Chapter 5

Market Timing Myths

One of the funny things about the stock market, every time one man is buying, another is selling, and both think they are astute.

William Feather

The search for superior investment returns leads many people to speculate on the future direction of the market. Those who can foretell the future can make spectacular profits. Market Timing is the common name used to describe this strategy, although it is also called tactical asset allocation.

Can tomorrow's prices be determined using yesterdays information? Identifying market moves before they occur has challenged mankind for thousands of years. Despite numerous claims from countless market gurus over the years, not one has been able to show that their crystal ball consistently works. Why is market timing so difficult? Superior timing implies superior information. In today's technology advanced world, it is difficult, if not impossible for one person to get information faster than everyone else. If a person acquires superior information, they also need to interpret it correctly and act on it very quickly, or the opportunity is gone. For most people reading this book, information flows too fast to be useful. By the time you get the news, it is too late. This is true of a majority of professional investors as well the individuals managing their own accounts. Ironically, brokers are usually the last people to figure things out.

Although there is little chance to make excess profits by timing the markets, many people believe the concept and spend a great deal of time and money searching for a profitable strategy. Wall Street and the financial press cater to this need by selling all sorts of market timing services. There are market valuation models, charting services, guru call-in numbers, newsletters, web sites, fax services, and a variety of gimmicks that tend to separate investors from their money. In truth, there is little academic evidence that any of these systems work. Vast majorities of people who follow timing strategies experience returns well below the market they are trying to beat, with no reduction in risk.

This chapter explains why a portion of the performance gap between investor returns and market returns is related to market timing. We will review the performance of various timing strategies as well as the results of popular self-proclaimed market "experts". Understanding the shortfall of market timing is a crucial step to understanding the performance gap in your portfolio. Bold market predictions by popular

gurus occasionally result in short-term price gains, but there is rarely any follow-through. Investors are wise to save their money, ignore the hype, and focus on long-term goals.

Academic Research on Timing the Market

Read almost any college textbook on investing and you will find a section on market timing. There will likely be a paragraph or two describing what the goal of market timing is, then a host of research explaining why it does not work. Almost every major study of market timing, including those conducted by Nobel Laureate economists, have unanimously concluded that any attempt to profit by predicting the direction of the market will ultimately fail.

> *This decade is strewn with examples of bright people who thought they built a better mousetrap that could consistently extract abnormal returns from financial markets. Some succeed for a time. But while there may occasionally be misconfigurations among market prices that allow abnormal returns, they do not persist.*
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> *Federal Reserve Chairman Alan Greenspan (1998)*

Any timing system designed to extract excessive returns from the market will eventually fail. If a strategy were developed that did work, it would be a closely guarded secret, and would only benefit a few people for a short period of time. If some alchemist found a secret formula that turns lead into gold, would they give it away for $99? No. When others use the strategy, the excess profits would quickly fad. Market timing strategies sold to the public en masse may have worked in the past, but they have no chance for excess profits in the future. These strategies have no value except to sell to a gullible public.

In the early 1900s, Harry Houdini exposed widespread fraud in the fortune telling industry. Houdini offered a large reward to anyone who could prove they could speak to the dead. Though many soothsayers tried to fool Houdini, he uncovered all their tricks. No one ever collected the prize.

Today, market timers run a similar business as Houdini's spiritualists. Their skill is not in predicting the direction of financial markets - it is in marketing their predictions. It does not matter if an advisor has no skill in choosing superior investments, what's important is to convince the public that they have special insight. These modern day soothsayers understand that selling their investment advice is much more profitable than following it. No broker has ever gotten rich by purchasing the products they peddle. They get rich off the commissions and fee charged to the gullible public.

A Short History of Market Timers

If I have noticed anything over these 60 years on Wall Street, it is that people do not succeed in forecasting what's going to happen to the stock market.

Benjamin Graham

Wall Street gurus have been predicting market prices since shares began trading in the 1800's, and researchers tracking the gurus continually find that their predictions have no value. Alfred Cowles, a research analyst and statistician in the early 1900s, studied Wall Street forecasts early in that century. In 1933, he reported his findings in the prestigious *Econometric* journal. Cowles statistically proved there was no benefit to market forecasts published by Wall Street strategists at the time. John Maynard Keynes, a famous economist and highly successful stock investor, rendered the same conclusion:

> The idea of wholesale [portfolio] shifts is for various reasons impractical and indeed undesirable. Most of those who attempt it sell too late and buy too late, and do both too often, incurring heavy expenses and developing too unsettled and speculative state of mind.

Stock market timing strategies evolve over the years. Until the 1960s, the rule-of-thumb was to sell when the dividend yield on stocks fell below interest rates on bonds, and buy when the opposite occurred. However, in 1959, stock yields fell below bond yields and never looked back. During the 1960s, the dividend strategy was revised and a new approach was established. When the market yield fell below 3%, wise investors were supposed to sell, and when it rose above 5%, investors should buy. That idea faltered in the early 1990s when the dividend dropped below 3% and stayed there until this day. Investors who followed popular dividend strategies missed one of the greatest bull markets in history.

Market timers are always fighting the last war. Timing techniques designed during the rising inflationary period from the 1940s through 1970s did not work during the disinflation period of the late 1980s and 1990s. Peter Lynch, former manager of the Fidelity Magellan fund, commented about the failure of market timers throughout the 20th century:

> The investment geniuses among us could have put all their money into the S&P 500 stocks in the 1920s, switched to long-term corporate bonds in the 1930s, moved to into small-company stocks in the 1940s, back into the S&P 500 in the 1950s, back to small stocks in the 1960s and the 1970s, and returned to the S&P 500 in the 1980s. The people who followed that inspired strategy are now billionaires living on the coast of France. Since I never met a single billionaire who made his or her

fortune exactly in this fashion, I must assume that they are in short supply relative to the rest of us who exhibit normal intelligence[1].

Wall Street and Market Timing Models

Many sellers of investment products and services feel the term "market timing" has gambling implications. The phrase almost sounds cheap. Therefore, in the 1990s, Wall Street came up with a new the name, *tactical asset allocation*. Many people claim there is a difference between market timing and tactical asset allocation, but don't be mislead. Tactical asset allocation is based on a belief that the stock and bond markets are predictable, and it is possible to profit by moving money from one market to another at an appropriate time. In other words, it is market timing dressed in drag.

Wall Street wizards squawk asset allocation advice on almost a daily basis. Large brokerage firms recommend tactical weightings in stocks, bonds, and cash as part of their daily routine. Today, the recommended allocation may to have a certain percent in stocks and a certain percent in bonds, but tomorrow the allocation may change due to "new information" or "current conditions". It does not matter if the word today is "buy" or "sell", either one makes money for the firm. When a company makes a big change to their asset allocation, they do so with great fanfare and lots of media coverage. A firm will issue press releases, offer conference calls, and have lots of phone conversations with reporters. In short, large Wall Street firms try to make a major asset allocation change a marketing extravaganza. In a sense, a successful asset allocation change is not one that accurately predicts the market, a successful change is when a firm can take this non-news worthy event and turn it into front-page headlines, which means free advertising for the firm.

Does tactical asset allocation work, or is Wall Street taking Main Street for a ride? Look no further than the *Wall Street Journal's* running scorecard on the issue. The results of tactical asset allocation models recommended by the major brokerage firm are regularly published in the Journal. The return of the models are ranked against each other and compared to the results of a static allocation. The static "Robot" blend holds 55% stock, 35% bonds, and in 10% money market funds. Although the robot blend never changes, the brokerage firms are free to vary their allocation anytime[2].

A 10% money market position in the Robot blend should make this model easy to beat, but that is not the case. The average brokerage firm does not beat the Robot portfolio. For five years ending in 1998, eight out of twelve firms were below the static blend, and two of the largest brokerage firms fell

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[1] Peter Lynch, *Beating the Street*, Simon & Schuster, New York, 1993, pg. 17
[2] John Dorfman, *Experts Urge Cutting Exposure to Stocks*, The Wall Street Journal, August 11, 1997, C1

significantly below the benchmark[3]. Of the firms who did outmaneuver the markets, no firm held the top spot for the entire period. One important point about the study, it suffers from survivorship bias. Several firms have dropped out of the study over the years due to mergers, acquisitions, or their own request. As a result, only the results of the surviving firms are reflected in the study, which tends to push the average higher than if all the firms stayed in the study.

The Real Reason for Tactical Asset Allocations

There is no denying that the more financial predictions you make the more business you do and the more commissions you get.

Fred Schwed, Jr.

If market timing does not work, why do so many brokerage firms spend time and money trying to make it work? The answer has nothing to do with finding a formula that beat the markets. It has to do with generating commissions and fees. When clients hear that a brokerage firm made an asset allocation change, they become curious, and sometimes concerned. This leads to phone conversations with brokers, which leads to more business. It is a known fact that brokerage firms increase sales after they change their opinion on the markets. An internal study by one large brokerage firm found sales in its wrap fee mutual fund products increased substantially following a suggested asset allocation change. Ironically, an informal study of those changes also reveals that clients would have been better off ignoring the advice. Following the recommendations would have lead to lower returns in the long run.

Investment Newsletters and Market Predictions

There's an old joke about high school physical education teachers that goes like this:
Those who cannot do - teach. Those who cannot teach - teach physical education.

The same logic can be applied to market timers who sell investment newsletters:
Those who invest poorly – sell advice. Those who sell poor advice - sell market-timing newsletters.

Look through any issue of Investors Business Daily and you will find dozens of ads for newsletters claiming superior market timing ability. John Graham and Campbell Harvey of Duke University graded the ability of newsletter writers to time the markets. They found little evidence to support the advertising

[3] Aaron Lucchetti, "Strategist Post Worst Results in 8 Years", *Wall Street Journal*, October 28, 1998, pg C1

claims of the newsletter writers.[4] The study covered hundreds of newsletters published between 1983 and 1995. Following the market-timing advice of the letters would have produced only a 12% annualized return for the period, while the S&P 500 compounded at a 17% return. An abstract of the study is as follows:

> Many investment newsletters offer market-timing advice; that is, they are supposed to recommend increased stock weights before market appreciation and decreased weights before market declines. Examination of the performance of 326 newsletter asset-allocation strategies for the 1983-95 period show that as a group, newsletters do not appear to possess any special information about the future direction of the market.

A second study by Roger Blake and Meir Statman looked at the reasons why letter writers changed their market opinion at various times. They found that movements in the market affect writer opinions and not the other way around. In other words, the letter writers as a group were following the market instead of leading it. The study also found that excess market volatility caused rapid changes in opinion, while low volatility caused a slow but gradual change[5]. Newsletter writers are basically trend followers. They prefer to drive forward by looking in the rear-view mirror. That causes many accidents in portfolios.

Professional Money Managers and Market Timing

I am certainly not going to predict what general business or the stock market are going to do in the next year or two, since I don't have the faintest idea.

Warren Buffet, Letter to Partners, 1963

Are professional fund managers able to predict the market better than Wall Street analysts? Do they possess skill or information the public does not have? There are dozens of academic studies on this subject. Measuring a fund manager's ability to market time can be conducted in one of two ways. The researcher can measure the level of cash held by a mutual fund at various turning points in the market, or they measure the level of risk the manager had taken at those times.

Mutual Fund Cash Levels

The amount of cash held in a mutual fund can give way to important information about a fund manager's market timing ability. When fund managers believe the market is overvalued, they typically reduce the

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[4] John R. Graham and Campbell R. Harvey, *Grading the Performance of Market-Timing Newsletters*, Financial Analyst Journal, Nov/Dec 1997

[5] Roger G. Clarke and Meir Statman*, Bullish or Bearish?,* Financial Analysts Journal, May/June 1998

stock allocation and raise cash. This cushions a portfolio against market loss, and prepares the fund for shareholder redemptions. If managers believe the market is headed higher, they typically increase the allocation to stocks and reduce the cash position. This will enable them to capture the higher return of the stock market.

The Investment Company Institute (ICI) tracks the cash position of mutual funds, and has data going back to early 1980's. Prior to the market crash of 1987, the average stock fund held steady at about 9% cash. There was no attempt to raise cash prior to the sell-off. After the 1987 market crash, managers as a group increased their cash position to 11% because they were anticipating further declines. But the market did not go down as expected. It quickly stabilized, and then produced significant gains in 1988 and 1989. At that point the managers bought stocks and reduced their cash position back to the 9% level. Managers were wrong on both sides of the 1987 crash. They were late getting out of the market and late getting back in during the recovery. Remember, these are the experts!

Let's look at a different period of time. In late 1990, during the build-up to Desert Storm, the stock market sold off and then managers sold stocks and increased cash to 11%. When the war began in mid-January 1991, the stock market surged, catching the managers with a large cash position. Over the decade managers gradually reduced the cash in their portfolios.

The data clearly shows mutual fund managers change cash positions after the market changes direction, not before. They react to market movements. They do not anticipate them. The idea that an active manager will "get you out" of a market before is falls is simply marketing hype. There is no evidence to support that claim.

By the time this book was published in 1999, mutual fund cash positions were at a historic low of 4%. Is this a bad sign for the market in the new century? Maybe. But then, we have already learned that over the long-term it does not pay to make predictions.

Mutual Fund Risk Levels

Another method of determining if managers can correctly predict market direction is to look at the risk of the securities in the portfolios. If a manager expects the stock market to move higher, they should increase the number of risky stocks in the portfolio to capture a return higher than the general market (technology). If they believe the market is heading lower, risky stocks should be sold in favor of conservative stocks (banks).

A review of mutual fund risk studies can be found in *Investment Analysis and Portfolio Management,* a textbook written by Frank K. Rielly, University of Notre Dame[6]. Rielly reviewed a number of risk studies conducted over a number of years. He finds convincing evidence that professional managers were not able to capture higher returns by changing the risk of their portfolios prior to a market turn, nor did any single manager exhibit consistent skill in changing their portfolio beta. Not surprising, Rielly concluded that portfolio managers have no market timing ability.

Market Timing and Individual Investors

So far we have learned that professionals have not been successful timing the markets, but how have individual investors faired? The general public seems to follow market timing on two levels. In the short run, the recent trend and popular opinion influence decisions to get in or out of the market. In the long-term, decisions are imbedded political and economic events that affect the moral of the entire Nation.

Short-term Market Timing

Short-term timing is emotional and reactionary. Typically, a person makes a change to their asset allocation as a result of a sharp turn in the direction of the markets that makes them nervous. During volatile markets, people listen closely to chatter they hear in the bathroom at work, or they may follow the recommendation of a popular market guru on television, or make a decision based on something someone in the family said, who knows someone who said something. Whatever the trigger, short-term timing decisions are emotional, not logical. Hopefully, they are not permanent.

In a bull market, investors are always skeptical that the market will continue higher. It is said the stock market climbs a "wall of worry". On the other hand, during times of sharp market declines, many investors are positive the market will continue to go down, and they believe they should get out immediately. In times of fear, investors herd together and imagine the worst outcome. In his epic work, *The Crowd*, Gustave Le Bon explains why following the advice of others during a time of market volatility is not the wisest action:

> The decisions affecting matters of general interest come to by an assembly of men of distinction, but specialists in different walks of life, are not sensibly superior to the decisions that would be adopted by a gathering of imbeciles...In crowds it is stupidity and not mother-wit that is accumulated[7].

Watching the flow of public money into and out of mutual funds is a good place to study short-term timing. Studies of mutual fund cash flows during volatile market conditions reflect popular opinion

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[6] Frank K. Rielly, *Investment Analysis and Portfolio Management*, Dryden Press, Third Edition, pg. 853-5

of the markets. In 1987, after the stock market crash, stock mutual fund redemption's increased significantly, and exchanges into bond funds went up dramatically[8]. A similar reaction occurred in 1990.

Stephen Nesbitt of Wilshire Associates studied mutual fund cash flows to measure the affect of market timing on returns[9]. His goal was to measure the cost of market timing to investors by measuring the movement of money between broad categories of mutual funds, i.e. moving from stock funds to bond funds. Nesbitt's research covered a period of ten years, from 1984 through mid-1994. He found the average investor lost about 1% each per year due to sector switching between stocks and bonds, not including commission costs. As investors try to time the markets, they loss money, and the more they moved, the more they lost. Effective portfolio management means choosing a level of risk that is right for your needs, and staying the course over the long-term. Chapter 14 covers this concept in detail.

Long-term Market Timing

Over a lifetime, stocks outperform bonds, and bonds outperform money market funds. Therefore, most people should invest a large portion of their lifetime savings in the stock market. Right? Not quite. While this advice works well in a bull market, the public has a totally different opinion about the future when major political and economic disruptions cause fear and uncertainty. Those events cause structural changes in our lives, which are typically reflected by a prolonged bear market for stocks.

Up until the publication of this book in 1999, there are two important periods of time that should be studied by every stock investor. They are the period following the crash of 1929, and the period following the market meltdown of 1973-74. These two periods offer clues as to how people shifted their investment behavior following a period of political turmoil and deep bear markets. The following data is complied from Federal Reserve records, the Investment Company Institute, the New York Stock Exchange, and other sources. In analyzing the information, one trend is clear - the public will abandon the stock market again in the future when some major event happens. I have no idea what that event will be or when it will occur, but investors will give up on stocks again in the future.

Major Investor Shifts from 1900 to 1999

In 1896, the Wall Street Journal began publishing the Dow Jones Index on a daily basis. It was a composite of the 12 best-known stocks at the time. Though the market was volatile, and stock manipulation

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[7] Gustave Le Baron, *The Crowd*, Cherokee Publishing Co., Marietta, GA, pg. 9
[8] ICI data on equity and fixed income mutual fund cash flow. 1984 -1998
[9] Stephen L. Nesbitt, *Buy High, Sell Low: Timing Errors in Mutual Fund Allocations*, Journal of Portfolio Management, Fall 1995, pg. 57-60

was common, the number of stock market investors was steadily increasing. After World War I, in the early 1920s, the stock market started to boom. Rising prices were fueled by speculation and borrowed money. Over 10% the working population joined in the speculation and bought common stocks[10].

The crash of 1929 came slowly at first. Then, following a Federal Reserve tightening and Congressional tax increase on imports, the stock market collapsed. By 1932, the stock market fell 82% from its high, and many people could not pay their margin loans. As a result, banks collapsed, sending the economy into a tailspin and throwing the country into period of despair. The public left the stock market in droves, claiming never to return.

The experience of the 1929 crash stayed on the minds of Americans until the end of the Korean War. By that time public ownership of stocks had fallen from 10% to 4%. The turnaround came in the early 1950s as a new generation of investors emerged. As the stock market moved higher, more investors became involved. These investors were not directly affected by the 1929 crash. During the 1950s, brokerage firms were busy expanding their reach to every city and town. Investment salesman even went door-to-door selling stocks, and a new product called "mutual funds".

By 1972, stocks as a percent of household financial assets hit 38%. Over 16% of the adult population owned stocks, more than any time in history. Unfortunately, as a result of the Vietnam War, the dollar was beginning to weaken, and in 1973, growing political pressure caused President Nixon to take the country off the gold standard. This policy change caused the value of the dollar to collapse and inflation to surge. Between 1973 and 1974, the S&P 500 fell 42%. The rapid decline drove another generation of investors out of the stock market, and many stayed out until the early 1990s.

Although stocks compounded at a 15.5% annual return from 1982 to 1992, few new investors entered the market. But, in the early 1990s, a third generation of investors came aboard. Baby Boomers became a major force driving the stock market to new highs and ethics on Wall Street to new lows. An assortment of new individual retirement accounts and the popularity of self-directed employee retirement plans helped fuel the rapid growth. As of 1999, there are more stock investors as a percent of the adult population than ever before. Stocks have grown to over 40% of household financial assets, a new record.

Figure 5-1 puts a lot of this information in graphic form. It compares the rolling 5-year return of the S&P 500 from 1950 through mid-1998 with the percent of household financial assets in stocks and stock mutual funds. For the entire period, the average household held 24% of their financial assets in stocks. However, the mix was constantly changing. Stocks ranged from 11% in 1982 to 40% in 1998.

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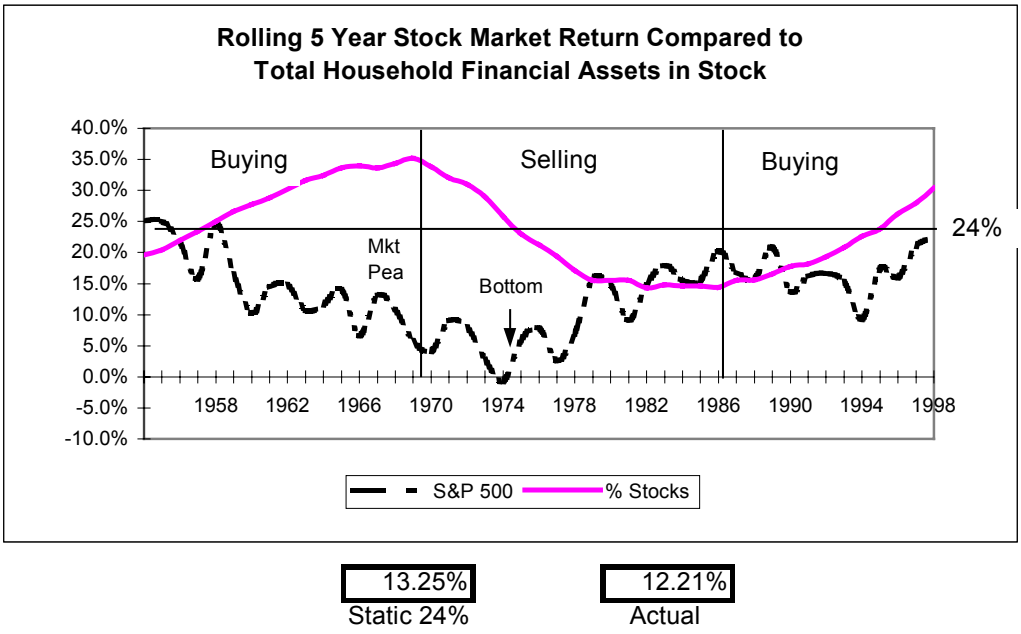
[10] Charles R. Geisst, *Wall Street: A History*, Oxford University Press, New York, 1997

Using this data, we can estimate the cost of long-term market timing decisions on a generation of investors. Had the public maintained a constant 24% in stocks during the entire 1950 through 1998 period, the annualized return on the stock portion of their portfolio would have been 13.2% (using the S&P 500 as a benchmark). Due to the effects of market timing decisions over a generation, the model produced a return of only 12.2%. Long-term shifts in investor beliefs brought about by political and economic upheaval lowered the investor returns by 1.0% annually. This study supports the conclusion of Stephen Nesbitt; the general public is not good at predicting when the stock market is cheap and when it is expensive.

Figure 5-1



How long the current bull market will last is anyone's guess. Some people believe baby boomers will maintain a high exposure to stocks even during a prolonged economic crisis. I do not believe that is true. When the tide turns, there is doubt how investors will react. The general public did not hold onto stocks after the crash in 1929, nor did they hold after the bear market of 1973-4, and they will certainly sell again in the future. This will have an adverse effect on investor performance in the long run.

Conclusion

This chapter explains the two ways market timing contributes to the performance gap between market returns and investor returns. Short-term timing decisions lower results by about 1% per year (not including trading costs or the tax consequences) and long-term decisions take away more return. The combined cost

of all market timing decisions is estimated at 1 1/2% to 2% per year over an investor's lifetime. It is very difficult to maintain a set allocation to stocks during adverse conditions, but it certainly pays to do so.