

## It is Time to Invest Again!

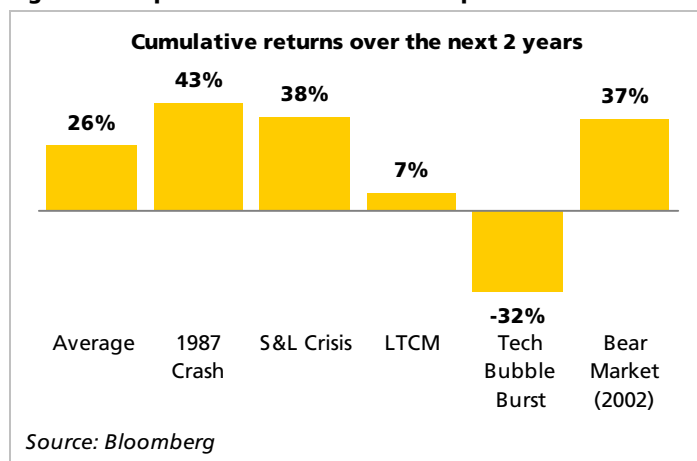
by Emre Erdogan, Ph.D., Quantitative Analyst

These days it seems that the downtrend in the market will continue forever. Such market plunges, however, create great opportunities for long-term investors. To identify when the market is oversold, I have defined a simple metric using book values, market prices, and recent performance of firms in the S&P 500 Index universe. According to this metric, if one invests in the market when the market is oversold he/she can have an average return of 26% in the following two years. I will explain how I calculate that the market is oversold. For an investor with a two-year investment horizon, it is my view that this is the time to invest in the market.

A preceding condition for a significant market rally is when value (i.e., cheap) stocks with good fundamentals are oversold and high momentum stocks with weak fundamentals are overbought. Therefore, in order to understand if value stocks are relatively oversold and momentum stocks are relatively overbought, I ranked the stocks in the S&P 500 universe according to their book value to price ratio. I also ranked the same stocks according to their recent performance<sup>1</sup>, and then computed correlations<sup>2</sup> among these ranks. Figure 1 shows the historical rank correlations between value and momentum. As can be seen, the correlations are almost always negative<sup>3</sup>. This implies that, in general, a value stock is not a momentum stock. However, I found that when the correlations are extremely negative one might expect a significant market rally.

It is interesting to see that the most of these extreme negative correlations given in Figure 1 coincide with some significant market rallies. I identified 17 such points; in 16 of these 17 events the market had positive returns over the 24 months following these dates. The average of these returns is 26%. In Figure 2, the averages and examples for some historical market events are displayed.

Figure 2: Deep Holes Have Produced Steep Climbs



Finally, as seen in Figure 1, this particular market correlation has most recently hit bottom at the end of June 2008 and has since started to increase. If history repeats itself, it is time to invest in the market to seek that average 26% gain over the next two years. ■

- 1 We use the momentum common factor computed by BARRA.
- 2 The correlations of the ranks are cross sectional correlations; we used the Spearman method.
- 3 Since in general if a value (cheap) stock has been doing well and it becomes a momentum stock, it will not be a value stock any longer due to the increase in its price.

Figure 1: A Bottom in This Market Model; A Bottom in The Market Still To Come

