Why Market Timing Does Work, and Why it Works So Well

What is Market Timing?

Market Timing is the discipline of buying and selling stocks, bonds, or funds periodically so that investors can be invested when the market is doing well, and safely out of the market when it isn't. There are many mutual funds that prohibit this frequent trading of their shares because in some cases it can dilute a portfolio's holdings, but there are many mutual funds that are designed specifically for such trading. In those funds, Market Timing can outperform other investors, and the market. We hope that this informational piece can help explain that in clear and unambiguous terms.

In the past year, you may have heard Market Timing depicted in a less-than-flattering light. If you've heard of it in the media over the past year, most of what you have heard may not have been very inspiring, nor accurate. Much of the recent news regarding Market Timing has been about such despicable companies such as Canary Capital Partners, who illegally bought and sold mutual funds in a manner that was prohibited in the mutual fund's prospectus. They and the fund managers also committed the crime of late-trading, meaning that they made trades after the market closed. Often misrepresented or misunderstood by the mainstream media, neither of these criminal activities is Market Timing.

Why use Market Timing?

The evidence of Market Timing's success is irrefutable. It is a discipline that has a place in *every* risk-averse investor's arsenal of investment tactics. The bold statement that "Market Timing Works" is deemed heresy to the curmudgeonly financial establishment, and it is important for every single investor to know why they feel that way and when it is important to ignore such an emotional bias.

There are those in the investment business who would claim that it is not only impossible to time the market, but that you shouldn't even try. Notably, many of these nay-sayers are those very same individuals and corporations who have a vested interest in repeatedly collecting fees from investors like yourself over a long period of time with a minimum of effort – a great job if you can get it.

Of course, the simplest explanation of the anti-Market Timers is that they may just want to discourage their own clients from firing them after losing their money.

What we have found most interesting is that these very same people make timing decisions regarding individual stocks, (which are what the market is made up of) using the same basic, and successful, timing principles. Interesting indeed.

The Arguments Against Market Timing

A few primary arguments against Market Timing usually revolve around either the abysmal performance of so many Market Timing newsletters, or upon the one-sided observation that, "If you miss the five biggest up days of the year, your returns will be significantly less than the market's." Further bolstering the aggressive anti-market timers' argument is the fact that taxes and commissions eat into returns, and since the market timer would have to pay more in taxes and commissions, his returns will be inferior to the buy and hold investor.

Argument #1: "Taxes and commissions make Market Timing fail."

These arguments are not completely without merit, but they certainly don't tell the whole story. One of the best ways to get people to believe one side of a story is to omit, or distort, the other side. To allow those in the investment industry to continue to distort the efficacy of Market Timing would be a grave disservice. So let's get started, one by one.

The Market Timing Arguments Debunked:

Argument #1: "Taxes and commissions make Market Timing fail."

Of course taxes take a bite out of returns, they take a bite out of your income, too. But in this case, what is being referred to is in relation to the tax differences between short term and long term capital gains. This can also interfere with the most powerful component of investing, which is compounding.

The long-term capital gains tax rate is either 5% or 15% (depending upon your individual tax rate), and short-term gains such as those garnered by Market Timing, are taxed as ordinary income and thus a much higher rate. Therefore, your compounded rate of return would be negatively affected by paying increased taxes, as well as paying taxes sooner than if the returns were long-term capital gains.

At first glance, the point seems to be a good one, until you step back and look at the reality for your average investor.

First, most investors nowadays have money in pensions and/or Individual Retirement Accounts (IRAs). These IRAs are tax free shells where gains are not taxed until the assets are withdrawn from the account. This means that those investors who would implement a Market Timing strategy in their IRAs would have zero, zilch, nada tax consequences, because gains in an IRA are not taxable.

Secondly, it is no surprise that many, if not most investors, regularly invest in the stock market through the use of mutual funds. A mutual fund is a very cost efficient investment tool run by a fund manager that allows individual investors to buy into an entire portfolio of specific securities so that by investing in a mutual fund, you can actually purchase stocks with much lower trading costs and greater diversification than if you tried to do it on your own.

So what about short-term capital gains using Market Timing versus buy-and-hold strategies in Mutual Funds? It may surprise you to know that since most mutual funds have considerable asset turnover, i.e. buying and selling of securities within the fund in an attempt to increase performance, you will still end up paying taxes on the short-term buying and selling of those securities.

Worse, when the fund manager sells securities within the fund for a short-term profit, you will have to pay the appropriate taxes on any profits made by that sale at a higher tax rate. Regardless of whether or not you are actually making a profit in the mutual fund as a whole, fund turn-over is likely to create tax obligation on those "gains".

Commissions and transaction expense used to be the big killer for market timers. It was the one expense that interfered with timing decisions and ate away at returns. Today, commissions are much less, in some cases pennies per share. Between aggressive competition between discount brokers and improved liquidity and tighter bid-ask differentials, the burden of commissions and transaction expense is small enough to be easily offset by a Market Timing strategy that adds even a small amount of value.

Argument #2: "Missing the five (or some other such number) biggest up days of the year makes Market Timing fail."

The anti-Market Timing crew trots this old saw with some regularity. The studies vary from 30-50 years and the missed periods vary from 3 days to 48 months, and the result is always the same—dismal results for Market Timing.

The problem is that they are

Argument #2: "Missing the five best up days of the year makes Market Timing fail."

assuming that market timers are always going to miss those biggest up days. Why is that? Right from the start the "cherry picking" of the data is simply misleading. So, let's take this claim a bit further.

If it's OK to assume that market timers are always going to miss the 5 biggest up days (or in some cases months) then why can't we assume that market timers are also going to always miss the 5 biggest <u>down</u> days/ months? If a market timer stays out of the market on just the five worst days of the year, (which, in reality is exactly what most market timers are trying to do) the results dramatically exceed those of a Buy and Hold approach.

How much better? According to a study by Laszlo Birinyi Jr.*, over the past 36 years, by implementing a Market Timing strategy and missing the five worst days beat a Buy and Hold approach by a factor of roughly 91. That's 9100% better than a Buy and Hold approach. And no, that's not a typo, it's says nine thousand, one hundred percent better than a buy-and–hold strategy.

The fact is that it's no more realistic to assume that a market timer is going to miss the five worst down days of every year than to assume that he's going to miss the five best up days, but it does prove that rather than being stacked against the timer, the odds show that missing a few key days each year is more likely to add to net returns rather than subtract from them.

Similarly, another study entitled "Stock Market Extremes and Portfolio Performance" by H. Nejat Seyhun, Ph.D., pointed out that missing the best 48 months from 1926 thru 1993 would have dropped an investor's average annual return to 2.83%. On the other hand, missing the worst 48 months increased one's average annual return to 23.0%. Ignoring for a moment why a market timer might somehow miss entire months, it would seem that missing the best months only costs about 9% while missing the worst months adds 11%.

Again, the proof shows that Market Timing is no more likely to cost returns than to add returns and decrease risk.

Argument #3: "Market Timing newsletters never beat the market over time"

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This last argument is often used by anti-market timers based upon Mark Hulbert's study of fund timers in 1997, which showed that over a 10 year period (mind you a very powerful Bull Market), none of the market timers that his paid service tracked, had beat the market.

There's not much use in debating the accuracy of Mr. Hulbert's study, since such would amount to hair splitting. Conceding perhaps a few errors, it still important to note the importance of context. It is to be expected that market timers will likely under-perform the market during very strong Bull markets. This appears to be a relatively consistent occurrence and likely relates to the fact that market timers are either out of the market or short enough of the time to negatively impact returns relative to passive index investments. So, it's no real surprise that a study of timing newsletters shows under-performance during the most dramatic Bull market since the 1920's.

How Market Timing newsletters perform over a longer period of time is a very different matter, however. Vicente Pons and Alok Kumar published a study in 2002 which showed that a significant number of Market Timing newsletters added value over a 21 year period. Their study showed that many timing newsletters showed persistency in their out-performance of the market, and more importantly, on a risk-adjusted basis. Between 20.1% and 39.8% of Market Timing newsletters beat a buy-and-hold approach. This too is to be expected, as one of the main goals of Market Timing is to reduce risk. This benefits investors most when the stock market is suffering losses, and over any 21 year period we might expect any number of difficult periods that could be actively avoided.

As interesting as this may be, the argument itself does miss a key point, which is: writing a Market Timing newsletter is somewhat different from managing a Market Timing portfolio.

Unlike managing money, where performance and risk control are key to financial success, the newsletter business is one in which publicity and marketing are crucial keys to financial success. This is not to say that newsletter writers do not want good performance, but they are also under considerable pressure to make dramatic calls of "THE TOP" prior to the next major decline (and "THE LOW" prior to the next big Bull move). The problem lies in that it is extremely difficult to pick exact market tops or bottoms.

Newsletter writers who successfully make a raucous top or bottom call will be able to grace the pages of the financial press and get more than a few television and radio interviews. All of this successful free marketing can translate into more newsletter sales and the growth of the newsletter's business. This alone can account for a considerable amount of underperformance by newsletters.

A Better Measurement Tool

Rather than focus on taxes, commissions, missing the best or worst days in a market, or newsletter writers, a truly better measure would be the returns of actual market timers, like Paul Tudor Jones, who started with 300K, and now runs a $6 billion Market Timing fund and to date has still not had a down year. Using Market Timing strategies, he has even had triple digit returns during bear markets.

In 2002, Pu Shen of the Federal Reserve Bank in Kansas City published a 30 year study of several Market Timing strategies. The results of this study showed many strategies significantly outperformed the market, while incurring much less risk than passive investing.

In 2001, Don Chance and Michael Hemler published a rather voluminous in-depth study of 30+ market timers. These results showed evidence of significant Market Timing ability across all tests and all portfolios, irrespective of transaction expenses.

Yes, You Can Time the Market

So, now that we've shown that the anti-market timers are blowing at least a little bit of smoke, how does one go about timing the market? We list just a few for starters:

Ben Stein and Phil DeMuth describe some rather basic and straightforward techniques for timing the market in their book, Yes, You Can Time the Market! (John Wiley & Sons, 2003), such as buying a stock when they are cheap on a price/book value basis, looking to stocks with high dividend yields, and when a stock is priced well below its long-term moving average. In their book they also demonstrate with over 100 years worth of data that using such simple, logical techniques, an investor can expect to dramatically outperform a passive Buy-and-Hold approach by 3.9% per year.

The key factor that to note is that a longer-term perspective is required to generate significant value added returns using their approach. Their research suggested that it becomes ever more difficult to add value as one's time-frame becomes shorter.

Another method one can employ to take a very simple, yet effective approach to Market Timing is utilizing the "Best Six Months" strategy outlined by Yale and Jeffery Hirsch, publishers of the Stock Traders Almanac. This method entails buying on November 1st and selling on April 30th of each year. That's it. Not including the 26+ years of interest received, over the past 53 years, one would have beaten the market with less than half the volatility. When interest is added in the return beats that of the market by at least 2% per annum (depending upon commissions paid and interest bearing instruments used).
Sy Harding (publisher of the Street Smart Report) discovered that if an investor wanted to work just a little bit harder and improve dramatically upon

the Hirsch approach all you needed was to add a technical filter. In this case, the filter would be a "Moving Average Convergence Divergence" (MACD) indicator, which would allow an investor to enter the market earlier if the market was in an up trend, or hold onto the position up to a month longer when an up trend persisted. Conversely, one could also enter the market a month later if the market was in a down trend and exit as much a month earlier. Over the past 53 years, investing using this technique would have turned $10,000 into $1,308,314 and would have avoided the 70%+ losses incurred during the negative part of the cycle.

Professionally, we use a technique similar to Sy Harding's, except that we use the primary market trend to provide a context for investing. Additionally we use a broader spectrum of technical indicators in order to provide somewhat more consistent returns and to further decrease risk. Since we began investing this way in 2000, our returns have dramatically exceeded those of the market by roughly 49 percentage points, while our portfolio volatility (risk) has been roughly 1/3 of that of the market.

So, what now?

Before you go out and start timing the market, there are some very important caveats that you must understand. After all, a lack of accuracy is not the only reason why Hulbert's database might have so many poor performers.

Market Timing is not easy, or as easy as some would make it seem. Market Timing is no panacea, either. If you think you are going to have nothing but gains, think again. Market Timing requires a disciplined approach, just like any other successful method of investing. Remember, the best results were from longer-term approaches. The shorter the timeframe, the more competition there will be and the harder it will be to even match the market's returns. Reduction of risk, however, is easier to accomplish on shorter-term time frames.

Following are some of the most important things to remember:

- Decide what you want to accomplish and determine if such is realistic. Reducing risk is very realistic. Reducing risk while making 50% per annum returns is not realistic for most investors.
- Develop a discipline that is consistent with your goals and personality. You have to be able to stick to a discipline in good times and bad.
- Avoid picking tops. Tops are slow to build and it's always best to give a Bull Market the benefit of the doubt.
- Learn to identify Bull and Bear markets. Declines in a Bull market should be bought. Declines in a Bear market should be sold.
- Be quick to buy when stocks are cheap and pessimism is high, and develop or find tools to help you determine when stocks represent value and when sentiment is excessively negative.
- Be slow to short regardless of how expensive stocks are or how high optimism is. Be fast to cover shorts. When in doubt cover a winning short.
- When in doubt, let long profits run.
- Do not try to catch every market wiggle. Stick with well-defined trends and sound investment principles.

Remember at all times that the market is full of very smart people who are better at trading than you are. Do not compete with them on their terms.

Stick with longer time horizons than they are interested in, and you may succeed in not only timing the market, but earning fantastic profits by doing exactly what the financial curmudgeons on Wall Street do, but want you to believe is impossible.

Credit and Research in Successful Market Timing

All claims presented here can, and should be verified by the reader if only to validate the accuracy and reliability of the information contained within this Market Timing informational brochure.

Please take the time to discover for yourself the following sources of information for more insight into the facts of successful and profitable Market Timing based upon empirical research, historical facts, and actual performance of Market Timing strategies in actual asset management.

Articles, studies, and publications:

Don Chance and Michael Hemler, 2001, "The Performance of Professional Market Timers: Daily Evidence from Executed Strategies," *Journal of Financial Economics,* 62(2), pp. 377–411

Alok Kumar and Vicente Pons, 2003, “Behavior and Performance of Investment Newsletter Analysts” published by the Department of Economics, Uris Hall, Cornell University.

H. Nejat Seyhun, 1994, “Stock Market Extremes and Portfolio Performance” A study commissioned by Townley Capital Management.

Pu Shen, "Market-Timing Strategies That Worked" (May 2002). FRB of Kansas City Research Working Paper No. 02-01.

Ben Stein and Phil DeMuth, <u>Yes, You Can Time the Market!</u>, published by John Wiley & Sons, 2003

Websites:

The IRS website regarding Individual Retirement Arrangements (IRA’s): http://www.irs.gov/publications/p590/

The SEC’s Introduction to Mutual Funds: http://www.sec.gov/investor/pubs/inwsmf.htm

Contacting Equity Guardian Group

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Equity Guardian Group
Registered Investment Advisory
630 Sanford St., Ste. #3
Covington, KY 41011 U.S.A.
Tel 800.769.6980

Mark Young, President
Equity Guardian Group

For more information, please visit www.EquityGuardian.com