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guestperspective... By Paul F. Desmond

An Exploration Of The Nature Of Bull Market Tops

Study Of 14 Peaks Shows They Don't Come Out Of The Blue

Almost every investor harbors the secret wish of being able to sell out on the exact top day of a bull market. The bragging rights would last a lifetime. But, exactly how does an investor identify the top day? An easy answer might be that it is the highest level reached by the Dow Jones Industrial Average (DJIA) before a major market decline. This is probably a reasonably good answer for historians studying the long term trends of the stock market, but it is not a practical, working answer for investors, since it can only be known long after the top occurred. Another answer might be that the exact top of a bull market is the point at which the vast majority of stocks reach their highest price levels for many years to come. More than a few investors would say that the first answer and the second answer are synonymous; that the majority of stocks reach their peaks at the same time as the peak of the DJIA. But, is that actually the case? Do most stocks reach their price peaks in unison, and do they do so simultaneously with the major price indexes? Does what seems so logical match actual experience?

There is a dearth of information about the nature of major stock market tops, and the sparse information that does exist is more theoretical than statistical. Stock market guru, Joseph Granville, once surmised that one-third of stocks reach their final bull market price peaks in advance of the DJIA's peak, one-third reach their highs in unison with the DJIA's peak, and one-third reach their peaks after the DJIA's peak. However, the sheer simplicity of Granville's theory suggests that it was based more on guesswork than on hard statistical analysis.

One thing that investors have known, if only in a very vague sense, is that major market tops are not the same as major market bottoms. Much more work has been done in defining the nature of major stock market bottoms than in understanding the nature of bull market tops. A 2002 Lowry study titled <u>Identifying Bear Market Bottoms and New Bull Markets</u>,** showed that major market bottoms can often be identified by evidence of panic selling (one or more 90% Downside Days) in which investors dump stocks with abandon. Then, with the desire to sell having been exhausted, buyers suddenly rush in to snap up the bargains (and cover short positions), resulting in a 90% Upside Day. The combination of panic selling across a broad spectrum of stocks, followed quickly by broad, enthusiastic buying, produces what might be described as a classic "V" pattern of prices at major bear market bottoms.

Bull market tops, on the other hand, tend to develop gradually over a long period of time. The reasons for this gradual process are easy to understand: It is the Law of Supply and Demand at work. Just as bull markets result from strong, persistent investor demand for stocks, bull market tops evolve when investors gradually stop buying. Some investors simply run out of new money to invest. Others begin to see individual stocks as being overvalued, and begin to hold back on new purchases. Whatever the reasons, the stock market cannot continue to advance without Demand exceeding Supply. The evolution of investor psychology from strong buying enthusiasm for stocks to passivity or complacency does not occur suddenly. Thus, bull market tops are commonly diffuse, possibly lulling most investors into inaction. Perhaps it is the slowness of the entire process that makes it difficult to recognize a bull market top.

However, beyond this vague and somewhat hypothetical supposition, little or nothing more is known about the nature of bull market tops. Despite our almost total lack of understanding of the subject, the end of a bull market and the simultaneous start of a new bear market is undoubtedly one of the most important moments in time for any investor. Many investors have experienced the frustration and anguish of making big stock market gains in a bull market, only to watch the gains turn into big losses during the subsequent bear market. Thus, the ability

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to avoid capital losses is, in many ways, a more important objective for investors than making big gains. Perhaps it is our almost total lack of understanding about the end of bull markets that is responsible for investors' almost universal inability to avoid bear markets. A greater understanding of investor psychology near bull market tops might emit warning signs in the making, and allow at least some alert investors to be able to take defensive actions in advance of the devastating losses that typically occur in the subsequent bear market.

There are several helpful tools that technical analysts have used for many decades to warn of impending stock market tops, such as the Advance-Decline Line and the number of stocks recording New 52-week Highs. History shows that these indicators often top out and begin to contract, as individual stocks fall by the wayside, months in advance of the final top in the Dow Jones Industrial Average. Therefore, it would not be a surprise to find that all stocks do not reach their peaks simultaneously or in unison with the DJIA. But, it is the degree and the intensity of the divergences of individual stocks from the DJIA that had never been measured before – until now.

Discoveries in science are frequently the result of happenstance rather than great scientific detective work. The discoveries to be related in this paper regarding bull market tops began in exactly that fashion. My firm, Lowry Research Corporation, had purchased rolls of microfilm of the Wall Street Journal covering the period from 1920 through 1930. Being able to step back in time, if only in recorded history, is a special experience. The first frame to be viewed in the microfilm reader, purely out of curiosity, was the page containing the New York Stock Exchange trading of September 3, 1929 – the absolute top day for the DJIA prior to the 1929 Crash. It is ironic that 1929 is undoubtedly one of the most important dates in stock market history, and so little is known about the forces of supply and demand at work in the market during that period.

In simply looking around at the trading data from that day – at the many unfamiliar names of the companies traded, at the volume of trading, at the highest prices for each stock – it became apparent that some stocks had traded that day at prices below their 1929 highs. Some stocks were considerably below their yearly high. That seemed strange for a day on which the DJIA was at the absolute highest point in history and at a level that would not be seen again for the next 20 years. Upon closer examination, it was difficult to find stocks that were at their highs on that fateful day.

Intuitively, something seemed to be very wrong. On a day when common sense would dictate that most stocks should have closed at their all-time highs, it was determined that very few stocks had closed at, or even near, their 1929 highs. Many stocks were down from their highs by 20% or more (Last price was lower than 1929 High price). Thus began a detailed examination of the trading of September 3, 1929. The results were most surprising.

TRANSACTIONS

1929. High.	Low.	Stock and Dividend Rate.	First.	High.	Low.	Last.	Net Ch'ge.	Closing Bid.	Ask.	Sales.
57⅞	38⅛	Abitibi Power & Paper.	56	56	55	55	..	53	54¼	1,000
88⅝	79	Abitibi P. & P. pf. (6)	84	84	84	84	+ 1	84¼	84½	100
750	389	Adams Express (h6)...	593	594	590	590	− 1	500	585	400
104⅞	27	Advance Rumely	31½	31⅝	29	29	− 1¾	29	30	2,200
119	40	Advance Rumely pf....	43	43	41⅛	41⅛	+ ⅞	40½	43	600
4⅞	1½	Ahumada Lead	1¾	1¾	1⅝	1¾	..	1⅝	1¾	600
217	95⅛	Air Reduction (3)......	216	217	212⅞	216	+ 2	214½	216½	4,900
48⅞	36	Air Way El. Appl. (2½)	39	39	39	39	+ ½	39	40	100
11¼	4	Ajax Rubber	4⅞	4⅞	4¾	4⅞	..	4¾	4⅞	1,000
10¼	4½	Alaska Juneau	8½	8¾	8½	8¾	..	8⅝	8¾	4,500
25	12	Albany Perf. W. Paper	19	19	19	19	..	18	19.	100
56½	27⅝	Alleghany Corporation.	54	56½	53½	56¼	+ 3¼	56	56¼	229,500
118¾	99⅛	Alleghany Corp.pf.(5½)	115	118	115	118	+ 3⅛	116½	118½	1,700
118	100⅜	Alleg. Corp. pf.rec.(5½)	115	118	115	117⅜	+ 2⅝	116½	118	3,900
86½	80¼	Alleg. Corp. pf. xw(5½)	82	82¼	80¼	80¼	− 3½	80	81	2,500
85¾	80¼	Alleg. Cp.pf.rec.xw(5½)	82	82¼	80¼	80¼	− 2	80	81	1,600
354¾	241	Allied Chem. & Dye (6)	352	354½	348	354	+ 4	350	354	5,600
125	120¼	Allied Chem. & D.pf.(7)	122½	122½	122	122	..	122	122½	200
330	166	Allis-Chalmers Mfg.(7)	317	317	316½	316½	+ 5	312⅝	317½	300
42⅝	22½	Amerada Corp. (2).....	27	27	27	27	..	27	27½	400
23⅝	10⅛	Am. Agricult. Chemical	11⅝	11⅝	11½	11½	− ⅛	11½	11⅞	500
73¾	40⅝	Am. Agricult. Chem.pf.	46¾	46¾	46¾	46¾	+ 1¾	45	46½	200
155	110	Am. Bank Note (†3)...	149⅞	155	149	151	+ 1¾	150	151	11,400
73¼	40½	Am. Bosch Magneto ...	66⅝	67	66	66⅞	+ 1¼	66¾	66⅞	4,900

Source: Wall Street Journal

Table 1: Examination of Trading on September 3, 1929

BULL MKT TOP DAY	% STOCKS @% NEW HIGHS	AT OR <2% OF NEW HIGHS	% OFF 20% OR MORE	% OFF 30% OR MORE
9/3/1929	2.30%	15.62%	31.84%	18.77%

On the day on which the Dow Jones Industrial Average reached its absolute high for the 1920s bull market, the percentage of stocks making new 1929 highs that day was not 80% or 75% or even 70%. It was 2.30%. Out of 826 stocks that were traded on theNew York Stock Exchange that day, only 19 stocks made their highs. Equally surprising, only 15.62% of Table 1: Examination of Trading on September 3, 1929 all issues traded on the NYSE were either at, or within 2% of their 1929 highs. In other words, about 84% of all stocks had topped out and had begun to decline at some time prior to September 3rd. In fact, it was determined that, on the same day that the DJIA reached its all-time high, 31.84% of the stocks traded on the NYSE had already declined by 20% from their 1929 highs. 18.77% of stocks had declined by more than 30%.

Stocks at, or within 2% of their highs were dwarfed by the number that had already lost
20% or more from their 1929 highs. Thus it became apparent that the absolute top for the vast majority of stocks had probably occurred months – perhaps many months – before
September 3, 1929. And yet, there had been no single, outstanding day of rally prior to
September 3rd that investors could identify as the ideal point at which to shift portfolios to a more defensive composition.

The pressing question was whether the 1929 case was a total anomaly, or whether somewhat similar conditions would be found at other important bull market tops throughout history. Therefore, we expanded our study to include each of the fourteen major bull market tops, based on the Dow Jones Industrial Average, from 1929 through
2000. Our basic assumption was that most stocks reached their highest prices in unison with the Dow Jones Industrial Average. But, our examination of each stock traded on the
New York Stock Exchange, comparing their bull market highs to their closing prices on the peak days of the Dow Jones Industrial Average, showed an unexpected picture.

Table 2: Examination of Trading at Fourteen Peaks in the Dow Jones Industrial Average

BULL MKT TOP DAY	% STOCKS @ NEW HIGHS	% AT OR <2% Of NEW HIGHS	% OFF 20% OR MORE	% OFF 30% OR MORE
09/03/1929	2.30%	15.62%	31.84%	18.77%
03/10/1937	6.05%	21.34%	5.94%	1.06%
05/29/1946	8.59%	30.44%	6.30%	0.86%
04/06/1956	5.32%	23.36%	1.92%	0.42%
01/05/1960	1.60%	5.83%	23.25%	7.67%
12/13/1961	3.56%	11.83%	25.29%	11.60%
02/09/1966	9.66%	19.04%	9.52%	2.68%
12/03/1968	9.43%	20.12%	9.51%	2.36%
01/11/1973	5.30%	11.82%	34.22%	20.51%
09/21/1976	10.97%	22.88%	21.65%	10.09%
04/27/1981	7.09%	15.18%	28.01%	9.39%
08/25/1987	6.23%	15.23%	17.37%	7.44%
07/16/1990	5.35%	18.11%	37.31%	22.74%
01/14/2000	3.54%	6.31%	55.33%	32.45%
AVERAGE	5.98%	16.88%	21.97%	10.54%

These findings defy the conventional wisdom about the nature of stock market tops. In each case, 11% or less of stocks (average 5.98%) were making new highs along with the new high in the DJIA – a generally accepted proxy for the broad list of stocks. Further, in 9 of the 14 cases covered in this study, a significant number of NYSE-listed stocks (average 21.97%) had already dropped in price by 20% or more before the DJIA had reached its bull market peak.

The primary conclusion to be drawn from these fourteen cases is that the vast majority of stocks reached their bull market highs well before the peak of the Dow Jones Industrial Average. If a portfolio manager had somehow been able to sell out on the absolute top day of the DJIA in each of the fourteen cases studied here, in most instances the portfolios would have already lost a considerable amount of value by that time. Investors who may have thought themselves lucky enough to sell all of their stocks on the exact top day of the DJIA could have actually suffered significant losses. The amazing similarity of the statistics in these fourteen cases suggests a pattern of deterioration at major market tops that investors cannot afford to ignore. In searching for a way to describe this phenomenon of market deterioration – the gradual process of hundreds of individual stocks rolling over into their own bear markets, one by one, over a period of many months – the picture of a feather emerged. We think that image is just about right.

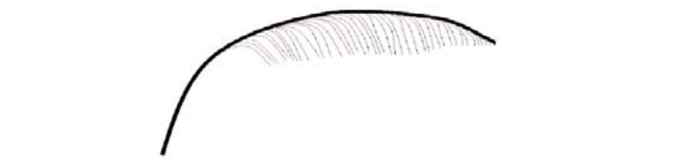

Table 3: The Dow Jones Industrial Average components as of September 3, 1929

DJIA Components	1929 High	Sept 3, 1929 Close
Allied Chemical	354 3/4	354
American Can	184 1/2	181
American Smelting	129 1/8	128 1/8
American Sugar	94 3/4	81 3/4
American Tobacco	205	200
Atlantic Refining	77 7/8	65 5/8
Bethlehem Steel	140 3/4	136 3/4
Chrysler	135	71 7/8
Curtis Wright	30 1/8	29
General Electric	403	391
General Foods	81 3/4	71 7/8
General Motors	91 3/4	71 3/4
General Railway Signal	126 1/2	123 1/2
Goodrich	105 3/4	73
International Harvester	142	140
International Nickel	72 3/4	54 1/2
Mack Truck	114 3/4	97
Nash Motors	118 7/8	84 5/8
National Cash Register	148 3/4	125 3/4
North American	186 3/4	184 1/8
Paramount	74	72
Radio Corporation	114	98 1/8
Sears Roebuck	181	171
Standard Oil N. J.	73 7/8	70 3/4
Texas Corporation	71 3/4	68 1/2
Texas Gulf Sulphur	85 1/4	72
Union Carbide	137 7/8	135 3/4
U. S. Steel	261 3/4	257 5/8
Westinghouse	295 5/8	285 7/8
Woolworth	100 7/8	99

Our study appears to show that the Dow Jones Industrial Average is a less than ideal proxy for the broad list of stocks. For example, as shown in Table 3, below, in the 1929 case, none of the thirty component stocks were making new highs along with the Industrial Average on September 3, 1929. This is due to a large extent to the reporting of closing numbers for the Average on a theoretical basis.

The study also suggests that, even at that early time in the history of the 30-stock Average, the price weighting of the components was producing an undue influence on the movements of the DJIA. However, the bigger issue is that the evidence drawn from all fourteen cases suggests that the highest price levels for the vast majority of New York Stock Exchange listed stocks have tended to occur well before the final peak in the DJIA.

The final days of a bull market are substantially different than the final days of a bear market. At most bear market lows, because fear and panic are the dominant emotional drivers, the vast majority of stocks tend to bottom in unison. At most bear market tops, where investors have been lulled into complacency, the vast majority of stocks seem to top out on an individual basis. This is not much different than observing that a farmer usually plants all of his seeds at the same time in the Spring. However, not all of the fruit reaches the point of peak ripeness at the same time. The ripe fruit must be picked individually, rather than all at once. In the same way, investors must commit to buying stocks quickly after a major market bottom, but must sell stocks one by one, as they reach their individual peaks.

This simple study of bull market tops should have far-reaching implications for all investors. The conventional wisdom of what a major market top looks like must be completely revised. Every portfolio manager must create a new strategic plan as to how and when to take defensive action. And, new indicators must be devised to eliminate the current guesswork of where individual stocks are within the primary trend. Investors must be able to see, and have time to react to, the gradual deterioration of market breadth that precedes periods of substantial stock market losses.

We will leave it to other researchers and analysts to determine all of the various reasons why so few stocks have reached their bull market highs in unison with the Dow Jones Industrial Average. Our principal concern, at this point, is to alert investors to the conditions that have consistently occurred at important stock market tops. Future studies will address the need to develop new indicators and a new portfolio management strategy to deal with the challenging conditions revealed in this study.

Respectfully submitted,
Paul F. Desmond
Lowry's Reports, Inc.

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W@W Trading Ideas Research Disclosure: *Paul F. Desmond is the President of Lowry's Reports, Inc., the oldest technical investment advisory firm in the Nation. Paul joined Lowry in 1964 as Director of Research and advanced to the presidency in 1972. Over the past 40 years he has earned the distinction of being regarded as the Dean of Supply/Demand analysis. Lowry's Reports is particularly unique in the advisory field in that its analysis, which is based solely on the Law of Supply versus Demand, has been conducted in exactly the same manner for the past 73 years. About 85% of the Lowry subscribers are professional investors, and almost 20% of them have subscribed for 25 years or more. Lowry's Reports was the subject of an Advanced Study Project at the Wharton School in December, 1975, which concluded: "...this study indicated that extraordinary gains can be achieved by sophisticated technical analysis using weak form data. This is a violation of both the Efficient Markets and Random Walk Theories."*

Paul was the recipient of the Charles H. Dow Award for 2002 sponsored by Dow Jones & Co. for his original research entitled "Identifying Bear Market Bottoms and New Bull Markets". He is also a Past President of the Market Technicians Association, and a Founding Member of the American Association of Professional Technical Analysts (AAPTA), and was the recipient of its 1st Annual Award for Outstanding Contribution to the Field of Technical Analysis. He has been featured in interviews in Barron's, the Wall Street Journal, CBS MarketWatch, Money Magazine and a wide variety of other financial publications.

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