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Smart Money/Dumb Money

***e*Research Corporation** is pleased to provide an article by Keith Richards of **VALUETREND**.

In this article, Mr. Richards provides information concerning good market traders and bad market traders.

The article is reproduced below, beginning on the next page, or you can go directly to it at the following link: http://www.valuetrend.ca/smart-money-dumb-money/

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Tuesday, October 10, 2017

Smart Money/Dumb Money

By: Keith Richards (bio at end)

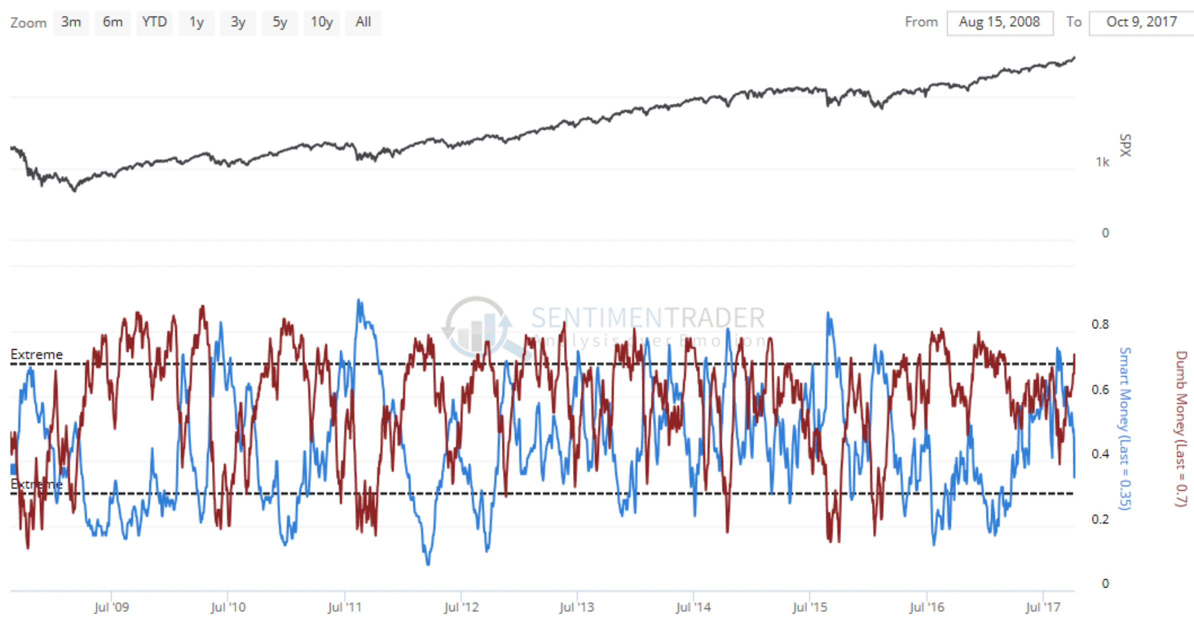
Sentimentrader.com is likely the best collection of sentiment indicators on the web. I have subscribed to their service for several years, and they constantly add new services for examining crowd behavior and sentiment on the markets, commodities, currencies, stock sectors, and even individual stocks. One of my favorite compilations that sentimentrader has put together is the "smart money/dumb money" indicator. **Here** is my last blog where I have covered this indicator.

Essentially, "smart money" is considered to be those investors and institutions that are generally more accurate in their assessment of future market direction. "Dumb money" consists of investors who are less accurate. We want to observe these two groups by comparing their confidence.

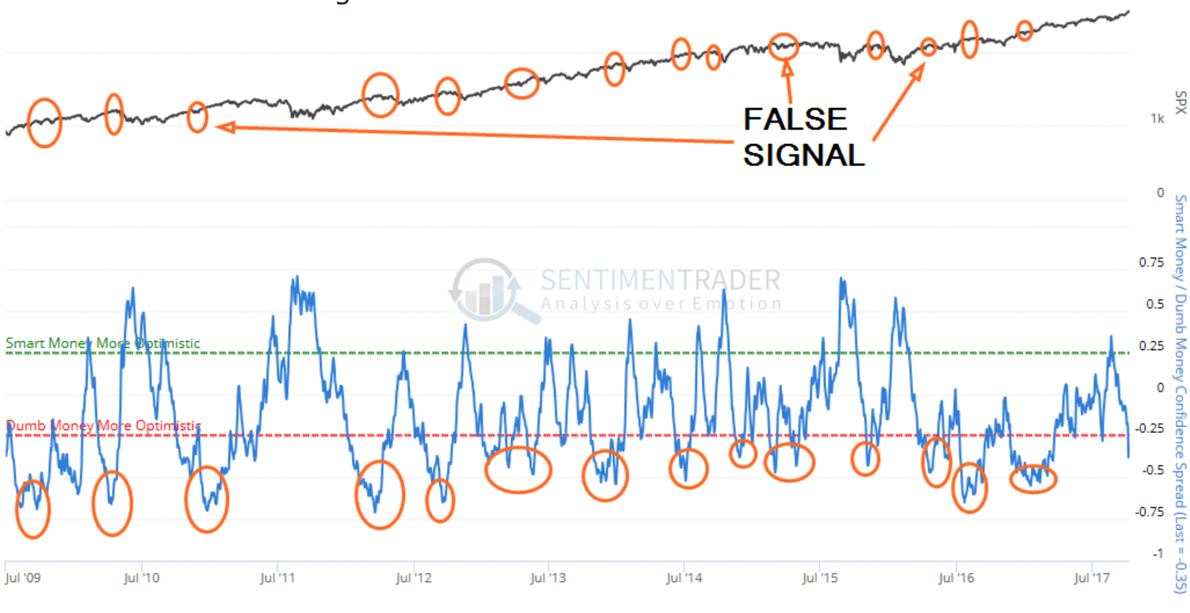
I encourage you to read the description of these indicators in the green font at the bottom of this blog – copied directly from the sentimentrader website.

Often, "smart" and "dumb" money move together. It is when they are at extremely opposing views that a potential for a higher or lower risk market might be signalled.

The chart below shows us the current situation – and historic sentiment readings from these two groups. You will note that the "dumb" money (red line) is well over the "too confident" line. But the "smart" money (blue line) is not yet at an extremely pessimistic confidence level. However, it is clear that the two groups are growing wider in their opinions on the markets.



The chart below shows us a spread between the two groups. It is calculated by taking the "smart" vote and dividing the "dumb" vote into it from the above chart. It gives us a ratio of smart:dumb confidence. As you can see on this chart, the line is below the danger line. That is bad news, but you will also notice that the best signals seem to come from a much deeper negative spread. The current ratio is -0.35. Typically, we see levels of -0.75 for the best signals. Note the false signals I have highlighted on the chart below. The 2010 signal did hit near the -0.75 level, but the two more recent signals in 2014 and 2016 were triggered near the current spread. A false signal in my mind is a move below the danger line that is not followed up by at least a 5% correction in the following month or two.



Conclusion

Like all indicators—the smart/dumb money spread cannot be used in isolation – as seen by the false signals it has issued in the past. We may need to see a bit more pessimism on the "smart" side to get us into a deeper danger zone. I will be reporting my results from the **Bear-o-meter** in the first week of November. By then, the seasonal weak period for stocks is over, and we will want to assess the risk/reward potential on the markets through a variety of indicators such as those used in the Bear-o-meter, which includes the smart/dumb money spread.

Sentimentrader.Com's Description Of Their Smart Money/ Dumb Money Indicators

The Smart Money Confidence and Dumb Money Confidence indices are a unique innovation that allows subscribers to see, in one quick glance, what the "good" market timers are doing with their money compared to what "bad" market timers are doing.

Our Confidence indices use mostly real-money gauges – there are few opinions involved here. Generally, we want to follow the Smart Money traders when they reach an extreme – we want to bet on a market rally when they are confident of rising prices, and we want to be short (or in cash) when they are expecting a market decline. The higher the confidence number, the more aggressively we should be looking for higher prices.

Examples of some Smart Money indicators include the OEX put/call and open interest ratios, commercial hedger positions in the equity index futures, and the current relationship between stocks and bonds.

In contrast to the Smart Money, we want to do the opposite of what the Dumb Money is doing when they are at an extreme. These traders have proven themselves over history to be bad at market timing. They get very bullish after a market rally and bearish after a market fall. By the time the majority of them catch on to a trend, it is too late – the trend is about to reverse. It tells us how confident we should be in selling the market.

Examples of some Dumb Money indicators include the equity-only put/call ratio, the flow into and out of the Rydex series of index mutual funds, and small speculators in equity index futures contracts. We also chart the spread between the Smart Money and Dumb Money. This gives us a quick view of the difference between the two groups of traders. Because the "dumb money" follows trends, and the "smart money" generally goes against trends, the "dumb money" is usually correct during the meat of the trend. So when the Dumb Money Confidence is higher than the Smart Money Confidence, that means sentiment is positive.

When it becomes too positive, however, then sentiment has reached an extreme, and stocks often run into trouble. This usually happens because the Dumb Money rises above 60%, and the Smart Money drops below 40%. That is a warning sign for stocks.
When the Dumb Money is below the Smart Money, then sentiment is negative and stocks are usually struggling. It is best to be defensive at times like this. However, when sentiment becomes too negative, then stocks are often poised to rally over the next 1-3 months. This usually occurs because the Dumb Money has dropped below 40% and the Smart Money has risen above 60%.

What is considered "smart" is simply based on an indicator's historical record at extremes. If an indicator is usually showing excessive pessimism near a market peak, and excessive optimism near a market bottom, then that indicator will be included in our Smart Money calculation. And if it consistently shows too much pessimism near a low and too much optimism near a high, it will be considered Dumb Money.

Confidence indices are presented on a scale of 0% to 100%. When the Smart Money Confidence is at 100%, it means that those most correct on market direction are 100% confident of a rising market and we want to be right alongside them. When it is at 0%, it means that these good market timers are 0% confident in a rally, and we want to be in cash or even short when confidence is very low.

We can use the Dumb Money Confidence in a similar, but opposite, manner. For example, if the Dumb Money Confidence is at 100%, then that means that these bad market timers are supremely confident in a market rally. History suggests that when these traders are confident, we should be very, very worried that the market is about to decline. When the Dumb Money Confidence is at 0%, then from a contrary perspective we should be concentrating on the long side, expecting these traders to be wrong again and the market to rally.

In practice, our Confidence Indexes rarely get below 30% or above 70%.

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See **About The Author** below.

ABOUT THE AUTHOR

ValueTrend Founder and Owner, Keith Richards, has been in the securities industry since 1990. ValueTrend manages over $100 million through a discretionary investment service for high-net-worth clients.

Keith Richards has been in the securities industry since 1990 and is a highly regarded member of the small, exclusive community of Chartered Market Technicians in Canada. Mr. Richard's articles appear regularly in INVESTORS DIGEST, MONEYLETTER, GLOBE AND MAIL, and the TORONTO STAR newspapers.

His appearances on BNN Television have inspired producers to acknowledge him as **"one of [our] most accurate technical analysts."** Mr. Richard's first book, SMARTBOUNCE: 3 ACTION STEPS TO PORTFOLIO RECOVERY, is available in bookstores and directly through his blog page **www.valuetrend.ca/blog/**. His second book, SIDEWAYS: USING THE POWER OF TECHNICAL ANALYSIS TO PROFIT IN UNCERTAIN TIMES was released in late 2011. He has been critical of the commission-based, follow-the-pack approach to investing – where brokers succeed regardless of performance.

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