Timing the Market

There are a number of perennial issues to do with investing, many of which will never be resolved to the satisfaction of some people. One is whether technical analysis has any merit. The closed-mind brigade simply will not even examine the evidence.

Another issue is whether investing in stocks is the most effective way to increase wealth. Of course, sensible people realise that there are many ways to make money and that all of them work to some extent. What is far more important than the actual method, is that the method chosen is compatible with the personality, attitudes and beliefs of the person concerned. If you are trying to do something you do not believe in, or do not have faith in, or that you just feel uncomfortable about, it is not going to ever work for you, no matter how well it works for others.

One of the frequently stated motherhood ideas is that it is *time in the market* that is important, rather than *timing the market*. The most recent time I heard this trotted out was in Brian Thomas' keynote address at the recent Australian Investors Association conference at the Gold Coast. Under the heading of *The Perils of Trying to Time the Markets*, Brian quoted from *Dow 100,000 Fact or Fiction* by Charles Kadlec:

US$10,000 invested in S&P500 in 1982 was worth US$255,836 in 1998

However, if the best 10 days were excluded, it was only worth US$130,000

And if the 30 best days were excluded, it was only worth US$45,000

I have heard this sort of statistic used to justify the time in the market strategy, i.e. buy and hold, over and over again. Brian is just the last person I heard rolling it out. It lies behind most of the advertisements and public exhortations by professional managers to private investors to hang in there even in clear bear markets.

Most of my readers will immediately recognise that this is very self-serving advice that professionals are giving to private investors. They do not want private investors to sell their mutual funds, because that would reduce the fees and income of the professionals. Nor do they want private investors to sell their direct shareholdings, because that will reduce the prices on which the professionals are evaluated for their investing performance. Although it is self-serving, this advice would be all right, providing it was sound in terms of the interests of private investors.

I feel that there are a number of problems with it. Some of them are minor quibbles, but others are more substantial. Here are some of the things that worry me:

1. This is a two-edged sword. If being out of the market on the best days degrades performance, being out of the market on the worst days must enhance performance. That suggests to me that timing the market cannot be judged on such a simple test. While a poor market timer will always do worse than buy and hold, a competent market timer may be able to capture many of the best days and avoid many of the worst days. Jack Schwager's Market Wizard books alone suggest there are many examples of market timers who beat the

buy and hold approach. Of course, most private investors will not be in this class, but there are too many examples of those who have done it to say it is impossible, or even unlikely.

2. Most of the great investors are market timers. Warren Buffett is a market timer in a very broad sense. So is John Templeton. They time the market in a specific way, that is not exactly what we usually mean by market timing: they only buy good stocks when they are cheap. They sell them if the price becomes silly or if the company ceases to have excellent prospects. Warren Buffett exhorts us to only buy at the right time.
3. Most professional fund mangers are market timers. If they were not, they would only offer index funds. However, they buy and sell all the time. Sure, they tell us it is their superior stock selection. But isn't this just another name for market timing? They buy a company when it has good prospects and sell it when its outlook deteriorates. The important word is *when*, which means timing. Telling private investors not to do what they do themselves is arrogant in the extreme and equivalent to telling us *not to try this yourselves at home*. What is even more irrational about this whole thing is that most of the professionals do not beat the index themselves.
4. The professionals waving these facts around are often active managers. We know that when the market is up, it is not every stock that is up. Only some of them are up a lot and others up or down a bit. If the active managers pick the wrong portfolio, are they not out of the market on the best days too? The only logical conclusion is that they should be index investors, unless they have really superior stock-picking ability. And we know that very few of them have such ability, because so few of them beat the index. Interestingly, the few professionals who do beat the index do not bandy these data around. Rather, they tell us that you can time the market and that it is their ability to buy the best stocks at the right time that gives their superior results.
5. The whole argument based on the damage to results from being out of the market on the best days rests on a huge assumption. That is that you hold the exact portfolio that is in the S&P500 (or whatever index is used). However, we know that the composition of the index changes all the time. Poorly performing and declining companies are dropped and strongly performing and growing companies are added. This suggests that the index itself is a market timing mechanism. A good question is what makes it the best market timing mechanism. Surely it is conceivable that if we as investors had the skill to weed out the poorly performing and declining companies earlier and add the best performing and growing companies earlier, we could beat the index.

My argument is that it is always possible to find stocks that individually grow much faster than the index. These stocks have to exist, because otherwise there could not be stocks in the index that perform less well. We know there are stocks that go backward even in bull markets, so there are outstanding stocks as well. So, theoretically it must be possible to buy the right stocks at the right time and beat the index.

All of this seems to me to be an area that is best ticked off as nonsense and ignored whenever we hear it. If someone tells you it is a bad idea to do what they are doing because they can do it better than you can, so put your money in their hands, and then they fail to perform themselves, they are either hypocrites or stupid.

What I think is a far more reasonable position in this matter is this:

a) Because of the way the index is constantly adjusted to include the best stocks, it is difficult to consistently beat it.
b) However, a small number of excellent investors beat the index over a long period of time. So, it is possible.
c) The important question is whether we can do it. In the same way that most of us cannot attain the elite level in all sorts of other pursuits in life, most of us are not going to become one of the super investors.
d) It boils down to a judgement as to whether we ought to try. If we are not prepared to make the effort and devote the time to learn the craft and practice it, we are better off to take Warren Buffett's advice and buy index funds and "go fishing". However, if we do want to try, it is not an impossible dream. Far more people succeed at investing than the professionals would have us believe. It might even turn out to be one of the most satisfying challenges to take on for a lifetime, keep us mentally healthy, and with a good chance of staying financially healthy.
e) So, if you want to try, go for it, but not half-heartedly. Do it properly or not at all. Get an education in investing first. Then do not devote a large part of your wealth to it until you have proved you can beat the index. If you can demonstrate that you can beat the index, then do it all yourself.

I believe that the starting point for successful investing is to have a sound investment plan.

To read more of my work

Previous Articles

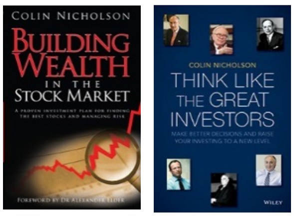
All my previous articles for the free website are now on the *Educational Articles* page on the Free Resources menu. They are now listed alphabetically by title with a brief description of their contents.

Books

I have written two books, both of which are available for purchase from the ***Buy Books*** menu:

BUILDING WEALTH IN THE STOCK MARKET – A proven investment plan for finding the best stocks and managing risk

THINK LIKE THE GREAT INVESTORS – Make better decisions and raise your investing to a new level



Members Website

Follow my thinking on my own investments, disclosure of my portfolio as I go, weekly market scans, weekly market charts and analysis plus many more articles about investing and analysis

I am one of the very few investors who publishes their investment results each year, which I have done since 2000 – see the Investment Returns page on the About Colin menu on the website