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Danielle L. Scott: Hello. This is Danielle L. Scott, Managing Editor for the Graziadio Business Report Blog. Today, we have Dr. Marshall Nickles and Dr. Ray Valadez of the Graziadio School of Business and Management here to talk with us about their paper on how to enhance investment returns during a volatile global stock market. Their paper won the Best Paper and Finance Award at the Global Business Development Institute's 11th annual conference this March. Dr. Nickles, Dr. Valadez, thank you so much for taking the time to share your takeaways with us and of course, congratulations on your award.

Dr. Marshall Nickles: Thank you.

Dr. Ray Valadez: Thank you.

Danielle L. Scott: So, you wrote that it may not be a good idea to stick with the traditional buy and hold strategy during this current economic climate. Why is that?

Dr. Marshall Nickles: Well, the current economic climate is unusual. It's been compared from time-to-time to the Great Depression of the 1930s. These anomalies that occur from time-to-time are global in nature and are very suppressive to the stock market. As a consequence, the defense of a diversified buy and hold strategy, which was supposed to deal with the risk factor, didn't hold up simply because the macro environment was so ominous and so broad in its scope that we found that it was just too much for the markets to hold up, particularly in the current environment where the heart of the matter started with the credit and banking systems, which are the lifeblood of money flows to the stock market. So simply doing a buy and hold, we found that over time when we had these anomalies that occurred, and they occurred in more recent history in the crash of 1987, the dot-com decline and the present decline, that they simply were so broad in scope and they were so depressing that you couldn't simply buy and hold for fear of getting behind the eight ball from a deficit perspective. And, the time it took to recoup those losses were overwhelming. So over time, you actually ended up being a loser for, say, a ten-year period as we found over the last ten years.

Dr. Ray Valadez: Yes, and the depth and the period, the length of time of these dips were a lot more in terms of depth and strength than had occurred before. So, obviously the buy and hold tradition, which we all advocate by the way in the financial community. That's one of the basic strategies that you learn to use and what had happened is over a period of time, maybe in the 1950s and 1960s and 1970s, that strategy was holding. But there again, when we got into the 1970s with the oil embargo and a few other things that occur with a dot-com as well as most recently with the financial meltdown on the securitization with these fancy financial engineering that took place of debt instruments caused all of these long and very deep dips in the market.

Danielle L. Scott: Dr. Nickles, you touched a little bit on diversification. Most people believe that as long as their portfolio is diversified that they'll be okay, but you said that you cannot rely solely on portfolio diversification either, especially during this bear market.

Dr. Marshall Nickles: Well, that's certainly what we have found currently, and I think it also is true of the periods that I mentioned earlier - 1987, dot-com and the present - as Dr. Valadez just pointed out. Diversification is based on the concept that if you hold securities in different industries and in different style levels - large cap, mid cap, small cap - and also internationally from an emerging nation to the other types of global investments that you will somehow at any one moment in time, somehow reap the advantages; one part of your portfolio doing better in one given time over another given time. And as a consequence, we'll somehow hold that portfolio at a level that was somewhat, hopefully, resistant to too much downside. But, what we have found that globalization is part of our landscape these days and the interrelationship between industries. For example, the General Motors issue currently afoot. We find that a lot of subcontracting and a lot of the industries that were feeding into the General Motors Corporation are at risk. So as you diversify your portfolio, it is conceptually a good idea, and I would say under normal circumstances, as Dr. Valadez has pointed out, you have periods like the 1980s and 1990s where the market had a propensity to go up during those two decades, that diversification does its job. But, when you get into these anomalies, as we mentioned earlier, diversification does not seem to be enough to prevent a total decline and that's what we have currently experienced and people who had held their portfolios during this most recent decline felt that it was impossible almost to skirt the decline through diversification.

Dr. Ray Valadez: And another way of minimizing risk is something that we discovered through our research is an item called the "Ulcer Effect," which measures really the draw downs and length in terms of those dips. Diversification is not really measured in that type of a scenario. So, we found that looking at another measurement, which is the "ulcer effect," we were able to then decipher that maybe perhaps there was an alternative to the buy and hold strategy. I think Dr. Nickles' work over the last 20 years has been in that area of looking at some of the draw downs in the political cycle years.

Danielle L. Scott: So, what you're talking about now is the seasonality approach, correct?

Dr. Marshall Nickles: Yes.

Danielle L. Scott: Tell us more about the seasonality approach and why you advocate it.

Dr. Marshall Nickles: Well, there are different ways to approach stock market investments strategically speaking. The strategies are anywhere from the very broad concept with diversification that we talked about just a moment ago. Other strategies include what we call maybe some type of technical analysis, which is a type of trading system where you trade more frequently in and out of the market, hoping to capture short-term gains and minimize your exposure to the market and therefore reduce your risk. Well, along those lines, our investigation was centered on seasonality and the seasonality concept is suggesting that there are certain times during a given year, during a given period where the market does better and certain periods when it doesn't do as well.

Danielle L. Scott: The market as a whole?

Dr. Marshall Nickles: The market as a whole, and again, we're using broad measurements like the S&P 500 for example. There has been other additional research investigations done that started us thinking along these lines. While we didn't investigate this, the literature suggests that the reason for some of the seasonality has to do with things like the increasing or decreasing of the monetary availability of money to drive markets. The Federal Reserve, as it turns out through other research that we discovered, as an example, that the Federal Reserve increases the supply of money starting in the fall of any given year to provide access to credit around Thanksgiving time and the holidays that follow, and then also provides that flow of money into the tax season. In addition, there's something called the "January effect" that takes place after the holidays where people are, if the markets are doing well, typically anxious to invest their monies into their retirement funds shortly after the New Year in order to gain an advantage of being more fully invested. So, as we looked at this, Sy Harding and Yale Hirsch and others who had done work along these lines began to put together a series of months that captured this phenomenon that we're describing. And as it turned out, what we investigated was simply a confirmation of this, which suggested that the period from November 1st until April 30th of any given cycle in the stock market had a better propensity for success over the other remaining times, which were after April and then through the end of October. We went back to 1970 on this. I had done some individual work back in 1950, and we found that consistently that that block of time outperformed the buy and hold. So by steering clear of the periods that were not as prosperous and as profitable for the market, you were able then to gain significant headwind on your investment objectives.

Dr. Ray Valadez: So, the strategy would be that one would invest between the periods of November 1st and April 30th and then stay out of the market; so to speak from May 1st to October 30th. The phenomena has been observed, but we needed to actually statistically prove that in essence there was significant difference, and I think that's the essence of the study and that is that we were able to statistically prove that in essence that there was significant differences between those two investment periods along with prove also that there was a political cycle year, but that was just an additional strategy that might be applied to it. But, the key to the whole thing and that is – we were able to prove that it was better, but also over a period of time that was significant. In this instance, we went back 38 years, and we were fortunate enough that we just reviewed those numbers and showed that in essence, that in 2007 and

2008, if you had followed the strategy, you would not have lost as much money as you would have if you had a buy and hold strategy. In fact, I mean the difference is almost 5:1 in favor of the seasonality.

Danielle L. Scott: Wow. So, you proved your theory to be true over the past 38 years. What about the next few years going into the future? Do you think that the seasonality approach will continue to work as well?

Dr. Marshall Nickles: Well, that's always a good question and one that always surfaces because people who hear things like this, all these studies that have been that attempt to substantiate one strategy or concept or philosophy over another. The question always surfaces, "Going forward, can we expect the same thing?" The answer is that based upon— As Dr. Valadez just pointed out, based upon our 38-year study, we found it to be consistent and it was consistent in two basic ways, as Ray has pointed out. One is that it outperformed a buy and hold, just share profit return by a considerable margin and it reduced the risk along the way by being out of the market half of the year approximately. So, those two things over that 38-year period encompassed a series of anomalies like the oil embargo, like the crash of 1987 and so forth and we've just described earlier. And so, therefore, the so-called strategy that we're talking about here performed well over a period of tough years, down years, and sideways years. So statistically, it has a lot of merit, a lot of legs to stand on as they say. But going forward, with the propensity for globalization to impact the U.S. markets much more than it ever did in the past, we're not so sure about how closely that statistical relationship will last in the future because it's conceivable that outbreaks of economic problems or political insurrections around the world, which had been somewhat limited in impact to the U.S., are now changing. As a result of that, it's conceivable that if we have enough interruptions along the way as we've had, let's say, from the 9/11 period in the U.S. going forward, that it's entirely possible, that the effectiveness of our investigation may be compromised.

Dr. Ray Valadez: And obviously, right now, everybody's thinking, "Well, what happened this past six months, and was there are a positive or a negative affect?" If you were in the market, you would have a negative affect and approximately from November to now, maybe a 12% loss in the Dow. But, I believe that what is proving itself out to be that the loss was a lot less than you would have lost if you had a buy and hold strategy over the last year. You would have lost 35%. So in essence, you would have lost less. But getting back to the whole reason for the study, we realized that the phenomenon not only was true in the United States, but is also true internationally. And, during our literature review, we were able to find a lot of documentation that showed that a lot of the markets, emerging markets as well as those that have been already established in Europe, follow a seasonality pattern as well. So, we were just adding to the knowledge in this area. As far as the future's concerned, I think it's held up well. I think what we did is we put it to the test. We assumed that going back; let's say, May 8th this year and going back ten years, and we said, Okay. Had you invested $10,000 ten years ago and held it up until now and absorbed all of these things that were going on in the market that you would have, in essence, had a positive return of approximately 25% or 30% whereas if you had had a buy and hold strategy, you would have lost somewhere in the vicinity of about 25%. So in essence, the true asset test is the time series analysis that we had done by taking ten-year cycles. It did prove itself. Even up to last Friday, if you had done the investment ten years ago, you would still have been in the positive side of the house.

Danielle L. Scott: So given the strength of your theory over the past 38 years and the uncertainty that may occur in the next few years, would your advice to investors be to employ a seasonality approach?

Dr. Marshall Nickles: I think that the way to answer that question is to recognize that any strategy, regardless of what it is, should be taken with a grain of salt. In other words, you don't put, in my opinion, you don't put all of your bets on a particular strategy because there's always that potential or possibility that for whatever reason, exogenous events or whatever they may be, can impact on a given strategy. So, nothing works consistently all the time. There are times that things work better and sometimes not as well. As Dr. Valadez was just pointing out, this last 12-month period, the seasonality strategy did lose money. It happened to turn out that it lost less money than a buy and hold, but substantiates our original argument and premise, but still, you lost. So, people that may have the expectation that "Well, if I use this strategy I'm not going to lose any money;" I think that they need to recognize that that isn't the case necessarily at all. But, to answer the question more directly, what we're suggesting is that seasonality has held up over a 30-year period, 38-year period statistically and therefore, investors should consider the possibility of addressing or looking at the seasonality strategy along with other kinds of approaches and advice from their advisors about when and how to invest in the market.

Dr. Ray Valadez: Obviously, no one has a crystal ball and if they did, obviously, they wouldn't be doing an empirical analysis as we have. But in our analysis, it's in the area of positive economics. It's what we empirically say "what is" and not necessarily what should be or what's going to be. Through analysis of the past, we can then predict somewhat what the future is going to be. But again, there are some dynamic things that are going on with globalization. Evident of that is the whole financial meltdown and the query that's going on right now as to what happened.

Danielle L. Scott: Well, professors, thank you, again, for taking the time to talk with us. We really appreciate the investment advice, especially in today's climate. So, thank you very much.

Dr. Marshall Nickles: You're welcome.

Dr. Ray Valadez: You're welcome.

Danielle L. Scott: This is Danielle for the GBR Blog. Find us online at gbr.pepperdine.edu/blog.

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