Is It Time Yet?

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Central Issue of the Paper

Asset allocation decisions, particularly those involving market timing, create both opportunities and pitfalls for investors. In the aftermath of the crash of October 1987, many investors sought protection of capital through market timing or tactical asset allocation strategies. Since then, the popularity of tactical asset allocation has increased both for professional investment managers and individual investors alike.

In "Market Timing: Opportunities and Risk," Wim Antoons explores opportunities for enhancing returns using tactical asset allocation and market timing, as well as the challenges posed by market timing, including higher costs and the risk of missing the best-performing days of the market. He examines whether investors can succeed using tactical asset allocation and market timing strategies and looks to behavioral finance concepts to explain why investors continue to embrace market timing in their investment process.

Approach Employed by Paper

While the lure of market timing strategies may be powerful, accurate market timing poses significant challenges. Poor investment decisions can result in excessive trading and opportunity costs. Additionally, over the long term, the U.S. equity market, as measured by the S&P 500 Index, has consistently shown an upward trend; much debate exists over the impact of missing the best parts of a bull market or remaining invested during the worst parts of a bear market. Using monthly data for the S&P 500 Index reveals that a disproportionate percentage of total bull market gains occurred at the beginning of a market recovery. In fact, the average gain during the first three months after a market downturn was 21.4%. Here, a market downturn is defined as a drop of 20% or more. The author believes most market timers tend to be concentrated in cash during the first three months just after a crash—so, market timers typically have missed most of a recovery's upside.

Believers in market timing argue that returns can be increased dramatically by avoiding the worst days in the stock market. On the flip side, non-believers argue that missing the best days in the stock market decimates long-term returns. The author tested both hypotheses by examining monthly returns for the S&P 500 Index from January 1961 to the end of December 2015. The buy-and-hold investor would have realized an annual return of 9.87%. The perfectly accurate market

timer who avoided the 25 worst trading days would have generated an annual return of 15.27%, before fees and taxes. However, the investor who missed the best 25 days realized an annual return of only 5.74%. Extending the analysis, returns for the best 81 trading days during the period (out of 13,844 trading days) would have equaled the total return for a buy-and-hold investor over the entire period. In other words, with perfect foresight, being invested only 0.59% of the time would produce the same results as if an investment were held over the entire 55-year period. Or, from a different perspective, had one missed these 81 best- performing days, the annualized return during the period would fall to a meager 0.03%.

On another note, the market research firm Dalbar conducted an annual study, "Quantitative Analysis of Investor Behavior," that measures the impact of market timing on short- and long-term performance. The study concludes that most stock market investors' underperformance is generated during the market's best- and worst- performing months. In other words, investors tended to underperform the market during months when returns were both positive and negative.

Lastly, excessive market timing decisions can result in unnecessary transaction and opportunity costs. Moving money in and out of cash may trigger front-and back-loaded fees for certain mutual funds, commission costs for stock and exchange-traded fund (ETFs) trades, as well as capital gains taxes, all likely resulting in lower returns. Opportunity costs may occur when the market timer is not invested as the market rallies. For example, during the 2009 rally in the stock market, described by many investors as a bear-market or sucker's rally, many investors stayed on the sidelines, convinced that equity markets would return back to the low levels seen in March 2009. These investors likely missed a large part of the bull market.

Findings of the Paper

The paper reveals that investors tend to be overconfident in their attempts to time the market and that market timing strategies underperform in the long run due to transaction costs, opportunity costs and poor investment decisions. The results of the Firer, Sandler and Ward study cited in the paper revealed how difficult market timing has been: a perfect market timer needed to reverse his investment course about 40% of the time. However, the compression rate was always around 10%, indicating that the ideal periods to switch were concentrated. The accuracy rate reveals a market timer needed to be right in about 70% to 80% of investment decisions; otherwise, he lost money due to transaction costs. One must also consider the gain/loss ratio, which was 1.5 or higher, meaning one could have lost more than one gained when attempting to time the market.

It's the authors belief that sound investment philosophy should be based on strategic asset allocation decisions, with limited flexibility to make tactical moves. If one wishes to engage in tactical moves, they must adhere to a strict discipline. For example, a balanced portfolio may have the flexibility to deviate from 50% equity/50% fixed income to a 45% equity/55% fixed income weighting, but not be permitted to deviate further.

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