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Are There Patterns in the Crystal Ball?

In 2008, management professors Jennifer Whitson and Adam Galinsky published an article in Science that explored how humans respond to loss of control. This loss of control, which we can also call uncertainty, caused their experiment participants to try and find order by describing patterns in what they saw. More importantly, the professors discovered that participants "found" patterns - even where none actually existed.

This is an important lesson for us whenever we attempt to predict short-term movements in stock prices. Although there is much evidence to suggest that long-term price movement is a function of a company's earnings performance (and that is the belief upon which we base our fundamental research), there are an untold number of factors that affect a stock's, or the entire market's, short-term price swings.

In our current environment of market volatility (uncertainty) it is good to remember that what's past is not necessarily prologue. One well known market "rule" is the September Effect. Historically, from 1926-2009, September has been the worst month for the stock market, based on average monthly returns. Moreover, in years where the market was down 5% from January to August, the average return for September had been a horrific **negative 4.0%**.[1]

So, with the S&P 500 down 4.7% for the first eight months of this year, one might have been tempted to just get out of the market and "skip" September. However, we just finished the month with a market return of **positive 8.9%.** Indeed, market timing has its risks; and one of them is being on the sidelines at the wrong time.

Another popular pattern in the market is that, beginning in 1943, the third year of a presidential term has always been positive for the market. As a matter of fact, since 1950 (the last fifteen "3rd years"), the S&P 500 has recorded an average annual gain of 22%.[2]

One plausible explanation for this is that the balance of power typically shifts toward the minority party in Washington during mid-term elections. Regardless of which party was in control, or what their economic policies were, the "market" seems to be mollified that they now have a stronger watchdog. Another plausible explanation is that it takes at least two years for each President to fully implement his economic policies, thus leading to positive results during the third year.

A third plausible, and even probable, explanation is that there is no correlation between the year of a President's term and market performance. The stock market has had a positive annual return in 60 of the last 84 years, that's almost 3 out of every 4 years.[3] Perhaps it's just coincidence that the third year of a presidential term is positive, and we should not make investment decisions based on a "pattern" we have found.

So, what do we make of next year, 2011? Will it be a great year for stock market returns? That's not for us to say, and if you've known us long enough, you know that we always forego short-term forecasts (and yes, 15 months out is still short-term) in favor of sticking to the fundamental research-driven strategy and practices that have served us well over the years. We will continue to strive to provide the most effective investment management that we can, given solid, proven portfolio management techniques – and deliver it with the utmost in client service.

That is our goal, and promise, to you.

Sources:
[1] Business Insider
[2] BTN Research
[3] Standard and Poor's
Adam Galinsky Ph.D., Morris & Alice Kaplan Professor of Ethics and Decision in Management, Kellogg School of Management, Northwestern University
Jennifer Whitson Ph.D., Assistant Professor, Department of Management, McCombs School of Business, University of Texas at Austin

If you have an IRA, and if you are at least 70 ½ during 2010, you will need to take your RMD (Required Minimum Distribution) from the IRA by December 31, 2010. We will be contacting you during October to discuss your options. Also, the IRS is allowing IRA holders who convert their traditional IRA to a Roth IRA by December 31, 2010 to pay the taxes due on the conversion over two years, instead of one. If you have questions regarding this, please give us a call.

Thank you for choosing Paragon as your investment management partner. As always, we are actively seeking new clients, so feel free to pass our names on to anyone who you feel might benefit from our services.

Regards,

Howard, Ward, Elizabeth, Ethel & Craig

A copy of our SEC Form ADV Part II is available to you at any time. This document describes who we are, what we do, and how we do it. If you would like to have a copy sent to you please contact Kelly at the phone number, or email, listed below. Also, our Proxy voting policy is available to you at any time. If you would like to receive a copy of the policy, or inquire as to how your shares have been voted, please contact Kelly at the phone number, or email, listed below.

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