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The Pro Shop

## To Err Is Human, to Profit Divine

By Lisa Scherzer

**WOODY DORSEY EXPECTS YOU** to be skeptical of what he has to say. After all, the stock-market forecaster has never worked on Wall Street, and he bandies about esoteric terms like memetics, cognitive errors and trend duration analysis as offhandedly as if he were talking about the weather. But that doesn't keep Dorsey from sticking to his guns on his somewhat unorthodox theory of what makes markets tick.

Behavioral finance argues that equity markets aren't efficient because investors at times are irrational, which leads to share prices that don't jibe with fundamentals. Dorsey takes this premise one step, or perhaps a few steps, further. He insists that, while he may not be able to quantify stock movements, he can use this human propensity toward irrationality to identify impending shifts — up or down — in the market.

Dorsey's approach is based on what he calls the Trinity Theory, a comprehensive, behavioral-finance-driven way to forecast the direction of the stock market. He uses technical indicators and analysis of market themes and rhetoric to predict how investors might act in the future. Three different gauges of the market that correspond to how participants feel (psychologicals), think (fundamentals) and act (technicals) help him figure out where stocks are headed.

According to Dorsey, his independent research firm, Market Semiotics, based in Castleton, Vt., caught the double-bottoms of the market in October 2002 and March 2003, as well as the low in the pharmaceutical sector at the end of last October. So those investors who trust Dorsey's aphorism, "Man is the measure of all markets," might want to listen up. He sees a downward trend in the stock market until mid-April, with the most negative period coming in late February. He's also bullish on oil.

**SmartMoney.com: Can you walk us through your current stock-market forecast?**

Woody Dorsey



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**Woody Dorsey:** One of the key issues I was bringing up about behavioral finance's focus is that investors make mistakes. We all do. This is the opposite of the approach of Wall Street, which is, here's what stocks are going to do. We tend to focus on the habitual errors. We're very good at doing this. When markets are making turns, the fact is that it's very difficult to see the error. We use the metrics of these three cognitive areas to try to diagnose when that might be occurring. We look at psychologicals, fundamentals and technicals. Psychologicals means investor optimism, which we measure through sentiment, or mood of the market. Only in the last part of December did it become extreme. We have seen some big optimism at the end of the year. That's a clue that we'll see some trouble.

**SM: What about factors beyond investor sentiment?**

**WD:** That's one piece. The market is a narrative; we describe some of these stages. What we've been saying is that over the past six months or so, we had a summer correction and a rally from last October, which was the "adoration" phase — the phase when everybody gets the idea that the market is good. The perception is that 2005 is going to be good. From a narrative point of view, the market is going through regular trends.

The idea behind technicals is that markets take time. It's a process. This market has been going up for over two years, and it really hasn't had a sharp correction, only a 5% to 6% correction. As for duration, the length of this rally was over two years, a typical bullish leg. So the market is very mature, people are bullish from a psychological point of view. We think maybe people are making a cognitive error.

**SM: The fundamentals component of your theory takes into account news stories or themes, what you call "memes." Why is this important?**

**WD:** For fundamentals, we look for financial slogans. [At the end of 2004,] there wasn't exactly a mania. It's a more subdued or complacent kind of adoration phase. The market's underlying assumptions, the thought process at the highs was that the economy is still doing quite well, earnings growth is going to be good, we know the Fed is going to raise interest rates, but it doesn't matter because they're so low. One of the things people are concerned about is oil. We saw a sharp decline in the price of oil at the end of the year. Now we see a mixed bag on earnings. Oil was at \$50 last week. We changed some of the assumptions that were so bullish.

What's important is to focus on what everyone else thinks is important. When a meme is gathering strength, we have to go with that... Our profile for oil and commodities is that they are in rallies that are not yet over. From all these three diagnostic areas, we think the market is very rich; it already started a correction, and will go down until April.

**SM: Does your forecast include a precise amount the S&P 500 index will move?**

**WD:** No. To even pretend that one would know the levels the market would go is pretty silly. The issue is, if you can be on the right side of the market — is the market going up or down — that's good. Sometimes there's an idea, there are certain areas people become fixated on, like Dow 10,000. It's interesting to see what people think is important in terms of price.

**SM: You quote Alan Greenspan as saying that price patterns essentially remain the same. In that case, are we experiencing stock-market behavior similar to another time?**

**WD:** The market is now trading like it did in early 2000. It's not like déjà vu, but it's an extra clue. The market topped — made a high — on the first day of the year 2000, and volatility picked up. We topped the last day of the year in 2004. When I compare the psychological phases, there was an adoration phase in Q1 of 2000 and there is an adoration phase now as well. In both cases, the

adoration phases were the culmination of a two-plus year rally. And in both cases, the sentiment was high during the adoration phases. There's some similarity here: How the market is trading, in trends, in psychological stages and in the technicals... Maybe there's something going on here that people aren't aware of.

**SM: How do you see memes factoring into the current market?**

**WD:** This is what I call financial culture. People were very nervous and uptight last week with the Iraqi elections, the terrible weather, the Fed. The financial culture was on the ropes. But risk appetite turned around. The elections turned out OK, the market feels better, and it's going to turn around. We'll see the market recover a bit.

People got really bullish at the end of last year, and they were wrong. They got hammered last week. Now it's going to bounce back for a couple of weeks. There will be a corrective until April.

**SM: How can an individual investor take into account your assertions?**

**WD:** My readership is sophisticated; they have their own investment ideas. Everyone does. But I focus on the errors. I make these diagnoses of the psychological conditions of the stock market, the bond market, gold and other sectors. So my clients use this information in combination with their other sources.

For example, we turned bearish on the energy sector and bullish on drugs for the month of November. That's a relatively short period of time. For another scale of time, what I've been saying over the last eight to nine months is that the market is probably going up into early 2005. So a portfolio investor, who has a long bias, might want to keep his investments, so he's not going to get shaken out.

Now what I've been saying is that the market is going to have a negative Q1, with a correction coming. Someone could say, I wonder if it's time to get out of the market, redo some of my holdings. It's an extra piece of information people can add in.

**SM: What was a big story that had an effect on the market in 2004?**

**WD:** Oil was the "meme extreme" of 2004. Peaks in oil correlated with lows in the S&P 500. The oil story became the primary negatives for the stock market. When people became obsessed with oil, there was a selling off, a bottoming in the market. We look for opportunity in oil. When oil was due to sell off in November, the stock market enjoyed that and went up. As we got into the end of December, people felt oil's had its day, it's going to correct. But oil started to rally again, and that's one of reasons why the stock market declined. Now oil is back to \$46, \$47, the market is rallying.

I do think oil is going to rally more over the next couple of months. If it goes back to \$50, \$55 a barrel, the market will sell off. I think that's part of the complex that's going on in the markets. We've really entered an era of high energy prices that will be drag on stock prices. It's part of what I call "repricing the planet," and it's problematic. I think there will be a bull market in commodities, but sloppy equity markets... The stock market will be sideways to down.

**SM: Why did you think the pharmaceutical sector was headed for lows at the end of October?**

**WD:** One of things we looked at was memes or slogans for **Merck** ([MRK](#)). The stock dropped, and the rest of the industry went down with it. **Pfizer** ([PFE](#)) came along. If I know that people are

totally obsessed with Merck — and Merck is a really important part of the drug index, and there's huge negative press on an issue, and huge volume and price movement — there tends to be an extreme. The second most important thing is whether it's new or old. The reality is that the drug index had been going down for the past nine months. It was a depressed area for nine months, which is a typical kind of correction. That was quite interesting. The other thing is that, in general, at the end of October the sentiment on equities was tactical pessimism. The broad sentiment was low.

**SM: What themes are telling for the market right now?**

**WD:** We're looking at the dollar, Social Security, the deficit. The markets were negative and nervous recently, anchored on the Iraqi elections. That's gone now. The financial culture was overly depressed last week. Now it's regaining some optimism. The trend is going to continue for a week or two, or something like that.