To Trade or Not to Trade … That Is the Question

By Sunny J. Harris

The stockbroker's credo resounds in my ears: "Just buy and hold. That's all that works for the long term." Average in by buying when the market is down. Average in by adding to your portfolio on a regular monthly schedule, regardless of what the market is doing. I listened to that advice for years. But, somehow I doubted it, thinking there must be a better way.

In the face of two back to back losing years in the stock market, one has to wonder whether buy and hold might not be a losing strategy overall. The pundits are worried; the public is worried; and the traders are worried. The question may not just be what and when to trade, but whether to trade at all.

Is there a better way? Or, is that all there is? Early in my trading career I wondered whether market timing could improve a portfolio's results over the buy-and-hold approach. So, I did what any good scientist would do: set up an experiment, test and measure.

For purposes of this article, we will use the Dow Jones 30 Industrial Average (DJIA or Dow) and the NASDAQ Index as proxies for "the market." One could argue that the Dow index contains only 30 stocks, and that it is representative of large, established companies, and that the NASDAQ was largely the focus of trading activity over the past several years. Nevertheless, we have historical data on the Dow for many, many years and it is widely used as an indicator of economic health. The main argument against using the NASDAQ as a proxy would be that it is representative of small, speculative stocks and is highly volatile. I argue for using both, because that's what the world did! During the feverish, speculative mania, investors and traders all over the world turned to the stocks in both these indexes for trading opportunities, hoping to make their fortunes.

Clearly, if you started buying in 1982, at the beginning of the lengthy bull market run, you would have faired well. Buying the Dow on January 1, 1982 at 882, and holding throughout all ups and downs to the present, you could close your position today at 10055, for a neat little profit of 9,173 points. Assuming you had held 100 shares, you would have netted a tidy $917,300 in the intervening 20 years. One-hundred shares, originally purchased at 882, would have cost you $88,200. Your return, then, would be approximately 13% per year over the 20 year period.

Figure 1—The Dow Over the Very Long Term (since 1982)

Figure 2—The NASDAQ Over the Very Long Term (since 1993)

But, what if you weren't around in 1982? Or, what if you weren't interested in trading at that time in history? Chances are you heard about trading as the bubble expanded in the dot-com boom, and you fell into the clutches of one of the purest motivations for trading: greed. Two emotions rule the markets—fear and greed—and these two emotions come heavily into play at market tops and bottoms. So, for purposes of examining the question (to trade or not to trade) let's say you decided to become a trader on January 1, 2000.

The DJIA closed the year 1999 at 11497.12; the NASDAQ closed the same year at 3707. Had you used the buy and hold approach from January 1, 2000 to now (May 23rd, 2002), you would have lost 11497-10216=1281 points on the Dow and 3707-1286=2421 points on the NASDAQ. If you had bought 100 shares (the same way you made 13% per year in the previous example), you would have lost $128,000 on the Dow and $242,100 on the NASDAQ respectively.

What happened? After a long, long bull market run, we finally entered a long overdue bear market. Bear markets are healthy for the economic cycle and continued growth of the economy in the same way that forest fires are healthy for the environment. We entered a cleansing period, and prices are normalizing during this phase.

But, as traders we need to know: is there any way to negotiate around in a bear market and not lose your shirt? The answer, of course, is yes, if you traded from both the long and short sides on the way down, or if you were psychic and went short at the top and were still holding your short position. As a more practical solution, I mark important pivot points with a yellow highlighter and then calculate the potential profit from each long and short position. (Actually I created an indicator that I call PHW and it automatically does the calculations, because I got tired of doing it by hand.) Knowing that it would be impossible to catch all the turning points, we need to take a practical percentage of the ideal and work with that lesser goal. Over the years I have found that it is possible to achieve 40% of the ideal, but rarely more. So that's the figure I use for PHW—40% of the ideal.

Figure 3—PHW™ calculates the ideal maximum possible profit

Had we been able to catch all of the ideal moves, both long and short, from the beginning of January 2000 to present, the PHW indicator shows that we could have made a maximum ideal profit of $10,373 on a single contract. Now, let's buy our 100 shares and the ideal total becomes an astounding $103,700. But, remember, it's impossible to catch all the highs and lows, so we estimate our goal to be 40% of the ideal—that is $41,480. That's certainly better than losing the $242,100 in the buy-and-hold scenario!

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