

Anthony Bolton: How to spot the market's turning point

By Anthony Bolton

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My strong advice for most investors is not to try to time markets. It is difficult to do it consistently well. In my experience, most investors have a positive or negative bias, which makes them good at buying but not selling or vice versa. This can cloud their judgment at turning points.

If you miss even a few of the best days of a bull market, your returns will be considerably eroded and some of these days often occur at the start of a new bull trend. It is better to take at least a three-year view when buying equities and not to

For most of my time, I have avoided taking a market view (except for some hedging), preferring to concentrate on my stock and industry positions. I would much rather take, say, 100 positions in individual stocks where I believe I have an advantage in analysing them. I know I will get some wrong, but, hopefully, the majority will be correct.

When it comes to betting on the market, I know I have less competitive advantage and I cannot benefit from the law of averages. Predicting the future for one company is easier than forecasting the outlook for all companies.

However, in the last 10 years or so, I have been asked more and more to give market views and have sometimes done so. I always do so humbly, knowing that second-guessing Mr Market is very difficult. Professional investors have a poor record at predicting the direction of markets, which tend to move in a direction that makes the majority wrong.

A bull market tends to climb a wall of worry. At the bottom, it is easy to find reasons not to buy – all the negatives are known. Gradually, as the market recovers, these become less convincing to investors. Remember that bull markets paper over the “cracks” while bear markets expose them.

Bear in mind, too, that the stock market is an excellent discounter of the future. It normally moves on what investors expect to happen in six to 12 months' time. So, if you wait for the news to get better or worse, you will miss the market's turning point. Arguments about a rosy future are always most persuasive, and prevalent, at the top – while the outlook always looks bleakest at the bottom. The more widely-held a belief that the existing trend will continue, the less likely that it will.

At the top, it is not that the news stops being good, it is rather that it stops getting better. The opposite is true at lows. However, it is extremely difficult to spot the catalyst that will turn a bull market into a bear or the reverse.

A possible exception to this rule is the onset of hostilities in the Middle East, which has marked the low in two bear markets that I've experienced. When a very negative or positive event is widely expected, the market generally makes most of its move in anticipation of the event, rather than after it.

The general environment at lows can be uncertain and worrying. It is normally darkest just before dawn and, just as you're looking into the abyss, feeling that the financial system might collapse or that no-one will ever buy equities again, the market turns. The bad news has by then fully permeated investment thinking and the last seller has sold. Markets hit the bottom not because of the appearance of buyers but when sellers stop selling. They peak when buyers stop buying.

When evaluating the market outlook, there are three things that I focus on and one that I don't. The one thing that I don't look at is the economic outlook, as this invariably looks great at tops and horrible at bottoms. In my experience, economic views won't help you time markets correctly.

The first of the three factors I do look at is how the current situation compares with the historical pattern of bull and bear markets. That is, how long and far we have risen in a bull market and fallen in a bear market. When the time and scale of the rise or fall are both high relative to historical averages, the odds of a change of trend increase.

The second factor is indicators of investment sentiment and behaviour. These include: put/call ratios, the sentiment of advisers, market breadth, volatility, mutual fund cash positions and the exposures of hedge funds. When these indicate extreme pessimism or optimism, it normally pays to bet against them. For example, high volatility often precedes a change of trend.

The third factor is long-term (30-40 year) market valuations, particularly measures such as price-to-book value or free cash flow. Again, when these move outside their normal range, it can signal risk or opportunity.

In my experience, when all three factors confirm each other, the odds are that you are near a turning point. It won't predict the right day, the right week or even the right month, but it might give you the right quarter. All three factors were aligned in the last quarter of 2008, making me optimistic that 2009 will be a better year for equities.

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Anthony Bolton's column appears in FT Money on the first Saturday of each alternate month. Next column: March 7.