

## December 5, 2006 – The Three Phases of a Rally

You pretty much would need to be living in a cave not to notice the wonderful rally in the stock market the last four months. As the market heads higher, there seems to be growing enthusiasm that stock prices will just keep on rising. But from my experience, the longer a rally continues, the tougher gains are to come by and the more dangerous it becomes to jump in. Take the current rally from the July 21<sup>st</sup> bottom until December 1<sup>st</sup> as an example. It is my experience, rallies can generally be separated into three phases.

**Phase One:** Let's call it the "bounce" phase. This is the start of a new rally out of a market downturn that establishes the bottom of the correction and begins a new advance. Typically phase one has the fewest participants because many investors are on the sidelines waiting for the downturn to end. When traders and shorter-term investors (institutional \$ managers) recognize the new uptrend, they throw money back into the market. It is my experience, phase one is the where the fastest gains historically occur in a new rally. This can also be seen after the bear market ended in early 2003 with the bounce off the bottom in March of that year.

**Phase Two:** The "trend following" phase. After the initial burst off the bottom, the market continues to go higher. Feeling safe that the bottom is in, more and more investors want back in on a pullback. But markets almost never do what we want/expect and the fear of "missing out" prompts many people to take a leap of faith that prices will continue higher and they close their eyes and jump back in. Gains can also be substantial in phase two but they generally appear over longer periods of time.

**Phase Three:** Let's call it the "get me in at any cost" phase. This is when we hear the experts tell us, "If you don't get in now, you will miss out." But by the time prices reach phase three, the smart money on Wall Street has already made nice profits and may be looking for an exit. Price gains in phase three are generally less than phases one and two. And if price gains are achieved, they are most easily given back since the market is more likely to turn down.

Let's take a look at the S&P500\* results based upon the above hypothesis.

Phase	Dates	# of trading days	% Gain of S&P500*	% gain/day	Annualized
One	July 18 - Aug. 18	24	5.40%	0.22%	55%
Two	Aug. 18 - Oct. 26	55	6.60%	0.12%	30%
Three	Oct. 26 - Nov. 30	24	7.50%	0.03%	7.50%

As you can see, the strongest gains happened in phase one. Phase three has had the most reluctant gains and as I mentioned are often the hardest to hold onto. So how can you use this information? When investing, it may be useful to know where we are in the current cycle to avoid falling into the trap of pulling out of the market at the bottom and getting back in at the top. Markets are run by humans and the dominant emotions that tend to drive decision making are fear and greed. A good rule of thumb is to often do the opposite of what you are thinking. Stay out if you have the urge to jump in and get in when things seem like they will never go up again...as it was in 2003.

\*The S&P 500 is made up of 500 common stocks representing major US industry sectors. Past Performance is not indicative of future results.