Introduction

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 this paper, I explore opportunities for enhancing returns using tactical asset allocation and market timing, as well as the challenges posed by 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.

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I find that strategic asset allocation was the most important driver of long-term investment success. This is because most market timers typically fail to accurately predict important equity market swings. The long-term odds are not in favor of market timing strategies.

Opportunity for Enhancing Returns

Academic research reveals that investment returns can be enhanced significantly using tactical asset allocation and accurate market timing. Exhibit 1 shows the value of $1 invested in U.S. large caps (S&P 500 Index), Treasury Bills (30-day T-Bills), long-term government bonds (20-year U.S. Treasury Bonds), and a tactical asset allocation strategy capturing only the best-performing asset classes between December 1925 and December 2015. In this scenario, I allocated once every year to the coming year’s best-performing asset class at the beginning of each year (without transaction costs). Returns are calculated on an annual basis before inflation. Exhibit 1 indicates that the
Investor who allocated 100% of his assets into the best-performing asset class each year would have a portfolio value of about $3.7 million at the end of the period. It’s also worth noting how poorly T-bills and long-term government bonds performed relative to inflation over this period.

**Market Timing Hurdles: Running with the Bulls and Bears**

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 (drawing on Bloomberg for the monthly returns data, the full extent was December 1927 to December 2015) 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.

Yet I believe 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.

An interesting study published in 1986 by finance researchers Jess Chua and Richard Woodward questioned whether poor results achieved by market timing result from an inability to avoid bear markets or the tendency to miss the early part of a market recovery. Their research showed that to achieve investment success, it was more important to correctly forecast bull markets than to correctly forecast bear markets. Their study showed that from 1926 to 1983 average returns achieved by predicting just 50% of bull markets underperformed buy-and-hold strategies, even when bear markets were forecasted with perfect accuracy.

They concluded that for market timing to pay off, investors required accurate forecasts in at least:

- 80% of the bull and 50% of the bear markets; or
- 70% of the bull and 80% of the bear markets; or
- 60% of the bull and 90% of the bear markets.

**The 25 Best and Worst Trading Days in the Stock Market**

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. I tested both hypotheses by examining monthly returns for the S&P 500 Index from January 1961 to the end of December 2015.

As shown in the Exhibit 2 (next page), the results are compelling. 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%.

**Long-Term Trends Have Been Against the Market Timer**

My analysis of monthly returns for the S&P 500 Index from December 1927 until December 2015 shows:

- 12 bear markets (defined as more than 20% losses in the equity market)
- 13 bull markets
- Average bull market gain of 179.8%
- Average bear market loss of -35.75%
- Average bull market lasted 66 months
- Average bear market lasted 16 months
- 27% of monthly returns during bear markets were positive

U.S. stocks represented by the S&P 500 Index. The launch date of the S&P 500 Index was March 4, 1957. All information prior to the index launch date is back-tested. Back-tested performance is hypothetical and not actual performance. The back-test calculations are based on the same methodology in effect when the index was officially launched. Returns include dividends but do not reflect effects of taxes or fees. Past performance is not a guarantee of future results. Please note that all indices are unmanaged and are not available for direct investment.
The results show that long-term returns were actually realized in very short periods of time. 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%.

Given the significantly better returns noted above if one were able to avoid the market’s worst-performing days, I attempted to answer the question of whether such market timing is actually possible. Exhibit 3 shows the 25 worst- and 25 best-performing days for the S&P 500 Index from January 1961 to the end of December 2015; note the best and worst days tended to cluster, as indicated by the matching colors. Almost half of these fifty days (the 23 light gray cells) show the worst and best trading days surrounding the market crash of 2008. While there were many days surrounding the crash in which the market realized superior gains, missing the market’s worst days seems to increase the likelihood of also missing its best days. Only the white-colored cells (or cells without color) indicate daily market movements that do not appear tied to sharp market moves in the opposite direction.

Looking back at Exhibit 2, an investor who missed both the 25 best- and worst-trading days would have realized an annual return of 10.94%, greater than the buy-and-hold investor. However, in my opinion, an investment strategy that attempts to miss both the best and the worst days is flawed. I disagree with researchers such as Mebane Faber who wrote in “Where the Black Swans Hide and The 10 Best Days Myth” that: “We continue to advocate that investors attempt to avoid declining markets where most of the volatility lies and conclude that market timing and risk management is indeed possible, and beneficial to the investor.” My concern with this line of thinking stems from my observation that the best trading days, as shown in Exhibit 3, often follow the worst trading days. I believe many investors panic when they see a bad trading day and sell, thus locking in their losses and eliminating the potential to participate in subsequent rebounds. Further, I do not believe that it is possible to consistently predict market performance—especially during these days when volatile returns (both up or down) have tended to cluster.

Market research firm Dalbar has conducted an annual study, “Quantitative Analysis of Investor Behavior,” that measures the impact of market timing on short-term and long-term performance. The study concludes that most stock market investors’ underperformance is generated during the market’s best- and worst-performing months. Exhibit 5 (page after next) shows the performance of the S&P 500 Index and the average equity investor’s return in the same months; it shows that investors tended to underperform the market during months when returns were positive and negative.

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.

Exhibit 6 (page after next) shows the impact on pre-tax capital accumulation a hypothetical investor may face as annual transaction costs and other expenses increase. For example, if annual costs of 1.5% lower returns from 8.0% per annum to 6.5% per annum, then the final capital accumulated would be 31.1% lower after 20 years.

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.
### Exhibit 3 *

Note: Cells in this table are color coded; days in close proximity are shaded the same. Cells without color occurred in isolation. * One cannot invest directly in an index. Source: S&P 500 Index via Bloomberg, as of 12/31/15.

<table>
<thead>
<tr>
<th>Date</th>
<th>Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>10/19/1987</td>
<td>-20.0%</td>
</tr>
<tr>
<td>10/15/1988</td>
<td>-9.0%</td>
</tr>
<tr>
<td>12/21/1988</td>
<td>-6.9%</td>
</tr>
<tr>
<td>09/02/2008</td>
<td>-6.5%</td>
</tr>
<tr>
<td>11/25/1987</td>
<td>-8.3%</td>
</tr>
<tr>
<td>10/09/2008</td>
<td>-7.5%</td>
</tr>
<tr>
<td>12/27/1997</td>
<td>-6.9%</td>
</tr>
<tr>
<td>09/31/1998</td>
<td>-6.9%</td>
</tr>
<tr>
<td>01/06/1998</td>
<td>-6.8%</td>
</tr>
<tr>
<td>11/20/2008</td>
<td>-6.7%</td>
</tr>
<tr>
<td>05/28/1982</td>
<td>-6.7%</td>
</tr>
<tr>
<td>08/06/2011</td>
<td>-6.7%</td>
</tr>
<tr>
<td>10/13/1989</td>
<td>-5.1%</td>
</tr>
<tr>
<td>11/19/2008</td>
<td>-5.1%</td>
</tr>
<tr>
<td>10/22/2008</td>
<td>-5.1%</td>
</tr>
<tr>
<td>04/14/2000</td>
<td>-8.8%</td>
</tr>
<tr>
<td>10/07/2008</td>
<td>-5.7%</td>
</tr>
<tr>
<td>01/20/2009</td>
<td>-5.3%</td>
</tr>
<tr>
<td>11/05/2008</td>
<td>-5.3%</td>
</tr>
<tr>
<td>11/12/2008</td>
<td>-5.2%</td>
</tr>
<tr>
<td>10/16/1987</td>
<td>-5.2%</td>
</tr>
<tr>
<td>11/06/2008</td>
<td>-5.0%</td>
</tr>
<tr>
<td>09/17/2001</td>
<td>-4.9%</td>
</tr>
<tr>
<td>02/10/2009</td>
<td>-4.9%</td>
</tr>
<tr>
<td>09/11/1996</td>
<td>-4.8%</td>
</tr>
</tbody>
</table>

### Exhibit 4 *

*Source: S&P 500 Index via Bloomberg, as of 12/31/15.*
Exhibit 5 * According to DALBAR, the method used to calculate the average equity mutual fund investor return, “captures realized and unrealized capital gains, dividends, interest, trading costs, sales charges, fees, expenses and any other costs.”

*Source: Quantitative Analysis of Investor Behavior, DALBAR, 2015 (for the 30-year period ended 12/31/14)*

Exhibit 6 *

*Source: This table based on an idea from David M. Darst’s book The Art of Asset Allocation. New York: McGraw Hill, 2003, pp. 179. This is a hypothetical illustration based on my calculations. Your actual results may vary.*

**Evidence from Market-Timing Newsletters: The Story of the Motley Crew**

It is often said that there are two kinds of investors: those who don’t know where the market is going and those who don’t know what they don’t know. Advice from market-timing newsletters seems to support this claim.

John Graham and Campbell Harvey performed an exhaustive review in 1994, published in the Journal of Financial Economics, of 237 market-timing newsletters. Their research showed that from 1980 to 1992 less than 25% of the recommendations made in the newsletters were correct, and that several of the newsletters’ predictions were incorrect with astonishing regularity. One well-known market-timing advisor produced a 5.4% loss during a 13-year period when the S&P 500 Index produced an annual return of 15.9%.6

Based on additional research published by CXO Advisory Group at its website, www.cxoadvisory.com. (These conclusions were based on data I analyzed at the site on August 17, 2016). Between 2005 and 2012, CXO Advisory Group “…collected 6,582 forecasts for the U.S. stock market [as measured by the S&P 500 Index] offered publicly by 68 experts, bulls and bears employing technical, fundamental and sentiment indicators. Collected forecasts include those in archives, such that the oldest forecast in the sample is from the end of 1998.” The best market timer made accurate predictions 68.2% of the time. This means that after transaction costs, no single market timer was able to make money.

**The Evidence from Fund Managers**

In his book Investment Fables Aswath Damodaran conducted some interesting research on cash levels held by investment managers during the period 1980 to 2001. He noted that cash balances seemed to increase after bad years for the market and to decrease after good years, but he found little predictive power in the level of cash holdings.7

Damodaran also noted that after the crash of 1987, many mutual fund managers claimed that they could have saved investors
money by steering them out of equities before the crash. They argued they could have moved between stocks, bonds and T-bills in advance of major market movements and this would have allowed investors to earn higher returns. Yet, during the ‘90s, returns delivered by these funds fell short of their promises. Analyzing returns between 1994-1998 and 1989-1998, he shows that the “S&P 500” (which reflected the performance of the overall stock market), delivered a higher average annual return (more than 15.0% annualized in the 5- and 10-year periods studied) vs. 12 so-called “Asset Allocation” funds that sought to avoid losses and deliver better-than-stock market returns (which gained about 12.0% and 10.0% annualized during the 5- and 10-year periods, respectively).

These results underscore the notion that buy-and-hold strategies historically have outperformed efforts to time the market. Another much broader study of returns for more than 400 U.S. mutual funds between 1976 and 1994 found “no evidence that funds have significant market-timing ability.”

**Evidence in the Market**

In a 1994 article titled “The Folly of Stock Market Timing,” R.H. Jeffrey examined the effects of moving assets between the S&P 500 Index and Treasury bills between 1975 and 1982 (using annual timing intervals) and concluded that the potential downside vastly exceeded the potential upside. (While Jeffrey focused much of his attention on this 8-year period, he also analyzed market-timing results between 1926 and 1982 and several periods within that multi-decade span.) Summarizing his findings, he wrote, “The point of these charts and statistics is simply to emphasize that a market-timing strategist has tremendous natural odds to overcome, and that these odds increase geometrically with the length of the time frame and with the frequency of the timing interval.” In fact, he determined that the process of allocating assets from stocks to cash and back may result in missing out on the best years of the market.

Using a measure Jeffrey called the “compression effect,” he quantified “...the degree to which the overall positive real return from the S&P [500 Index] depended on ‘being present’ in equities during the few periods when real equity returns were high.” His compression effect was calculated at the end of the period by removing sequentially the best quarter’s returns for the S&P 500 Index in his study, then the second-best quarter and so on. In essence, the compression rate refers to the percentage of holding periods with the most influence on the results from perfectly timing the market. Missing these periods would have yielded a return below that of a buy-and-hold investor. The smaller this figure, the more difficult it was to beat a buy-and-hold strategy. Jeffrey added that the rationale for being fully invested lay not in the frequency with which stocks outperformed cash, but rather that most of the gains in his study were “...compressed into just a few periods, which (perversely but understandably) tend to follow particularly adverse times for stocks.” Summing up one of the many challenges for investors seeking to time the market, success “...depends on buying stocks when the prevailing view is that they should be sold, and vice versa,” Jeffrey wrote.

Further evidence of the difficulty in effectively timing the market is provided in a detailed 1992 study conducted on the South African stock exchange. In this study, academics researched the results of perfectly accurate market timing (0%-100% equity) between South African T-bills and the JSE All Share Index (AS) over the period 1967–1989. Rebalancing was calculated on a monthly, quarterly and annual basis. A buy-and-hold strategy in the JSE All Share Index would have yielded 20.1% annually; T-bills would have yielded 8.9% annually. Perfectly accurate market timing on a monthly basis would have increased the returns to 48.8% annually. The less one rebalanced (quarterly or annually), the lower the results were.

Consistently incorrect timing (on a monthly basis) would have resulted in an annual loss of 23.6%. (The results of incorrect timing were better when rebalancing on an annual basis.) The spread between perfect correct timing and incorrect timing was a spectacular 72.4%. The loss/gain ratio was always greater than 1.0, indicating an investor could have lost much more than he could have gained with market timing. In order to be a perfectly accurate market timer, investors needed to reverse their investment course on 42% of the observations. The compression rate in this study was always about +/-10%. In other words, in order to gain with perfect market timing, you would have needed to be accurate in at least 87.4% of the switches. If you were right in 68.3% of the cases, your return would have equaled a passive buy-and-hold strategy.

**Evidence from Mutual Fund Investors**

Revisiting Dalbar’s research (See Exhibit 7 on the next page), for the 30 years ended 2015, the S&P 500 Index earned 10.35% annually, but the average equity fund investor earned just 3.66%. Underperformance also occurred for fixed income investors. In fact, inaccurate market timing in fixed income investments resulted in lower returns (+0.59% annualized) than inflation (+2.60%).11 It is also worthwhile to notice the poor performances generated by shareholders in tactical asset allocation funds, in which returns lagged inflation over the 30-year period.

**Evidence from Technical Indicators**

Patterns revealed using technical analysis to evaluate stock prices show trend reversals over short- and long-term periods and more consistent trends over medium-term periods. Yet academic studies do not find similar evidence when it comes to the broader market.

As shown in Exhibit 8 (next page), during two-year periods when the market has risen significantly, there has been neither evidence nor clear patterns indicating that future returns will be negative. There is, however, some evidence for price momentum over one-year periods (in an up year to be followed by an up year) and price reversal (highest return coming after a down year). We can conclude that there is limited information that we can see in past returns that allow us to make reasoned judgments about the future.

Another study, “Technical Analysis Around the World,” looked at over 5,000 popular technical trading rules applied to 49 MSCI Country Indices from 2001 to 2007. The study found that technical analysis was not consistently profitable once data mining bias was accounted for. The authors concluded that applying more than 5,000 trading rules did not add value to investment performance.12

**Are We Better Than Our Competitors?**

Many academics describe market timing as a losing investment...
strategy. On the other hand, many investment professionals continue to believe they can be successful market timers. The school of behavioral finance cites two reasons to explain this dichotomy: (1) the folly of forecasting and (2) overconfidence. Investment professionals and laymen investors alike have been proven to not be successful forecasters. Yet many investment professionals tend to be overconfident in their own forecasting abilities and continue to use market timing as the core of their investment processes. James Montier provides evidence of this in his book *Behavioural Investing*.13

When investors forecast markets incorrectly, it becomes increasingly difficult for them to reverse their bets the longer they wait. The reason is that they must admit that they were wrong. According to behavioral finance concepts known as anchoring and Prospect Theory (or the tendency to treat losses differently than gains), investors’ perception of their losses is reference dependent. Once a bet turns against them, their natural reaction is to reverse their course of action the next time they see the reference point. Unfortunately, in many cases, this never happens and investors don’t learn from their past mistakes.

**Conclusion**

My belief is in line with those who believe market timing is detrimental to a sound and disciplined investment process. For example, economist J.M. Keynes believed that deviating from strategic asset allocation decisions was impractical and counterintuitive to achieving positive long-term results. In fact, deliberate short-term deviations from policy targets, he wrote, introduce substantial risks to the investment process:

“The idea of wholesale shifts is for various reasons impractical and indeed undesirable. Most of those who attempt to, sell too late and buy too late, and do both too often, incurring heavy expenses and developing too unsettled and speculative a state of mind.”14

David Swensen, manager of the Yale Endowment Fund, wrote, “Market timing explicitly moves the portfolio away from long-term policy targets, exposing the institution to avoidable risks. Because policy asset allocation provides the central means through which investors express return and risk preferences, serious investors attempt to minimize deviations from policy targets. To ensure that actual portfolios reflect desired risk and return characteristics, avoid market timing and employ rebalancing activity to keep asset classes at targeted levels.”15

My research reveals that investors tend to be overconfident in their attempts to time the market and that market timing strategies actually 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 earlier 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.

While many successful investors attribute their successes to
superior stock picking or adherence to a sound investment
discipline, I know of no single Wall Street guru who made his
or her fortune using market timing. Elaine Garzarelli became a
superstar on Wall Street by predicting the Wall Street crash of
1987 a few weeks in advance, and was ranked for 11 years on the
“first team” in Quantitative Analysis in Institutional Investor’s
all-star poll. Looking back, that was a great run. But by 1998,
BusinessWeek asked, “Remember Elaine Garzarelli? Two years
ago, the investment strategist—who made her name by turning
bearish a month before the 1987 crash—yelled ‘sell!’ at Dow 5400.
Six months later and 1200 points higher, she turned bullish. But
too late: Her bad call took Garzarelli out of the guru game.”

Fifteen years later, in a special issue of BusinessWeek published in
Spring 2003, Garzarelli predicted, “The stock market is stuck in a
holding pattern for years.” That predication came shortly before
a prolonged multi-year bull market.

It is my 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. I strongly advise against more
extreme market timing decisions and always encourage decision
makers to keep top of mind the trust our clients put in us to
provide the best advice possible.

*Past performance is not a guarantee of future results. One cannot
invest directly in an index. Exhibits do not reflect the effects of fees
and taxes.

**Endnotes**

Andrew Duncan and William Massina contributed to this report.

1. Based on analysis of monthly returns for the S&P 500 Index
(from Bloomberg) between Dec. 1927 and Dec. 2015. The launch
date of the S&P 500 Index was March 4, 1957. All information
prior to the index launch date is back-tested. Back-tested
performance is hypothetical and not actual performance. The
back-test calculations are based on the same methodology
in effect when the index was officially launched. Returns
include dividends but do not reflect effects of taxes or fees. Past
performance is not a guarantee of future results. One cannot
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(ICI), Standard & Poor’s, Barclays Capital Index Products and
proprietary sources to compare mutual fund investor returns
to an appropriate set of benchmarks.” Dalbar analyzes “…
mutual fund sales, redemptions and exchanges each month as
the measure of investor behavior.” These behaviors reflect the
“average investor.” Based on this behavior, the analysis calculates
the “average investor return” for various periods. These results are
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Wim Antoons is Head of Asset Management at Bank Nagelmackers. In this role, he oversees the investment process for the private banking and fund of funds businesses. He established the firm’s value investment philosophy and its open architecture fund platform. He is also co-manager of the Nagelmackers Funds and manager of the Nagelmackers Privilege Fund. Before joining Nagelmackers, he worked for 6 years in the unit-linked business at BNP Paribas Bank, responsible for the selection of value equity funds. He earned a Master of Commercial and Financial Sciences at the Hogeschool-Universiteit Brussel (EHSAL) and has 22 years of investment experience.