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MARKET TIMING

There is probably no more tempting an objective in investing than the possibility of putting money into the market when it is low and taking it out when it is high - namely the enhancement of total return through enlightened market timing. For the advisor to confess inability, or to abdicate responsibility, for performing in this arena may, indeed, even jeopardize the faith his client might otherwise have in him.

Lest my reader think my own position on this matter a cop-out, let me begin by quoting a paragraph from a most authoritative source - *Managing Investment Portfolios*, edited by Maginn & Tuttle and published by the Institute of Chartered Financial Analysts:

> Despite the enticing appeal of reducing market exposure through astute sales when securities appear to be overpriced and bold commitments when prices appear to have declined to attractively low levels, the overwhelming evidence shows that market timing is not an effective way to reduce market risk - for the dour but compelling reason that, on average and over time, it does not work.

I would like to address the challenge of market timing quantitatively, and so let me make a mathematical digression: In the domain of statistics there is a principle that the probability of the occurrence of both of two events is the product of the probabilities of each event's occurring independently. For example, the probability of having two heads on two flips of a coin is 25% (50% x 50%).

To be a successful market timer in the stock market, it should be realized that one must make, not merely one, but two, correct decisions. He must sell (or buy) at the right time, and he must subsequently repurchase (or sell) at the right time. If he is correct in his first decision but fails in his second, he may negate, with the second decision, much of, all of, or more than, what he gained by the first.

Let us assume that we subscribe to a market guru who boasts a 70% batting average calling turns in the market. If we stand a 70% chance of being right on the first call and a 70% chance of being right on the second, we stand a 49% (70% x 70%) chance of being right on both. With our chances less than 50-50, pretty clearly we had better stay put. If our guru is correct 75% of the time, our overall batting average should reach 56% (75% x 75%) - barely enough to cover the transaction costs, let alone possible capital gains taxes, on the trades. If our guru stands an 80% chance of being correct on each of his market calls, we stand a 64% (80% x 80%) chance of being right on both - a marginally tempting pair of transactions. Unfortunately (or fortunately) not even the most headstrong of gurus often professes an 80% reliability factor in his prognostications.

So what is one to make of the foregoing? I suggest the following rules-of-thumb:

First, one should be either "in" the market or "out" of the market, and not "in-and-out" and "out-and-in."

Second, one's decision to be in the market or out of the market should be based upon an assessment of the market's probable behavior, not in the days, weeks, or months ahead, but rather in the years ahead.

Third, one should recognize that, though shorter term stock market patterns tend to be cyclical and, in the very short-term, for all practical purposes, random, the longer term secular trend has been strongly upward.

Fourth, though one might legitimately change the mix of one's assets based upon changes in one's personal financial circumstances, one should not make a habit of changing one's asset mix based upon his changing assessments of the shorter term outlook for the securities markets.

Fifth, though one might sell the securities of certain companies or institutions that no longer fulfill his standards of quality and/or growth potential, and replace them with securities that do, he should not be prone to trade in securities based upon anticipated fluctuations in the securities markets as a whole, irrespective of the relative merits or demerits of the underlying companies or institutions.

At this point, let me interject the observation that, after four decades of watching other people manage their investments, I have never encountered a successful market timer. Even, of those few who have been sagacious enough to bail out of the market before it went down, I have never known anybody who was smart enough to get back into the market before it subsequently rose back above the level at which he had previously sold.

Finally, more for illustration than as proof, let me conclude with a second digression - this time into the realm of small particle physics. There is a general recognition among physicists that, in the sub-atomic world, it is impossible to predict the trajectories of individual particles. While scientists may predict the course of the planets with uncanny precision and the "collective" behavior of electrons with a high degree of accuracy, they are at an utter loss when it comes to trying to predict the specific course of any particular electron.

What holds true in the dimensions of space and with respect to numbers for the behavior of matter, seems also to hold true in the dimension of time and with respect to numbers for securities prices. The shorter the time frame in question and the less well diversified the portfolio, the more random and unpredictable appears to be the performance. On the other hand, the more broadly diversified the portfolio and the longer the time span over which it is allowed to perform, the more nearly predictable and reliable, and so the more rewarding are apt to be the results.

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