value and you find that the market has undervalued that company, that's a great company to buy.
4. If the stock market has overvalued a company relative to its intrinsic value, that becomes an excellent stock to short sell.

Quantitative Measures of a Company's Financial Health

1. Include income statement data as sales, operating costs, net profit margins, return on equity, cash flow, and earnings per share.
2. Include balance sheet entries such as asset and debt ratios as well as the capital structure of the company.

The Key Fundamental Analysis Questions

1. Has the company consistently earned a profit and, more importantly, is it likely to continue to do so?
2. Is the company's revenue base growing?
3. Does the profit the company earns before taxes actually flow through to the shareholder?
4. Has the company borrowed so much money that it is likely to get into a cash crunch in an economic downturn?

Qualitative Measures for Fundamental Analysis

1. Management quality.
2. Labor-management relationships.
3. A company's rate of technological change and innovation.

Our Goal for Fundamental Analysis

1. It is not to teach you how to become your own fundamental analyst. Rather, the goal is to teach you how to become a sophisticated consumer of fundamental analysis.
2. Using the Internet, put your stocks through a quick fundamental screen.

Two Fundamental Analysis Traps

1. Buy a fundamentally sound company when the entire market is moving down. In such a downward trend, even the best companies find it difficult to swim against the tide.
2. Buy a fundamentally sound company in a weak market sector. In such a case, the broad market may be moving up. But the particular sector may either be moving down or, more likely, simply under-performing other sectors in the bull market.
3. The best way to avoid both of these traps is to augment fundamental analysis with technical analysis.

The Behavioral Roots of Technical Analysis

1. Virtually every technical indicator and chart can actually be explained within the context of basic human behavior and investor psychology.
2. This means that technical analysis is not just some chartist voodoo as it may appear to be at first glance. Rather, technical analysis provides a very powerful graphical and mathematical reflection of the ever-changing moods of the market.

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The Basic Price Chart

1. It quite literally paints pictures of the market trend, sector trends, and individual stock trends.
2. When you look at price charts, look not only for the direction of the price trend. Keep your eyes open for some very tell-tale patterns that historically have had some nice predictive powers for determining whether the trend is going to continue or whether it may, in the language of technical analysis, reverse.
3. Three common patterns are the "head and shoulders" top or bottom, the "cup with handle," and the double or triple top or bottom.

Volume Indicators

1. It's not just the raw number of shares sold that we want to look at. Rather, it's the number of shares sold relative to what it usually sells.
2. A stock moving up on heavy volume is likely to be a much better prospect than a stock moving up on light volume.
3. A stock under accumulation is a better prospect than a stock under distribution. Never buy a stock unless it is under accumulation and never short a stock unless it is under distribution.

Moving Averages

1. The most common moving averages include the 10-day, 20-day, 50-day, and 200-day moving averages.
2. Moving averages can be used to clarify and amplify the direction of a trend and also to smooth out the noise that can arise from the day-to-day price and volume fluctuations.

Momentum Indicators

1. As a stock price—or a sector trend or market trend—moves in one direction, it can either be gathering more steam and moving faster or losing steam and slowing down.
2. When there is growing momentum, this is a very bullish sign that the stock, sector, or the broad market is moving up. But if momentum is flagging, that should be a warning sign to you.

Sentiment Indicators

1. Measure the mood or sentiment of the majority of investors in the market.

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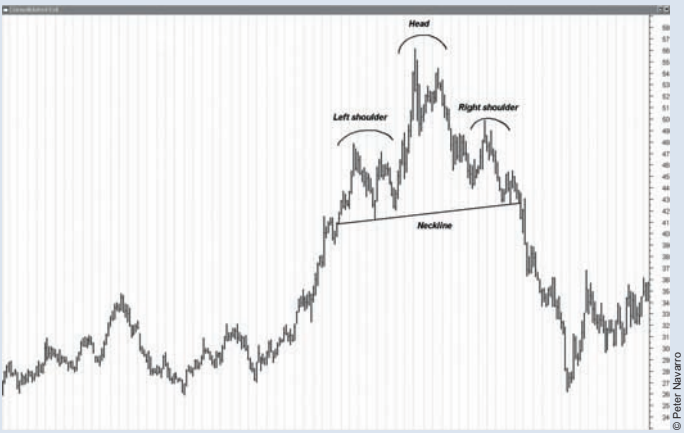

A Head and Shoulders Technical Chart Pattern

A Cup with Handle Technical Chart Pattern

Coca Cola Trades Sideways in a Trading Range

2. They are typically used in a contrarian way. If most investors are feeling bullish, that is often interpreted as a bearish sign by technical analysts.
3. If most investors are bullish, they are likely to have probably already put most of their money into the market. That means there's not much fuel left on the sidelines to spark a further movement in the markets.
4. When many investors are bearish, they are likely to be on the sidelines with a mountain of cash waiting patiently to get into the market. In such a case, any kind of movement up can spark a huge move of cash into the market and this cash fuels the rally.

Use Your Fundamental and Technical Screens

1. When you find a potential stock pick you are considering buying or short selling, go to the Internet and conduct both a fundamental and technical screen.
2. From a technical analysis perspective, you want to know: Is the stock under accumulation or distribution? Are the key moving averages stacked one above the other? Is the momentum of the stock increase growing?

The Final Points

1. Both technical and fundamental screens can be done very simply and very quickly on the Internet using key websites.
2. Put every stock through a fundamental and technical screen.

FOR GREATER UNDERSTANDING

Consider

1. Please write down some of the criteria that fundamental analysts use to determine whether a stock is under- or over-valued.
2. Please write down the four major tools of technical analysis.
3. If you want to learn more about fundamental analysis, visit www.stocks.about.com and click on the "Fundamental Analysis" link.
4. Take a list of your favorite stocks to the *Investor's Business Daily* website at www.investors.com. Use *IBD*'s "Power Tools" to do an "*IBD* Stock Checkup" to check the "Fundamental Rank" and "Fundamental Rating" for each of your stocks. Do you have lemons or diamonds? [Note: You must be a subscriber to the paper. If you aren't, please remember you can try a free trial subscription.]
5. Visit the paid subscription website www.marketedge.com and take a cruise around this technical analysis treasure. Sign up for a free trial subscription and then do a technical analysis check of your list of stocks from the previous question. Do any of those stocks have excellent fundamental ratings from *IBD* and excellent technical ratings from Market Edge? These could be good stocks to buy.
6. At the time of this writing, www.prophet.net was a free website that required registration. Check out some of the sophisticated technical analysis charts and tools available. Try using some of these tools on the stocks you have evaluated in the previous two questions.

Suggested Reading

Pring, Martin J. *Technical Analysis Explained: The Successful Investor's Guide to Spotting Investment Trends and Turning Points*. New York: McGraw-Hill, 1991.

This book requires some heavy lifting, but if you want to learn more, you can find it here.

Visit www.peternavarro.com, click on the "Macrowave University" link and find the article entitled "The Efficient Market Hypothesis & the Random Walk Theory."

Lecture 10:
Managing Your Portfolio and Its Many Risks

LESSON OBJECTIVES

1. Understand the nature of risk and why it is necessary in order for there to be the possibility of earning a reward in the stock market.
2. Provide an overview of the major kinds of risk. This will include market risk, sector risk, and company risk as well as country, currency, interest rate, and liquidity risk.
3. Systematically examine market risk, sector risk, and company risk. Illustrate how the Three Golden Rules of Big Picture Investing will help you manage all three types of risk.
4. Introduce "basket trading," which will further help you manage company risk.
5. Sequentially discuss liquidity risk, regulatory risk, credit risk, country and geo-political risk, exchange-rate risk, and interest-rate risk.
6. Show how portfolio risk is traditionally measured on Wall Street using a tool known as the Sharpe Ratio.
7. Provide you with a set of additional risk-management rules that will range from "never bet the farm" and "don't put all your eggs in one basket" to "when in doubt, go flat."

From Risk Comes Reward

1. From a stock-market investor's point of view, risk is important because it is the basis of the reward you hope to earn.
2. You should never enter into an investment unless the risk-to-reward is favorable. In practical terms, this means that you should never risk more than $1 of loss unless there's the potential for at least $3 of gain.

Market Risk

1. The risk associated with owning any particular stock in a market that tends to trend up or down.
2. The traditional "buy and hold" investor manages such market risk essentially by riding out any bearish storms.
3. More sophisticated buy and hold investors may also employ what's called an "asset allocation strategy" where, during bearish downturns, the investor may choose to move some of his or her money out of stocks and into bonds.
4. The Big Picture investor takes a totally different approach, which is embodied in the Three Golden Rules of Big Picture Investing: never buy a

stock unless the market trend is moving up, and never short a stock unless the trend is moving down.

Sector Risk

1. Sector risk arises because patterns of sector rotation naturally occur.
2. The traditional "buy and hold" investor manages sector risk by holding a broad portfolio that includes most or all of the sectors so that over the course of the stock-market cycle, the greater rewards from the strong sectors balance out the lesser rewards or losses from the weaker sectors.
3. The alternative strategy, embodied in the Three Golden Rules of Big Picture Investing, is to only buy stocks in strong sectors and only short stocks in weak sectors. Using this approach, the Big Picture investor is able to stay on the right side of sector risk and thereby maximize the reward associated with such risk.

Company Risk

1. There are many kinds of company risk—a CEO dies in an airline crash, an effective drug to fight heart disease turns out to have unpleasant side effects that expose the company to huge liabilities, a company's CFO announces that the company won't be meeting its earnings expectations, and a company that moved its production facilities offshore to Malaysia is now the victim of significant labor strife.
2. One way to manage company risk is to avoid it altogether. You can simply invest in the broad market using an exchange traded fund like QQQ for the Nasdaq market or SPY for the S&P 500.
3. The Big Picture investor prefers to manage company risk in two specific ways. The first is to only buy strong stocks and only short weak stocks. The second is to basket trade.

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Basket Trading to Manage Company Risk

1. Suppose you determine that there is a solid upward market trend and that the semiconductor sector is showing signs of significant strength.
2. Using your fundamental and technical stock screens, you have uncovered at least three stocks that are showing significant strength.
3. With basket trading, rather than put all of your cash into one of the stocks, put a third of the cash into one of the strong stocks, another

third in a second strong stock, and the remaining cash into the third strong stock.

4. Sell the laggards and reallocate that cash into the stocks that are showing more strength. In this way, you effectively manage company risk.

Liquidity Risk

1. On any given day, a certain number of shares of a stock are traded. That's the volume of the stock. Liquidity risk arises when a stock is thinly traded.
2. If a stock does not have an average volume of least 300,000 shares per day, that stock likely poses too much liquidity risk. Avoid such stocks.

Regulatory Risk

1. Talk of taxing the Internet or gambling results would have a measurable negative impact on Internet or gaming stocks. That's a form of regulatory risk.
2. Every time the Congress begins debating issues of Medicare, you see increased volatility in pharmaceutical stocks because pharmaceutical companies are exposed to the prospect of price controls on prescription drugs.
3. Other examples include the deregulation of the telecommunications sector or the re-regulation of the electricity sector.
4. Be mindful of how regulatory risks can impact any given stock that you have bought or short sold.

Credit Risk

1. Some companies take on more debt than others and, in the case of a recession, the prospect of default and possible bankruptcy arises.
2. Your fundamental screen should help pick up any of this credit risk, but it is not a sure thing.

Geo-Political Risk

1. There are various geo-political risks associated with either selling one's product or producing one's product in a foreign country.
2. Risks range from earthquakes to political unrest.

Currency or Exchange Rate Risk

1. Suppose McDonald's is selling a lot of Big Macs in Europe. Consumers pay for these hamburgers using euros, not dollars. In order for McDonald's to transfer any profits from these transactions from Europe to its shareholders, it first has to convert euros to dollars. If the Euro is falling in value, McDonald's will lose on these transactions because of such exchange-rate risk.
2. Many companies that are exposed to exchange-rate risk try to hedge such risk. If you are really serious about investing in a company, particularly a multinational company, you may want to look into how it manages such exchange-rate risk.

Interest-Rate Risk

1. When the Federal Reserve raises interest rates, companies in certain sectors are going to respond much more negatively than others because of their interest-rate exposure.
2. By paying attention to the patterns of sector rotation and closely following the interest-rate cycle, the Big Picture investor effectively manages interest-rate risk.

The Sharpe Ratio

1. This ratio allows you to calculate a "risk adjusted return" on your portfolio based on the volatility of the stocks that you have in your portfolio.
2. The Sharpe Ratio can expose the difference between the "lucky gambler" who may win in the markets by assuming excessive risk versus the successful speculator who earns rewards without assuming undue risk.

"Don't Put All Your Eggs in One Basket"

1. Don't invest more than 10 to 20 percent of your cash in any one stock.
2. Never invest more than 10 to 20 percent of your cash in any one sector either.

"Never Bet the Farm"

1. Never put yourself in a position where you can lose all your money—or possibly more.
2. While margin buying increases your purchasing power in the stock market, it also exposes you to significantly higher losses, and in a market that is falling sharply when your portfolio is on the long side, you can, indeed, lose more than you have.

When in Doubt, Go Flat

1. Remember, as Big Picture investors, we are first and foremost intelligent speculators, not reckless gamblers.
2. When there is no discernible market trend, we are either out, or for more sophisticated investors, fully hedged.

Do Your Research: "Chance Favors the Prepared Mind"

1. The Big Picture investor who takes the five to ten hours a week to do his or her research will be in a much better position to manage risk than other investors who either don't do their research or who don't have the Big Picture framework to do their research properly.

FOR GREATER UNDERSTANDING

Consider

1. Please explain how the Big Picture investor uses the Golden Rules to manage company risk, sector risk, and market risk.
2. Contrast how the traditional buy and hold investor versus the Big Picture investor manages sector risk.
3. Besides company, sector, and market risk, name at least five other types of risk.
4. Visit the "Industries" link at www.bigcharts.com, and click on the link for a sector you may be interested in investing in, like technology or health care. Within that sector, click on the link for a sub-sector like "Semiconductors" under technology. Scroll down to the bottom of the page and click on the link "Show All Stocks in This Industry." This will give you a list of publicly traded stocks in that sector. Print the list.
5. Use the IBD fundamental screen and the Market Edge technical screen to screen all of the stocks in the list you printed in exercise 4. Create a list of the ten strongest and the ten weakest stocks in the sub-sector that have an average daily volume over 300,000 shares (to ensure there is proper liquidity for the stock). The strong stocks might be good to buy and the weak stocks might be good to short, provided the other requirements of the Golden Rules are met.

Suggested Reading

Pontell, Henry N., Stephen M. Rosoff, and Robert Tillman. *Profit Without Honor: White Collar Crime and the Looting of America*. 2nd ed. New York: Prentice-Hall, 2001.

This book is a reminder that even at the highest levels of corporate America, crimes can take place that will erode the value of companies and the shares of their investors.

Lecture 11:
Managing Your Money:
The Key to Long-Term Investing

LESSON OBJECTIVES

1. Explain the concept of money management and why it is so important to long-term investing.
2. Discuss the four most important rules of money management, which include cut your losses, let your profits run, never let a winner become a loser, and never average down a loss.
3. Show you how to calculate your stock-picking average, which will help you determine how much risk you want to bear.
4. Show how to use the concepts of support and resistance for a stock price to calculate the "reward-to-risk" ratio for any given stock.
5. Introduce the concepts of investment capital, risk capital, and maximum draw down to help you determine what your level of "risk aversion" is. This will help you quantify just how much of your portfolio you want to put at risk in your pursuit of profits.
6. Illustrate why the question of how many shares of a stock to buy or short will depend on your "position limit," which is the maximum amount of cash you are willing to allocate to any one stock.

Money Management

1. Your first goal in investing should not necessarily be to make money. Rather, it should be to preserve your capital.
2. If you manage to lose half of your money, just to get back even, you will have to then double your money. This is exceedingly hard to do, even in the best and most robust of bull markets.

Cut Your Losses!

1. Every investor must learn to ruthlessly cut his or her losses.
2. As a first pass at how to do this, you should never lose more than 10 percent in any one stock.

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Let Your Profits Run

1. For whatever reason, many investors have a very strong tendency to want to cash out a winning stock well before its time.

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2. A failure to cut your losses and a tendency to take your profits too soon is a flat-out prescription for a losing portfolio.

Never Let a Winning Stock Become a Loser

1. Many investors will buy a stock and see that stock increase significantly.
2. But, rather than sell the stock when it starts heading back down, that investor will hang on to that stock even when it falls well below the original purchase price.
3. Never turn a winner into a loser.

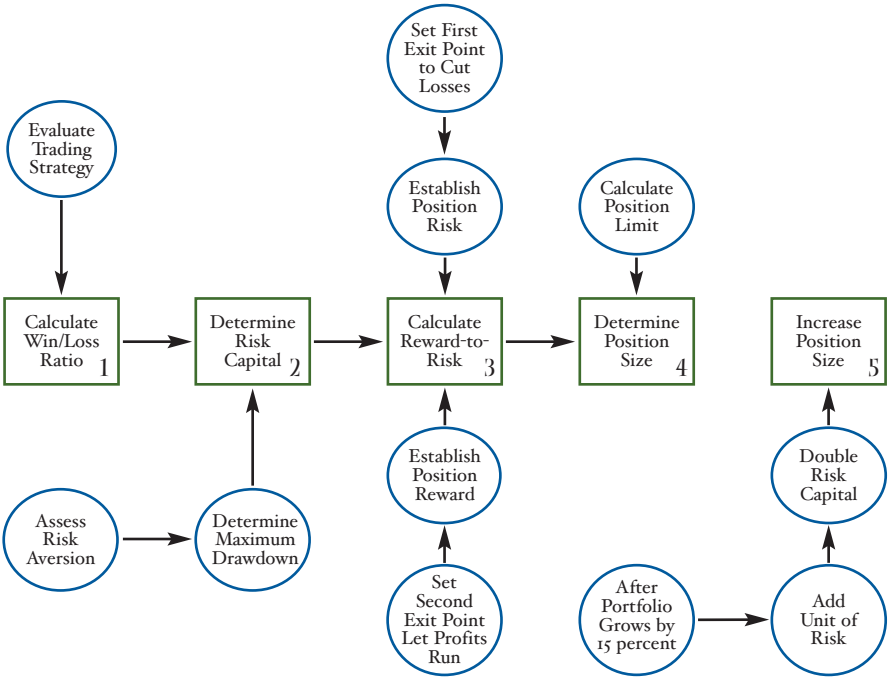
Never Average Down a Loss

1. Far too many gambling investors, when they buy a stock and see the price fall, will then buy some more of that stock. The logic seems to be that if I buy a hundred shares of a stock at $50 and the stock price falls to $40, the stock price will only have to go back up to $45 in order for me to break even if I simply by another hundred shares.
2. Averaging down a loss is much more like quicksand than a sensible strategy.

Your Stock-Picking Average

1. This average is akin to the batting average of a baseball player. It basically will tell you what percent of your trades are profitable.
2. The benchmark average you are trying to beat is 50 percent. If you merely picked stocks to buy or short at random—by throwing darts at a board or picking stock names out of a hat—you should have a fifty-fifty chance of being right.
3. Your stock-picking average is important because it helps you define how much risk you're willing to bear and how much risk capital you might be willing to lose on any given trade.

The Full Money-Management Process



Source: Navarro, Peter. *When the Market Moves, Will You Be Ready? How to Profit from Major Market Events.* New York: McGraw-Hill, 2003.

4. The better you are as a stock picker, the more you are able to lose on any given trade, because over time your excellent stock-picking skills will mean that more winners will offset any of your losers.

Support and Resistance Yields Risk and Reward Levels

1. The support level of a stock defines a price where any movement downward toward that price results in a bounce up and they are often found at key moving averages like the 50-day or the 200-day moving average.
2. The resistance level is a point where sellers begin to outnumber buyers and where a stock price may begin to run out of steam and is often found at or near a 26-week or 52-week high.
3. Support levels help you determine your downside risk of buying a stock and resistance levels help you determine your upside reward.
4. Unless you can quantify your risk with a specific price where you will cut your losses, you will be unable to effectively cut any losses.
5. You should also expect your reward to be significantly greater than your risk, and in order to determine that, you must have some expectation about how much a stock will make for you. Unless you have such an expectation, you won't be able to efficiently let your profits run.

Investment Capital, Risk Capital, and Drawdown

1. Your investment capital is simply how much money you're going to put in your portfolio initially, or how much money you have at any point in time in your portfolio.
2. Your risk capital is how much of your investment capital you are willing to lose at any one time if all stocks in your portfolio go against you and you're forced to cut your losses.
3. Your maximum drawdown is how much of your total portfolio or investing capital you are willing to lose if you are wrong ten times in a row with your positions.
4. Together, these concepts can be used to determine your level of risk aversion. Once you determine how aggressive or conservative you want to be in your investing, this will be reflected in the amount of risk capital you choose.
5. A more conservative investor will risk no more than 2 percent of his or her capital while even the most aggressive investor should never risk more than 5 percent. Otherwise the prospect of going bust at some point in time looms large.

An Example of Determining Your Position Limit

1. A stock sells for $50 per share and you have determined that if the stock price falls below $48, you will sell the stock and cut your losses.
2. You are a conservative investor willing to risk no more than 2 percent of your portfolio and you have $100,000 to invest. This means you are willing to risk no more than a $2,000 loss on the stock. That's your risk capital.
3. Since our risk capital is $2,000, that means we can buy one thousand shares of this stock. That is your position limit.
4. If you buy more shares than this position limit, you would be forced to sell the stock before it falls down to its support level—in which case you would likely be pushed out of the stock prematurely because of the normal volatility of the stock.
5. Alternatively, if you waited until the stock fell to the support level, your loss would be higher than was acceptable given your level of risk aversion.

Another Example of Determining Your Position Limit

1. If you have more than one stock in your portfolio, you simply divide your risk capital by the total number of stocks that you intend to hold in your portfolio at any one time.
2. If you want to own four stocks, you divide the $2,000 of risk capital by four, and you come up with the conclusion that you are willing to lose no more than $500 on any single stock position.
3. With the $50 stock and $2 position risk, you would only buy 250 shares of the stock with a $500 acceptable loss. This is in contrast to the one thousand shares you could have bought of that stock if it was the only one in your portfolio and your position limit was $2,000.

FOR GREATER UNDERSTANDING

Consider

1. Please write down three of the most important rules of money management.
2. Suppose over the last six months I've bought or short sold fifty stocks and twenty-four of them made money. What's my stock-picking average? Is this average good enough to make money?
3. Suppose Microsoft is trading at $20 a share and your technical analysis indicates that the nearest support level for the stock is at $16 and the nearest resistance is at $24. What's the reward-to-risk ratio and is this ratio high enough for you to want to buy the stock?
4. Suppose you have $100,000 in investment capital, you are an aggressive investor, and you are willing to risk 4 percent of your capital on any one set of trades. What is your maximum drawdown and how much investment capital would you be left with if you picked ten bad sets of stocks in a row?
5. Suppose your risk capital is $4,000 and you are only going to buy two stocks. One of the stocks has a position risk of $2. Another has a position risk of $4. How many shares of each stock should you buy, assuming you want to divide the risk capital evenly between the two stocks?
6. Fill in the blanks in the table below:

Company	Sym	Current Price	Support	Resistance	Position Reward	Position Risk	Reward to Risk	Position Limit	# of Shares to Buy
Kraft Foods	KFT	$30.00	$31.00	$39.00				$1,000	
Dole Food	DOL	$26.00	$34.00	$32.00				$1,000	
							Risk Capital	$2,000	

Suggested Reading

Schwager, Jack. *New Market Wizards: Conversations with America's Top Traders*. New York: HarperBusiness, 1993.

This is the second volume from Jack Schwager. As he interviews some of the best traders in the business, you will see why proper money management is so important.

Go to the "Macrowave University" link at www.peternavarro.com and click on "David W. Aloyan's Money Management Rules." This article will explain in more detail how to add additional risk as your profits grow.

Lecture 12:
How to Buy and Sell Your Stocks Efficiently: The Art of Trade Execution

LESSON OBJECTIVES

1. Learn when to use a market order versus a limit order. This decision depends on whether you are trying to capture what's called the "price spread" versus what's called the "price movement."
2. Learn about the dangers of placing market orders with your broker when the market is closed, particularly for shares of IPOs.
3. Master the three rules of setting intelligent stop losses, which include avoiding round numbers and technical decision nodes as well as setting loose stops based on the volatility of a stock price.
4. Learn how to use "trailing stops" to lock in profits and never turn a winner into a loser.
5. Learn how to use the "buy stop" to implement the stock-picking strategies of the "breakout."
6. Alert you to the dangers of churning your own portfolio and the tendency to overtrade.

The Goals of Efficient Trade Execution

1. **Get the best price available when you buy or sell a stock.**
2. **Properly time your stock transactions to take maximum advantage of changing market conditions.**
3. **Never get stopped out of an investment prematurely.**

Market versus Limit Orders

1. With a market order, you do not specify a price but simply the number of shares you want to buy; your order will be filled at some price.
2. With a limit order, you specify a price above which you do not want your order filled and there is absolutely no guarantee your order will be filled.
3. The question as to whether to use a limit order or market order depends on whether you are trying to "capture the spread" between the bid price and ask price versus "capturing the price movement" that results when a stock moves up in price.

A Trading Range versus Trend Market

1. In a trading range market, there is less chance that the stock that you want to buy will be undergoing significant price movements. Therefore, a limit order might be better than a market order.

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2. When the market is trending upward and you want to buy a strong stock in a strong sector, it typically makes no sense at all to use a limit order.
3. Never place a market order unless the market is open, especially for an IPO. You may wind up paying substantially more. It also makes it much more difficult for you to profit in that stock because you start from a higher price.

Intelligent Stop Losses

1. Every stock that you buy or short sell should have at least two stops. One should mark the exit point where you will cut any losses. The other should mark the exit point where you will take your profits.
2. What you are trying to avoid by setting an intelligent stop is to get stopped out of a stock prematurely.

The First Trap

1. The first trap is to get stopped out because you set your stop within the range of a stock price's normal daily volatility.
2. Such volatility can be measured by looking at the difference between the daily highs and daily lows of the stock.
3. Depending on a stock's volatility, you may have to adjust your stops and your share sizes, or position limits to take such volatility into account.

The Second and Third Traps

1. Many investors like to place their buy and sell orders at or very near round numbers like $10 or $20 rather than $9.79 or $19.79. Avoid placing your stops near round numbers.
2. Use technical analysis to find the approximate locations for your stops. But then move the actual stop far enough away from the technical decision nodes so that you don't get caught up in any technical programmed trading. Avoid technical analysis decision nodes like areas of support and resistance.

Trailing Stops

1. A stop loss that moves up by a certain specified amount as the stock moves up in price.
2. The use of such trailing stops could have saved millions of investors from losing billions of dollars in the bear market of 2000.
3. By using a trailing stop, you can follow a stock all the way up. Then, if the stock begins to fall back down, you exit with some profits.

4. Trailing stops help you lock in your profits. They also make sure that you never turn a winner into a loser.

The Buy Stop

1. With a limit order, you specify the highest price at which you want to buy a stock and pay no more than that price.
2. With a buy stop, you specify a price to buy a stock that is actually higher than the current price and do not buy it until the current price rises up to your buy stop.
3. Buy stops are useful to implement within the "buy high, sell higher" strategy discussed in lecture eight. Once a stock is able to rise above its resistance level, it has a very good chance of breaking out to new highs.
4. There is a significant danger with using a buy stop if the breakout fails. Be sure to use this tool with caution.

Other Important Trade Execution Tools

- **Set Intelligent Stops**
  - Take volatility into account
  - Avoid Round Numbers
  - Avoid Technical Decision Nodes
- Beware the Failed Breakout When Using a Buy Stop Order
- Don't Churn Your Own Portfolio

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The Problem of Churning

1. In the old days before online trading, unscrupulous stockbrokers used to overtrade the portfolios of their clients just to generate commissions. This practice is known as "churning."
2. Today, many online investors ironically churn their own portfolio by overtrading. They do so out of either boredom or greed or some other emotion.
3. A good bit of time, market conditions warrant sitting tight—just as the Third Golden Rule of Big Picture Investing requires. So don't churn your own portfolio!

Three Golden Rules

1	**Buy strong stocks in strong sectors in an upward trending market.**
2	**Short weak stocks in weak sectors in a downward trending market.**
3	**Stay in cash (and out of the market) when there is no definable market or sector trends.**

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FOR GREATER UNDERSTANDING

Consider

1. Please write down the difference between a market order and a limit order and under which conditions it is best to use each one. Which kind of order do Big Picture investors more typically use?
2. Please write down the three traps you can fall into when you are setting your stop losses.
3. Please write down the reasons why “trailing stops” can be useful.
4. What can be a big danger using a “buy stop”?
5. Why do some investors tend to overtrade?
6. Check out www.investorpedia.com and look up the definitions of market order, limit order, buy stop, trailing stop, and so on. This is a great site to add to your favorites list.

Websites to Visit

Visit the website of *Financial Times* at www.ft.com for a European take on America and the broader global economy. If you invest globally, this might be worth a free trial subscription.

Lecture 13:
How to Manage Your Portfolio Over the Internet

LESSON OBJECTIVES

1. Highlight the problems with using a traditional broker. These range from bad advice and portfolio churning to slow trade execution and very expensive commissions.
2. Discuss your computer and Internet connection needs in order to use an online broker.
3. Identify the five major criteria you should consider in choosing an online broker—from commission costs and speed of trade execution to the availability of trade execution tools, the quality of the research, and various account management tools.
4. Discuss the critical differences between Level I versus Level II online brokers and discuss why Level II is a superior option for most investors—both because of its market transparency and its direct access to the market.
5. Examine the benefits of portfolio simulation for both novice and experienced investors alike.

Why You Shouldn't Let a Traditional Stockbroker Manage Your Portfolio

1. In one form of relationship with a stockbroker, you simply hand over your funds and let the broker manage your whole portfolio. This is dangerous!
2. Many stockbrokers are not very well-trained and simply do not have the skills to invest your money wisely. In fact, many stockbrokers are simply sales people. Their goal is simply to bring your money into their brokerage firm so they can earn a management fee.
3. A second problem is that the stockbroker may "churn" your portfolio, which involves buying and selling stocks with your cash simply to generate commissions.

Beware of Broker Tips

1. In a second form of relationship with a stockbroker, you have the primary responsibility of choosing which stocks to buy and sell. However, your stockbroker will still often try to entice you into buying certain stocks.
2. There can be a big problem with this kind of advice as well. Very often, the brokerage firms do business with the very companies whose stock they are trying to sell to you. This is an obvious conflict of interest.

The Ultimate Reason Why You Don't Need a Traditional Stockbroker

1. In a third kind of relationship you can have with a stockbroker, you may well be fully in charge of your portfolio's destiny and only call your broker

to tell him or her to place your orders.

2. However, you will pay a very hefty commission for very slow trade execution and this is a very bad bargain.

The Bottom Line

1. Full-service traditional stockbrokers need not be a part of your investing life.
2. Many can't be trusted, they often don't provide very good advice, they execute your orders slowly, and the commission costs are very expensive.

Your Internet Connection

1. There are two basic ways you can connect—by telephone modem or by broadband.
2. Broadband is much faster than the telephone modem approach, but more expensive.
3. Broadband is certainly worth the expense, as the increased speed and wealth of data will more than pay for itself.

Your Computer

1. It should be fast with plenty of hard drive space.
2. You can connect two separate monitors and display literally twice as much material on the screens.

The Key Questions in Shopping for an Online Broker

1. How high are the commission costs?
2. How fast are the trades executed?
3. What kind of trade execution tools does the broker offer? For example, can you only send market and limit orders—or does the broker offer more sophisticated tools like trailing stop losses?
4. What kind of research tools are available—from historical price quotes to charting capabilities?
5. What account management tools are available to track your profits, losses, and risk?

The Commission Cost Question

1. Your online broker may charge you in one of two ways—a flat fee or a per share fee. If you do intend to trade in small share lots, the per share fee will be better for you.
2. Read the fine print: some brokers will charge a flat fee up to a certain amount of shares, say five thousand. After that you may pay an additional charge on a per-share basis. That means if you do buy large share lots, you can incur some hidden charges.
3. Some brokers actually charge more for limit orders than market orders. Don't use these brokers!

Speed of Execution

1. A budget online broker that offers you the cheapest commissions can wind up costing you a lot of money if that broker is slow to execute your trades.
2. Suppose you put in a market order for a stock that is showing a price of $14 when you placed your order. If the trade is executed quickly, you may get the $14 price. But if the online broker does not execute the trade quickly, the asking price may jump to $14.25 or even $14.50 in a matter of seconds. This extra amount you had to pay must be added to that seemingly cheap commission.

The Level I Stock Quote

Last Price		Bid	Ask	Volume
JDSU	17.31	17.27	17.31	14,692,600

Trade Execution Tools

1. Virtually every online broker uses the basic market order and limit order. But some brokers offer more sophisticated trade-execution and trade-management tools.
2. You may be able to use trailing stop losses. Some brokers may also allow you to do your own more sophisticated "programmed trading."

Research Tools

1. A lot of online brokers charge you significantly higher commissions and justify those higher commissions because of the higher quality research they allegedly offer you.
2. On today's Internet, most, if not all, of the research capabilities that an online broker might offer you can be obtained for free, so the quality of research offered by an online broker really shouldn't be a consideration in your choice.

Account Management Tools

1. Look for a user-friendly approach to calculate your profit or loss on every trade.
2. This information is critical for two reasons: it helps you analyze your trades and it also helps you with your tax preparation.

Level I versus Level II

1. With a Level I broker, you see the top-line bid price, ask price, and last price. With a Level II broker, you see all of the bids and ask prices and the sales that are clearing in real time. Thus, you get complete "market transparency."
2. Market transparency allows you to see the relative strength and weakness of both the supply and demand sides of the market equation as well as the momentum of the stock to either the up or down side.
3. By using a Level II online trading platform, you can also avoid "slippage," which occurs when you place your order at one price and get filled at a worse price because of slow trade execution.

4. Level II online trading platforms allow you to see the whole market. They offer faster trade execution and more direct trade execution. They generally have more sophisticated trade-execution and trade-management tools available. However, commissions tend to be more expensive.

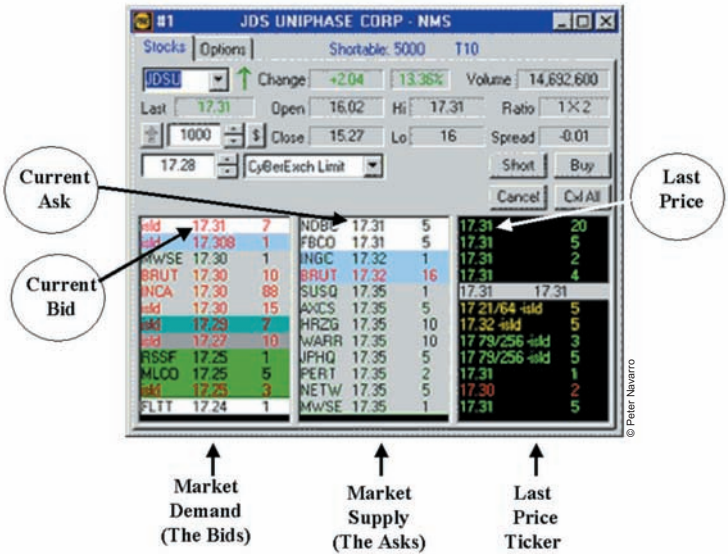
Choosing an Online Broker

1. Go to the Internet and find a comparison of the major brokerage firms. Then, log onto the websites of some of the possible brokers you might consider and learn more.
2. With Level II online brokers, try their simulation models that you can load onto your computer for free and see how the investing platforms work.
3. This is a very important choice, so take whatever time you need to make a wise choice. And don't be afraid to switch brokers at any time.

Portfolio Simulation

1. You can use "play money" to trade stocks in real-time situations to hone your investing skills. And you can do so using any one of a number of computer softwares available on the Internet.
2. Novice investors invariably make "rookie mistakes" that needlessly cost them some of their hard-earned capital. To learn to avoid such mistakes, novices can simulate their investing for at least a few months before putting any real money down.
3. Experienced investors can use portfolio simulation to identify flaws in their investing strategies.
4. Investors can learn to short sell the market better in a portfolio simulation context and thereby conquer their "shortaphobia."

LEVEL II Stock Screen



FOR GREATER UNDERSTANDING

Consider

1. Please write down the five major criteria you should consider in choosing an online broker.
2. Visit www.google.com and try to find some comparisons of the commission costs and other features of online brokers. [Hint: Try a search term like "online brokers and commissions."]
3. Visit www.tradingacademy.com for a wealth of information on Level II, direct access investing.
4. Visit the websites at www.cybertrader.com, www.rushtrade.com, www.tradestation.com, and www.ameritrade.com to sample just some of the direct access, Level II trading platforms.
5. Go to www.google.com and type in the search words "front running and stock market" and read some of the links that refer to this unethical practice. Do the same for "churning and the stock market."
6. If you currently do not have a broadband connection, please call your local phone company and get a price for DSL broadband service (if it is available). Then call your cable company and price their broadband service. Consider choosing one or the other.

Suggested Reading

Pick up an issue of the *Economist* magazine to get a more global take on the economy and markets.

Lecture 14:
A Day in the Life of a Big Picture Investor

LESSON OBJECTIVES

1. Show you how to prepare for each of the four stages of Big Picture Investing.
2. Use this preparation to actively manage your portfolio on a weekly basis.

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The author at work.

The Investment Week Begins with *Barron's* on Saturday

1. The front section of *Barron's* contains a review and preview calendar along with many stories on individual stocks, sectors, and broad market movements.
2. The second section is devoted entirely to mutual funds.
3. The third section is called "Market Week," and the lead story is very valuable, as it analyzes both the previous action in the market week and also tries to make some judgments about what will happen in the next week. This section also contains valuable columns on everything from options trading, commodities trading, and the bond market to global stock-market exchanges—from Europe and Asia to South America.
4. The fourth section is called "Technology Week" and I don't read it very carefully. If I want to stay abreast of movements in the technology sectors, I prefer to focus on *Investor's Business Daily* and some of the monthly magazines like *Technology Review*.

The Review and Preview Feature of *Barron's*

1. I look carefully at the preview section, which has a nice summary of the coming week's macroeconomic calendar.
2. It lists which major macroeconomic reports are coming out—from consumer confidence and existing home sales to personal income and consumer sentiment. It also provides commentary on the likely direction of these reports.

3. This section will also tell us whether or not there are any major meetings or speeches during the week that you should pay attention to.

The Rest of the Magazine

1. As I read it, I look very carefully for any news or analysis that is likely to move an individual stock, an individual sector—or perhaps even the entire market.
2. *Barron's* magazine moves the market! For example, if *Barron's* comes out with a scathing story about the accounting practices of Cisco Systems, it can shave the price of Cisco's stock. Because Cisco is an important technology bellwether, it can also move the whole Nasdaq market.
3. By carefully reading the magazine, you can make better judgments about the direction of the market trend as well.

Reviewing the Coming Week's Macroeconomic Calendar

1. I visit one of my favorite websites on the Internet—www.dismalscience.com—the absolute gold standard when it comes to macroeconomic research.
2. I read about each of the coming macroeconomic reports for the week in order to come up with my assessment of the broad market trend or any changes in that trend.
3. I also try to come up with one or more of the macroeconomic reports that I think will yield a positive or negative surprise for the market.

To Summarize

1. I start with *Barron's* magazine to get the broad overview.
2. Then, I go to the www.dismalscience.com website to probe a little deeper into the macroeconomic calendar and try to make some judgment by Sunday night about which way I think the market is going to go.
3. This sets the tone for my investing for the week.

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My Sector Analysis

1. Over the weekend, I look a bit more deeply at movements in the individual sectors of the market.
2. What I am looking for is not just which sectors are strong and weak but, even more importantly, which ones are gathering strength and which ones are showing signs of weakness.
3. I always want to be positioned at the start of a trend rather than caught at the end of one.

My Monthly Magazine Reading

1. Over the weekend, I catch up on my monthly magazine reading.
2. I have previously mentioned one of the magazines that I subscribe to, *Technology Review*. This magazine is my favorite when it comes to finding cutting-edge technology stocks.
3. I read the *Economist*, which provides a very interesting global perspective not only on the stock market, but also upon the geo-political environment.
4. Another magazine, which I have written extensively for, is *Active Trader*. I like this magazine because it is a very hands-on manual not just for shorter-run traders but for active investors as well.

My Fundamental and Technical Screens

1. In the course of the previous week as well as over the weekend, I may have located some additional potential stock picks. Over the weekend, I like to put each of the stock picks through a complete technical and fundamental analysis to see if they pass muster.
2. I will use technical analysis to calculate both my entry and exit points from the stock.

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3. I simply won't buy a new stock unless it has a strong fundamental rating by *Investor's Business Daily*. Nor will I short one unless it has a weak fundamental rating.

My Daily Routine

1. The first thing I do in the evening after the market closes is go to the *Investor's Business Daily* website and read the "big picture" column.
2. This front-page column of *IBD* provides an excellent summary of the day's market action as well as some intelligent speculation on the likely direction of the market for the remainder of the week.

3. This is a great column and if there's any one thing I recommend you do is read this column faithfully every day.

High-Volume Movers Screen

1. Once I've read the big picture column, I go back to the home page of *IBD* and look at all the high-volume movers that day in the stock market. I take the list of high-volume movers and put them through a variety of fundamental and technical screens.
2. If I find a stock that has promise, I look at the leading stocks in the sector. If these stocks are likewise showing strength, I have almost certainly found a winner to speculate on—a quintessential strong stock in a strong sector.
3. This method works well because any stock that is going to make a big move will, sooner or later, show up on the front page of *Investor's Business Daily* as a high-volume mover.

When the Market Opens

1. I don't engage in any kind of day trading so I am certainly not glued to my computer trading stocks all day long. Because of my other obligations, I can only spend about an hour in the morning managing my portfolio—but that is certainly enough.
2. In the half hour before the market opens, I scan *Investor's Business Daily*, the *Wall Street Journal*, and my local paper, the *Los Angeles Times*.
3. I turn on my television set and begin flipping between Bloomberg Television and CNBC. Bloomberg TV provides a little more detailed perspective on the international markets while CNBC has the slight edge on domestic analysis.
4. I watch the action in the futures markets because the direction of the futures for the Dow, the S&P 500, and the Nasdaq are very good indicators of how the market is going to open and perhaps close.
5. I watch very closely how the European and Asian markets have fared. The direction of these foreign markets can offer clues as to how the U.S. market is going to fare that day.

As the Market Actually Opens

1. I log on to my computer and my online investing account to make sure I have all my stop losses and any buy stops in place, so that my trading strategy will be executed in an efficient way.
2. I will watch the market for maybe twenty minutes or so, execute any trades that I have planned, and then it's time for me to go to my main job.

On a Monthly Basis

1. I analyze each of my trades.
2. I am especially attentive to any trades that turned out to be losing trades, because you can learn a lot more from a losing trade than a winning trade.
3. By analyzing your losers, you can pinpoint any mistakes and make sure they never happen again.

Closing Remarks

1. I hope you have enjoyed this course as much as I have enjoyed teaching it.
2. Wall Street is one very mean street unless you are totally prepared. My whole goal in this book is to provide you with just such preparation.
3. This Big Picture perspective will not only help you in your investing, it will also help you in the rest of your personal and professional life, because so much of our life is dictated by movements of the economy and the stock market—our jobs, our wages, decisions about whether to buy cars and houses, choices about college and so on.

Please Stay in Touch

1. My website is www.peternavarro.com.
2. On my website, you will also be able to access my regular newsletter, which you might find very helpful in your investing.
3. I would love to hear from you.

Best to all,

~Peter Navarro

FOR GREATER UNDERSTANDING

Consider

1. Pick up a copy of *Barron's* on Saturday and read it cover to cover. As you read it, jot down all of the stocks that *Barron's* gives significantly positive or negative coverage to. Then try to pick the one stock that you think will drop the most on Monday in percentage terms when the stock market opens because of unfavorable *Barron's* coverage. Also, pick the one stock you think will jump the highest on favorable coverage in percentage terms. On Monday, after the market closes, see how many of the stocks on your list experienced the "*Barron's* effect." Did you pick the stock that jumped the highest and the stock that dropped the most? Did any of the stocks move in the opposite direction of the *Barron's* coverage?
2. Visit www.peternavarro.com on a Monday and read the latest version of the newsletter. Then, during that week, closely follow the release of the macroeconomic data at www.dismalscience.com and compare the newsletter's analysis to the actual events. Also, follow the "stock picks" over the next several weeks to see whether we got it right or wrong.
3. For the next market week, watch CNBC or Bloomberg TV every day beginning fifteen minutes before the market opens and extending forty-five more minutes after the market opens. In the pre-market action, note which way the futures for the Dow, Nasdaq, and S&P 500 are pointing and further note whether the market opens in the same direction as the futures—up if the futures are up and down if the futures are down. Finally, note each day whether the market closed in the same direction that the futures pointed before it opened. [If you can't watch the show live, tape it with a VCR or a device like Tivo.]
4. As you watch the pre-market action on CNBC or Bloomberg, also note which way the European and Asian markets are pointing. Does the U.S. market open in the same direction?
5. By watching CNBC or Bloomberg TV for another forty-five minutes after the market opens, you will likely be briefed on the major economic reports for the day, most of which are released just before or after the market opens. Note how the market responds to each report or set of reports (which will also help you in fully benefiting from Exercise 2 above).

Suggested Reading for This Course:

Navarro, Peter. *When the Market Moves, Will You Be Ready? How to Profit from Major Market Events.* New York: McGraw-Hill, 2003.

Suggested Readings for Individual Lectures:

Gonzalez, Fernando, and William Rhee. *Strategies for the Online Day Trader*. New York: McGraw Hill, 1999.

Lefevre, Edwin. *Reminiscences of a Stock Operator*. New York: John Wiley & Sons, Inc., 1994.

Navarro, Peter. *If It's Raining in Brazil, Buy Starbucks*. New York: The McGraw-Hill Companies, 2001.

Niederhoffer, Victor. *The Education of a Speculator*. New York: John Wiley & Sons, Inc., 1998.

O'Neil, William. *24 Essential Lessons for Investment Success: Learn the Most Important Investment Techniques from the Founder of* Investor's Business Daily. New York: McGraw-Hill Trade, 1999.

Pontell, Henry N., Stephen M. Rosoff, and Robert Tillman. *Profit Without Honor: White Collar Crime and the Looting of America*. 2nd ed. New York: Prentice-Hall, 2001.

Pring, Martin J. *Technical Analysis Explained: The Successful Investor's Guide to Spotting Investment Trends and Turning Points*. New York: McGraw-Hill, 1991.

Schwager, Jack. *Market Wizards: Interviews with Top Traders*. New York: HarperBusiness, 1990.

———. *New Market Wizards: Conversations with America's Top Traders*. New York: HarperBusiness, 1993.

Thau, Annette. *The Bond Book: Everything Investors Need to Know About Treasuries, Municipals, GNMAs, Corporates, Zeros, Bond Funds, Money Market Funds, and More*. New York: McGraw-Hill Companies, 2000.

All materials are available through www.modernscholar.com or by calling Recorded Books at 1-800-636-3399.