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The Market Timing Myth

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For years, the investment industry has tried to scare clients into staying fully invested in the stock market at all times, no matter how high stocks go or what's going on in the economy. "You can't time the market," they warn. "Studies show that market timing doesn't work."

They'll cite studies showing that over the long-term investors made most of their money from just a handful of big one-day gains. In other words, if you miss those days, you'll earn bupkis. And as no one can predict when those few, big jumps are going to occur, it's best to stay fully invested at all times. So just give them your money... lie back, and think of the efficient market hypothesis. You'll hear this in broker's offices everywhere. And it sounds very compelling.

There's just one problem. It's hooey.

They're leaving out more than half the story.

And what they're not telling you makes a real difference to whether you should invest, when and how.

The best long-term study relating to this topic was conducted a few years ago by Javier Estrada, a finance professor at the IESE Business School at the University of Navarra in Spain. To find out how important those few "big days" are, he looked at nearly a century's worth of day-to-day moves on Wall Street and 14 other stock markets around the world, from England to Japan to Australia.

Yes, he found that if you missed the 10 best days you missed out on a lot of the gains. But he also found that if you managed to be out of the market on the 10 worst days, your profits went through the roof.

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.

What does this mean for you, the investor?

First, let's be clear what it doesn't mean. It still doesn't mean you should try to "time" the market day to day. Mr. Estrada's conclusion is that a small number of big days, in both directions, account for most of the stock market's price performance. Trying to catch the 10 biggest jumps, or avoid the 10 big tumbles, is almost certainly a fool's errand. Hardly anyone can do this sort of thing successfully. Even most professionals can't.

But, second, it does mean you that you shouldn't let scare stories dominate your approach to investing. Don't let yourself be bullied. Least of all by someone who isn't telling you the full story.

Third, it offers yet another argument in favor of investing for dividends, not simply for capital gains. Most of these "market timing" studies, including Mr. Estrada's, focus purely on stock market price movements. They ignore dividends. (The reason is technical. Reliable total return data is hard to find once you go back more than a few decades. And calculating the interaction between daily price movements and reinvested dividends is a heroic undertaking.)

But the omission of dividends matters for shareholders. That's because dividends are likely to make up a significant bulk of your long-term returns. And you know when your dividends are coming. You don't have to guess on which days, if any, AT&T or Johnson & Johnson will send out checks.

Over long periods, a strategy focused on good dividend-paying stocks has usually proven successful. You don't know what the stock market is going to do in a week on Thursday, but this way you don't really care either.

Fourth, even if there is little point trying to catch twist and turn of the market, that doesn't mean you simply have to be passive and let it wash all over you. It may not be possible to "time" the market, but it is possible to reach intelligent conclusions about whether the market offers good value for investors.

Consider the data from Professor Robert Shiller at Yale University. He tracks something known as the "Cyclically-Adjusted Price-to-Earnings Ratio." (These days it is also known as "the Shiller PE"). This compares stock prices with after-tax company earnings, but only after adjusting those earnings to take account of the fluctuations of the economic cycle. This helps avoid the distortions commonly found when you compare stock prices to a single year's earnings.

At the peak of a boom, earnings are artificially inflated, while at the trough they are artificially depressed. The Shiller PE smooths that out.

You can see the chart here. 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."

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