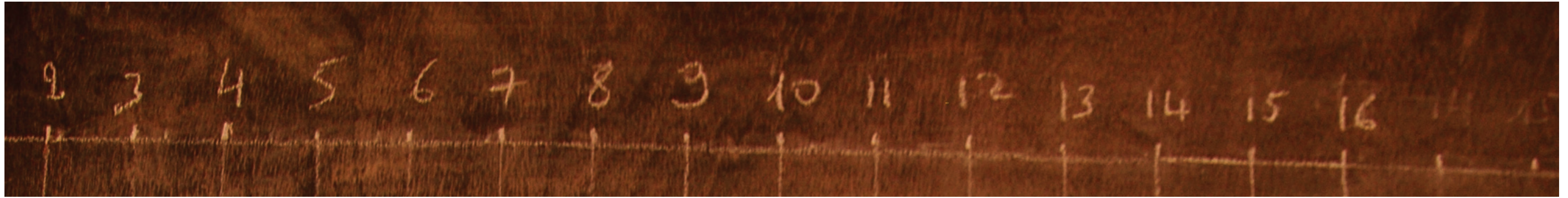

Dreaming the impossible dream? Market Timing

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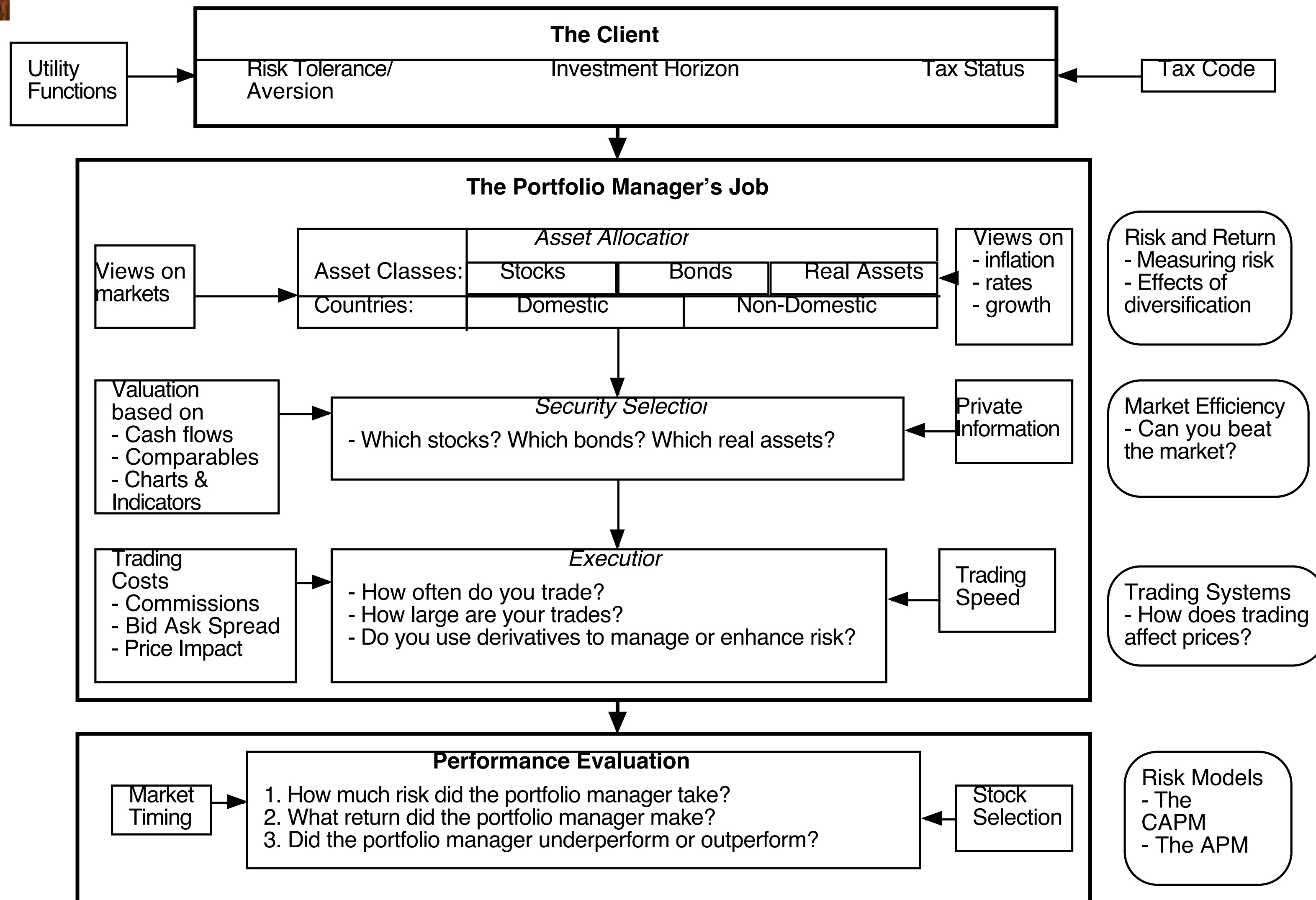
Figure 1.1: The Investment Process



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The Payoff to Market Timing: It explains differences in returns

- In a 1986 article, a group of researchers raised the shackles of many an active portfolio manager by estimating that as much as 93.6% of the variation in quarterly performance at professionally managed portfolios could be explained by the mix of stocks, bonds and cash at these portfolios.
- Ibbotson examined the relative importance of asset allocation and security selection of 94 balanced mutual funds and 58 pension funds, all of which had to make both asset allocation and security selection decisions. Using ten years of data through 1998, Ibbotson finds that about 40% of the differences in returns across funds can be explained by their asset allocation decisions and 60% by security selection.

Return to being "out of the market" at the right time

- In a study in 1992, Shilling examined the effect on your annual returns of being able to stay out of the market during bad months.
- He concluded that an investor who would have missed the 50 weakest months of the market between 1946 and 1991 would have seen his annual returns almost double from 11.2% to 19%.

The Cost of Market Timing

- Out at the wrong time: In the process of switching from stocks to cash and back, you may miss the best years of the market. In his article on market timing in 1975, Bill Sharpe suggested that unless you can tell a good year from a bad year 7 times out of 10, you should not try market timing. This result is confirmed by Chua, Woodward and To, who use Monte Carlo simulations on the Canadian market and confirm you have to be right 70-80% of the time to break even from market timing.
- Transactions Costs: These studies do not consider the additional transactions costs that inevitably flow from market timing strategies, since you will trade far more extensively with these strategies. At the limit, a stock/cash switching strategy will mean that you will have to liquidate your entire equity portfolio if you decide to switch into cash and start from scratch again the next time you want to be in stocks.
- Taxes: A market timing strategy will also increase your potential tax liabilities. You will have to pay capital gains taxes when you sell your stocks, and over your lifetime as an investor, you will pay far more in taxes.

Market Timing Approaches

- Non-financial indicators, which can range the spectrum from the absurd to the reasonable.
- Technical indicators, such as price charts and trading volume.
- Mean reversion indicators, where stocks and bonds are viewed as mispriced if they trade outside what is viewed as a normal range.
- Macro economic variables, such as the level of interest rates or the state of the economy.
- Fundamentals such as earnings, cash flows and growth.