July 2001 – Market Timing

One variation of stock market timing involves investing funds in the market prior to predictable overall upward price movements and withdrawing funds prior to overall price decreases. Such an approach, although it sounds very appealing, is extremely difficult to implement successfully. One must be able to forecast almost exactly the times to buy and sell in order not to miss price gains while out of the market, and one must reap sufficient additional gains to offset the significant additional transaction and tax costs inherent in this strategy. A review of some relevant research will illustrate the above points.

A recent *Forbes* article by Weinberg and Maiello describes research by Ibbotson Associates. The study demonstrated that a $1000 investment in the overall market 75 years ago would have grown to $2.6 million by the end of the year 2000. If the funds had been withdrawn from the market during only the best 40 months, which represents 4.4% of the time, the ending value would have been just $15,330. Thus, most of the gains were dependent on being invested for a tiny, but very difficult to predict, portion of the time and the penalty for being out of the market at the wrong time was enormous. The above example does not even consider the additional transaction and tax costs of exiting and reentering the market.

Siegel in his book *Stocks for the Long Run* provides some additional relevant findings. First, recognizing that the stock market almost always falls prior to recessions and rises before recoveries, he examined all recessions since World War II. If one had been able to invest four months prior to the economic bottoms and withdraw four months prior to the economic tops, one would have increased the returns by 4.8% per year. If one lagged the tops and bottoms by just one month one would have actually lost .6% per as compared to a buy-and-hold strategy. Siegel further noted that since economists are notoriously inept at predicting the timing of tops and bottoms, a strategy of trying to time the economic cycle is extremely difficult to employ. Second, Siegel explored whether one could utilize significant economic or political news events as signals to enter or exit the market. Since 1885 for the 123 days when the market moved by 5% or more, only 28 of those movements could be traced to any such news events. Additionally, timing based on news could cause one to miss the majority of the best days. Finally, he focused on technical analysis, which attempts to predict future market movements by examining past price trends. He did find one variation, based on 200-day moving averages, that appeared to produce incremental returns over a buy-and-hold strategy during certain periods. He concluded, however, that the additional gains were virtually wiped out when transaction costs were included.

Business Week in 1998 commissioned a study to examine the market timing success of newsletters offering timing advice to mutual fund investors. The study, which identified 25 such letters, calculated the returns achieved following each letter's recommendations for the most recent ten-year period. Not one letter's returns matched the S&P 500 return of 18.06% annually, and the entire group averaged 11.06% per year. Like the Ibbotson study, this one

found that missing the best six months of the ten-year period would have reduced the 18.06% return to 12.55%.

Finally, the *Financial Analyst Journal* recently reported on a study analyzing one million market-timing sequences for the period 1926 to 1999. The study compared each outcome to a buy-and- hold strategy with the results favoring the buy-and hold strategy 99.85% of the time.

One should conclude from the above that market timing requires a level of accuracy in predicting that is rarely achieved. Such accuracy would be required in order to avoid missing the short windows in which the majority of returns are earned and to compensate for incremental transaction and tax costs. Most prudent investors, therefore, are far better off following a buy-and hold strategy, which returned 10.6% annually over the period 1926 to 1997.