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SENIOR CONSULTANT

The Voice of the Investment Management Consultant

Liquidity Theory: A Means to Achieve Absolute Positive Returns in Any Investment Environment?

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Editor's Note: I have been following TrimTabs.com since late 1999 and have been most impressed with how liquidity theory, created by Charles Biderman, can explain the direction of the market weeks before it moves. Charles called the end of the bull market in 1999 and has a lot to say. His science-based methodology has a far higher degree of predictive value (78.9%) than the 51% attributable to the sage advice of popular pundits. My fear is now that Charles will be a regular contributor to CNBC, that everyone will see the logic in liquidity theory and that its impact will be diluted. I have asked Charles to share with us how liquidity theory works and explain how he translates liquidity research into his model portfolio, which has performed so brilliantly. Starting in April, each month Charles will tell *Senior Consultant* readers what his liquidity research is telling him on the market's direction on a 3-4 week delayed basis. This should explain what is going on in the market in real-time. Charles' research is available to advisors with $100 million or more under advisement, and he is creating an investment vehicle which will bring his work within the reach of all advisors. This is a **must-read** because liquidity theory is a non-conventional (not style-based) investment methodology that works in good markets and in bad.

The key to predicting major moves in the stock market is embodied in a neat and tidy principle called *TrimTabs Liquidity Theory*. The theory is grounded in the simple economic principle of supply and demand. Application of this principle to the stock market looks like this.

When corporate investors are net buyers of their own and other public company shares, the overall market sooner or later goes up. By corporate investors, we do not mean individuals buying for their own account. Corporate investors buy shares via stock buybacks and/or cash takeovers of other public companies. Market bottoms occur when individual investors are heavy sellers coincident with corporate investors becoming big buyers.

HOW TRIMTABS.COM GENERATED 74% MODEL PORTFOLIO GAINS IN 2002 AND A 6% YTD GAIN THROUGH MID-MARCH 2003

Between the fall of 1994 and October 1999, corporate investors were heavy buyers of shares. Starting in the summer of 1995, after the stock market had been rising for nine months, individuals caught on and started investing in equities in ever-rising amounts as the market rose higher. The TrimTabs.com definition of a bull market is more money chasing fewer shares. No surprise to us that the U.S. stock market tripled in market cap over those five years.

Conversely, when corporate investors are net sellers, or in other words, when new offerings and insider selling of never-before issued shares are greater than buybacks and cash takeovers, the stock market eventually goes down. Starting in November 1999, corporate investors became heavy net sellers at the same time coincident with individuals pumping records amount of cash into the equity markets.

The TrimTabs.com definition of a bear market is less money chasing more shares. It was no surprise to our clients that the overall stock market dropped over 45% from the end of the March 2000 peak to the early October 2002 trough.

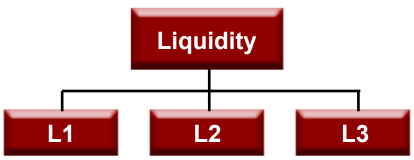
Therefore, the most important factor affecting the U.S. stock market is the net change in the trading float of shares. TrimTabs,com. has developed a unique way to estimate this activity daily — since actual buybacks and insider selling are not readily available — and use the results to time buy or sell decisions on the entire market via either stock index futures or no-load stock index related mutual funds.

Before we get into the nitty gritty of liquidity theory, a brief history is in order. I started offering unique stock ideas — mainly short sale recommendations — to institutional investors starting in January 1990. Then starting in 1995, as a former *Barron's Financial Weekly* associate editor and successful real estate entrepreneur, I combined the fundamental

analysis of stocks with the knowledge of how important liquidity is in real estate in a weekly institutional research service called Liquidity TrimTabs. Over the years, the company shifted its primary focus to solely stock market liquidity, providing analysis and advice on timing the market in the form of daily and weekly research publications to subscribers.

The key to understanding liquidity theory is: "All there is in the stock market are shares of stock and the money to buy them — nothing more, nothing less." Therefore, liquidity analysis measures three key factors: (1) the net change in trading "float" of stock, (2) flows of cash, both in and out of U.S. equity funds and (3) change in the amount of debt being used to buy shares of stock.

In a nutshell, liquidity looks like this:



where:

L1 = **Float** is the net change of shares trading. L1 is derived by adding new equity offerings and insider selling, and then subtracting cash takeovers of public companies and newly announced share buybacks.

L2 = **Flow** is the money going in or out of U.S. equity mutual funds. Obviously, individuals invest directly in the market. However, changes in direct holdings is not currently measurable. Therefore, we use flows in and out of U.S. equity funds as a proxy for total individual investment.

L3 = **Debt** is the change in amount of margin debt to purchase equities as reported by member firms of the New York Stock Exchange.

Having tracked liquidity for almost 13 years, we have observed that L1 leads the market sometimes by only a few days to as long as a few weeks. On occasion, such as major turns, L1 leads by several months. For example, L1 turned bearish in November 1999, and the market did not start to sell off until March 2000. L2 lags the market by a few days to a few weeks and is a contrary indicator at market extremes. L3 lags the market significantly. Unfortunately, margin debt data is made only available once a month — and with a 2-3 week lag. For the remainder of this article we will focus on L1 and L2, and how these two indicators combined with income tax analysis can be used as successful market timing tools.

L1: Float

L1 becomes negative, which is bullish, as a result of more stock being removed from the market via cash takeovers and stock buybacks than stock being added via new offerings and insider selling. Figure 1 is a year-over-year view of L1 from 1995 through 2002, which illustrates the relationship between L1 and the market.

During the period from 1995 through 1999, the trading float was strongly negative as many more shares were removed from the market through mergers/acquisitions and stock buybacks than added. Then, in November 1999, there was a major change.

Starting in November 1999, corporate selling began to swamp corporate buying. In a TrimTabs.com year-end 1999 special report "Why the Five Year Bull Market Was Ending," we estimated that the value of shares unlocking in 2000 from IPOs sold in 1998 and 1999, plus options becoming exercisable, was in excess of $1 trillion at year-end 1999 prices.

There was one major problem. There wasn't anywhere near $1 trillion available to buy those shares, not that individuals didn't try. Between November 1999 and April 2000, over $153 billion poured into U.S. equity funds. At least that amount went directly in stocks, or $300 billion in aggregate. One source of that $300 billion was debt. Margin debt rose by $100 billion between the end of October 1999 and the end of March 2000. We all know what happened after that.

Figure 2 is a plot of the week-to-week variations of the 4-week moving average of L1 vs. the S&P 500 from January 2001 through February 28, 2003.

Figure 1.
The Relationship of L1 to the Stock Market
(Year-Over-Year Comparison 1995 through 2002)

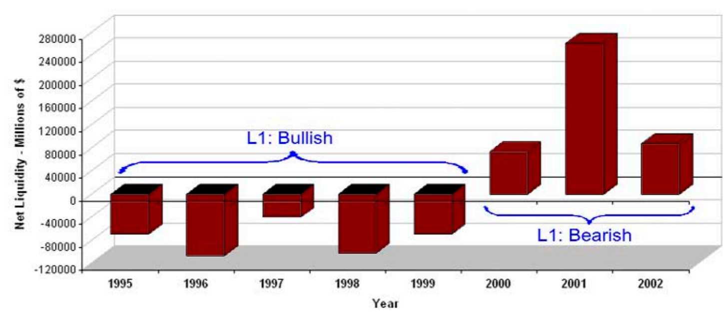
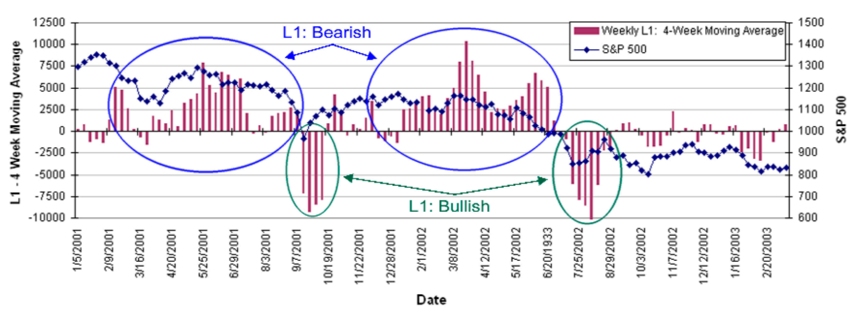


Figure 2.
S&P 500 vs. L1: 4-Week Moving Average
(January 2001 through February 2003)



L2: Flow

L2 is the flow of money into and out of U.S. equity mutual funds. U.S. mutual fund flow into and out of the market is illustrated in Figure 3. Note that U.S. Equity Fund Flows were $150 billion and $247 billion, respectively in 1999 and 2000, and then dropped to $47 billion in 2001. While mutual funds experienced a –$25 billion net outflow in 2002, bond funds experienced a $148 billion inflow.

Figure 4 gives us a much more detailed view of L2. We use a 20-day moving average to smooth the volatility. Note that peaks and troughs of L2 lag slightly behind the trend of the S&P 500, and when outflows are at extremes, the market turns bullish.

Figure 3.
U.S. Equity Fund Flows vs. Bond Flows
(1999 through 2002)

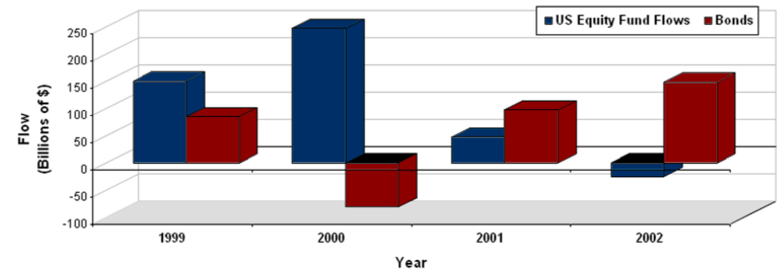
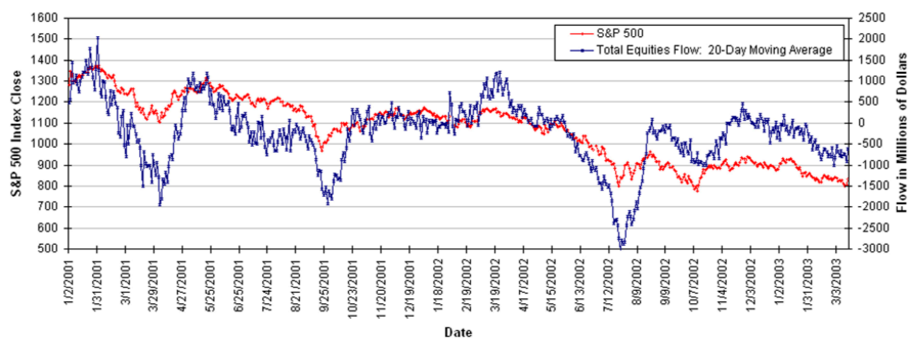


Figure 4.
S&P 500 vs. Total Equities Flow: 20-Day Moving Average
(January 2001 through February 2003)



Incomes and Liquidity

Over the past few years, we have noticed that L1, or the net change in the trading float of shares, is a correlate of the year-over-year change in income tax collections — both withheld income and employment taxes, and corporate income tax payments.

The best coincident indicator for any economy is income. The U.S. Treasury, in the Daily Treasury Statement, reports income taxes collected each and every business day. If income tax rates are known, then knowing the year-over-year amount of income taxes collected, we then know the year-over-year change in incomes. When income taxes grow, so do incomes and vice versa.

We do not know why the Bureau of Economic Analysis and the Bureau of Labor Statistics ignores the Daily Treasury Statement when they put out monthly data. We have asked. There is an obvious relationship between government statistics and sausage. One doesn't want to watch either being made. On the other hand, some sausage actually tastes good. What we do know is that anything that comes out of those two government bureaucracies should be ignored.

Since companies buy when they see growth ahead, there is an obvious relationship between growth or decline of incomes and corporate buying. For example, in February 2001, corporate income tax payments turned lower year-over-year, and there was a dramatic downshift from high single-digit growth to low single-digits for withholding collections. L1 turned bearish in February as well.

We turned bearish and the market sold off.

Starting in July 2002, both corporate income tax payments and withholding rose year-over-year after dropping since February 2001. At some point in time, the rest of the world will realize the U.S. economy was in recession between February 2001 and July 2002.

No surprise, L1 turned bullish in July 2002, and so did we. More on our 2002 calls below.

Both withholding and corporate income tax payments turned down year-over-year starting the second day of December 2002. What happened then was that Venezuela stopped pumping three million barrels of heavy oil. Venezuelan production topped 50% by the third week of January.

Starting January 23, 2003, both corporate income tax and withholding payments again started rising year-over-year.

TrimTabs.com Model Portfolio

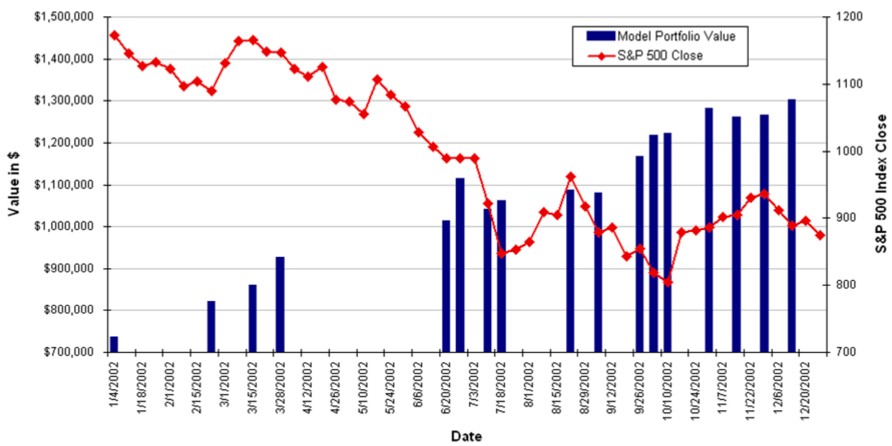
TrimTabs.com uses Liquidity Theory to manage a "model portfolio" of index futures comprised of S&P 500, NASDAQ and Dow Jones index futures. Currently this "model portfolio" is on paper only. There is no reason why we couldn't use no-load mutual index funds that go long and short the various indices instead of index futures. Each week, after analyzing both L1 and L2, TrimTabs.com makes a market call, either bullish or bearish based upon liquidity analysis. Table 1 on the next page summarizes the relationship between a bullish or bearish call and the positions.

Using Liquidity Theory to make market calls, TrimTabs.com Model Portfolio of Index Futures was up 74% in 2002. Since January 2003, the portfolio is up 6%. Figure 5 is a graph of TrimTabs.com Model Portfolio value vs. the S&P 500.

Table 1.
Summary of Market Calls vs. Positions

Call	Position
Strongly Bullish	200% Long
Bullish	100% Long
Cautiously Bullish or Cautiously Bearish	50% Long/50% Short
Bearish	100% Short
Strongly Bearish	200% Short

Figure 5.
S&P 500 vs. TrimTabs Model Portfolio Value
(January 1, 2002 through December 31, 2002)



TrimTabs.com Model Portfolio Increases 74% during 2002!

To summarize, TrimTabs.com. entered 2002 short, having initially turned short early in October of 2001 — after having turned bullish three days after the market reopened post-9/11. Corporate buying had slowed by the start of October 2001, and new offerings began flooding the market. The market kept going up through November. In early December 2001, we doubled up our short position due to the realization that it was pension fund rebalancing that had bulled stocks higher in November and that was completed by December.

We maintained that bearish position until June 28th, with a brief foray into a small long position from February 22 to March 8, when liquidity had a slight positive hiccup before resuming a bearish slant. All-in-all, we maintained a short position from the beginning of 2002 through the end of June 2002 due to the predominance of corporate selling.

On June 28 2002, TrimTabs.com turned neutral, basing our decision on the huge outflow from U.S. equity funds, symptomatic of a bottom, and the slowdown in new offerings and insider selling. Corporate buying was also beginning to stir. Our biggest mistake last year came one week later when at the end of the first week of July, we turned cautiously bullish. We were two weeks early. Corporate buying spiked in July, individuals were panicking and new offerings stopped. We stayed bullish (long) until September 6, 2002.

On September 6, 2002, we turned bearish as corporate buying abruptly stopped. As a result, we took a large short position in S&P Index Futures. Corporate selling continued to dominate the market, punctuated by heightened insider selling until October 11, 2002. We increased our short position to the largest position we had taken so far that year.

On October 11, 2002, we turned cautiously bullish from bearish, going long the S&P 500 and NASDAQ 100 Index Futures as a result of a rise in corporate buying, causing L1 to drift into negative territory. We stayed bullish until November 2, 2002.

On November 2, 2002, we turned cautiously bearish, going short the S&P 500 Index Futures as the new offering calendar began to gear up and corporate buying slowed. We stayed bearish for only two weeks, returning to neutral on November 14, 2002 due to a spike in corporate buying.

On November 22, 2002, TrimTabs.com. turned cautiously bullish from neutral. This was a difficult call as the indicators were not strong in either direction. Sometimes making a call is as much an art as science, and you make a call on a wing and a prayer, hoping you are right. In this case, we were right but only stayed bullish one short week as corporate selling began to ramp up the last week in November and corporate buying slowed.

W stayed short until December 13, 2002 when we covered and went long. There was a slowdown in new offerings and insider selling and a resumption of corporate buying. More importantly, we were expecting a huge inflow into pension funds by corporate sponsors. Our preliminary estimate was as much as $100 billion. In hindsight, it was probably more.

As 2002 closed, our model portfolio was up 74% as illustrated in Figure 6 on the next page. In 2002, TrimTabs.com made 19 market calls, 15 of which were profitable. Table 2 is a summary of the market calls and positions.

As this is being written during the second week of March, we are neutral. We are expecting a spike in corporate buying as soon as it becomes evident that the Iraqi incursion will not be fought here in the U.S. At that point, we would expect the huge number of amateur shorts to run for cover. We then expect pension funds to sell from $50 to $100 billion of bonds to buy stocks. At that point, individuals will start to join the game, and the stock market could be up by as much as 20% to 25% in a relatively short period of time after a successful incursion into Iraq. ■

About the Authors

Charles Biderman began Trim Tabs Financial Services in 1990 to provide unique investment ideas to portfolio managers. Over time, Charles began developing Liquidity Theory as the key to the stock market. Prior to starting TrimTabs.com, Charles, a Harvard MBA, was associate editor of *Barron's*

Figure 6.
TrimTab's Liquidity Model Portfolio Up 74% in 2002

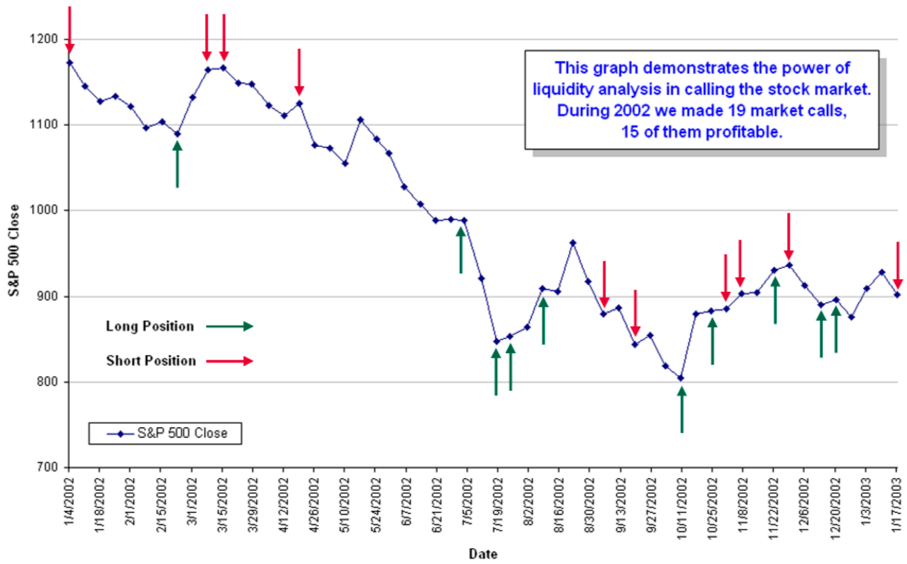


Table 2.
Summary of Model Portfolio Position and Investment Results
(January 1, 2002 through December 31, 2003)

Position Established	Position Liquidated	Position	# of Ctrs	Contract	Symbol	Starting Price	Ending Price	Profit or Loss	Profit or Loss ($)	Portfolio Value	Pct. Change
1/4/2002										$ 734,777	
1/4/2002	2/22/2002	Short	4	S&P Mar	SP02H	1175.5	1091.5	84.0	$ 84,000	$ 818,777	11.43%
1/4/2002	3/15/2002	Short	2	NDX Mar	ND02H	1679.0	1482.5	196.5	$ 39,300	$ 858,077	16.78%
2/22/2002	3/8/2002	Long	2	DJIA Mar	DJ02H	9990.0	10575.0	585.0	$ 11,700	$ 869,777	18.37%
3/8/2002	3/28/2002	Short	2	S&P Jun	SP02M	1164.2	1149.2	15.0	$ 7,500	$ 877,277	19.39%
3/8/2002	6/21/2002	Short	1	S&P Jun	SP02M	1164.2	991.3	172.9	$ 43,218	$ 920,495	25.28%
3/15/2002	3/28/2002	Short	2	NDX Jun	ND02M	1482.5	1459.5	23.0	$ 4,600	$ 925,095	25.90%
3/15/2002	6/21/2002	Short	2	NDX Jun	ND02M	1482.5	1053.6	428.9	$ 85,786	$ 1,010,881	37.58%
4/19/2002	6/28/2002	Short	1	S&P Jun	SP02M	1126.7	990.1	136.6	$ 34,150	$ 1,045,031	42.22%
4/19/2002	6/28/2002	Short	2	NDX Jun	ND02M	1389.0	1054.0	335.0	$ 67,000	$ 1,112,031	51.34%
7/5/2002	7/12/2002	Long	4	S&P Sept	SP02U	991.0	917.3	-73.7	$(73,700)	$ 1,038,331	41.31%
7/19/2002	8/2/2002	Long	2	S&P Sept	SP02U	819.8	865.0	45.2	$ 22,600	$ 1,060,931	44.39%
7/26/2002	8/23/2002	Long	2	S&P Sept	SP02U	893.7	941.0	47.3	$ 23,650	$ 1,084,581	47.61%
8/9/2992	9/6/2002	Long	2	S&P Sept	SP02U	907.8	894.5	-13.3	$ (6,650)	$ 1,077,931	46.70%
9/6/2002	9/27/2002	Short	5	S&P Dec	SP02Z	894.5	825.3	69.2	$ 86,500	$ 1,164,431	58.47%
9/20/2002	10/4/2002	Short	5	S&P Dec	SP02Z	846.2	805.8	40.4	$ 50,550	$ 1,214,981	65.35%
9/20/2002	10/11/2002	Short	3	S&P Dec	SP02Z	846.2	838.5	7.7	$ 5,805	$ 1,220,786	66.14%
10/11/2002	11/1/2002	Long	3	S&P Dec	SP02Z	838.5	898.5	60.0	$ 45,000	$ 1,265,786	72.27%
10/25/2002	11/1/2002	Long	5	NDX Dec	ND02Z	992.5	1020.5	28.0	$ 14,000	$ 1,279,786	74.17%
11/1/2002	11/15/2002	Short	3	S&P Dec	SP02Z	898.5	908.9	-10.4	$ (7,800)	$ 1,271,986	73.11%
11/8/2002	11/15/2002	Short	3	S&P Dec	SP02Z	891.4	908.9	-17.5	$(13,125)	$ 1,258,861	71.33%
11/22/2002	11/29/2002	Long	3	S&P Dec	SP02Z	928.8	936.0	7.2	$ 5,400	$ 1,264,261	72.06%
11/29/2002	12/13/2002	Short	3	S&P Dec	SP02Z	936.0	887.4	48.6	$ 36,450	$ 1,300,711	77.02%
12/13/2002	12/31/2002	Long	4	S&P Mar	SP03H	887.4	878.9	-8.5	$ (8,500)	$ 1,292,211	75.86%
12/20/2002	12/31/2002	Long	4	NDX Mar	ND03H	1015.3	987.0	-28.3	$(11,304)	$ 1,280,907	74.33%

Financial Weekly and a successful real estate investor.

Madeline Schnapp is a research analyst specializing in identifying emerging trends that significantly impact financial marketplaces. Before joining TrimTabs as a research consultant and editor of "Madeline's TrimTabs," Madeline worked as director of marketing research for O'Reilly & Associates, a leading provider of information for leading edge computer technologies.

A Consultant Toolbox Solution

Senior Consultant, in conjunction with TrimTabs.com, has arranged for its readers to have a FREE one-month trial to TrimTabs Liquidity research. This research has very high predictive value on the direction of the market, typically 3-4 weeks before the market moves. Given the Iraq factor, this may be an opportune time to avail oneself to this information.

Notes

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