Is it possible to time the market?

The odds aren't good

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At its core, *timing the market* is the attempt to forecast the future direction of a security and/or market segment before it occurs. This is done because the market timer believes he has the additional information necessary to detect inefficiencies that the marketplace as a whole does not yet perceive. The portfolio of the market timer will generally generate of a high level of transactions which tend to cause additional fees and tax inefficiencies. Professional market timers also tend to charge their clients very high management fees. Taken together, for the exercise of market timing to be profitable, the market timer must consistently create enough additional return to exceed the associated additional costs. In the investment world, this additional performance that market timing hopes to bring is called "*alpha*".

The market timer faces considerable headwinds, however. There are tens of thousands of professional financial analysts around the world who each rely on the same exact information to determine the "true" value of an investment. When an investment trades hands, one of the parties expects the price will go up while the other expects it will go down. Obviously, one of them is incorrect. Mathematically, one half of investment managers will beat the market in any one year, while the other half will not. Unfortunately there is no place in the investment world like *Lake Wobegon* where the children are all above average. It is simply not possible.

Due to management fees, transaction costs, and tax inefficiencies, being above average isn't enough to beat average market returns. A market timer must create enough additional performance to cover the additional fees before he breaks even with market returns. Performance data consistently shows 60% of market timers in any one year fail to create enough additional performance to cover the cost of associated with their management style.

What's worse is that market timers need to be consistently good. Many studies have been undertaken to discover exactly how consistent these market timers need to be at predicting the future, but all come to the same basic ballpark figure of 66%. So if a market timer is not correct at least 66% of the time, effort and money have been wasted.

What percent of market timers have consistently predicted the future more than 66% of the time? Again, many studies have come to the same ballpark conclusion. In the long run only 1 in 5 market timers are able to consistently predict the future more than 66% of the time. The question then becomes whether we can identify these select few successful market timers.

Many studies have shown that past performance is not a good indicator of future results. Due to the sheer number of market participants, some are likely to get lucky in the short run, but this luck won't last. We can then examine the market timer's process, but if the process is a good one not only do we not have any guarantee the

process won't change in the future, but other market participants would likely adopt the process thereby making it no longer profitable.

If we do decide upon a market timer to manage our investments, even successful market timers have bad years. How will we determine beforehand that the long term results of the market timer will be successful while currently mired in a few bad years? Only time will tell, but can we afford to stick with a market timer who will in the end be unsuccessful?

The likelihood of successfully wading through all this noise to pick a truly successful market timer is extremely slight.

Studies have consistently shown that timing the market by simply using a random decision making process yields a pool of successful market timers equaling approximately 1 in 5 of the population. As it turns out this figure looks suspiciously like the 1 in 5 of above average market timers that exist in the real world. This is not to say there are not truly great market timers, but we must realize that a large part of them are likely so through chance alone.

I have been involved with financial planning and investing for 15 years. I have been part of groups having some of the finest investment professionals in the world. These folks are absolutely brilliant, but I can tell you they are not good at consistently timing the market. This is because the global community of these brilliant professionals is competing against one another in search for the elusive alpha. The resulting effect is known as the *Efficient Market Hypothesis* or "EPH".

EPH doesn't state that markets are always priced correctly; it simply states that all available information has been taken into account by market participants and as new information becomes available, that too will be immediately reflected in price. Evidence of EPH's validity can be found in the fact only 1 in 5 of market timers beat the market in the long run. These are simply not good odds.

An alternative to market timing would be to simply purchase the entire market utilizing a low-cost index fund, but it is often asked whether doing so would in itself create market inefficiencies. The answer is no. If inefficiencies were to be created by the introduction and growth of index funds, this inefficiency would immediately evaporate due to the return of more active market timers. The potential issue of market inefficiency is self-correcting.

If EPH is correct, then why do approximately 80% of mutual funds consist of market timers? As humans we tend to believe we can do better than average. We also tend to look for patterns and relationships even when they don't exist. There is also big money at stake. Brokers receive fees totaling 2-5% per year on client accounts. Advertising and television (think CNBC) are paid handsomely to constantly bombard us with information that feeds into our innate tendencies of fear and excitement.

Even when faced with substantial data showing 80% of market timers fail to provide market returns, many continue to believe they can pick the top 20% beforehand. This is not unlike gamblers who know their odds of winning are slim, but they are captivated by the chance.

What about the successful managers the media parades before us each year? By realizing there are tens of thousands of analysts making different decisions throughout the year we come to realize that statistically some of them necessarily will perform exceptionally well. We are simply only shown the winners. To entice gamblers, casinos also often parade their winners by displaying banners. Not only would it be detrimental for casinos to also display banners of the losers, but I doubt any casino has adequate wall space!

Managing your portfolio should not resemble gambling. The "game" of investing is better won by not losing. The stakes are simply too high.

Are we losing control by purchasing low-cost index funds? Absolutely not! By realizing very few market timers can beat the market over the long term we are actually moving toward the discovery of things we do have control over. Indexing actually allows *more* control, not less.

Indexing allows frees us from the naïve notion we will be able to pick among the top 10% of market timers before the performance occurs. Indexers know they will beat 90% of market participants in the long run by taking control of those things they know they can control and letting go of those they can't.

What do we *know* we can control? We can control:

- Fees & other expenses
- Asset allocation targets
- Assumed asset classes to improve a portfolio's risk/return profile
- Investment vehicles utilized to fulfill assumed asset classes
- Rebalancing strategies
- Strategies to minimize taxes
- Our knowledge of history
- Our own actions

Of all of these things we can control the last is probably the toughest since decisions are often based on emotion. A proper program that is understood and agreed upon by both client and advisor greatly helps to overcome this issue. This generally takes much time and effort, though. Many years of bombardment by investment professionals, advertising, and the media have taken its toll on most of us. Developing an understanding that is contrary and perhaps counterintuitive doesn't happen overnight. I have posted several recommended books on my website www.commencefp.com. I am in no way affiliated with the authors or publishers, but I highly recommend these books. They are based on prudent practices, grounded in history, and will substantiate and begin to solidify all I am telling you here.

Once you understand there is a better way, the next step is to understand how the process actually works. This will be the subject of a later discussion.