



Missing out

Why market timing is a recipe for regret

Market timing is a tempting mistress. It's so simple. Just wait on the sidelines until the market is ready to move up, and then pounce. And when the market nears a rational peak, sell before the inevitable decline begins. Conceptually, market timing is an irresistible approach to investing. But in real life, like a mistress, it can be unforgiving and full of unintended consequences.

Consider October 1985. The Dow had raced to a lofty 1300 level, up 70% from a cyclical low. Investment gurus and financial headlines cautioned investors to wait. The run-up was a classic market timing signal to take profits and pause. And then, as is often the case, the market ignored the signal and barreled onward and upward.

An investor who tried to time the market by selling at Dow 1300 waited for a downturn that never arrived, and missed out on some of the strongest gains in the century. In the following eight short months, the Dow rose almost 50% to 1903. And the index has since reached 13,500 – through the Crash of '87, the Russian debt crisis of '98, the Internet bubble, 9/11 and every crazy thing in between.

That, in a nutshell, is the unpleasant reality of market timing – by trying to see and act on trends in the market, most investors guess wrong more often than right. They sell before the rise. They buy before the fall. Forget “they.” I've done it all myself. Markets are funny that way. They confound most of the people most of the time.

Seeing patterns that aren't there

As I described in last month's article, stock prices do not move in recognizable or exploitable patterns (and that's just as true for bonds). It is humbling to accept that price movements are a random walk, but pretending that they are predictable is not only humbling; it's costly too. Between transaction costs, capital gains, and simply guessing wrong, timing strategies are not likely to match the performance of much simpler buy and hold strategies.



When the market plunges, is that a buy signal, or a sell? Will a climbing market continue or reverse? Ultimately, we do not know and cannot know ahead of time. Investing is lived forward and understood backward. The many investors scared completely out of stocks by the 22% market drop on October 19, 1987, ultimately missed a decent return. A broad market portfolio returned to its pre-crash value in 18 months, and within 4 years had a 12% annualized return. Those who panicked and left had to buy back in at higher prices.

Wait loss

The greatest danger in a market timing strategy is being out of the stock market when it lurches forward. Consider the landmark research of Roger Ibbotson and his colleagues (see www.ibbotson.com). It shows that a single dollar invested in the S&P 500 in 1925 would have grown to a staggering \$2600 by 2005. However, if the investor missed the 39 best months over those 80 years, the take would have totaled a mere \$17...a dollar less than being in T-Bills. Because we cannot systematically predict when one of those big months will arrive, trying to time exit and entry can be exceedingly costly in lost opportunity.

The same is true in the shorter term. In *A Random Walk Down Wall Street*, Burton Malkiel cites research that shows that during a 31-year period beginning in the mid-1960s, 95% of stock returns came on just 90 days...barely more than 1% of the 7500 trading days in that period (H. Negat Seybum, University of Michigan). When the market moves up, it moves fast, like a bullet train. Good luck trying to jump on.

Missing out on those wild equity ascents would have been catastrophic for long-term investment results. Happily, a simple buy and hold strategy eliminates any chance of being out of the market when in would be better.

Time, not timing

One argument for timing is that by selling before a big decline, investors reduce risk. Of course, the strategy completely falters on the inability to predict downturns. So how, then, can we reduce risk? One answer is time.

Again, Ibbotson has the data. Based on eight decades of market results, he demonstrates that longer holding periods tend to even out the ups and downs. Hypothetical portfolios invested completely in stocks and held for twelve-month periods averaged a return of 10.4%. But that average is reached via



some years with losses of more than 50% and others with gains of more than 150%. Expand the holding period to 120 months, and the range shrinks to approximately -5% to +20% compound annual returns. Without making any decision other than to buy and patiently hold (even through the painful, dark days of big declines) historically, we can, on average, dramatically reduce portfolio risk.

What does not correlate makes you stronger

Our position is that time mitigates risk. And so does diversification. Because different asset classes move in different directions – that is, their movements are uncorrelated – holding a mix of assets historically tends to drive down overall portfolio volatility. This is the crux of modern portfolio theory – reducing volatility through a mix of global stock holdings, bonds, alternative investments, cash, commodities, and real estate.

The OCM advantage

OCM is a fee-only family investment office specializing in tax-efficient globally diversified portfolios for individuals. We do no market timing.

Think about it another way

You are the CEO of a multibillion dollar global company with thousands of employees. In the course of the day you hear that the Dow has surged/plunged 500 points. What's your reaction? Beyond surprise, probably none at all. Your long term strategic plan is not contingent on daily fluctuations in the markets. You would not sell your business based on short-term news, nor would you immediately buy another company. The same calm, long-term approach makes sense for your personal investment portfolio.

Don't mix fun and folly

Let's be honest, market timing can be fun. When we bail out of the market right before a big slide, or buy in on day one of a big move up, it's an exhilarating jackpot moment. But like hitting a jackpot at the slots, it relies more on chance than skill. Trying to systematically move money in and out of markets that do not move systematically is, in the eloquent words of Barbara Tuchman, 'pursuit of policy contrary to self-interest.' Trying to do so with the family fortune is folly waiting to happen.

Go fast, or slow, but go

If one accepts, as I do, that market timing is wasteful and needlessly risky, then constructing a strongly diversified portfolio, utilizing tax-efficient, low cost index investments, such as exchange traded funds (ETFs), is a



recommended approach. In my experience, investors typically proceed to invest in one of two ways: “pedal to the metal,” or “slow and steady wins the race.”

The first type goes all-in immediately, reasoning that the sooner their plan is implemented, the sooner and longer they will get its investment benefits. The second type feeds money in slowly, figuring that gradual, phased investment over time, even into down markets, will lead to benefits over the long run.

I think both approaches work, and choosing one is more a statement of personal preference and emotional make-up than investment acumen. It pays to heed one’s emotional investment stamina, to avoid regret, and to sleep comfortably. *OCM can demonstrate potential investment results with either technique, based on a fact set you select and using Bloomberg analytics. I’m happy to provide this customized service at no cost.*

John Osbon, Chief Investment Officer
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