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Moving average

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Like a new swear word sweeping across school playgrounds, suddenly everyone is talking about 200-day moving averages. The S&P 500 index is flirting with this crucial level, point out the pundits, having broken through it at the end of May for the first time in a year. That is a bullish signal, apparently. If the market drops below its 200-day moving average again, however, many reckon that is not so good.

Should investors beyond the inane chatter of the day-trading blogosphere care? Looking at moving averages is certainly a useful tool for smoothing out volatility and observing longer-term trends. That the 200-day moving averages for Russian and Brazilian equities are still falling in spite of their extraordinary bounce this year, for example, is a sobering reminder that this is still a bear market.

But history is one thing; having predictive power is quite another. From 1886 to 2007, buying and holding US stocks when the Dow Jones Industrial Average was above its 200-day moving average and selling them when the market fell below this level would have returned an annualised 8.6 per cent after costs, compared with 9.7 per cent for a buy and hold strategy, according to Jeremy Siegel, author of *Stocks for the Long Run*. That said, such a trading strategy would have avoided the 1929 meltdown while nicely capturing the subsequent upturn. Those watching 200-day moving averages would have also dodged the 1987 crash, although the practice has been pretty much useless since, completely messing up during the dotcom period.

Worse, buying US stocks because the S&P 500 was above its 200-day moving average would have seen money piling in right up to the market's peak in September 2007. And again the following March. Ouch. Investors should remember that all trading techniques sometimes work and sometimes they do not. Far better to at least overlay whichever hokery-pokery takes your fancy with some genuine valuation analysis.

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