

# the low-down

## the perils of market timing

**Despite repeated attempts by investors to guess the direction of markets, the evidence suggests that market timing rarely pays off in the long term.**

### the premise

Market timing involves buying a stock when the price is low, holding on to the investment until its market price peaks, and then selling out and moving into cash until the market price hits bottom. The process begins all over again as one waits for the right moment to get back in. Sounds simple enough. The problem though, is that all timing strategies are based, at least in part, on second-guessing the market.

However, many financial advisers all over the world have related tales of clients who felt that 'now' might not be a good time to be in the market. These investors believe that by avoiding the market during troubled times, they can reap the benefits that equities have provided over the years, while sitting out the downturns. In this way, many investors try to time their entry and exit to and from markets.

The fact that everyone seems to have a 'sure-fire' way to time the market just adds further encouragement to market timing investors. Just do a search on the Internet. You will discover a myriad of web pages advertising market timing services. A visit to your local library will yield an equal number of market timing theories. And some of these may even work – for a while.

### the reality

Trying to make money by predicting short-term market moves and by attempting to pick the perfect moment to get in and out of the market doesn't work in the long term. Period. Why? Because you cannot know which way the market is going to move in the short-term.

Many investors, believe different:

- ~ after the September 11 terrorist attacks, US investors pulled approximately \$US29.5 billion out of US stock mutual funds. These investors were in for a rude surprise when the US S&P 500 Index recovered within a month.
- ~ General Electric fell below \$US30 per share after September 11, but within seven weeks, the stock had risen above \$US40.

Investors in the above examples would have been sorry. The US S&P 500 Index had its second largest one-day gain in 2001 just five days after September 11. Within a month of September 11, the index had risen 3.7%. This just goes to show that you can't guess market moves from one day to the next, as you don't know tomorrow's price given that it will be determined by tomorrow's events.

History has shown that the market refuses to cooperate with market timing strategies. The simple reason is that even during the worst of times, equity markets can still have many good days. To demonstrate this, **ipac** analysed the daily performance of the US S&P 500 Index over the last 20 years ending December 2003. Of the best 50 trading days, 28 of these (56%) occurred during 2000-2003, a bear market period. It is safe to say that this period has been one of the most difficult in memory for most clients, yet this was when the best one-day gains were to be found.

### the costs are less visible than the perceived payoff

Lured by the 'possibility' of succeeding, investors often ignore the all too real costs associated with market timing. The fact is that the costs are significant and do erode returns. The costs include:

- ~ missing the best trading days
- ~ potential tax liabilities from selling securities
- ~ transaction costs eg. brokerage

trying to guess which way the market is going is not a good strategy

you can't guess market moves from one day to the next

investors often ignore the costs of market timing

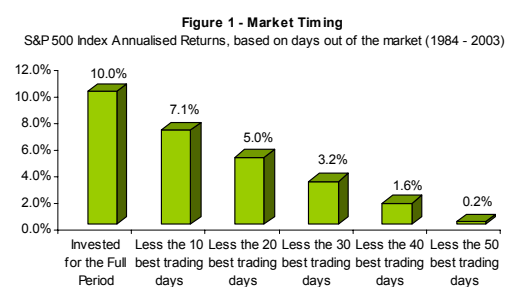
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What happens if your timing is off and you don't reinvest in the market at the right time? The consequences of not being fully invested when a major market upturn occurs can be disastrous to your long-term investment plans. Investors must remember that if market timing were costless, everyone would try to time markets, given the huge payoff for getting it right. But it is unlikely that one investor can have an informational advantage over other investors in picking stocks over the long term.

## some hard facts

Despite hearing or reading about the costs associated with market timing, such as missing the best trading days, investors still wonder if they may benefit by staying on the sidelines just a bit longer, to make sure the bear market is really over. Or to maybe sell out now because of a previous month's negative market returns. The fact is that missing only a small proportion of large one-day market gains makes a difference. **ipac's** research shows that the difference is significant.



source: Bloomberg

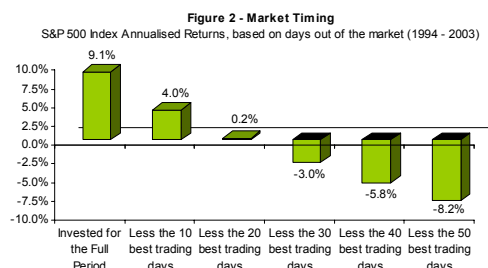
## how was this calculated?

**ipac** looked at the performance of the S&P 500 Index on a daily basis, for the 20 years ending 2003, for trading days only. **ipac** used daily performance data, calculating the return an investor who remained fully invested for this entire period would have achieved on an annualised basis if they had missed out on the 10 best, 20 best, 30 best, 40 best and 50 best trading days in the market.

The results in Figure 1 show that missing only a small number of the best trading days during this period had a profound impact on performance.

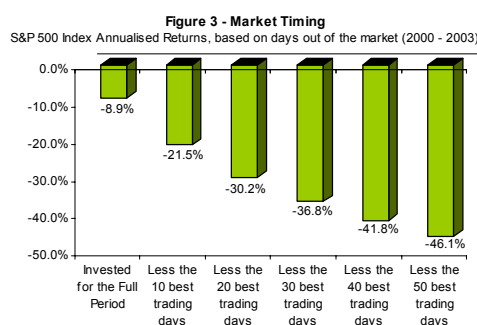
- ~ an investor would have achieved a **return of 10% p.a. by remaining fully invested throughout the whole period**
- ~ **missing only 50 of the best trading days** during this period, which represents only 0.01% of all trading days, would have resulted in an **annualised return of just 0.2%**
- ~ even **missing out on only the best 10 trading days** would have delivered a **return of only 7.1% p.a.**

**ipac** then repeated the calculation using shorter periods of time - 10 years and 3 years - and found similar results. The data is presented in graphical form in figures 2 & 3. **ipac** believes that these make a strong case for remaining invested and avoiding the temptation of trying to time the market.



source: Bloomberg

Figure 3 covers the bear market period 2000-2003. In this example, remaining fully invested would have limited an investor's loss (-8.9%) as opposed to missing out on the best 50 trading days, which would have delivered a return of -46.1%. The obvious question is wouldn't it have been better to not have been invested? But how would one have known that? The answer is that you can't know and can only guess. The evidence clearly shows that it doesn't pay to sit on the sidelines, waiting for the perfect day, but to remain fully invested.



source: Bloomberg

## the best defence

Discipline, discipline and more discipline. Investors should not let short-term volatility drive their long-term investment planning. The best defence against a fluctuating market is a well diversified portfolio, spreading investments among stocks, bonds and cash, in a strategic asset allocation that takes into account their time frame, risk tolerance, need for investment income, and long term goals that can help their portfolio produce more consistent returns, regardless of whether markets move up or down.

investors may sometimes wonder if its best to wait on the sidelines just a bit longer

but missing just a few of the best trading days can make a huge difference to returns

the best defence is discipline, discipline, discipline!