

OUTSIDE THE BELTSTREET

2004

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THE BEAR MARKET CASE—TECHNICALS AND MATH

This 2nd paper will be further evidence on why I feel we are in a historic bear market and why denial of it will be extremely costly. I will write this paper using three books and two of the oldest technical trading patterns in the markets today. Neither of the two men I listen to every week, give market commentary on a theory they discovered. Both of these theories are as old or older than the modern financial theories used in the industry today.

But before reviewing what these two men, and the theories they follow, could teach investors today, I must start by going back in history to the 1960's.

“I have been a lone rider so often and for so long, that I am not even bothered by it anymore.” Great words! Sounds like “Never follow the crowd.” But who is this investment guru?

These words were spoken by Professor Benoit Mandelbrot in his latest book (at age 80), called **The (Mis) Behavior of Markets.** While you may have never heard of him, just ask a math teacher, especially one that teaches geometry. Mandelbrot's work over the last 40 years, especially in fractals, places him as one of the top mathematicians of the 20th century. In fact, when I opened my oldest son Grant's geometry book recently, I found a picture titled “The Mandelbrot Set” in the section on fractals.

So what does that have to do with the markets? Plenty!! (*cont. on pg 2*)

BEAR CASE (CONTINUED)

According to Mandelbrot, many of the assumptions of Modern Financial Theory have major flaws. For those reading this who are in the investment industry, you know of Dr. Eugene Fama's contribution to the schools of finance. His theory, the Efficient Markets Hypothesis (EMH) is one of the bedrocks of our financial world. Fama, was one of Mandelbrot's doctoral students. According to Dr. Mandelbrot, his writings in the early 60's, when the EHM theory came out, were already revealing flaws to this theory.

"In the 1960s most theoretical economists were lionizing Bachelier (proposed the Random Walk Theory in 1900 and was one of Fama's predecessors) and his heirs. The next decade Wall Street embraced their theories. They became the intellectual foundation for stock-index funds, options exchanges, executive stock options... and much of the world financial industry as we know it today. Throughout this time, I was being heard, but as a near-lone voice denouncing the flaws of logic. By the late 1980s and 1990s, however I was no longer alone in seeing those flaws." "However dogmatic the professors, the practical men of Wall Street did eventually open to new ideas. My principal objections— that prices do not follow the bell curve and are not independent— were heeded, and hundreds of economists and market analysts have by now documented their validity. But despite recognition of the problem, the old methods have surprising staying-power."

So what are some of the problems with the modern theories of finance and how much more risk are we taking than we realize? Let's address a few.

1. *Theory-Assumption*— People are rational. People when given relevant information will make the obvious rational choice. Thus the greater the access to information, the more rational investors. This in turn would lead to more rational markets.

Reality— This is so obvious, it is almost laughable. People are not rational. This assumption alone has opened up a whole area in finance in the last 25 years called behavioral finance. And who says all investors have ALL relevant information.

2. *Theory-Assumption*— All investors are alike. Given the same information, they make the same decisions. Economists call this homogeneous expectations.

Reality— People are not alike. I know you needed my help to figure this one out.

TECHNICALS

3.Theory– Assumptions-Price change is practically continuous. Prices move smoothly from one point to the next in a smooth continuous flow. Nature does not take leaps.

Reality– Prices jump, both trivially and significantly.

As hard as this is to face, let me draw this part of the paper to a close with why many of the theories of modern finance versus the results in the real markets , must be understood, and RIGHT NOW!

“From 1916– 2003 the daily index movements of the Dow Jones Industrial Average did not spread out on a graph paper like a simple bell curve. The far edge flares too high: too many big changes. Theory suggests there should be 58 days when the Dow moved more than 3.4%; in fact, there were 1001. theory predicted 6 days of a swing beyond 4.5%; in fact, there were 366. A swing over 7% should come once every 300,000 years; in fact the 20th century saw 48 days. Perhaps our assumptions are wrong.”

Elliotwave and Dow Theory

These are two of the oldest and most widely used technical analyst theories in the markets today and yet most investors and professionals have probably never heard of them or if they have, they, like I used to be, have never studied them. I will only give a few comments about these theories due to lack of space. However it should be stressed that these two theories, like those of modern finance, have had decades to prove their case. Dow Theory came about by the writings of Charles Dow, of the Dow Jones Industrial, who started a newspaper in 1889. You may have heard of it. The Wall street Journal. While Dow never published the writings he did for the Journal, the fourth editor, William Hamilton wrote a series of 252 editorials from 1903-1929 based on what became known as the Dow Theory.

Ralph Elliot wrote to the editor of Robert Rhea’s newsletter, which was based on the Dow Theory, in 1934. He encouraged them to review his discoveries of patterns in the markets as follows: “ The student should recognize that there are cycles within cycles.”

BEAR MARKET CASE- CONT.

In the 1960's, as was written in the first article, Benoit Mandelbrot did extensive work on fractals. What are fractals in geometry? A fractal is an object where the property is self-similar; thus a part of the shape resembles the whole shape. WOW!!!

But in case that is not fascinating enough, consider the fact that both Ralph Elliot and Benoit Mandelbrot were preceded by Leonardo Fibonacci; born in Pisa, Italy (yes, the Leaning Tower city), in 1175. He is known as one of the greatest mathematicians of the Middle Ages. While I still stop with the history lesson at this point, you will notice from the chart on the page 7 that Fibonacci numbers are still being used as a tool by traders in the markets today.

The markets in 2004 based on Elliotwave: comments by Robert Prechter and Dow Theory: comments by Richard Russell.

Prechter– January 8,2004-

Forecast– the cycle should last 499 days from October 9,2002 and end on February 20,2004.

Results– The Dow hit an intraday high on February 19. Earlier the NASDAQ peaked on January 26, 2004 at a .50 time relationship between this wave up and the 2000-2002 wave down.

Forecast– The Dow will have a retracement of 77-82% of the previous decline in a range of 10,702-10,924. A .786 retracement would be 10,773.

Results– On February 19, 2004 the Dow topped at 10,753, an intraday high.

INSIDE STORY HEADLINE

While these may sound like lucky calls, professional traders live by retracement levels which are grounded in Fibonacci's math discoveries. Don't ask me to explain why, it just has been and continues today.

Dow Theory– In order to tell if a market is *weakening* you would look back at previous times in history when the Dow Transportation and the Dow Industrials diverged.

History– 1969– Feb. to May– the Dow Industrials rose but the Transports did not. Result– the Dow fell from 968-769(21%-decline)- 1972– April to October-Dow moved higher, but the Transports did not. Result– From 12/72– 6/73 the Dow declined. The Dow rallied til 11/73 with the Transports failing to follow. The markets collapsed in 74. From 12/72 til 12/74 the Dow went from 1036 to 577. (44% decline) Richard Russell called for the beginning of the bull market in his December 20,1974 newsletter.

2004-Feb– Sept . The Dow declined and the Transports were up. “I call the seven months since February, a period of the most flagrant divergence and series of non-confirmations in the history of the US stock markets.”- 9/20/04.

TECHNICALS

While many will argue that these market calls are “isolated luck” I will only say that with this much history to compare options, if the risk of another August 1998, Oct ‘97, or Oct ‘87 lies in front of me, I would want to base my investment strategies on a theory of “avoid if possible” when dealing with large market unknowns than, “just ride through it”. As Dr. Mandelbrot illustrates after the largest hedge fund in history collapsed in 1998, Scholes, of the Black– Scholes model(1973)denied that the options-pricing models played anything but a “minor role”. However, John Meriweather, the partner who may have lost the most stated, “ Our whole approach was fundamentally flawed. With globalization increasing, you will see more crises. Our whole approach is on the extremes now, because I never want to go through that again.”

*Sources– The (Mis) Behavior of Markets, by Benoit Mandelbrot and Richard Hudson. 2003

— Elliot Wave Principle, 20th Anniversary Edition, Frost and Prechter, 1998

— The Wave Principle of Human Social Behavior and the New Science of Socionomics, by Robert Prechter ,1999

— The Elliot Wave Theorist, March 2004 www.elliottwave.com

— The Dow Theory Letter and Daily Remarks, 9/04

www.dowtheoryletters.com

TECHNICALS



Solutions

1. Diversify among traders versus asset classes. In the 3rd quarter of 2002 99% of equity funds lost money. While some lost less, those who were inverse the markets made money. It is imperative that money managers use tools that go inverse the markets at times.
2. Consider using a short only manager. While this will absolutely lose you money in bull markets, it can work to your benefit in bear markets. For this reason you need to study history and many technical and economic factors. However, this tool gives the investor a way to grow your money in a long term bear market.

Feel free to send any question you may have to: doug@genadv.com

Solutions Continued

3. Buy Gold as an asset—While I would not recommend this asset unless you have an entrance and exit strategy, gold can benefit investors in the proper context. Even though as of this publication I am not recommending holding gold, it is something that I review weekly in consideration of the long term view(4-5 years).

4. Consider other currencies – While this does carry risk that **must** be understood before using this tool, holding dollars when the dollar falls sharply as it did from 2002-2003, is a risk most individuals do not even realize they are taking. For a great understanding of currency moves and bear markets, you should read, [Balance Sheet Recession](#) by Dr. Richard Koo. He is the Chief Economist of Nomura Securities in Japan today and started his career with the Federal Reserve in the 1970s. The Nikkei 225 averaged 38,916 in December of 1989. It closed at 11,278 on October 4, 2004.

5. Be content with less – The more inflexible you are with your current lifestyle, the fewer options you leave yourself in the long run. Enjoy the simple things today!

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