THOUGHTS FROM THE FRONTLINE

Advice Worth Taking

By John Mauldin | November 29, 2019

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We've reached the Thanksgiving weekend, and as always, I'm thankful for loyal readers like you. I hope you are enjoying some quality time with family and friends.

And because of the holiday, this week's letter will be shorter than usual, but I think it will offer real value. Year-end is rapidly approaching, which means time to review your investing strategy. Below, I have some time-honored advice that may help. Both Dennis Gartman and Bob Farrell are legendary traders, and they kindly shared the rules they've found most helpful. I know they help me. So read these, and I'll have a few more words below.

Oh, and by the way, as you read these rules think about your own personal portfolios, investment decisions, and your life, and how these rules may apply to you. It will make the process a lot more valuable.

The Gartman Rules

Several different versions of Gartman's rules are floating around the internet. This one is my favorite. Note that Dennis is first and foremost a trader, so these are rules for traders but also offer insight to investors.

1. NEVER, EVER, EVER ADD TO A LOSING POSITION: EVER!: Adding to a losing position eventually leads to ruin, remembering Enron, Long Term Capital Management, Nick Leeson and myriad others.

2. TRADE LIKE A MERCENARY SOLDIER: As traders/investors we are to fight on the winning side of the trade, not on the side of the trade we may believe to be economically correct. We are pragmatists first, foremost and always.

3. MENTAL CAPITAL TRUMPS REAL CAPITAL: Capital comes in two forms... mental and real... and defending losing positions diminishes one's finite and measurable real capital and one's infinite and immeasurable mental capital accordingly and always.

4. WE ARE NOT IN THE BUSINESS OF BUYING LOW AND SELLING HIGH: We are in the business of buying high and selling higher, or of selling low and buying lower. Strength begets strength; weakness more weakness.

5. IN BULL MARKETS ONE MUST TRY ALWAYS TO BE LONG OR NEUTRAL: The corollary, obviously, is that in bear markets one must try always to be short or neutral. There are exceptions, but they are very, very rare.

6. "MARKETS CAN REMAIN ILLOGICAL FAR LONGER THAN YOU OR I CAN REMAIN SOLVENT:" So said Lord Keynes many years ago and he was... and is... right, for illogic does often reign, despite what the academics would have us believe.

7. BUY THAT WHICH SHOWS THE GREATEST STRENGTH; SELL THAT WHICH SHOWS THE GREATEST WEAKNESS: Metaphorically, the wettest paper sacks break most easily and the strongest winds carry ships the farthest, fastest.

8. THINK LIKE A FUNDAMENTALIST; TRADE LIKE A TECHNICIAN: Be bullish... or bearish... only when the technicals and the fundamentals, as you understand them, run in tandem.

9. TRADING RUNS IN CYCLES; SOME GOOD, MOST BAD: In the "Good Times" even one's errors are profitable; in the inevitable "Bad Times" even the most well researched trade shall go awry. This is the nature of trading; accept it and move on.

10. KEEP YOUR SYSTEMS SIMPLE: Complication breeds confusion; simplicity breeds elegance and profitability.

11. UNDERSTANDING MASS PSYCHOLOGY IS ALMOST ALWAYS MORE IMPORTANT THAN UNDERSTANDING ECONOMICS: Or more simply put, “When they’re cryin’ you should be buyin’ and when they’re yellin’ you should be sellin’!”

12. REMEMBER, THERE IS NEVER JUST ONE COCKROACH: The lesson of bad news is that more shall follow... usually hard upon and always with worsening impact.

13. BE PATIENT WITH WINNING TRADES; BE ENORMOUSLY IMPATIENT WITH LOSERS: Need we really say more?

14. DO MORE OF THAT WHICH IS WORKING AND LESS OF THAT WHICH IS NOT: This works well in life as well as trading. If there is a “secret” to trading... and to life... this is it.

15. CLEAN UP AFTER YOURSELF: Need we really say more? Errors only get worse.

16. SOMEONE’S ALWAYS GOT A BIGGER JUNK YARD DOG: No matter how much “work” we do on a trade, someone knows more and is more prepared than are we... and has more capital!

17. PAY ATTENTION: The market sends signals more often than not missed and/or disregarded... so pay attention!

18. WHEN THE FACTS CHANGE, CHANGE! Lord Keynes... again... once said that “ When the facts change, I change; what do you do, Sir?” When the technicals or the fundamentals of a position change, change your position, or at least reduced your exposure and perhaps exit entirely.

19. ALL RULES ARE MEANT TO BE BROKEN: But they are to be broken only rarely and true genius comes with knowing when, where and why!

Bob Farrell’s Rules for Trading

Bob Farrell was a widely followed genius at Merrill Lynch. Wall Street people still speak of him reverently. Some of the greatest traders and investors I know referred to his rules on a frequent basis, and I suggest you do the same. Here are his rules with commentary from *MarketWatch’s* Jonathan Burton.

1. Markets tend to return to the mean over time

   By “return to the mean,” Farrell means that when stocks go too far in one direction, they come back. If that sounds elementary, then remember that both euphoric and pessimistic markets can cloud people’s heads.

“It’s so easy to get caught up in the heat of the moment and not have perspective,” says Bob Doll, global chief investment officer for equities at money manager BlackRock Inc. “Those that have a plan and stick to it tend to be more successful.”

2. Excesses in one direction will lead to an opposite excess in the other direction

   Think of the market as a constant dieter who struggles to stay within a desired weight range but can’t always hit the mark.

   “In the 1990s when we were advancing by 20% per year, we were heading for disappointment,” says Sam Stovall, chief investment strategist at Standard & Poor’s Inc. “Sooner or later, you pay it back.”

3. There are no new eras -- excesses are never permanent

   This harkens to the first two rules. Many investors try to find the latest hot sector, and soon a fever builds that “this time it’s different.” Of course, it never really is. When that sector cools, individual shareholders are usually among the last to know and are forced to sell at lower prices.

   “It’s so hard to switch and time the changes from one sector to another,” says John Buckingham, editor of The Prudent Speculator newsletter. “Find a strategy that you believe in and stay put.”

4. Exponential rapidly rising or falling markets usually go further than you think, but they do not correct by going sideways

   This is Farrell’s way of saying that a popular sector can stay hot for a long while, but will fall hard when a correction comes. Chinese stocks not long ago were market darlings posting parabolic gains, but investors who came late to this party have been sorry.

5. The public buys the most at the top and the least at the bottom

   Sure, and if they didn’t, contrarian-minded investors would have nothing to crow about. Accordingly, many market technicians use sentiment indicators to gauge investor pessimism or optimism, then recommend that investors head in the opposite direction.

6. Fear and greed are stronger than long-term resolve

   Investors can be their own worst enemy, particularly when emotions take hold.

   Stock market gains “make us exuberant; they enhance well-being and promote optimism,” says Meir Statman, a finance professor at Santa Clara University in California who studies investor behavior. “Losses bring sadness, disgust, fear, regret. Fear increases the sense of risk and some react by shunning stocks.”

After grim trading days, it's easy to think you're the patsy at this card table. To counter those insecure feelings, practice self-control and keep long-range portfolio goals in perspective. That will help you to be proactive instead of reactive.

"It's critical for investors to understand how they're cut," says the Prudent Speculator's Buckingham. "If you can't handle a 15% or 20% downturn, you need to rethink how you invest."

7. Markets are strongest when they are broad and weakest when they narrow to a handful of blue-chip names

   Markets and individual sectors can move in powerful waves that take all boats up or down in their wake. There's strength in numbers, and such broad momentum is hard to stop, Farrell observes. In these conditions you either lead, follow or get out of the way.

   When momentum channels into a small number of stocks, it means that many worthy companies are being overlooked and investors essentially are crowding one side of the boat. That's what happened with the "Nifty 50" stocks of the early 1970s, when much of the U.S. market's gains came from the 50 biggest companies on the New York Stock Exchange. As their price-to-earnings ratios climbed to unsustainable levels, these "one-decision" stocks eventually sunk.

8. Bear markets have three stages -- sharp down, reflexive rebound and a drawn-out fundamental downtrend

9. When all the experts and forecasts agree -- something else is going to happen

   As Stovall, the S&P investment strategist, puts it: "If everybody's optimistic, who is left to buy? If everybody's pessimistic, who's left to sell?"

   Going against the herd as Farrell repeatedly suggests can be very profitable, especially for patient buyers who raise cash from frothy markets and reinvest it when sentiment is darkest.

10. Bull markets are more fun than bear markets

    No kidding.

This is not the first time, nor will it be the last, when I bring these rules to your attention. I suggest, when you are feeling particularly bullish or disastrously bearish, pull out this letter and reread it.

Before I go, let me remind you to take our 2019 Investor Survey, which, I believe, is an excellent sentiment indicator *and* an opportunity to make your voice heard. So please, if you haven't taken the survey yet, click here to do it now. I really appreciate it.

Dallas and Home in Puerto Rico for the Holidays

If you are reading this letter over the weekend, I am most likely still in Dallas. Shane and I fly back to Puerto Rico Sunday, getting in late at night. Just the way American Airlines schedules its flights from Dallas to San Juan. Then I intend to be home in Dorado Beach for the holidays, welcoming guests from time to time, but focused mainly on writing and research.

Thanksgiving is typically the season when we count our blessings. I have so many to count and you are one of them. The time and attention you give my letters and thoughts is extraordinarily valuable, and I try to deliver high value for your precious time. Thank you from the bottom of my heart. I enjoy reading your feedback and working with the rest of Team Mauldin to find ways to make your life better.

I'm especially thankful for those of you who have recommended *Thoughts from the Frontline* to your friends, helping to grow our family. If you enjoy the letter, maybe your friends will, too. I hope it sparks some fascinating conversations for you.

I recently turned 70, and fully plan to write for at least another 10 years. I am still very involved in my businesses and intend to launch a new business next year. Well, at least, we're exploring one. I want to make the future happen rather than simply going along for the ride. So many potentially powerful biotechnologies that can improve the aging process (something I am very aware of at this point of my life) are simply begging to be developed. How can we shorten the time and cost of getting them to you (not to mention me!)? It's worth a little exploration.

And with that, I will hit the send button. You have a great week. I am looking forward to spending the long weekend with family and friends, and hope you get to do so as well.

Your probably still too full of Thanksgiving dinner analyst,

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