



A Supplement to

The Wall Street Traffic Light's

Chapter 11, Significance of the Test Results

(Read this material as if it appeared immediately before the “The Real Test” section, p. 98.)

A CASE STUDY OF 1969-1970

This case study illustrates the sharp contrast between viewing the stock market through the eyes of the WSTL model and through the eyes of the efficient market theory. From 5/14/69 to 5/26/70, the S&P 500 had a very steep decline of 34.7%. In *The Wall Street Traffic Light*, Exhibit 9-3 (p. 80) indicates the classification of 1969 is a 1C year, which was established at the end of January. Exhibit 2-4 (p. 21) indicates the classification of 1970 is a 3C year, which also was established at the end of January. The trades in both of those years were profitable. The two-year accumulations from a one-time investment of \$10,000 at the end of 1968 under the WSTL model and under buying-and-holding the S&P 500 were as follows:

Year	WSTL Return	S&P 500 Return	Profitable Trade	End-of-Year Accumulation from One-Time Investment of \$10,000 Using the WSTL	End-of-Year Accumulation from One-Time Investment of \$10,000 in the S&P 500
1968				\$10,000	\$10,000
1969	5.8%	-8.5%	14.3%	\$10,580	\$9,150
1970	17.7%	4.0%	13.7%	\$12,453	\$9,526

For 1969-1970, the WSTL model beat buy-and-hold by a stunning 30.7% $[(\$12,453 - \$9,526) \div \$9,526 = 30.7\%]$.

In 1973, James Lorie and Mary Hamilton—strong proponents of the efficient market theory—published their classic book, *The Stock Market—Theory and Evidence*. Albeit somewhat lengthy, their commentary on the 1969-1970 decline illustrates the sharp contrast between the efficient market theory and the WSTL model (pp. 9-10):

What caused this rapid and large decline? First, a minor recession began “officially” according to the National Bureau of Economic Research during the third quarter of 1969 and brought with it virtual certainty of a decline in corporate earnings. In fact, between the second quarter in 1969 and the second quarter in 1970, corporate earnings declined by almost 14 percent, at

seasonally adjusted annual rates. Second, the yield to maturity on 90-day Treasury bills and three-to-four-year government bonds rose from about 6.2 percent and 6.6 percent to 6.7 percent and 7.8 percent, respectively. Those two factors alone could plausibly account for a substantial decline in stock prices.

For an explanation of the balance of the decline, one must rely on conjecture. Although American society was noticeably distinguishable from either Utopia or the Garden of Eden in early 1969, dissatisfaction did not seem to be as acute and violent prior to 1969 as it did in 1969 and 1970. In the later period, the extension of the war into Cambodia and Laos and the accompanying domestic reactions and other factors could have increased social malaise and caused decreased confidence in the future of the American society, the American economy, and the value of American corporations.

Added to all of the above was the disarray—some felt the near dissolution—of Wall Street....For a variety of ancient fundamental causes and current precipitating causes, many brokerage firms disappeared through bankruptcy or absorption into stronger firms. Confidence in the soundness of basic financial institutions was shaken.

Thus, a decline in profits, a rise in interest rates, foreign wars, domestic violence, and apprehension and disarray in Wall Street plausibly accounted for the sharp decline in stock prices, but *it would have been more difficult to predict it. Prediction would have required a gift of prophecy not often possessed by economists, investors, politicians, or even investment counselors. It would have been necessary to foresee the recession, the continued rise in interest rates, the course of foreign affairs, and the progressive alienation of American youth. Of course, those rare individuals with either the gift of prophecy or good luck, who got out of the stock market...or who even sold stocks short, did very well by comparison with investors less gifted or lucky. The gifted or lucky ones may have acquired not only money but also the reputation for wisdom, which is valuable even when ill founded.* (emphasis added)

Lorie and Hamilton's postmortem is probably a reasonably accurate description of the factors that caused the decline. In contrast, the WSTL model aims to forecast the future short-run movements in the S&P 500 well enough so that the infrequent trades out of and back into the S&P 500 will be profitable. Using the WSTL model for 1969-1970, it would not "have been necessary to foresee the recession, the continued rise in interest rates, the course of foreign affairs, and the progressive alienation of American youth." Moreover, neither "the gift of prophecy" nor "good luck" would have been required to make profitable forecasts of the S&P 500's short-run movements.