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Risk Management

How Right Do You Have to Be?

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How right do you have to be to avoid losing money during an equity market downturn and obtain a net after-tax return superior to the return you would have earned if you had simply held your portfolio through the market turmoil trusting that the market will eventually recover?

The answer is that you would have to make *two correct market timing decisions in a row* – one correct decision to sell just before the market drops, and another correct decision to buy just before the market begins to recover. So far as we know, no one has ever been able to do that consistently. Furthermore, if you hold equity positions with deferred capital gains, you must pay tax on those gains upfront when you sell. This substantially increases the risks associated with market timing because you have to pay tax costs as the entry fee to the market timing game.

There have been many studies of market timing. A few of those studies are listed in the notes at the end of this article, if you wish to read them. The studies conclude that, to be successful, a market timer must achieve a minimum of 70% accuracy, and possibly as high as 91%, in predicting market moves.

Another set of studies has examined the level of accuracy actually achieved by “market gurus.” Not a single guru achieved 70% accuracy. Most were far below that level. Still another set of studies has examined the performance of investment predictions in market timing newsletters. One study tracked 15,000 predictions made by 237 market-timing newsletters from June 1980 to December 1992. By the end of the period, 94.5% of the timing newsletters had gone out of business with an average life span of just four years. “There is no evidence that newsletters can time the market,” the study concluded. “Consistent with mutual fund studies, ‘winners’ rarely win again and ‘losers’ often lose again.”

For private investors, it is important to note that all of the above studies ignored the impact of taxes. When taxes are taken into account, any attempt to time the market becomes a losing game because of the tax costs that investors must incur as the entry fee to the game.

Why does market timing fail?

Almost all big stock market gains and drops are concentrated in just a few trading days each year. Missing only a few days can have a dramatic impact

on returns. The following chart illustrates how an investor who hypothetically remained invested in the S&P 500 Index throughout the 20-year period from 1998 to 2017 (5,036 trading days) would have earned a sizable 7.20% annualized return, growing a $10,000 investment to $40,135. When the five best -performing days in that time period were missed, the annualized return shrank to 5.02%, with $10,000 growing to $26,625, which is a gain of only $16,625, and if an investor missed the 20 days with the largest gains, the returns were cut down to just 1.15%. If the 40 best-performing days were missed, an investment in the S&P 500 turned negative, with $10,000 eroding in value to just $5,670, a loss of $4,330.

Of course, market timers want to miss the worst-performing days *without* missing the best days. The predicament, however, is that some of the best days tend to *immediately* follow some of the worst days. Because investors who engage in market timing tend to be loss-averse, it seems highly unlikely that such an investor would jump back into the market immediately after a sharp loss occurs. Therefore, that investor is likely to miss out on many of the days with large gains.

The Problem With Market Timing: Missing The Best Days

20 Years (1/1/1998 - 12/31/2017)

$10,000 Invested in the S&P 500 Index	S&P 500 Annualized Return	Value of $10,000 at the End of the Period	Gain/ Loss	Impact of Missing Days
All 5,036 trading days	7.20%	$40,135	$30,135	--
Less the 5 days with the biggest gains	5.02%	$26,625	$16,625	-45%
Less the 10 days with the biggest gains	3.53%	$20,030	$10,030	-67%
Less the 20 days with the biggest gains	1.15%	$12,570	$2,570	-91%
Less the 40 days with the biggest gains	-2.80%	$5,670	-$4,330	-114%

Source: Yahoo! Finance

What does work?

Investors have been well served by rebalancing their portfolios using dollar cost averaging to buy into equities in response to a market correction. This requires discipline and courage. This approach turns an unfavorable event (i.e. a market correction) into a buying opportunity that enhances returns for long-term investors. The closer you can come to identifying the market bottom the better, but an investor can still derive substantial benefits from rebalancing in response to a downturn using dollar cost averaging. In a subsequent article we will explore this idea in more detail.

About Roy C. Ballentine, ChFC, CFP®

Roy is the Executive Chairman and Founder of the firm. Roy dedicates his time to thought leadership, strategic oversight of client engagements, and coaching and training our team members.

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