

Profiting in a Sideways Market

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Four years ago, the Dow Jones Industrial Average hovered in the range of 10,500 points – nearly the same place it is now.

Although the Dow topped the 11,200 mark in May 2001 and fell below 7,600 in October 2002, its path has traced what stock traders call a "sideways market" – always on the move, but not going anywhere.

"We are in what I would consider a bear market," says Jack Rothstein, chairman of Virginia-based Rothstein Investment Advisory Services and editor of the Web site Wealth cast.com. He compares the current market to a time when the Dow lingered for 16 years (from 1966 to 1982) before reaching a new high.

But Mr. Rothstein and other experts note that despite the challenging investment environment, savvy strategies can still yield relatively solid returns.

"We don't have a market where you can invest, go away, and come back in three months with triple your money," says Neal Frankle, president of Wealth Resources Group and author of the book *Why Smart People Lose a Fortune*. "In everything there's a time to play offense and a time to play defense. Why not with investing?"

Behind the current environment, according to economist Joel Naroff, president of Pennsylvania-based Naroff Economic Advisors, is a U.S. economy that is "moving into a moderate but sustainable growth pattern." He expects quarterly GDP growth around 3 percent, with consumer spending holding steady. As a result, corporate earnings "will be consistent but not spectacular."

For Mr. Rothstein, that means investors should be selective and buy stocks based on their individual strengths. Ernesto de la Fe, managing director of the Americas region for Lehman Brothers in New York, also notes that the question of how to profit continues to be based on an investor's philosophy. "Are you investing for the long term or short term? Timing the market is still very difficult," he says, "and few can do it consistently."

But in a market with no clear direction, a sense of timing can mean the difference between profit, loss, or stagnation. Mr. Frankle disagrees with the popular notion that investors should buy quality stocks and never sell them, especially in the current climate.

"With buy and hold, you can suffer tremendous losses," he stresses. "They say you can't time the market, so don't try. But 20 years ago, the average hold time for a mutual fund was five years. Today, it's two and a half years. People aren't buying and holding, so they should use a method to guide their investing."

Mr. Rothstein advocates watching stocks that seem to move between consistent highs and lows and investing accordingly. "The way to make money in this market is nimble trading – not by being a day trader, but a swing trader. Hold [stocks] from a few weeks to several months and ride the cycle," he suggests.

Research shows that three out of every four stocks move in the general direction of the market, according to Mr. Frankle. To get a general feel for that direction, he watches trading volume. If the Dow goes down while simultaneously the volume of trading goes up, it means large institutional investors are selling.

These institutions – pension funds, mutual funds, and professional investment firms – account for 85 percent of the capital in the stock market and collectively drive price movements.

Mr. Rothstein agrees with monitoring money flows and following the sectors and companies preferred by institutional investors. "Large caps look better than small caps now, and value better than growth," he says. "Oil, chemicals, health, and retail – that's where the action is on the long side."

"Expect a flight to quality, large-cap stocks which underperformed last year," says Jason Press, global strategist at New York-based Banorte Securities International, the investment arm of the Mexican bank Banorte. "One investment opportunity is the Dow Jones index, which may rise 7 percent this year, according to a survey of market strategists. We expect the trend toward dividend-paying stocks to continue given high corporate cash levels and recent changes to the U.S. tax code."

But investors should remember to play defense first. "Our first priority is managing risk," says John Riley, CEO of Cornerstone Investment Services in Providence, Rhode Island. "For every investment within a portfolio, we have an exit strategy. We have multiple 'if, then' scenarios already planned out. ... We already have a strategy in place and are able to anticipate instead of react to events and news."

Mr. Riley, who stresses that his opinions are entirely his own, says he "will trade any stock, strictly short term." He currently likes raw materials, including oil and gas stocks.

For investors to take advantage of cyclical stocks, they must be prepared to sell, Mr. Frankle points out. "If a stock starts drifting – no emotion, no research – you sell it," adds Mr. Rothstein. "That's how you deal with a sideways market."

Another approach is to consider investment options beyond the traditional U.S. stock market. For 2005, experts recommend Asian and Latin American markets (see accompanying story, "Looking South"). Also, to take advantage of the sideways market, "pension funds are focusing on non-traditional investments," says Mr. de la Fe. They range from real estate to private equity at both the initial and mezzanine stages to hedge funds.

Since the sideways market began, real estate has become the main focus of household investors, says Mr. Rothstein. But Mr. Riley warns that real estate's rise has been a function of easy credit. As interest rates go up, fewer people will have the income to cover the mortgage payments. "Distressed and foreclosed real estate is where the best buys will be, but not yet," Mr. Riley explains. "It is during these times that investors will be able to pick up great buys for a fraction of their value – that is, those that have either cash or a source of available credit."

While no one can foresee how long the sideways market will last, Mr. Riley expects 2005 to be more dynamic than 2004. Accordingly, investors need realistic expectations on the upside – and plenty of caution on the down.

"Generally speaking, we view the short-term like a poker game. You can only play the cards you are dealt," Mr. Riley says. "What is nice about short-term trading is that you don't have to play every hand, and it costs you nothing to fold. We review the charts daily but sometimes go weeks without finding a trade that looks good. So we wait. There's no rush. The market will always be there."

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