Jay Kaeppel has over 30 years of varied experience in options, equity, and futures trading as a research analyst, trader and portfolio manager. Professionally, he began his career as head trader at Essex Trading Co. managing futures accounts for eight years, and as a programmer, he co-developed Option Pro trading software, which was the winner of our Readers’ Choice Award for six consecutive years in this magazine in the category of Options Trading Systems. He then became a trading strategist and trading instructor for Optionetics, writing a weekly column for nine years called “Kaeppel’s Corner.”

For the past five years he has been a vice president and director of research at Alpha Investment Management, Inc. In addition, he offers regular market commentary on his website JayOnTheMarkets.com.

He is a prolific writer, as evidenced by his authoring four books on trading: Seasonal Stock Market Trends (Wiley), The Four Biggest Mistakes In Option Trading (Wiley), The Four Biggest Mistakes In Futures Trading (Wiley), and The Option Trader’s Guide To Probability, Volatility, And Timing (Wiley).

Kaeppel currently writes the monthly Explore Your Options column for this magazine, as well as contributing many articles on a variety of subjects since 1999. Kaeppel can be reached at jaykaeppel@gmail.com.


You first became interested in the stock market in 1981. What has changed in the markets since then?

Everything moves faster because of technology. But trends are still trends, ranges are still ranges, breakouts are still breakouts, and human nature is still human nature. Which reminds me of one of my favorite sayings: “Human nature is a detriment to trading and investment success and should be avoided as much as humanly possible.”

Then you are a believer in an objective, rule-based approach to trading rather than flying by the seat of your pants, right?

Yes. Fear and greed are part of that pesky human nature and no one is impervious to it. An objective plan allows an individual to take the emotion out. While there are individuals who have the ability to trade successfully by the seat of their pants, my frank advice to most people is “assume you are not one of them.”

When did you first encounter technical analysis and how did you build your knowledge base?

During my first job out of college I went to the library at lunch and read everything I could get my hands on. My primary influences were many and I learned different things from different people, such as:

- Norman Fosback: quantitative analysis of various indicators plus seasonality
- Marty Zweig: the importance of price trends, interest rates and the Fed
- Yale Hirsch and Peter Eliades: the value of seasonal and cyclical trends
- Martin Pring and Gerald Appel: a variety of technical tools
- More recent influencers: Larry Connors, Linda Bradford Raschke, and Tom McClellan

All of their old books are still relevant. In my opinion, Linda’s recent book, Trading Sardines, is required reading for anyone considering trading as a full-time career.

I would also mention the Trading Wizard’s books by Jack Schwager. There are two things to pick up from those books: 1) there are lots of trading methods that work well. There is no one best way. The trick is finding what works well for you, and 2) the overwhelming importance of risk control and minimizing losses. They all touch on that as a primary key to their success.

In your mind, is there a difference between investing and trading?

Yes, I think of them as separate endeavors. Investing is “putting money to
work,” hopefully in some sort of objective manner to grow one’s capital over time. Trading is about making money here and now. Two completely different approaches in my mind.

**What would be your most important advice for traders?**

1. Remember this phrase, “It’s not how much you make when everything goes right that matters, it’s how much you keep when everything goes wrong.” Bad things happen to every trader, period. Job one is to be able to come back and be a trader again tomorrow, that is, never, ever put yourself in a position to “lose the farm.” A lot of traders who fail never take the time to learn proper position sizing.

2. In a nutshell, trading success or failure is determined by the following calculation: “# of winners divided by # of losers” times “average winning trade divided by average losing trade.” That’s the entire game in one number. A high value equals success, a low value equals failure. So focus your efforts on maximizing this number.

3. The day that you experience absolutely no emotion as you are stopped out of a properly managed losing trade is the day you gain the potential to become wildly successful in the markets.

4. Everyone knows Murphy’s Law, which says, “Whatever can go wrong will go wrong.” Traders need to live by what I call Murphy’s Corollary, which says, “Murphy hates you. Plan accordingly.”

**What about for longer-term investors?**

Two things. One, there is no such thing as “one best strategy.” If you can combine, say, three non-correlated strategies you can generate a nice smooth upward-sloping equity curve over time. I call it “LLUR” for lower left to upper right. That’s the goal. The more one’s equity curve slopes up to the right, the more likely they are to stick with their approach.

The second thing is that buying and holding a stock index fund with 100% of your capital is a mistake—in my opinion. I call it a “drifting with the tide” strategy. If the sky is clear and the seas are calm, then it’s smooth sailing. But storms are inevitable for both the weather and the stock market. And the longer the sailing has been smooth, the more people forget about the storms.

The peaks in the Shiller P/E ratio in 1929, 1937, 1965, and 2007 were followed by declines of -89%, -49%, -40%, and -54% for the Dow and the 2000 peak was followed by an -83% decline for the Nasdaq 100. Prior to the 2020 selloff people had forgotten all about this. But why ride declines like that to the bottom?

**Any other dangers of buy & hold in your mind?**

Yes. The stock market can go sideways for very long periods of time. Some people resolve themselves to believe that “timing is impossible” and that they have to simply ride out the bear markets to get their long-term returns. But ironically, buy & hold success is also actually a function of timing as well, that is, during which years were you in the market? If you’re fortunate you are in during the good years. But consider a little history:

- From 1927 to 1949 the stock market went sideways for 22 years. Imagine someone saying this in 1949: “Hey Honey, remember that money we put to work in the stock market back in 1927? Great news! We’re back to breakeven!” I can only speak for myself, but I would prefer not to have that conversation.
- From 1965 to 1982, the stock market went sideways. While this is technically a 0% return over 17 years, it was actually worse than that. Because of high inflation during this period, purchasing power declined a fairly shocking -75%.
- From 2000 to 2012 the stock market went sideways. Despite the terrific bull market in the past decade, it is interesting to note that from August 2000 through January 2020 (19 years and 5 months), the average annual compounded return for the Vanguard S&P 500 index fund (ticker VFINX) was just +5.75%. Not exactly a stellar rate of return for almost 20 years of a “ride ‘em out” approach.

**So what would you suggest as an alternative approach?**

Well, it’s more food for thought than a formal suggestion, but consider this:

- **30% invested buy & hold:** While I don’t advocate 100% because the market does go up in the long run, it makes sense to always have something in there.
- **30% invested using trend-following:** Occasional whipsaws are inevitable but the important point is that you don’t ride those 30% to -80% declines all the way to the bottom. The psychological benefit cannot be described, only felt. And you actually have some cash available to invest when things turn around.
- **30% invested using tactical strategies:** This can be a single strategy or a variety of technical, seasonal, or even fundamental-based strategies. Once again, the point is that these types of strategies are typically intended to: a) outperform buy & hold over time, and b) do something besides just “sit there and take it” when things go severely south. Also, it is useful to combine strategies that—using highly technical terms here—when one “zigs” the other “zags,” which
There is no such thing as “one best strategy.” If you can combine, say, three non-correlated strategies, you can generate a nice smooth upward-sloping equity curve over time.

- 10% invested using whatever approach you want. A lot of investors make the mistake of being afraid to ever trust their gut and others make the mistake of risking too much of their capital on their instincts. Think of a stock you wish you had bought, or conversely, that you bought way too much of. Well, if you only risk 1% to 5% of your entire portfolio and the stock tanks, is that really the end of the world? Go ahead and trust your gut. Take your shot. Just don’t bet the ranch. If you’re good at it you might just make yourself rich. And if you are not, you will figure that out in time too.

Obviously, splitting things up as I have just described (Figure 1) can get a little involved. But it gives you the potential to make money in any kind of market, and stands to insulate you from a lot of potential pain by avoiding riding the market to the bottom, or just holding on while the market goes sideways for many years.

One of the ways to limit losses is to use stop orders on trades. Is that something that you do? If so, how do you determine the stop levels to exit?

As with everything else, there are different philosophies. For example, I like Larry Connors’ work a lot. I have all of his books. Straightforward, rule-based, and the numbers look good. Yet most of the strategies in his books advocate for not using a stop-loss—and the numbers associated with those strategies back him up. But my mindset is that if I am going to risk a certain percent of capital, I have to have some way of doing that, and a stop-loss—for better or worse—automatically cuts a loss. Just a different mindset. The best way I’ve heard it put is this: “The purpose of a stop-loss order is not to maximize profitability. The purpose of a stop-loss order is to save your sorry assets.”

Like I said, different people have different philosophies and that’s okay. The main thing to remember is that successful traders: a) control risk ruthlessly, and b) have short memories when it comes to losing trades. They don’t drag them forward and allow them to influence future trading decisions. By the way, it’s much easier said than done.

What type of stops have you found most useful (e.g., standard stops, stop limits, trailing stops, and ATR-based stops), and how do you determine where to place them?

For purposes of limiting an initial loss a standard stop order typically serves that purpose most efficiently. If you decided you are going to risk x% on a trade and you are down x%, cut bait, move on. Period. No remorse. For a trailing stop—where you are locking in a profit—one can be a little more creative (ATR-based, x-day low, etc.)

What are the keys to trading and investment success?

The main thing is finding an “edge” and exploiting it repeatedly. A chart pattern, an indicator setup, a seasonal trend. Maybe add in some trend-following to make sure you are typically “going with the flow.” Something you are comfortable with, something you believe will continue to work. Then add in some reasonable position sizing and some inviolable risk controls and have at it.

From your research, what patterns have you found that repeat over time in the markets?

Well obviously, I am a big fan of seasonality. There are a few reasons why. First, as I said, one key to success is “finding an edge.” The vast majority of people in the market look at technical and fundamental information. Very few look at seasonality. So I feel that you are more likely to find a unique edge if you look where others are not. Also, there are a lot of unique anomalies related to seasonality.

Now I will say that committing capital based solely on the date on the calendar does require a leap of faith. But that is not always the only way to use seasonality. For example, one can look at a particular seasonal trend that is bullish—say, soybeans typically rise during February into May—and then add in some trend-following and ask “is price action actually bullish?” If some asset is in an actual price uptrend during a typically bullish time of month or year or whatever, that can be a pretty simple yet pretty powerful combination.

Since you are a believer in seasonality, is it safe to assume you are an advocate of “sell in May and go away”?

Yes, but not necessarily in the way most people think. The key as I mentioned is finding an edge and exploiting it repeatedly. There is an abundance of research regarding the fact that the stock market tends to perform pretty well November through April/May, especially if you follow that approach over a five-year period. No remorse. For a trailing stop—where you are locking in a profit—one...
period. Certainly, a lot of volatility can happen along the way, but since 1949, buying and holding the Dow November 1 through May 31 every year for five years has shown a gain 64 out of 66 five-year rolling periods. That's 97% accuracy. That's a pretty consistent trend to hang your hat on.

In the November 2019 issue of this magazine, you wrote an article titled “Stock Market Seasonality: A Global Phenomenon” based on the “sell in May and go away” approach, using data from seventeen single-country ETFs. What conclusions did you reach, and were you surprised by the outcome?

Well, doing the research was a real eye opener. Most every study I had ever seen or done looked at the Dow and/or the S&P. But the reality is that the “power zone”—as I like to call it—is a global phenomenon. Virtually every single international stock index and every individual single-country stock index tested showed a strong net gain if held every year November through April and—with one minor exception—they all showed significant losses over time during the other months of the year.

Did you uncover any other surprises in researching this phenomenon?

I'll give you three:

1. If you look at rolling five-year returns across a variety of indexes—growth, value, large-cap, low volatility, momentum, etc.—most show a five-year cumulative power zone gain 100% of the time, or close to it. There is no guarantee that this will last forever, but if you are looking for an “edge,” this seems like a good place to look.

2. The top-performing index during the power zone (Figure 2) historically over time has been the S&P Midcap 400 index. Now the reality is also that it can underperform for several years at a time as well. However, since 1981, it has gained almost three times as much as the S&P 500 index during November through May. That's what we quantitative types refer to as, ahem, “statistically significant.” My theory is that this is because that’s where the bulk of growth occurs over time—that is, the midcap space is essentially comprised of formerly small-cap stocks on their way to becoming large-cap stocks—that is, the growers.

3. For whatever reason, the power zone in the US extends from November 1 through May 31, while the international power zone is November through April plus the month of July. If you had held the MSCI EAFE Index during those power zone months starting in November 1970, you would have gained +12,461% versus a loss of -46% if you had held during all other months, which I refer to as the “dead zone” (Figure 3). Call it data mining if you’d like, but the consistency is tough to beat.

And what about the rest of the year, or as you call it, the dead zone? Do you suggest avoiding the stock market altogether?

The reality is that on a year-to-year basis, the S&P and Dow do advance about 60% of the time between the end of May and end of October, so it is not technically correct to call it a “bearish” period. But two thoughts to keep in mind: First, from 1949 through 2019, the cumulative price gain for the Dow during June through October was just +34%.

Secondly, consider an alternative investment. If we look at total returns for the S&P 500 index and three- to seven-year treasuries only during June through October since 1981, we find bonds earned 289% versus 107% for the S&P 500 stock index. Just as significantly, bonds had a maximum drawdown of -2.5% versus -40.8% for the S&P. If you are focused on consistency and low volatility, those numbers are pretty compelling.

What are some examples of seasonal trends that most investors may not be familiar with?

The bond market is extremely cyclical. Stock-correlated bond vehicles such as ticker CWB (convertibles) and HYG (high-yield) typically perform best December through April. Long-term treasuries (ticker TLT) have been best between May and August, and intermediate-term treasuries (ticker IEL) are favored September through November. Using Vanguard funds VWEHX, VUSTX, and VFITX in this manner, since all three funds were available in 1991, has outperformed buying-and-holding the three funds by over 3-to-1. Almost no one is aware of this.

Are there any other seasonal/cyclical factors at work in the bond market?

You bet. For years, long-term treasuries have made all their money during the 10th, 11th and 12th trading days of the month and during the last five trading days of the month. All other days combined have almost always shown consistent losses over time.

Do you think this trend will continue to hold if interest rates rise?

That’s an important question. Interest rates tend to move in roughly 30-year waves. We have now been in a downtrend for almost 40 years, so conventional wisdom argues that rates are due to rise. But now that I see negative interest rates in many countries around the globe, I am
The vast majority of people in the market look at technical and fundamental information. Very few look at seasonality.

not so sure that it won’t happen here. If it does, long-term treasuries may still have a long way to go on the upside.

At the same time, I read a study somewhere that calculated that if the long bond yield rose from 2.8% to 6.2%, long-term treasuries would lose -65% in principal. Now, one can argue that that type of rise in rates is unlikely anytime soon, but the point is, is anyone out there worried about that, or even aware of the level of potential risk?

Is there a way to avoid that kind of outcome?

One really simple way is to keep an eye on the 10-year and 30-year yields (tickers TNX and TYX) versus their respective 120-month—yes month—exponential moving averages. If rates are below their long-term averages—as they have been for most of the last 40 years—it's okay to hold bonds. But if the 10- and 30-year yields establish an uptrend—that is, above their long-term average, it is imperative that investors avoid long-term bonds or they will never know what hit them until it’s too late.

Any other insights regarding seasonality?

How much space do you have? Seriously though, yes, there are a lot. The thing to remember is that like anything else, seasonality is not for everyone. Some people just cannot wrap their heads around the idea that certain things tend to move at certain times. And that’s fine. If someone is not comfortable with a certain idea, they should not attempt to use it because it violates the “use a method you are comfortable with” rule. That being said, here are some quick mentions:

Housing and construction (using FSHOX as a proxy): November through May up 30 times in 33 years and total return 1986 through 2019 equals +8,584%. Meanwhile, cumulative return for May through October equals -63%. A pretty stark difference, to put it mildly.

Energy (using FSESX as a proxy): Held June through November every year since 1986 has lost -95%! Seriously, what is the point of bucking those kinds of odds?

What about within a given month?

Let's talk trading days of the month. Here is a crazy set of numbers. Let's consider what would have happened if you held the S&P 500 stock index during every day of the month except during the period from the 10th-to-last trading day of the month through the 5th-to-last trading day of the month. In other words, every month, you get out of the market for those six days and then get back in. A lot of people will think about that idea and their first reaction is, “well, that sounds like a pain in the rear.” And from a logistical real-world trading point of view, it really actually is.

But consider this. From the end of 1949 through the end of 2019, the cumulative price gain for this approach was +130,588% versus +19,268% for buy and hold. To put it another way, by holding the S&P 500 only during the period from the 10th-to-last trading day of the month through the 5th-to-last trading day of the month, for the past 70 years, you would have lost -86%! This is an example of “finding an edge” using seasonality. And realistically, is the whole world going to read this and adopt this strategy and negate this edge? Not likely.

You write the monthly column on options for this magazine (“Explore Your Options”), so let’s turn our attention there. Do you see option trading as different from other kinds of trading?

Absolutely. With stocks, futures, or ETFs you are either long, short, or flat. With options you can achieve any kind of exposure you want. Which leads me to point out that the best thing about option trading is also the worst thing about option trading.

How’s that?

The best thing about option trading is that there are so many choices. The worst thing about option trading is that there are sooo many choices!

In your opinion, what are the keys to success in option trading?

The first thing is to determine what your objective is, both overall and on a trade-by-trade basis. The primary categories are: a) speculating on price direction, b) generating income, and c) hedging. What are you trying to achieve by taking this trade? The second thing is to learn which strategies can best serve your purpose. The last thing is to learn how to put the odds as much in your favor as possible on a trade-by-trade basis.

Can you give us an example of what you mean?

Sure. If you think price is going up, buying a call option is the most straightforward approach. But from there, you then have the decisions of which expiration month to trade and which strike price to buy.

Are there any rules of thumb?

There are lots of rules of thumb, but there are no definitive “correct” answers. As I alluded to, that’s what makes option trading trickier than other types of trading.

For example, if you think a stock is going up, you can buy the shares and hold them for however long you’d like. If you are going to trade an option, it’s different. If you absolutely believe the stock is going to pop 3% in the next five days, then you would likely make a different trade than if you just expect it to work its way over the course of several months. If you have a specific outlook, you can take a more or less aggressive trade. Which goes back to my earlier point: It’s great to have the flexibility—but it can also complicate things a bit if you are not entirely focused.

Probably the most useful rule of thumb is that the best way to make money in the
long run is to avoid trying to make all the money in the world in the short run.

**When you hear or read an article by a market commentator, financial advisor, or brokerage firm indicating that market timing can’t be done successfully, how do you respond to that and what is your take on the validity of market timing?**

I ignore them. If that is their opinion, what do I care? I do what I do, they do what they do, the world keeps turning and the markets keep fluctuating.

**You have written four books. Is there another book in your future? And if so, what would be its focus?**

I would love to. It would probably be along the lines of my last book *Seasonal Stock Market Trends* since I have a lot of material on the topic. I would also love to combine seasonal trends with trend following and other overbought/oversold indicators to use as a basis for trading rather than just seasonal trends on an esoteric basis.

**You also write a blog called JayOnTheMarkets.com. What do you write about there?**

Whatever comes to mind pretty much. Sometimes it’s options, sometimes it seasonal or commodities, or economic indicators, trading setups—whatever. I refer to it as “the ramblings of a market-added mind.” I don’t make recommendations or offer trading advice, it is just “here is what I see,” or at least, “what I think I see.” It’s fun for me because I can just put the ideas out there and the reader can agree, disagree, use it, ignore it, whatever. But I have been doing it for six years now so there is a lot of material there in the archives.

**Any changes in the future you see forthcoming?**

I am not too good with “predictions,” but I am pretty good at identifying cycles and relationships, and there are a few that I believe will change again in the years ahead. In no particular order:

- US stocks and international stocks have a long history of back and forth in terms of relative performance. US stocks outperformed in the 1970s, the 90s, and in the most recent decade. Internationals led during the 1980s and the 2000s. I am keeping a close eye on the SPX/EAFE ratio. When it turns down in a meaningful way, chances are it will signal a long-term shift in favor of internationals (Figure 4).
- Second, unbeknown to most investors, the midcap space is where the bulk of growth takes place. From 1981 through 2019, the S&P 400 gained +13.225%, the S&P 500 gained +6.468% and the Russell 2000 gained +4.155%. In recent years the large caps have outperformed. I expect the midcap space to re-exert itself in the years ahead relative to the other indexes.
- Lastly, commodities are the dogs of the investment world, and have been for some time. This is unlikely to last forever. The ratio of the Goldman Sachs Commodity Index to the S&P 500 had been trending steadily lower since the peak in 2008. Now the bottom has pretty much dropped out. This won’t last forever. At the same time, no one knows “how low is low,” so as a trend-follower at heart, I haven’t really acted on this idea so far. The good news for investors is that when the trend starts to turn in favor of commodities, they can now gain exposure to commodities through ETFs rather than having to get into the futures market.

In the November 2001 issue of *Stocks & Commodities*, you wrote an article on a monthly Fidelity Select funds trading system you called the “pure momentum system.” Have you run these models for the 2000 to 2010 timeframe (for example, double bear market period) to see if the strategy works as well as during bear market years compared to the blistering bull market of the late 1980s and 1990s?

Interestingly, the good news is that it vastly outperformed the S&P 500 index during 2000 through 2009; +125% versus -9%. The bad news is that in the past 10 years it underperformed pretty substantially: +193% versus +257%. Overall, since November 2001, the median 12-month gain was 14.9% for the strategy versus +12.8% for the S&P 500. So still a viable long-term strategy. To tie some things together, in my mind, a strategy like this fits nicely in that 30% of a portfolio that uses tactical strategies.
An objective, rules-based approach that cranks out market-beating gains over long periods of time—provided you have the financial and emotional wherewithal to follow it.

Do you still follow the Dow Jones Industrials 11-month rate of change indicator? How accurate has it been, and when was its last signal?

It’s technically known as the Coppock guide (Figure 5). The calculation is actually a little more involved and I use the S&P 500 stock index now. When it goes negative and then turns up, you buy and hold for 12 months or until the indicator turns down—whichever comes first. This is more of a “weight of the evidence” type of indicator. By that I mean: 1) every once in a while it generates a signal, 2) typically those signals are useful, but 3) like a lot of other indicators, just when you think it’s infallible you get a flurry of errant signals—see 2002.

Including the 2002 whipsaws, the average gain was +16%. If you exclude the 2002 signals, the average 12-month gain following a buy signal was +26%. So it is certainly worth paying attention to. But you can’t really base your whole investment strategy on it.

Jay, thank you very much for your insights on many different trading ideas. I am sure some readers will now have a more in-depth understanding of how to benefit from seasonality, options trading, and other strategies you covered.

Thank you, Les. I appreciate the opportunity to share some examples of market anomalies and insights that I’ve worked with over many years.

**FURTHER READING**


