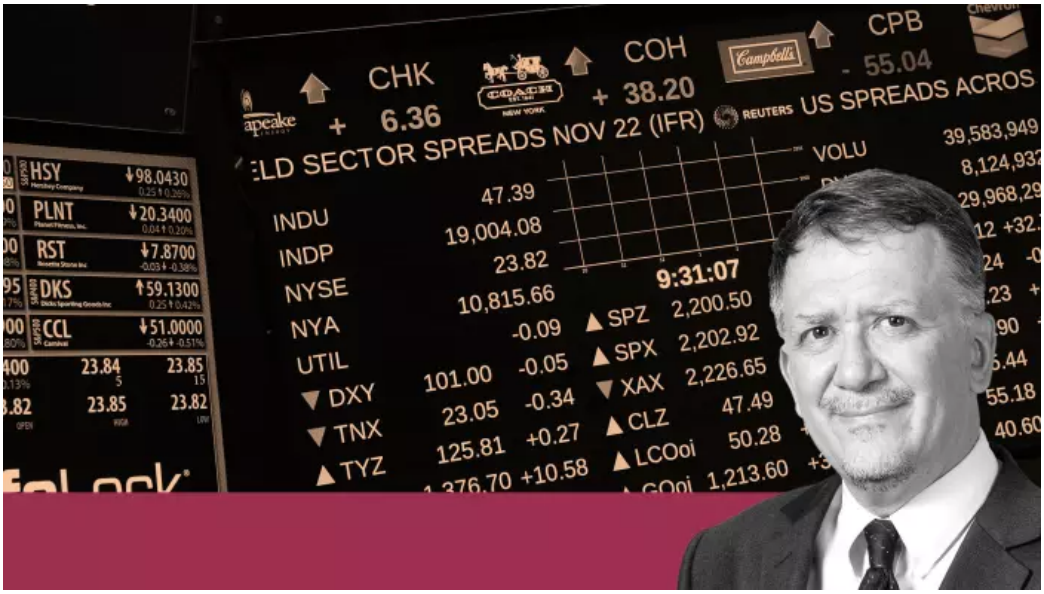
Opinion **Authers' Note**

Authers' Note: Timing the Market

The FT's daily newsletter on the world of investment

JOHN AUTHERS



John Authers FEBRUARY 23, 2017

Should we try to time the market? It is close to a timeless debate, but there are some interesting new developments. They also have an impact on how passive investments, the flavour of the month, should be sold.

I will start with the back story. If (a big if) you time the market correctly, you can make money beyond the dreams of avarice. The returns that can be made by big asset class bets are always enormous with hindsight, as I demonstrate at the end of each year with the Hindsight Capital pieces.

Further, the strong long-term returns of the stock market turn out to be concentrated in a few days. Earlier this week, a commenter pointed me to this piece on timing, from realinvestmentadvice.com. It cites research by Javier Estrada of the IESE Business School showing the extraordinary difference just missing out on the 10 worst days can make. This chart goes from 2008, and shows that avoiding the worst days of the 2008 meltdown would indeed have made a huge difference:

The bloggers at realinvestmentadvice.com go on to cite Brett Arends from a piece in 2010, who said:

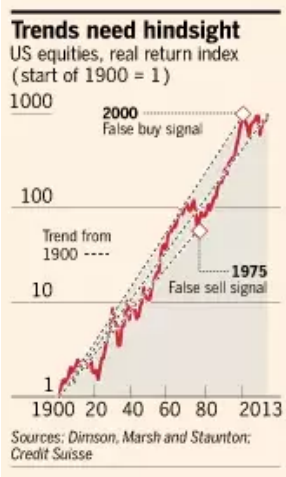
> "*Over an investing period of about 40 years, he calculated, missing the 10 best days would have cost you about half your capital gains. But successfully avoiding the 10 worst days would have had an even bigger positive impact on your portfolio. Someone who avoided the 10 biggest slumps would have ended up with two and a half times the capital gains of someone who simply stayed in all the time.*

> *In other words, it's something of a wash. The cost of being in the market just before a crash are at least as great as being out of the market just before a big jump and may be greater. Funny how the finance industry doesn't bother to tell you that."*

Also, there are some junctures when it is painfully obvious, even at the time, that the market is too high. You may get out too early, but there are still times when you want to take cover and will be glad you did. As Arends concluded:

> *"Can't time the market? It was clear as a bell that investors should have gotten out of stocks in 1929, in the mid-1960s, and 10 years ago. Anyone who followed the numbers would have avoided the disaster of the 1929 crash, the 1970s or the past lost decade on Wall Street. Why didn't more people do so? Doubtless, they all had their reasons. But I wonder how many stayed fully invested because their brokers told them 'You can't time the market.'"*

This is powerful stuff, but there are strong arguments against it. Four years ago, the stock market historians Elroy Dimson, Paul Marsh and Mike Staunton looked at how strategies of market timing based on the ongoing trend in the market would have worked, at the time. In retrospect, a trend is clear and so a deviation from it is also clear, but at the time it is not so clear.



In 2000, average returns had been so inflated by the bubble that was then afoot that a policy of tracking deviations from the long-term mean might actually have found it to be a time to buy.

I summarised their research in the Long View as follows:

> *The academics tested a strategy that sold stocks and went into cash every time price-to-dividend multiples went clearly above their historic mean at the time, and re-entered when they had become cheap. Despite expectation, in all of the 20 countries they studied, this strategy fared worse than simply buying and holding stocks. In Austria, Italy and Japan, it inflicted outright losses. There is simply too strong a tendency for market timers to miss out on periods of recovery.*

So the potential returns from market timing are enormous but it is very difficult (maybe not impossible, but very difficult) to do.

That brings us to the latest entrant into the date. The consumer research group Dalbar regularly publishes surveys showing how much investors actually make from investing in mutual funds (which have provoked some serious methodological arguments, as you will see from the comments on the piece just linked). This invariably finds that they fare far worse than the advertised returns of the mutual funds themselves, because most money tends to go in at the top, and come out at the bottom. Retail investors, and also institutions tend in aggregate to be bad market timers.

Their latest research compares results for active and passive funds. Passive funds, as all readers should be aware, tend to beat active funds in the long term, largely because they have far lower costs. But Dalbar finds that the curse of bad timing by ultimate holders of the funds afflicts passive funds far worse than active funds, to the point where investors in active funds achieve better results over the long term. This table shows the key results:

Period Ending 12/31/2016	Annualized Investor Returns		Active Advantage
	Actively Managed	Passive Funds	
15 Year	4.04%	2.85%	1.19
10 Year	4.37%	4.37%	0.0
5 Year	8.51%	8.12%	0.39
3 Year	3.66%	5.40%	(1.74)
1 Year	6.73%	9.38%	(2.65)

The 15-year number is startling indeed, while the shorter-term numbers show how well passive funds have profited from the post-election rally. For context, the annualised return on the S&P 500 over 15 years would have been 4.98 per cent. This would have been achievable, minus some very small charges, by investing in an S&P 500 tracker fund and holding it, without an attempt at market timing.

So holders of passive funds have, in aggregate, proved to be terrible market timers. Also, they have been far worse market timers than holders of active funds. Why?

Dalbar offers a number of reasons. I disagree with several of them. This point, however, strikes me as critical:

> *Because Passive Investments typically track major stock market indices, news reports of Passive Investments are inescapable. Investors are inundated with the activity of popular indices every second on television or Internet based services, every day in news casts and when news magazines are published. This barrage of information eventually will include a nugget or pattern that creates concern for one investor or another. With no filter other than to fill a news cycle, there is little context for careful evaluation. Instead we see imprudent investing in response to excessive exuberance in the news and untimely cashing out when claims of catastrophes are made. These activities often result in buying at market highs and selling at low points. The effect of this excessive exposure is a significant loss of return for the average investor.*

Authers' Note

ETFs, in particular, are set up to be very easy to trade into and out of. You can get in and out of a given asset class in the course of a day. Switching is easy, and investors are very conscious of how well they are doing. They are thus far more likely to succumb to the temptation to sell at the bottom and buy at the top than other investors. The classic advice of Vanguard adviser Jack Bogle might be to buy a broad market index and hold it through thick and thin, but it would appear that many investors do not follow this advice. And in aggregate, human nature appears to make us more prone to miss out on the big rises than to miss out on the big falls.

I would add a further reason for concern, about how passive investments are being sold. It is now very common for investment advisers, who these days receive a fee rather than a commission, to offer an asset allocation service. Armed with ETFs, they will time the market for you. I suspect — and this needs more research — that many of them try to justify their fee by moving their clients around more than they need to.

A model that keeps a reasonably fixed asset allocation and rebalances regularly makes a lot of sense. This is the default option that should be offered to most investors. And as I have written in the past, citing research by Mebane Faber, the discipline of rebalancing in itself matters far more than the precise choice of assets (I do recommend chasing this link — it was fascinating research). This is exactly the kind of model, incidentally, that can be offered by the new trend for "robo-advisers".

The critical insight from the Dalbar research, as I see it, is that the selling of passive investments has to be improved to help clients counter their natural tendency to sell at the bottom. Sensible asset allocation packages would do this. And for all but the most knowledgeable and competent, attempts at market-timing should not go much beyond the tendency to sell at the top and buy at the bottom that comes with regular rebalancing.

More market timing

OK, here is a current example of difficulties with market timing. The US market is plainly expensive, and is now enjoying a startling winning streak. The Dow has been up 10 days in a row, the most since the record in early 1987.

The phrase "early 1987" should strike fear into anyone who remembers the Black Monday crash of October that year. The market did not look wildly expensive by historical standards, but the speed with which it gained before peaking and then crashing always looked hard to justify. Should we take such excitement and animal spirits — based largely on the slender reed of some sketchy tax plans of which we still know very little in detail — as a reason to get out of the US stock market?

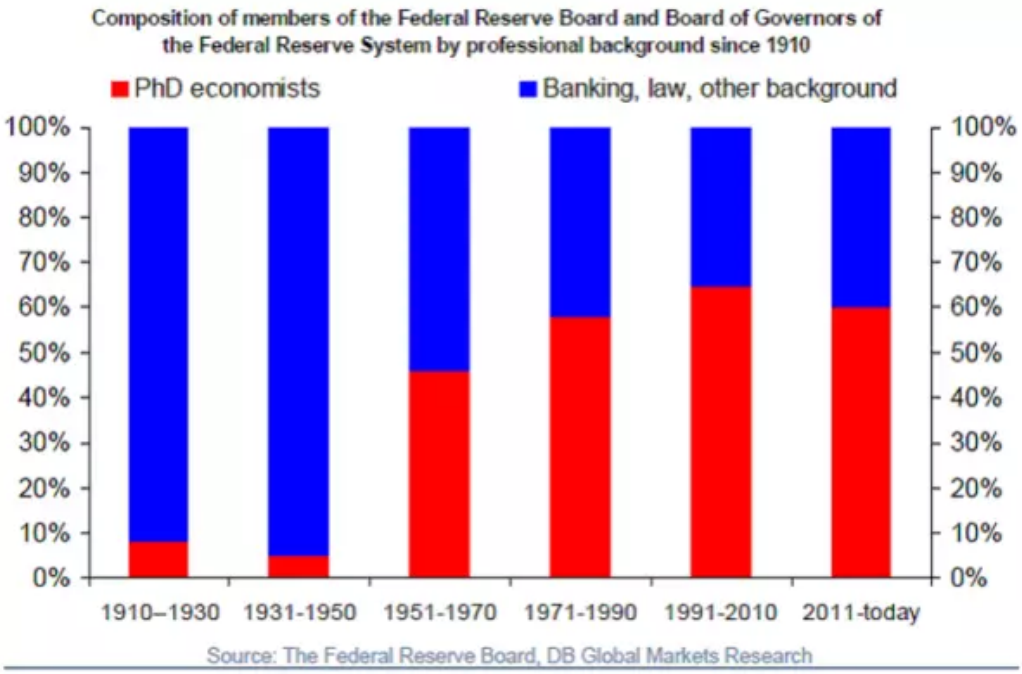
As one follower on Twitter handily pointed out, selling as the Dow's record streak ended would have involved selling seven months too soon, and missing out on the last glorious upsurge, as investors went wild:

Market timing can make you a lot of money, but you have to be careful. That is particularly the case when, as for a US investor, there is a paucity of other investments that look cheap. Getting out of the market altogether would carry its own risks, but caution and diversification should be the order of the day.

Doctors of Doom

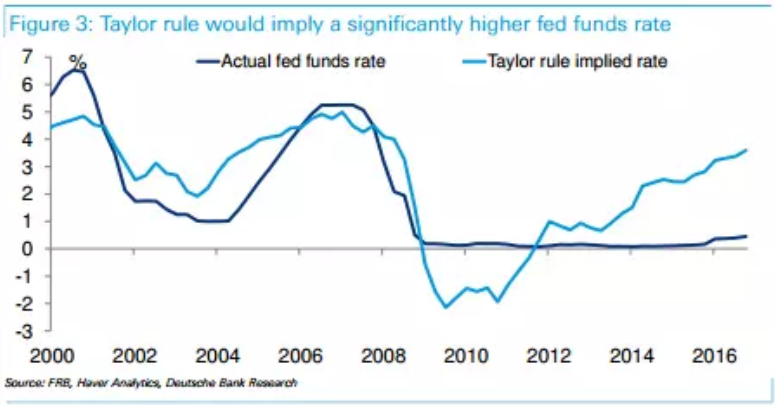
Economists get a bad press. So, in general do academics and indeed all experts. So is it true that economic experts have ruined the economy?

Deutsche's economist Torsten Slok took a look. This is the changing composition of the Federal Reserve's board over time:

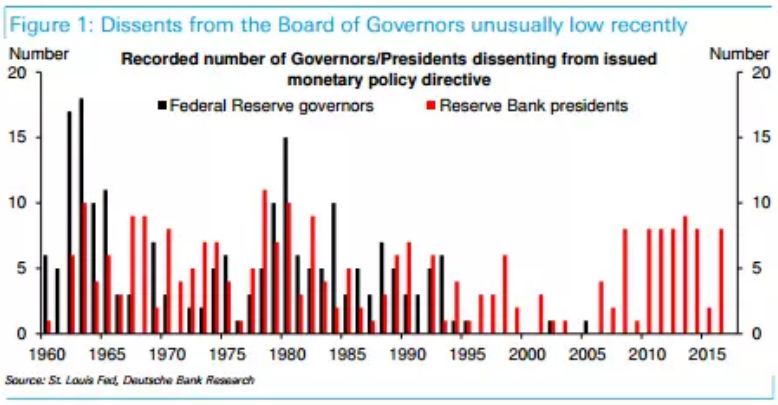


So the period in which we now know the Fed made some disastrous errors, in the 1920s and 1930s, was steered by a group of defiant non-economists. The era of the Greenspan Put (note: Alan Greenspan does not have a doctorate in economics) and then the Bernanke Put (Ben Bernanke, by contrast, was a hugely successful academic economist) saw the Fed largely run by academically trained economists.

This matters because President Trump has three vacancies he can fill forthwith, while chair Janet Yellen's term expires next year. He can remould the Fed's leadership in very short order, and we all know that he is sceptical of establishment experts. This issue is still low on the agenda for the time being, but it will bubble up soon enough. If the administration appoints people to the Fed who do not have the confidence of the market, that could be dangerous. And if they go through with appointing more conservative academic economists, who tend to be more hawkish and think rates should be higher than they are, that could also be a big deal. This is what rates would have done if the Fed had followed the "Taylor Rule", named for the academic economist John Taylor who is often discussed as a potential Fed chairman. Such a policy would not have gone down well with the Trump administration:



Also, the market has become accustomed to a unified Fed which speaks with one voice. There are very few dissents these days, which is a far cry from the days of Paul Volcker:



This issue will grow and grow, alongside the critical debate that is still only starting on taxes. And it would probably be helpful, despite all the negative publicity around academics, if the Fed keeps a few PhDs around.

(Full disclosure: I do not have a doctorate in economics. I do however have a degree in PPE, and as this fascinating piece in The Guardian explores, that is not necessarily something to be proud about.)

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