Market Timing Can Improve Your Returns, But You Better Be Good!

A while ago, we came across an article, where the author suggested that market timing could enhance your returns. In this case, he qualified by saying that you must stick with it over a long period of time. By now, most of you know our position on this; we are against it. We think it is naive to believe that you can second guess the markets often enough to justify this approach. This is why we keep pushing our IFC Investment Principles. However, since this author has very high credentials, and is widely published, we felt that it was prudent to re-examine the issue.

First, we should point out that we are in very good company. Many of the most successful portfolio managers share our opinion. To give some examples:

- A year or so ago, we heard a speaker from Fidelity mutual funds (the worlds biggest mutual fund company). He continually stressed that you should not second guess the markets. He also quoted Peter Lynch (one the most successful mutual fund managers of all time). Apparently, Peter said something to the effect that he did not know which way the next thousand point move would be, but he was confident which way the next four thousand point move would be.

  In his book, "One Up On Wall Street," Peter Lynch actually titled one chapter "Is This A Good Market? Please Don't Ask."

- The book, "The Warren Buffet Way," continually refers to Warren Buffet's principle of ignoring the markets (Warren Buffet is considered to be the richest person in the United States). In the beginning of chapter three, the book describes how in 1956, Buffet's father counseled him to hold off making any purchases, because at 200, the Dow Jones Industrial Average was too high, (the Dow is currently trading above 7600). The book says that Buffet, who started with $100, figures that if he had listened to his father, that is all that he would have today.

These positions and statements lead us to believe that we are right. After all, if the best managers in the world do not believe that they are good enough to do this, how can we believe that we are.

Nevertheless, in 1995 we did some analysis. While we do not consider the following to be completely scientific, it does help us understand what kind of success ratio you need to make market timing effective. And that is the key question, how often do you have to be right?

First, we determined what the results would be if you held a diversified portfolio of U.S. stocks since 1925. Then, we determined the results of holding Treasury Bills since 1925.

If in 1925, you had invested $1 in U.S. stocks, at the end of 1994, your investment would have been worth $812 (10% average annual return). If you had picked the T-Bill option, you would have had $15 (4% average annual return). Obviously, the stocks far out-performed the T-Bills.

Then we asked, "What if you exercised some market timing?" Lets say on January 1 of each year, you had made a decision for the year, and put your money into Stocks or T-Bills. If you had made the right choice every year, your $1 would have grown to $32,462 (16% average annual return). Clearly, if you always get it right, market timing works with a vengeance. Then again, if you had always made the wrong choice, at the end of 1994, your $1 would have been worth only 38 cents.

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If you are good enough, it will enhance your returns, if not it will reduce your returns.

Of course, neither of these examples are realistic, no one is that consistently right or wrong. The question is, how often do you need to be right? Traditional wisdom says, if you can be right over 50% of the time, you are doing well. So what if you had made the right choice every other year, (right 50% of the time). If you had, your $1 would have been worth $60 (6% average annual return) at the end of 1994. What about two out of three times (67% right). Then your $1 would have been worth $457 (9% average annual return). On the other hand, if you were right three out of four times (75% right) your $1 would have been worth $1,386 (11% average annual return). Remember, if you had bought and held the U.S. stocks, you would have had $812. So only the last option beat a buy and hold strategy.

While these results are not totally scientific or conclusive, what they suggest is that for market timing to match a buy and hold strategy, you have to be right about seventy percent of the time. This actually is a reasonable conclusion, when you consider that the stock market normally goes

up about seven out of ten years. While this may be possible, it is rare. Accordingly, we will continue to recommend that you follow our IFC Principles.

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