Market Mastery First Quarter 2006

The Van Tharp Institute

Van K. Tharp, Ph.D.

In This Issue

Trading Strategies That Fit the Big Picture

by Van K. Tharp, Ph.D.

For every dollar added to [America's] GDP, there are now 4 dollars added to indebtedness. This is the worst performance in terms of credit expansion in history and of course in comparison to any other country.

— Dr. Kurt Richebächer, Economic Lecture, November 2005

When I wrote the first edition to my book, *Trade Your Way to Financial Freedom*, I left out one style of trading that I called mental scenario trading. My experience of it was that it was an art form practiced by some of the best investors and traders. For example, I would describe Market Wizards Bruce Kovner and Jim Rogers with the label "mental scenario traders." And the best way I could describe what they did is to say that they kept up with everything going on in the world and through that knowledge developed great ideas to trade. Jim Rogers has said about mental scenario trading, "How can you invest in American Steel without understanding what is going on in Malaysian palm oil? … it is all part of a big, three-dimensional puzzle that is always changing."[1]

I've never modeled a mental scenario trader, so I haven't talked much about it in my books and courses. But my thoughts about mental scenario trading have evolved. I believe that everyone, at minimum, should keep track of the big picture and trade two or three systems that develop from the patterns that seem to emerge. Here are a few of my beliefs about the big picture. Once again realize these are just my beliefs, my filters for reality.

- I believe we are now in a global economy in which emerging nations are starting to consume great qualities of raw resources.

1. Jack Schwager. *Market Wizards*. New York: NY Institute of Finance, 1987, p 306.

Volume 12, Number 4 (146-148) First Quarter, 2006

Market Mastery

PUBLISHER/EDITOR
Van K. Tharp, Ph.D.

PRODUCTION DIRECTOR
Cathy W. Hasty

Market Mastery is published by The Van Tharp Institute, 102-A Commonwealth Court, Cary, NC 27511, Telephone (919) 466-0043; Fax (919) 466-0408; web site www.iitm.com

- I also believe that United States is in the beginnings of a secular bear market during which such issues as our massive debt and the retirement issues of the baby boomers must play out.
- I believe the U.S. has probably reached its peak as a world power and will decline long-term. I'm just being realistic here because throughout history this happens to every great nation.
- Given that scenario, I believe that the U.S. must endure at minimum a general devaluation of the dollar (best case scenario) and perhaps a fairly strong inflation, which will really erode the purchasing power of the dollar. We could see a DOW of 40,000 with the dollar worth about 5 cents in today's purchasing power. And, just in case you thought I was predicting a great boom in the stock market, that translates to a DOW of 2,000, which is quite low.

These beliefs lead me to want to focus on certain trading ideas:

- Be careful about the U.S. dollar and the U.S. stock market over the long term.
- Expect great trading opportunities in global stock markets over the long term.
- Expect great trading opportunities in gold, oil, and commodities in general over the long term.
- Focus on consumable assets (e.g., timber) over equities (e.g., General Motors). And collectables will probably do very well over the next 10-15 years.

I plan to discuss some of these ideas (and others) in more detail. However, my reason for discussing them is to give you an example of laying out a big picture scenario. My big picture may not be the same as yours, but hopefully, I'll give you some questions and ideas that you might want to focus upon in your own big picture planning. Furthermore, when you do lay out your big picture, you should have a way to measure it and update its progress.

I recommend that all of my clients develop a business plan in which they play out their own long-term scenarios for trading. In that plan you must ask yourself, "What do you think the big picture will be over the next five to twenty years?" And the answer to that question will help you focus on which markets to trade and the type of trading you might want to do.

As I was laying out my version of the big picture for you, it suddenly dawned on me that what I'm suggesting is that everyone does some form of mental scenario thinking as the basis for your trading. At one level, you can focus on the big picture as I just did and come up with markets that you want to concentrate on with some expectation of results you can get. Or, as an alternative, you can drill down into the big picture on a regular basis and become more and more of a mental scenario trader/investor.

You basically have a choice. If you want to be a good trader/investor, then I suggest that you focus broadly on the big picture to get an idea of the types of markets you want to concentrate on and how you might want to trade them. If this is your choice, then you probably need to gather some data weekly (or at least monthly) to refresh your big picture scenario. Doing so will help you know 1) if your beliefs need to be changed or 2) if you were totally wrong about one aspect of the big picture or even all of it.

On the other hand, you might want to gather more and more ideas and information about the big picture to the point that doing so is a part of your daily routine. When you do this, specific trading ideas will develop that you'll want to act upon. And, if this is your style, then in my opinion, you've become a mental scenario trader/investor.

So let's look at where you are in your development as a trader/investor. At this point you should have a list of your beliefs about yourself and the market. Now I'd like to encourage you, at minimum, to think about developing systems that fit with the big picture and to develop some monthly measurements that will help you keep up with changes that might occur in the big picture.

This article reflects my beliefs, which I've found useful in my trading and in helping me to be a top trading coach. I'm going to be talking about the big picture as I see it today in early 2006. *This is just to give you an example of big picture thinking. Your beliefs about the big picture might be totally different. Furthermore, my beliefs in the future might be totally different as new developments unfold.* However, if things change, I have a method of monitoring the market for data that would cause me to think differently about what might be going on in the world. You need that as well. *You'll also need to understand that while some aspects of the big picture imply a crisis, every crisis is also an economic opportunity.*

The Big Picture As I See It

When looking at the big picture today, I believe that several primary factors must be considered. First, the debt picture in the United States is absolutely horrific with the total government debt equaling about $125,000 per person in the United States. Second, I believe we're currently in a secular bear market that started in 2000 and could easily last until 2020. That doesn't mean that stock prices will go down, but it does mean that stock valuations, measured by price-to-earnings ratios will go down. Third, we're becoming a global economy with former third world countries like China and India now becoming significant economic players. The fourth key factor in the big picture, as least for Americans, is the impact on the stock market of the large portfolio managers. Right now they support the major stock averages, such as the S&P 500, but when baby boomers start to retire in 2010, there will probably be a net redemption for many years and this will have a negative impact on the major averages. The fifth key factor in the big picture is changes in taxes, policy, regulations, etc. that could change the entire economic picture. The government generally does what it can do to fix problems so that they look good now, and this is usually at the expense of future generations. The final key is that people are very inefficient when it comes to money decisions, but this is good news for you. You can actually become efficient. There are probably other keys that you may want to consider in your mental scenario planning, but these are my major ones.

My reason for reviewing my beliefs about the big picture is simply to give you a starting point. The key issues you come up with could be entirely different.

Factor 1: The U.S. Debt Situation

In 1983 the United States was the largest creditor nation in the world. Two years later, we became a debtor nation for the first time since 1914. And now, in 2006, we are the largest debtor nation in the history of the world. In 1993, Rep. James Traficant, Jr. (Ohio) made the following comments to the floor of the House of Representatives:

> "Mr. Speaker, we are here now in chapter 11. Members of Congress are official trustees presiding over the greatest reorganization of any Bankrupt entity in world history, the U.S. Government. We are setting forth hopefully, a blueprint for our future. There are some who say it is a coroner's report that will lead to our demise." [2]

I can remember when the U.S. debt hit a trillion dollars in 1980. I kept thinking "How can it get any higher?" Well, it's now much higher and we don't seem that much worse off, so perhaps it can go on forever. But can it? I decided to take a look at a graph of the U.S. debt of the past 100 years shown in Figure 1. It's not a pretty picture.

In 1900 our debt was about 2.1 billion dollars. The debt begins to take off in the sixth decade (i.e., 1950) after the expenses of World War II. It takes off again in the eighth decade after the expenses of Vietnam. But since that time, it's gotten totally out of control and the 11th decade is not a full 10 years. It's priced as of May 12th, 2006. We could easily see our "official" debt at 15 trillion dollars by 2010. Furthermore, this table does not include future entitlements such as social security, which the government includes when it now estimates our total debt at 37 trillion.

We currently have a balance of payments problem to the tune of $750 billion per year, with about $200 billion of that going directly to China. This means that the U.S. is spending about $750 billion more each year with other countries than it is exporting to other countries. Already, foreign countries hold about three trillion in U.S. debt instruments. They seem to be willing to do this because the U.S. consumer supported the growth of the world economy during the 1990s. But it took decades for foreign governments to accumulate three trillion in U.S. debt. With our current balance of payments now at $750 billion per year, it will only take four years to double the commitment that foreigners must hold of our debt. What happens if they decide they don't want

2. United States Congressional Record. March 17, 1993. Vol. #33, page H-1303. Speaker Rep. James Traficant, Jr. (Ohio) addressing the House.

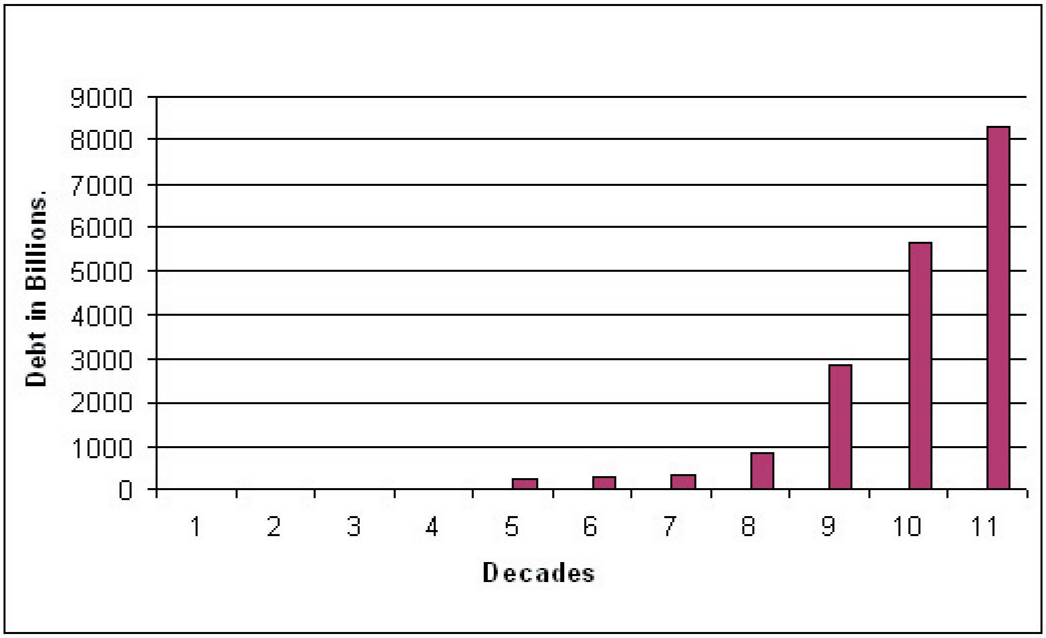

Figure 1: The U.S. Debt During the Last 11 Decades

our debt any more? They are sort of in a catch-22 situation. If they decide they don't want our debt, then the dollar will dramatically shrink in value and the debt they hold will be worth even less. And if the dollar shrinks dramatically, it will be almost impossible for them to sell more of their products to "toy-hungry" U.S. consumers.

U.S. Corporate Debt. Furthermore, the debt problem is not just due to the U.S. government. U.S. corporations have taken on massive debt over the years. My friend Steve Sjuggerud in May of 2002, when the NASDAQ was down 70% from its all time high, discovered that the debt of all NASDAQ companies in the U.S. was 2.3 trillion dollars. If we take away the two biggest stocks (Microsoft and Intel), then you have a picture in which the entire NASDAQ was worth two trillion dollars with a debt of 2.3 trillion. That's a little like buying a $200,000 house with a $230,000 mortgage. The NASDAQ decided to stop publishing this data right after Steve first reported it. The bottom line is the debt situation of U.S corporations is not good.

To look at the value of U.S. corporations, we take the current assets (i.e., what the corporation is worth if we liquated everything within the next year) and subtract from that number its total debt. Why don't you try doing this for about 10 to 15 major U.S. corporations? Try some big household names like General Electric, Boeing, Google, Microsoft, or IBM, plus some stocks you might pick randomly out of the newspaper. For about 70% of them or more, you'll find that this number is negative. What does that mean? U.S. corporations have way too much debt and are in trouble.

U.S. Consumer Debt. And now let's look at the U.S. consumer debt, less you think that the U.S. consumer is any different that the U.S. government and U.S. corporations. U.S. consumer debt has reached staggering levels, going well over 2.2 trillion dollars by 2006. This is up from 1.3 trillion dollars in 1998. And if you count mortgages, it amounts to more than 10 trillion dollars. According to John Wasek, who writes for *Bloomberg*, consumer debt has increased over disposable income by an annualized rate of 4.5% throughout the decade of the 2000s.[3] The Federal Reserve showed that personal savings had dropped to a mere 2% of after tax income in the first part of 2003. By 2006, it had reached negative territory for the first time since the Great Depression of the 1930s. This is shown clearly by the graph from the U.S. Bureau of Economic Analysis given in Figure 2.

The Debt Solutions

So what's the solution? There are several. **First, we could be logical and politicians could stop spending.** The government could sell of some of its

3. John Wasek commentary. See www.bloomberg.com, January 17, 2006.

assets, such as some of its vast reserves of public land, and we might manage to get out of debt. Do you think that will happen? If you do, then the politicians you know are different from the ones I know. And since Americans themselves are not logical with regard to debt, how can we expect our elected representatives to be logical?

The second solution is that we could simply default on our debt. What would happen if we did that? Treasury bills would move from being considered "risk free" to worthless and our treasury bonds also would be worthless. The U.S. dollar would be worthless and our country would be bankrupt. Our country would have no credit because no one would lend to us. Thus, solution two is not a viable solution.

The third solution is that we could have a massive economic collapse and a big depression. During such scenarios our money becomes worth much more and things become worth less. If our money was worth more, then our 37 trillion debt might seem like 370 trillion and be impossible to pay without a default. This deflationary scenario is not likely at all. Our current Federal Reserve Governor, Ben Bernanke, made the following remarks to the National Economists Club in November 2002:

> "The second bulwark against deflation in the United States … is the Federal Reserve System itself. The Congress has given the Fed the responsibility of preserving price stability (among other objectives), which most definitely implies avoiding deflation as well as inflation. I am confident that the Fed would take whatever means necessary to prevent significant deflation in the United States and, moreover, that the U.S. central bank, in cooperation with other parts of the government as needed, has sufficient policy instruments to ensure that any deflation that might occur would be both mild and brief."

And the Fourth Solution is to Inflate the Debt out of Existence. Bernanke after saying that the Federal Reserve will prevent deflation at all costs, then goes on to say

> "…the U.S. government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost. By increasing the number of U.S. dollars in circulation, or

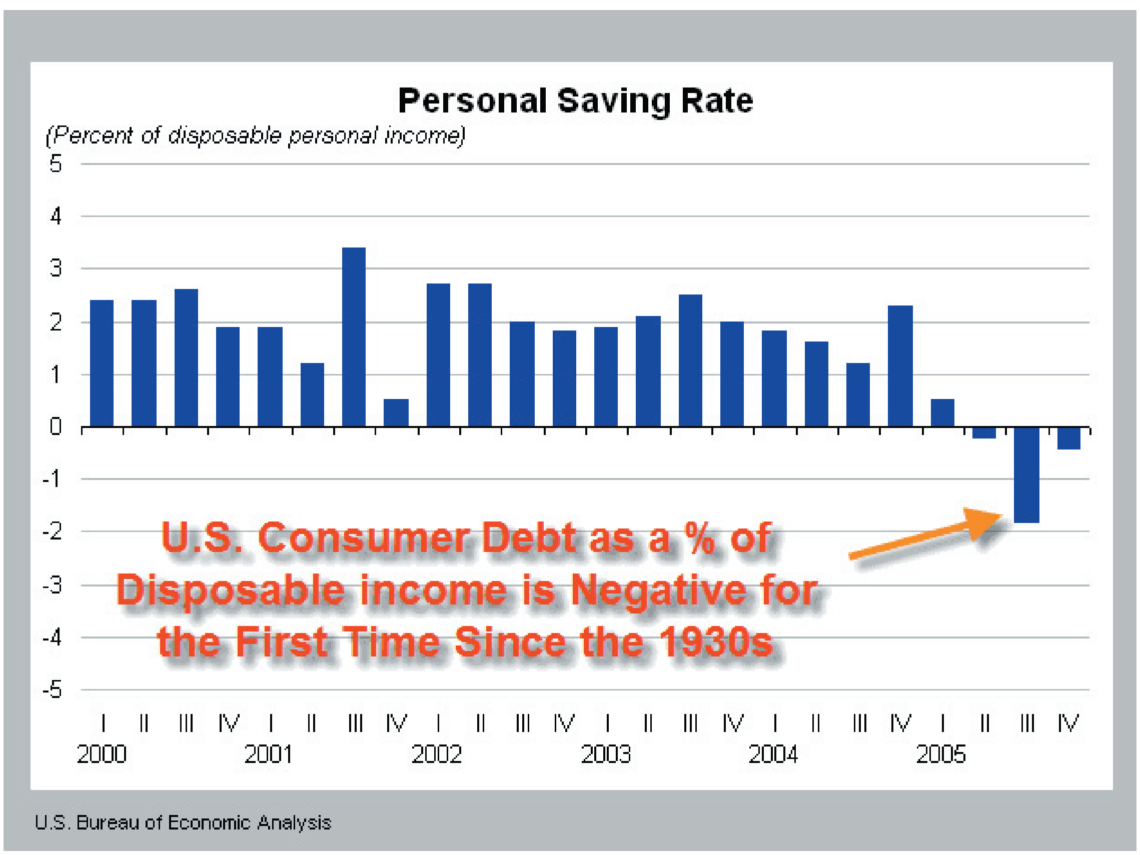

Figure 2: Personal Saving Rate as Percent of Disposable Income

> even by credibly threatening to do so, the U.S. government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services. We conclude that, under a paper-money system, a determined government can always generate higher spending and hence positive inflation."

Thus, Bernanke points directly to the most logical solution—we'll inflate our debt out of existence. Inflation really means that our money will become worth less and less.

My mother, who would be nearly 100 now if she were alive, could remember going to the movies when they cost five cents. I can remember, as a child, going to double feature movies (i.e., they actually showed two movies for one price) for fifty cents. All night drive-ins were even better, you could get four to six movies for a car full of people for a few dollars. Today you could pay $8 to $10 for a single movie ticket, and movie theatres make most of their money off of concessions, not the price of the ticket. Thus, it could easily cost you $20 per person for a movie, popcorn and a drink. That's inflation.

However, we've seen relatively mild inflation throughout most of America's history. The Federal Reserve actually targets having about 2% inflation. But what if inflation ran 100% per year as it has in some South American and Latin American countries? If it did, our debt would soon be worthless, as would the dollar. But we could always start again with a new currency. Such an inflationary scenario would be the mostly likely solution to the problem of a continually growing American debt. Our debt could be inflated out of existence. And under such circumstances, things would go up in value dramatically.

What would happen to the stock market under such an inflationary scenario? We had a relative high inflation during the 1966-1982 bear market. The stock market basically had a lot of volatility, but was range bound, with the DOW trading between 500 and 1000 for much of the period. During the entire period, stock prices went up a little, but stock valuations went down a lot and people generally lost money. And that could easily happen. By 1982, the price-to-earnings ratio of the major averages was in the single digit range.

The fifth solution is that the dollar depreciates relative to other currencies. The solution will make the balance of payments shrink to zero or even become positive, assuming that Americans stop spending as foreign goods become more and more expensive. As a result, it should be considered a possibility. This will generally occur as the U.S. raises interest rates because money moves to where it is treated best. However, high interest rates mean that our debt becomes more and more costly to service. So under that scenario, how would we get rid of the current accumulated debt or even manage it?

What's Your Personal Assessment of Factor One?

- Do you believe that government, business, and consumers in the United States can continue to spend at current rates without serious consequences?
- Or even if we stopped deficit spending right now, do you believe that we can get out of the current massive debt without serious economic consequences?
- If your answer to the first two questions is "no," then what do you think the economic consequences will be? Your answer should be part of the planning you do with respect to the big picture.
- If your answer to the first two questions is "yes," then how do you deal with the fact that our gross Federal interest payments are now 14% of the government's expenses (although they cheat on this and credit about half of it to social security)? If the deficit keeps growing, what will happen?

Factor 2: The Secular Bear Market

The U.S. stock market tends to move in large secular cycles, lasting 15-20 years. During the bull cycles, stock valuations go up, which means that price-to-earnings (PE) ratios increase. It also means that equity prices go up. During the bear cycles, stock valuations go down (i.e., PE ratios do down), which usually means that prices go down.[4] Table 1 and Table 2, show the major cycles that have affected the U.S. stock market over the last 200 years.

According to market historian, Michael Alexander, we have had many such cycles during the last 200 years. Table 1 shows a listing of primary bull markets. On the average, these bull markets tend to last about 15 years and investors who buy and hold the major averages earn about 13.2% per year. These bull markets lasted 103 years of this 200 year period.

Unfortunately, for people who believe in buying and holding stocks, primary bull markets tend to be followed by primary bear markets. These are major shakeouts, which tend to correct the excesses of the bull market. The

4. My primary sources for this material are Michael Alexander's book, *Stock Market Cycles* (2000) and Ed Easterling's fabulous research at www.crestmontresearch.com and his book, *Unexpected Returns* (2005), plus my years of reading Richard Russell's commentaries on the Dow Theory.

Table 1: Primary Bull Markets

Bull Market	Approximate Dates	Real Yearly Returns
Good Feelings	1815-1835	9.6%
Railroad Boom	1843-1853	12.5%
Civil War and Beyond	1861-1881	11.5%
Pre World War I	1896-1906	11.5%
Roaring 20s	1921-1929	24.8%
Post WWII Boom	1949-1966	14.1%
High Tech Boom	1982-2000	14.8%

Table 2: Primary Bear Markets

Bear Market	Approximate Dates	Real Yearly Returns
Pre-War of 1812	1802-1815	2.8%
First Great Depression	1835-1843	-1.1%
Pre-Civil War Era	1853-1861	-2.8%
Banking Crisis Era #1	1881-1896	3.7%
Banking Crisis Era #2	1906-1921	-1.9%
2nd Great Depression	1929-1949	1.2%
Inflation Era	1966-1982	-1.5%
War on Terrorism	2000 – present	?

United States is now in such a primary bear market, which began in early 2000. Table 2 shows a listing of primary bear markets.

The average primary bear market lasts 18 years and shows a "real" return of 0.3% per year.[5] Thus, stocks may be facing a long period of decline ahead.

At this point, you might be thinking, "This is just someone's theory. You could go into the past and make arguments for all sorts of cycles. And just because cycles may have occurred in the past doesn't mean they'll continue now." But perhaps your thoughts will change if you understand Ed Easterling's "financial physics."

Here are some key points to consider:

- A secular bear cycle doesn't mean that the stock market will go down for 18 years. Instead, it just points out the overall direction of a major cycle within which there will be other bull and bear cycles that could last years. For example, Alexander in 2005 actually commented that we could have a bull cycle that goes into 2007.
- A secular cycle doesn't forecast prices. Instead, it forecasts valuations. For example, in an inflationary atmosphere, prices could go up dramatically but not as much as inflation, meaning that you'd lose real value in the stock market. In addition, stock earnings could go up dramatically while prices rise relatively slowly. This could eventually produce quite low PE ratios while the stock market continues to go up. During the 1966-1982 bear cycle, the Dow Jones Industrial average bounced off the 1000 level several times, while PE ratios continued to erode. During secular bull and bear markets, the number of up versus down days does not vary that much. It's just the results of investing that

5. "Real" returns are adjusted for inflation. The overall real return for stocks since 1802 is 6.8%, according to Michael Alexander. And two thirds of that return comes from dividends.

change because secular bear markets are associated with a high percentage of big down years whereas secular bull markets are associated with a high percentage of big up years.[6]

- Secular bull and bear markets have nothing to do with the economy. For example, from 1966 to 1981 the economy grew at an average rate of 9.6% each year while the stock market declined. And while the economy grew at a pace of 6.2% per year from 1982 through 1999, the stock market grew at a pace of 15.4% per year during that time. And ironically, over the last 100 years, economic growth has actually been stronger during secular bear markets when the stock market was weak.

If you have never seen it before, I strongly suggest that you look at Crestmont Research's matrix that shows real returns from the stock market over 20 year periods.[7] What clearly strikes you when you view this chart is that if you invest when PE ratios are high, then you can invest for periods as long as 20 years with a negative return from the stock market. And when the last secular bull market ended, stock market PE ratios were at historical highs. Even in 2006, they are still way beyond the average at which one can expect reasonable returns. What's the bottom line? The stock market is a dangerous place to be if you just invest and hold onto stocks.

What's the current picture? As of Februray 1, 2006, the PE ratio of the S&P 500 stands at 19.26. This still ranks it in the bottom 10% of 10-year groups for expected returns. Furthermore, it is still way above the historical average for the last 100 years of 15.8.

When the PE of the S&P 500 is 19 or higher, the average PE ratio 10 years later is usually around 9. Figure 3 shows the change in the PE ratio of the S&P 500 since the secular bear market started in 2000. Notice that even though 2003-2005 have not been major down years for the stock market, the PE ratio has still declined sharply since 2002. And if Easterling is correct about his theory, we could have much more downside.

The next observation that Easterling came up with is that secular bear markets start when dividend yields are very low. The average dividend rate of the S&P 500 over the last 100 years has been around 4.4%. Bull markets tend to begin when dividend rates are high, whereas bear markets tend to begin when dividend rates are low. And while today's current divided rate of the S&P 500 is rising (perhaps due to the impact of favorable taxation on dividends), it is still historically low at 1.48%. Bear markets begin at levels this low.

Lastly, the key element of Ed Easterling's research, in my opinion, is his theory of why PE ratios change. It all has to do with inflation or deflation. Basically, when inflation is low and stable, the stock market will support PE ratios in the S&P 500 of 20 or higher. But when inflation starts to grow or deflation sets in, then PE ratios plummet. And during the end of secular bear markets, PE ratios are usually in the single digit range. Furthermore, the worst time to invest, according to Easterling's research is when PE ratios are high and inflation is relatively stable. Thus, even though Figure 3 shows that PE ratios are generally declining, they are still historically high and inflation is starting to appear.

Easterling believes that U.S. economic growth (real GDP) is relatively stable over time and that U.S corporate earnings grow consistently with the GDP. Therefore, he believes that one only needs a perspective on inflation/deflation to determine future valuations of companies. Under moderate inflation, 1-2%, we can support high PE ratios of 20 or higher. But when inflation goes to 3-4%, PE ratios will plummet to around 15. At 4-5% they will go down to about 13 and 7% and higher they'll go to 10 and below. And under deflationary conditions of any magnitude (e.g., –3%), they will also plummet to the single digit range.

What's Your Personal Assessment of Factor Two?

So what does this mean for you? These are some of the questions you'll have to ask yourself when thinking about the stock market long term:

- Do you believe that stock PE ratios go through cycles?
- Do you believe that during high PE levels (over 19%) long term returns from the stock market could easily be zero?
- Do you believe that PE ratios are likely to fall when inflation heats up or deflation enters the picture?
- Do you believe that this pertains to your investing system? In my opinion, the shorter your time frame, the less it pertains to you. However, it would be a mistake to say, "I'm a day trader and this doesn't pertain to me." because most day traders could not make it as stock market volatility disappeared during the initial phases of this secular bear market.

Factor 3: Globalization of Economic Factors

The economic picture is becoming very global. You cannot afford to hide your head in the sand of the U.S. markets and not pay attention to what is going on globally. For example, 2003 appeared to be a great year for the U.S. stock market with the S&P 500 going up about 25%. But even if you made 25% in the U.S.

6. See Easterling, page 49-52.
7. This can be viewed at http://www.crestmontresearch.com/content/Matrix%20Options.htm.

Figure 3: Weeky S&P 500 PE Ratios

stock market, you still lost money on a world wide basis because the dollar was down about 40% and the U.S. stock market was one of the poorest performing stock markets in the world. In 2003, for example, you could have made 50% in Europe, 50% in Asia, 38% in Latin America, and even 39% in Japan, which has been in a major recession/depression for ten years. A smart investor must look at the entire picture from a global economic standpoint.

So let's look at some factors that are influencing the big picture globally. In my opinion, there are three major factors.

First, the economies of emerging nations are starting to rise. Second, these emerging economies need raw materials and are therefore starting to produce a huge boom in commodity prices. And lastly, the countries of the world are currently supporting the U.S. dollar because most of the world growth of the 1990s was due to the U.S. consumer. This phenomenon has been called Brenton Woods II by some economic commentators.[8]

The first major issue is the growth of emerging countries. China and India, for example, are emerging as major players globally. Many U.S. companies are going into China and investing huge amounts of money in China's growth so that they can have a part of that growth and have access to a billion Chinese people who may want their products in the future. And these companies are giving up major concessions in order to do so.

While manufacturing tends to be moving to China, the service area tends to be moving to India. India produces many highly trained professionals in business and engineering each year. They will work for a fraction of the cost of their U.S. counterparts; so many companies are starting to outsource their services to India. For example, if you call up technical support for Microsoft or Dell, chances are you'll end up talking to a technician in India. And according to Forrester Research, by 2015 about 3.3 million U.S high-tech and service industry jobs will be moved overseas, mostly to India. That represents about $136 billion in lost wages.[9] In addition, international businesses are replacing their top American executives with executives from India because they are much cheaper and they are better trained.

The second major issue is that the growth of emerging countries is creating a boom in the prices of raw materials. The *Economist* magazine has said that "If China's consumption of raw materials and energy were to rise to rich country levels, the world supply would not have the resources to supply them."[10] Slowly, but surely, however,

8. I've seen the term "Brenton Woods II" in both John Mauldin's week e-letter and in Bill Gross's market commentary.
9. See *Christian Science Monitor*, July 23, 2003.
10. *Economist*, August 19, 2004.

the Chinese are securing raw materials world wide. And this suggests, that even without inflation, we should have a huge boom in commodities in the next 10 to 15 years.

For example, in late 2004 my friend Steve Sjuggerud was in Argentina. He said that the Chinese were everywhere and they were doing their best to secure supplies of timber, copper, agricultural products, and whatever raw materials they could get their hands on cheaply. Why do you think the cost of oil has risen to over $70 per barrel in this decade? It's not because oil is becoming scarce. It's because the world-wide demand is increasing and China is a major source of that demand.

If you look at commodity prices over the last few years, you will find that they are in a major uptrend. Commodity price increases tend to signal that inflation is increasing, but part of it is simply due to the huge worldwide demand for limited commodity resources. Figure 4 shows a chart that illustrates the basic rise of the CRB (a commodity index). Notice that the trend is clearly up, with prices rising from 280 to about 360—an increase of almost 31% in the space of a single year.

The third major issue globally is the support of the U.S. dollar by foreign countries, especially Asian countries, so that they can continue to sell to the U.S. consumer. It's estimated that most of the growth of the world economy during the 1990s was due to the insatiable demand for products by the U.S. consumer. Other countries want to continue to sell to the U.S. consumer, and they can only do that reasonably if their currencies remain low in cost compared with the U.S. dollar. As a result, an unofficial agreement, known as Brenton Woods II, has sprung up in which foreign countries tend to support the U.S. dollar from falling (despite the huge deficit in the balance of payments) by purchasing U.S. debt. Foreign countries now own about 3 trillion dollars in U.S. debt, which they maintain by purchasing treasury bills, notes, and bonds. However, that debt took more than a decade to accumulate, but it could double within the next three years if our balance of payments does not change.

So what are foreign countries going to do? If they don't continue to support our debt by buying U.S. debt instruments, then the dollar will fall sharply. This will have undesirable effects in that 1) the U.S. consumer will no longer be able to able to afford their products and 2) they will lose lots of money because they are holding U.S. dollars in the form of debt instruments.

The solution to this problem that many foreign countries have adopted is to slowly move away from supporting the U.S. debt and the U.S dollar. For example, China is allowing its currency to slowly move up in measured increases. Furthermore, they are using their U.S. dollars to purchase commodity based products and industries world wide rather than accumulate U.S. debt.

What's Your Personal Assessment of Factor Three?

In my opinion, when you look at your investment results, you must look at it from a global perspective. If your investments go up, that's great, but what is happening to the major currency in which all of your investments are based? For example, if you make 25% on your investment in the stock market, while the dollar loses 40% relative to other currencies, you've basically lost money. If you make 25% of your investment, but you could have made 50% by looking outside of the United States, then your performance is relatively poor.

Thus, when looking at your investment style, you should always consider the global economy by asking yourself the following questions:

- What has my base currency done (relative to other currencies) during the time period that I am considering?
- What has inflation done to my value of my base currency?
- Are my returns reasonable when compared with other markets worldwide that I could have invested in during the same time period?
- How is the global economy moving during this time period and what is the impact that it will have upon my investment strategy?
- For example, what if commodities continue to escalate at 30% per year?
- What happens if the economy of the country in which I largely invest (e.g., the United States) shrinks relative to the economy of other nations in the world?
- What happens if "Brenton Woods II" disappears and other countries stop supporting the U.S. debt and the U.S. dollar?

Factor 4: The Impact of Mutual Funds

During most bull markets, people have participated by buying stocks directly. The last bull market was different. Instead, most people were participating through mutual funds. These funds are supposedly managed by a full time professional manager who could spread his risk around and do full time research for you. In fact, by the peak in the market in 2000, there were nearly as many mutual funds as there were listed stocks. Furthermore, most of these funds were run by fairly young people whose only experience in the market was during the 18 year bull market from 1982 through 2000. They had never seen any sort of bear market of significance.

After the first 30 months of this primary bear market, 566 mutual funds had been absorbed into other funds. In addition, another 414 had been liquidated. This means that 980 mutual funds disappeared in the first 30 months of the bear market.

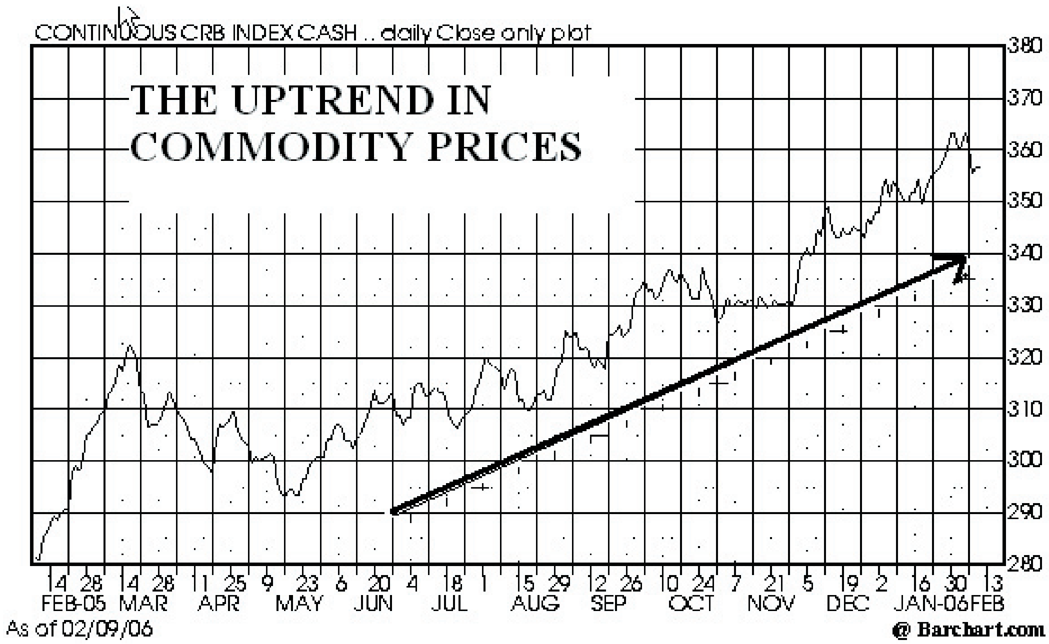

Figure 4: The Growth in Commodity Prices

According to Gregory Baer and Gary Gensler in their book, *The Great Mutual Fund Trap*,[11] most people are much better off in a passively managed index fund than they are in an actively managed mutual fund. Here's why:

- Actively managed mutual funds generally cannot outperform an index fund with no professional management. According to Baer and Gensler the average annualized performance of actively managed mutual funds that had been around for at least five years trailed the S&P 500 Index by 1.9 percentage points per year. And these figures did not include those funds that failed entirely.
- The financial media is largely supported by the brokerage and mutual fund industries. Consequently, the information that is conveyed to you through that source is biased to support the "bread and butter" of the media. As a result, what you hear is generally not in your best interest. Instead, it is designed to keep you in the market and actively trading.
- People tend to invest in the hot mutual fund. However, these "hot" funds usually under-perform the rest of the market once they are advertised to the public.
- The best funds tend to be very small and less than three years old. This is because a mutual fund family can give favorable treatment to a new small fund, giving it preference for new stocks (initial public offerings that they can get at a huge discount) and by allowing it to trade prior to the larger funds in its family. When it becomes hot, the fund can then advertise it aggressively until it becomes large. Baer and Gensler report that funds that are advertised have had great past track records, but those records seldom continue once they are promoted to the public.
- While a few mutual funds may outperform the market, they usually do so with a lot of risk. One year the fund may make 40%, the next year it may lose 15%, the next year it might be up 35% and the next year down 30%. It might be the best overall performer, but it is doing so with a huge variance (i.e., risk) in its performance. You probably wouldn't like that sort of performance, especially when you could do much better simply buying an index fund.
- When a mutual fund sells a stock at a profit, it must pass on its tax gains to its shareholders. Thus, you could buy a mutual fund in November, watch it go down in value, and still have to pay taxes on the gains that the mutual fund incurred by selling stocks at a profit earlier in the year before you invested. This tax is different from the tax you must also pay if you sell the mutual fund at a profit, but it is still your responsibility.
- Mutual funds have more than just management fees, administrative fees and marketing fees that are passed onto you. They also have

11. Gregory Baer and Gary Gensler, *The Great Mutual Fund Trap*. New York: Broadway Books, 2002.

trading costs and the costs of needing to have a certain amount of its assets in cash. Many mutual funds also have a sales load when you buy or sell your fund. These fees are paid by you. Thus, the costs of investing in funds that are actively managed are huge. According to Baer and Gensler, these fees are the primary reason that actively managed mutual funds cannot outperform a passive fund that simply buys and holds a major stock index.

There are also several drawbacks to mutual funds that Bear and Gensler do not point out:

- First, mutual funds control much of the stock market through their ownership. Most of them tend to invest in the large blue-chip companies of Wall Street, partially because these are the most liquid. In addition, if the fund falls in value, the public is not likely to fault them much if their holdings include giants such as General Electric and Microsoft. However, in the bear market scenarios described in Factor 2, there is a huge risk to the market in this sort of strategy. When panic selling sets in, which is almost a certainty in a major market crash, the only way mutual funds can raise cash is by selling their most liquid stocks, those of the major blue chip companies. When this happens, we will see the major indexes going down very sharply.[12]
- Second, active mutual funds cannot outperform the market indices because they are generally traded on a model that doesn't expect outstanding performance. Instead, the goal of the average mutual fund is to outperform the market averages and other mutual funds. This means that if the overall market is down 15% on the year and most funds are down 20% or more, then a fund manager who is only down 5% will be considered to be a star performer. However, losing money is still losing money!
- In addition, most mutual funds are guided by a charter that shapes their investing. This charter usually requires that they maintain a particular level of commitment to stocks. For example, a mutual fund's charter might require that it be at least 90% invested in S&P 500 stocks even in a bear market. Different mutual funds will have different charters, but most of them do not allow the flexibility that would be required to practice the most common risk control techniques that I have been giving to my clients for some time. In other words, they cannot practice proper risk control and position sizing techniques. As a result, it would not surprise me if we had 1000 or less mutual funds remaining by the time this bear market is over.
- Lastly, most retirees have been forced to put their retirement funds into mutual funds because their 401K plans do not allow any other form of investment. As a result, when the baby boomers start to retire between 2008 and 2011, we will start to see a massive liquidation of mutual funds. And since these funds basically support the major averages, we will probably see huge falls in the major averages as the retirement funds move out of the market.

This last point is probably the most important point of all. Think about it carefully and decide whether or not you believe it. If it is true, it is one of the major factors that will play itself out before the current secular bear market ends.

However, one aspect of mutual funds has become very helpful to the stock market long term: the development of exchange traded funds (or ETFs). You can find exchange traded funds for almost everything—countries, sectors of the market, styles of investing, and even some commodities such as gold and energy. What this basically means is that even though the stock market might not be the best place to be long-term, you can probably find an ETF that represents some sector of the world economy that is doing very well. In my opinion, this is a huge silver lining. Whenever there is a potential crisis, there is also an opportunity.

What's Your Personal Assessment of Factor Four?

In my opinion, when you look at the big picture you must look at what institutional money is doing. I've basically laid out my beliefs about how mutual funds affect the market. Right now they shift money around a lot to see if they can get better returns, but it doesn't leave the market and it tends to support the major averages. But you must begin to think about what will happen when retirement funds move out of the market.

In addition, I did not discuss other aspects of institutional money. I believe that institutional traders are among the most inefficient in the world, yet they control a good share of the money in various markets. Banks make markets for foreign exchange, but bank traders (in my opinion) are largely very inefficient and very poorly managed. What impact does this have on you if you are a forex trader?

At minimum, I believe you should ask yourself the following questions:

- What markets will I be trading and who trades most of the money in these markets?
- What is the system by which the big players operate in my market?

12. Most of the market decline from 2000 through the end of 2002 was due to individuals selling stock. Mutual fund redemptions still are not that high. If large mutual fund redemptions do not occur, then I would not expect the huge downward scenario described earlier in this book.

Is there some way that their system could totally break down? How and under what condition is it likely to occur?

- How can I monitor what the big traders are doing?
- How will "what the big traders are doing" affect my strategy and my performance?

Factor 5: Changes in Rules, Regulations, and Taxes

Another factor that strongly influences the big picture in trading are changes in the rules, the regulations, and the laws (especially tax laws) affecting the market you wish to trade. These are especially important to keep up with, although it is sometimes difficult to discern exactly what the future effects will be on your markets. However, let me give you a few examples of such changes and how they impacted the markets. You can then decide for yourself how much you want to keep up with them.

Tax Reform Act of 1986 Wipes Out Many Real Estate Investments and the Boating Industry. When Ronald Reagan tackled tax reform in the 1980s, he dramatically lowered the top tax rates, which, in my opinion, helped to greatly stimulate the economy. However, he also closed many loopholes. Many real estate partnerships, for example, sprang up in the 1980s in order to take advantage of significant loopholes in the tax law. But when those loopholes were closed by the Tax Reform Act of 1986, those partnerships basically went out of business. The net result was a record amount of bankruptcies for people involved in those loopholes. It also produced a savings and loan crisis in which the government had to bail out the savings and loan industry to the tune of $125 billion dollars. Here are some of the implications of that tax bill:

- Depreciation on real estate went from 19 years to 31 years, effectively making profitable investments unprofitable.
- Real estate losses were denied to passive investors, making real estate partnerships that accumulated real estate for tax savings for their limited partners obsolete overnight.
- In addition, the dividend tax exemption was eliminated and there was an increase in taxes on the purchase of luxury boats, which caused the boating industry to collapse.

Now ask yourself this question: had you been involved in any of those businesses that were taking advantage of some major tax loopholes, do you think it might have been to your advantage to do some planning just in case the loopholes were closed? In essence those businesses were a form of arbitrage (taking advantage of loopholes). And in any arbitrage system, you must know when the loophole closes and have a way to get out without getting killed.

Day Trading Regulations Changed by the SEC. On February 27, 2001 the SEC imposed rules that changed day trading forever. First, they declared that anyone making four or more day trades in five consecutive days was a pattern day trader. The rule is ridiculous: you could enter five long-term positions but get stopped out the same day and suddenly you are a day trader.[13]

Second, if you became a day trader, there was one positive benefit, you got your margin increased to four times your equity (but this margin could not be carried overnight). But, it also required that you must have a $25,000 account, which immediately wiped out about 80% of the day traders at the time. It was a significant move that had a major impact on trading.

It is ironic that my day trading book came out in 2001. Not only did the scope of day trading change dramatically, just prior to the publication of the book, but New York Stock Exchange went to decimalization. Suddenly, the minimum bid ask spread was no longer a 1/16—it was now a penny. And in an instant, some of the strategies we'd developed for that book were obsolete.

Again, you must ask yourself, what regulations could suddenly change for my selected markets that would totally change how I approach the market? Such regulations will change how you trade and your profitability.

Development of the Roth IRAs. The Taxpayer Relief Act of 1997 established the Roth IRA. Money placed into a Roth IRA was not deductible, but money taken out of the Roth IRA was not taxable at all, including accumulated profits. What a short-term windfall for the government! Suddenly, everyone was transferring their funds from traditional IRAs to Roth IRAs. And for every one of these transfers the government received a tax on the total amount based upon your tax bracket. During the late 1990s, the Clinton administration was credited with having a balanced budget. But how much of the balanced budget was due to the massive tax infusion that came from millions of taxpayers transferring all of their IRA contributions into Roth IRAs? While I don't know the answer to this question, the example is a classic one of the government changing a regulation to make the current administration's economic picture look very bright at the expense of future government revenues. To gain back some revenues, the government could easily change its mind and make the profits from Roth IRAs taxable. In fact, I predict they will. They said that they'd never tax social security, but that promise certainly changed when money was needed.

13. I'm not a day trader, but I've achieved that status because of being stopped out quickly.

Strong Dollar Policy to Weak Dollar Policy. During the Clinton Administration, the U.S. government had a strong dollar policy. They supported the U.S. dollar vigorously and short-term interest rates were high enough that the dollar was an attractive vehicle for foreign money. When the Bush administration took over, the strong dollar policy was dropped as interest rates were taken down dramatically. The results on the dollar were obvious, although the effects on the economy of such policies are more subtle.

What's Your Personal Assessment of Factor Five?

To a certain extent assessing factor five involves looking at the most recent changes and attempting to determine the long-term effect of those rules, regulations, policy, and law changes. You need to ask yourself the following questions:

- What are the long-term effects of the most recent government changes on my investments and investment strategies?
- Are they fully played out? Are they in progress? Or are they just beginning to impact the markets?

  In addition, you need to ask yourself what are the effects of proposed legislation to my markets and my strategies?
- What's being proposed and could it totally ruin my strategy or market?
- Is there any way I can take advantage of these changes?

And lastly, you need to anticipate things that could change. For example, many of the real estate strategies that were ruined by the tax reform act of 1986 were taking losing real estate deals and making them profitable to investors just because of the tax implications. You can probably state as a rule of thumb that if something costs you money and is worth doing only because of the tax implications, then it is probably a very dangerous strategy.

- Do any of my strategies fall into this category of only making sense because of the tax implications?
- If so, how can I find something that is more effective and makes me good money without needing support from the government?

Factor 6: Human Beings Tend to Play Losing Economic Games

The last factor I want to talk about is human inefficiency. When I model some aspect of success, I usually find that most people in general are "programmed" to do exactly the opposite. I can give you a few of these examples here, and I believe they should enter into your long term planning.

- Some of the best investments you'll ever make are those with real intrinsic value, selling at bargain prices because everyone hates them. This occurs because of the fear and greed cycle that most human beings have. People sell (because of fear) at market bottoms and they buy (because of greed) at market tops.
- If everyone is talking about the investment you are interested in and you hear about it through the media, it's time to sell. In 1999, I can remember the bartender at our hotel saying he didn't need to take my stock market course because he could teach it. And I remember a waiter at a restaurant telling me that this was part time because he was a full time trader and had accumulated nearly $400,000 in trading capital. That's when I get very nervous.
- The key to making profits in the market is to cut your losses short and let your profits run. However, Prospect Theory (which won the Nobel Prize for Economics) basically says that the average person will be risky with losses and conservative with profits. In other words, they do the opposite of the golden rule of trading, which I've been saying for more than 20 years.
- The average person thinks that market success is all about picking the right stocks and if you lose money, it's because you picked the wrong stocks. Good traders know it's all about how you sell that really counts. And really successful traders also understand the impact of position sizing and your personal psychology on real success.
- The most important factors in trading are your personal psychology and position sizing. The average person knows little to nothing about either of these topics and you certainly will not hear the media discussing them. They might discuss the psychology of the market, but not your personal psychology. Furthermore, they might discuss asset allocation, but few people understand that the real advantage of asset allocation is that it tells you "how much" to invest in each asset, including cash.
- An easy way to play the money game is to have passive income that is greater than your expenses. This is what I call financial freedom, and the average person with a plan can achieve financial freedom in five to seven years. However, most people think they win by having a lot of the latest toys and if the down payment and monthly payments are low enough, they can have it now. This idea basically produces financial slavery and is why U.S. consumers now have a negative savings rate.

These comments are just a few of the ideas that suggest to me that the average person is doomed to financial failure. The average person is just too full of biases that lead to financial disaster. My solution to this problem is to help people become more efficient in their decision making. However, I believe that you can bank on the fact that most people (including big money institutions) will generally do things very inefficiently when it comes to money. However, big money institutions have one advantage: they tend to make the rules that most people follow to win the money game.

What's Your Personal Assessment of Factor Six?

Monitoring this factor can also help you generate trading ideas and determine when a potential strategy might stop working because the psychological tide is changing. For example, you should constantly be asking yourself the following questions:

- How am I being inefficient and how can I become efficient by working on my personal psychology?
- What are the major trends that the crowd is following? Look at magazine covers and pay attention to the financial media. When the media starts to talk about trends, then they are probably over with or at least due for a correction.
- What is currently out of favor that has tremendous value? And what happens when I mention these investments to my friends? If they absolutely hate it, then it's probably a good investment provided it is not going down in price or (better yet) it has started an uptrend.
- How can I emphasize my personal psychology and position sizing to be a more efficient trader/investor?

Other Areas You Might Consider

The six factors I've brought up are by no means everything you could (or even should) consider in viewing the big picture. What about global warming? If you believe that global warming is a real, significant trend, then monitor it. Major climate changes over the next five to ten years could have a much greater impact on finances and markets than anything I've mentioned. Look at what's happened with hurricanes recently. What if that is just the beginning of the impact of global warming?

What about the potential for major hostilities in the world? The scenarios that were mentioned are all based upon peace. But what if the War on Terror escalates either because of the action of the United States or because of greater terrorist attacks? What impact will that have on your markets or your trading strategies? And what about major hostilities erupting between countries in the world? Perhaps these things are worth planning and thinking about.

What about major trade wars? What if certain countries stop trading with other countries? What will happen to your markets as a result?

What about the health crisis in America and the world? We currently have a trillion dollar a year industry that feeds America processed foods that destroy our health. And we currently have another trillion dollar industry that is designed to treat the symptoms of eating processed foods, rather than the cause. And when one doctor told his patient that the cause of his problems was being overweight, he was sued and lost his license to practice medicine. I think this will also have a major impact in the economy, but, of course, these are just my beliefs.

These, along with major other factors that I've probably overlooked, also could become part of your big picture planning.

How Will You Monitor the Big Picture?

Let's say that you decide to look at six factors on a monthly basis. It doesn't matter what they are at this point; they could be different for everyone. However, you do need to work out the impact of each factor on your markets and strategies. You also need to understand what conditions would cause you to shift the markets and the types of strategies you use. In addition, you need to determine how you will measure those factors and how you will keep up with them.

Let me give you several examples of what you could do. I write a monthly update on the markets that's published on the first Wednesday of each month in my free email newsletter, *Tharp's Thoughts*.[14] Doing so forces me to keep up with what I think is important and allows me to help others who refuse to do the work themselves.

Ken Long, who teaches a workshop for us on various strategies you can use with Exchange Traded Funds, writes a weekly commentary on the market that he publishes. That commentary includes a relative weighting of the performance of all of the ETFs that are now traded. Ken's weighted summary looks pretty much like Figure 5.

The boxes in Figure 5 each represent ETFs for various sectors of the world economy. And with each box is a weighted relative strength number.[15] The idea is to look for sectors of the economy that are much stronger than the S&P 500, which is represented by the SPY box in the center with a rating of 39. Notice that different boxes have different ratings with the strongest being EWZ (Brazil with a rating of 66) and the weakest being bonds (Treasury Bonds, TLT, and corporate bonds, LQD, both at 33).[16]

14. *Tharp's Thoughts* is a free weekly email available by subscription at www.iitm.com.
15. While Ken uses a weighted average of the strength, you could also monitor ETFs in terms of efficiency (i.e., change in price divided by daily volatility), or you could use risk adjusted strength, or any of a number of other measures based upon your beliefs about what is important.
16. Relative strengths tend to change quite rapidly and this model was out of date by the time this article was written. However, Ken's strategy is to remain with the strongest ETFs as long as they are outperforming the S&P 500, so he can remain with a position for a long time.

The entire world is represented in this figure. The center nine boxes represent the overall U.S. stock market with big cap stocks on the top (DIA, SYP, and QQQQ) and small cap stocks on the bottom (IJS, IWM, and IJT). Value stocks are on the left. Growth stocks are on the right. And balanced stocks are in the middle. Thus, at a glance you can tell that the place to be in the U.S stock market on February 11th, 2006 was in small caps (bottom row) and value stocks (left row). However, those areas are nowhere near the strongest on the chart.

You can get a world view by looking at Asian markets on the left of the chart, European Markets on the right, and American continent countries at the bottom. As of February 11th, 2006 Latin American (ILF), Emerging Markets (EEM), Brazil (EWZ), Germany (EWG), Austria (EWO), the Netherlands (EWN) and South Korea (EWY) were the strongest sectors of the world.

The top of the graph shows other financial markets in the US: Gold, Long Term Treasury Bonds, Corporate Bonds, and Real Estate. While there are certainly some factors that are not on the chart, it does give you one of the best pictures of the world markets that I see on a regular basis. And you could either pay for this sort of service from Tortoise Captial[17] or make up a similar chart on your own.

Summary

One method of trading is based upon mental scenarios. However, I recommend that everyone do at least a monthly view of the major factors influencing the markets, including having a way to measure changes and their impact on the way you trade.

Below is a rundown of the factors affecting the major markets of the world based upon my beliefs:

- U.S. Debt
- The U.S. Secular Bear Market
- The emergence of countries like China and India with their impact on the world's raw materials.
- The current mutual fund structure and the problems that will happen when the baby boomers retire.
- The impact of rules, regulations and new laws, especially tax laws.
- The fact that most human beings play a losing game.
- Plus other potential major factors.

I strongly suggest that you think about the impact of potential factors that you think are significant. In addition, I recommend that you find a way to measure these factors and their potential impact on your markets and your strategies at least monthly. I have given you several sources of monthly information to begin with.

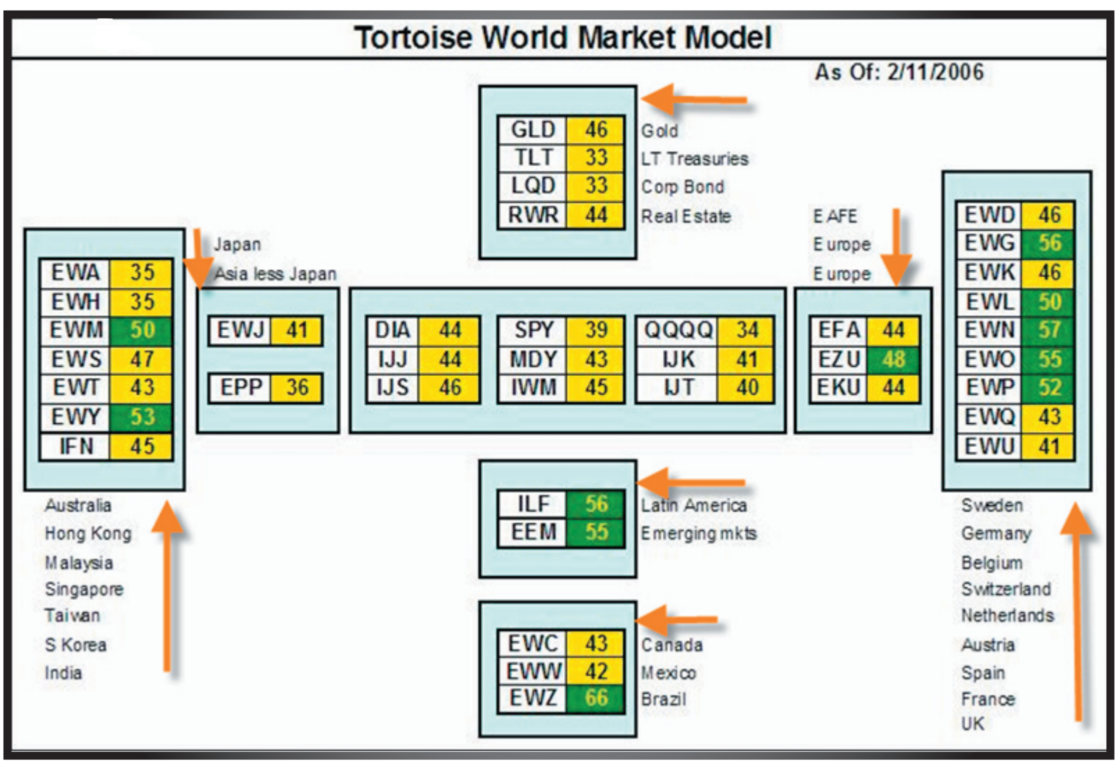

Figure 5: A "TORTOISE" World View Based Upon ETFs

17. Go to www.tortoisecaptial.com for more information about Ken Long's weekly updates.

The End of an Era

by Van K. Tharp and Melita Hunt

After more than ten years of writing the Course Update *and* Market Mastery *newsletters, Dr. Tharp has decided to bring the newsletter to an end. Over the last decade, his commitment to creating an insightful newsletter and keeping the creative juices flowing has allowed him to bring new concepts, timeless principles and unconventional thinking and ideas to his readers.*

So let's look back on what was, and then see what Van is planning to do next.

You've written a lot about your trading experiences as a young man and your desire to study the trading process because of the mistakes you made. Let's start with a brief overview of how it began.

I have a Ph.D. in Psychology. I think that gave me enough sense to decide after several episodes of losing money in the markets that the losses might have something to do with me. As a result, in 1982, I began a research project to determine what qualities great traders had (that I lacked).

That same year, the *Investment Psychology Inventory* was born. Over the years more than 5000 people have taken that test. It predicts investment success based upon "where you are now." But, of course, nothing is set in stone. I've seen people who rank in the bottom 10% totally transform themselves.

Initially, about 700 traders had taken the test and they started asking me, "How can I do better?" I didn't know, but I knew how to find out. I became an NLP modeler and started modeling some of the best traders in the world to find out what they did. And over the next five years, I wrote a five volume course on peak performance trading, which has been the cornerstone of our business.

I've been coaching traders for about 25 years now. I've modeled all aspects of trading from discipline to system development, position sizing, and even the wealth process. And we teach it all. There are many, many people that I've coached who have since made millions trading the markets.

When did you start trading stocks and have you ever traded full time?

My first trade was in 1962. I bought 100 shares of a stock at $8. I watched it go to $20 and then down to zero. And on the way down at $4/share and at $2/share, I bought more. I broke every rule that I teach in that one trade. But there are some people who just say I picked the wrong stock.

Of course, after all of the transformational work I've done, I consider myself to be a good trader. However, I am not a full-time trader. I do manage my company's retirement funds and we do very well. But I'm a full-time coach for traders and there is a big difference. If I were a full-time trader, that's all I'd be doing.

Prior to starting on this trading coach journey, what other jobs did you hold?

I did sleep research for the Navy and then I got into research on compulsive gamblers and sociopaths. Eventually, I was doing drug research with the emphasis on human performance, and I helped to standardize the sobriety test battery for NHTSA (National Highway Traffic and Safety Administration), used by the police nationwide. At the same time, I was working with the Los Angeles police helping them develop tests to detect people driving under the influence of drugs.

That work sort of upset the government because I was going way beyond the scope of what they wanted. It's typical of what happens when you do contract work and I hated it. It was just one red tape event after another.

I teamed up with another psychologist, a police sergeant, and a criminologist to create a company called DARTS (Drug Alcohol Recognition Training Seminars) that gave workshops to police all over California. That gave me a flavor of being self-employed, although I still worked for the research company.

What, if any of this, prepared you for what was to become your vocation?

None of it. Other than knowing how to do research! Most of my work in the trading world came through my NLP (Neuro Linguistic Programming) skills. Learning the skill of modeling is what enabled me to work out the nuances behind people's beliefs, mental states and mental strategies, which make them do the things that they do.

So you started to seriously look at trading after you experienced your second big loss, which happened in 1982, exactly twenty years after your first loss. What is one of the first things you did?

I read every book that I could get my hands on about the psychology of trading because I wanted to learn what the common myths were about trading—especially the psychological ones.

As I said earlier, the *Investment Psychology Inventory* was born in that first year. It is a profile test for traders and investors and is comprised of a series of 176 questions that gives insight into whether someone's personal life interferes with his/her trading success, whether his/her attitude supports his/her trading activity, whether the decisions he/she makes are done without worrying about what others are doing, how disciplined and patient he/she in his/her approach to the markets, and more.

How did you start testing traders?

Back then, most guys in the trading world were proclaiming doom and gloom, and a popular commodities newsletter was *The Reaper* by R.E. McMaster. McMaster took my profile and so did all of his clients. When that original bunch of 700 traders took the profile, it really launched my career.

Did people share openly about their trading back then?

I think a lot of people shared what they did, and their so-called "secrets," with me because I wasn't a trader. There will always be traders who think that if they have a good method that they should keep it a secret, but I think that over the years, through my teachings, I have pretty much dispelled that there are any "big trading secrets."

Didn't some of them have proprietary trading systems?

Back then most people truly believed that a trading system was a bunch of setups and entry indicators; they were therefore less receptive to learning what a trading system really was and how to create one to fit them.

Even today, most people don't understand trading systems, so in that sense they don't really have a trading system. And if they do, more often than not it's flawed. As I said, in my early days as a coach, most trading systems equated to a set of setup conditions for entry. For example, people thought CANSLIM (William O'Neil's setup conditions) was his trading system rather than just a series of setups—which is just part of the overall system. And he doesn't spend much effort talking about position sizing in his book.

Is that why people lose money?

Most people never get a reasonable system. If they do get a reasonable system, then they probably don't understand position sizing. And if they don't understand position sizing, then they probably make a lot of mistakes.

Let me explain it this way. Expectancy is the mean R-value of your trading system. Thus, if you have a trading system with an expectancy of 0.75 that gives you 100 trades per year, then you'd make 75R on average per year. That's a reasonable system. If you risked 1% per trade, then you'd probably make 75% per year trading that system…maybe even 100% with compounding.

However, let's say that you make one mistake each week and every mistake you make costs you 2R. That means that over the course of a year you've cost yourself 104R in mistakes. If your system produces an average profit of 75R per year, then the net result is a loss of 29R. I'd say that probably describes what happens with most traders that have a reasonable system.

They continue to make mistakes and don't learn from them, so their profits turn to losses.

Which brings us back to the psychology of trading. The *Peak Performance Home Study Course* was eventually born from this modeling, correct?

Exactly, it took me five years and over $200,000 to create that course, but it is timeless information that has helped thousands of traders and I trust that it will continue to do so well after I'm gone. The basic nature of humans is not going to change, so I just identified what mistakes people commonly make in trading. I also researched, studied and modeled what made great traders great, and put it all together in this program.

Why is the information in home study course so important?

Simply because it is the original model of what works in the trading process.

You started writing this newsletter as a supplement to your home study program. What was happening that kept so much information flowing that you were able to write it for ten years?

It's still the case now; I love to trade, read and discover new things that I can share with my clients. When I started the original newsletter I discovered that about every three months or so I had some new perception or idea to share and that's how the quarterly updates got started. I wanted to ensure that the students of the home study program continued to get valuable information on an ongoing basis. One problem with my idea, however, is that most people didn't subscribe to the updates.

What prompted the move from a quarterly to a monthly newsletter?

That was Jay Abraham's idea. He told me that I should be communicating with my clients at least monthly. So I changed the format, but I had to get additional writers to help me then. Thankfully over the years some of my successful students have also been great writers, and they have been willing to share additional insights and their trading processes in these newsletters, which enabled me to give an even wider and diversified amount of information to my clients.

A couple of *Market Mastery* newsletters and *Course Updates* have become favorites and best sellers over the years, and some are used as supplements to your workshops. Which ones stand out for you?

I like the six interviews that I did with myself. They were a personal statement of what was going on for me at the time.

Also, the ones on self-sabotage; they are the core of my work and really delve into what's important. If people really understand this stuff and choose to do something about it, then they can make massive changes in all aspects of their lives.

How does your newsletter differ from other trading newsletters?

I believe that what I write about is timeless and in some ways I wish that I had never called it a newsletter. People pay hundreds and thousands of dollars to get a trading system, and they will also pay big bucks to get a newsletter that provides them with current information about the markets or specific stocks or investments. All of these things are pretty soon out of date. So the word "newsletter" is often associated with something that is in the moment and only useful at the time that it is released.

As I said, what I write is not obsolete on the week that it comes out; it has no expiration. I write about what is necessary for trading success. But this type of newsletter has always teetered around the 400 subscriber mark. Unfortunately, it has been an ongoing battle for years to get people to realize that back issues are still as valuable today as when they were written. Old newsletters are seen as expired—as though they are worthless—which is very discouraging for me because I do believe that the information would help new and experienced traders alike if they took the time to learn it.

In addition, people can get snippets of information from the Internet now, in a format that is quick and easy to read. They want something that fits in with the fast pace of society that they can read on the run.

You have done a number of interviews over the years. Which ones in particular stand out? Tell me about some of the people that you've interviewed for your newsletters.

We would be here all day if we spoke about all of the interesting characters that I have interviewed over the years, but there are three that I have interviewed that questioned traditional norms in the trading world or given me insight as to how things work from the inside:

I have most recently interviewed Scott Brown in the article *How Academia Leads Wall Street Astray*. I interviewed Scott because he was well versed in the subject of "Tharp think" before he went to graduate school to get his Ph.D. in finance. In fact, I warned him that he would have to forget many of the ideas that he believed in order to survive in academia. My work is often the antithesis of what they teach in academia; however, Scott has studied both sides of the equation, and his opinions on many of the current theories in finance and how they feed the "Wall Street Machine" are quite charged. We discussed what the average person learns when they get a finance degree and just how blind academics in finance are to the real issues that are relevant to investors.

Steven O'Keefe's interview was another that exposed me to a much different perspective on Wall Street. After doing numerous talks throughout Asia, I became more and more interested in the guidelines and rules that dominated institutional investors. Many of the concepts that I teach in the areas of position sizing and risk were not even known about and in some cases couldn't be implemented because of restrictions. This concerned me because of the massive amount of money that flows out of investors' pockets and into these firms on a daily basis. Steve has worked as both an analyst and a portfolio manager, and because he is no longer in the field, he was able to speak freely about his experiences with me and what actually happens behind the scenes.

Chris Weber was another interesting character. He accumulated a net worth of over $10 million from a starting point of $650 that he saved delivering newspapers. He has never had a traditional job and currently resides in a villa in the French Rivera. He has chosen to live a life of enjoyment and invests without being encumbered by the traditional standards of living and working.

You would have seen a lot of changes over the 25 years that you have been coaching in the trading arena. What would be the most significant changes that you've noticed?

Years ago there were huge edges that don't exist anymore. An example would be to be one of the first computerized trend followers that understood position sizing. As computers were virtually unknown back then, this would have been a huge edge for them.

However the most significant changes would be:

1. Internet trading, and the speed of transactions nowadays.
2. Cost of trading. When I started it was $65 to get into a trade and $65 to get out of a trade. In fact, when I counted my losses for that year, I had spent the equivalent amount (about $20K) in transaction costs.
3. Market makers becoming electronic as opposed to human beings. This will mean that the markets will become more efficient and less likely to be taken advantage of. In fact, it would be very interesting if we ever got rid of the specialists in New York! Many floor traders in Chicago say that they would be arrested if they did what they do in New York.

On the flipside, many things have stayed the same—the fundamentals. What would you say are the main things that stand true for traders today as they did over 20 years ago?

There are probably a lot more than five, but here's my list:

1. Trading is 100% psychological.
2. Trading is a business and should be treated like one.
3. It is imperative that you find a trading system that fits you.
4. Position sizing is the key to meeting your objectives.

5. This is a new insight that has evolved over the years, but basically, your trading system needs to be designed to get you a high quality system number. This means that the higher the number is, the easier it is to use position sizing.
6. People are programmed to do the wrong things, especially when it comes to money and trading.

What is the most common but easily corrected fault you see in traders?

There are many, but I'll give you one that is the root of everything else. Make the assumption that you totally create your investment results. That way, if you are not meeting your objectives, you will look to yourself as the source of the problem and not the market or your broker.

So if traders are responsible for their results, how do traders adapt to longer term market shifts?

I think we're in a secular bear market that will last another 15 years. This doesn't say anything about what the stock market will do in 2006. It doesn't even predict prices. Rather a secular bear market means that I expect PE ratios to decline over the next 15 years. Secular bear markets usually end with single digit PE ratios.

Since 2000, we've only had one good up year, 2003. In 2003, the S&P 500 finished up 25%. However, during 2003 the dollar lost 40% versus the Euro and almost every stock market in the world outperformed the U.S. stock market. That is what typically happens in a secular bear market.

However, I think crisis means opportunity. You can go short the market when it goes into a prolonged down periods. Also ETFs now exist that represent most sectors of the market, different commodities, and even most foreign stock markets. So there are many opportunities out there. However, the most dangerous place to be, in my opinion, is in mutual funds. When I first started trading, there were about 500 mutual funds. Now there are more mutual funds than stocks, so something has to give. And in a prolonged bear market, in which they must remain fully invested, a lot of them will just disappear. My guess is that 75% of them will be out of business by the time the secular bear market is over.

A lot of avid and long-term readers will probably wonder why you've decided to stop writing a regular newsletter. How would you explain this to them and what can they expect from you in the future?

I really want to do things when the creative mood hits me rather than being required or obligated to come up with something to write about every month or even every quarter for a newsletter.

Thus, I'd prefer to work without any limitations. I would like to do more special reports in key areas, and I will probably write more books.

I write other articles for my weekly email newsletter, *Tharp's Thoughts*, as they come to mind and also on the first Wednesday of every month I write my *Market Update*. This allows me to stay in touch with my clients and still have the time to write and do other things.

For now I am re-writing the next edition of *Trade Your Way to Financial Freedom* and I'll finally have time to finish the *Definitive Guide to Position Sizing and Expectancy*.

Finally, tell us about the social side of Van. What else do you like to do outside of the trading world?

I definitely enjoy poker but that probably still falls into the realm of learning about money, myself and the psychology of it all.

Outside of trading, I have a strong interest in spiritual studies; I am an avid stamp and art collector and a big supporter of the Green Bay Packers (I own some of their stock). My wife and I enjoy going to theatrical productions and shows. I've always been a big music and dancing fan and will try everything from the ballroom to the disco dance floor—just because I like the beat. My favorite music would definitely be jazz, especially big band and the old Dixieland stuff.

I have a son Robert from my first marriage, he lives in San Diego and although he has been a trader in the past, he now has a successful on-line business and social training business.

I have been married to Kala for 14 years and our niece, Nanthini, from Malaysia lives with us. She is like a daughter and we are putting her through college.

Do you have any last quotes or words of advice that you would like to give to your readers?

First and foremost, I just want traders to know that it isn't hard to create a system that will generate 80R, which is 80% a year (if you risk 1%). The important part to realize is that every mistake that you make can cost you 2R, and your profits can just slip away. So the ultimate goal is to make as few mistakes as possible.

If you create a good system and do not make mistakes, you can make a decent living trading.

Finally, I would like to thank the people that have read my work and especially the newsletter subscribers that have been with me since the beginning. It is a gift and blessing that people continue to follow my work, and as long as traders are continuing to gain insight and transforming their lives, I will stay in the game.

I therefore invite you to subscribe to our e-mail newsletter, if you have not already. Or, at least check in with us occasionally to find out what's new.

I wish you success on your trading journey.