

BUTLER, LANZ & WAGLER, L.C.
REGISTERED INVESTMENT ADVISOR



Market Timing

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Maybe you've heard the phrase "buy-and-hold" before. Since this is a very important concept, it requires a definition before moving on. The phrase is somewhat self-explanatory – a buy-and-hold strategy consists of buying some investment (usually high grade stocks, high grade bonds, or mutual funds) and then holding it indefinitely. However, this exposes the investor to considerable risk. For example, if an investor had bought the NASDAQ index fund in March of 2000, **they would have lost over 70% of the value of that investment by October of 2002**. Even though the market rallied from the 2002 lows, by the end of 2008 it was still down almost 70% from the 2000 highs. And remember, the NASDAQ Composite Index has thousands of stocks in it, so this is an extremely "well-diversified" index. Yet, it still lost 70% of its value from 2000 to 2008. Having an understanding of the business cycle, and how that cycle impacts asset classes like stocks, would have led an investor to conclude that the risk of owning stocks was increasing starting in the middle of 1999. Having interest rates hiked for a prolonged period of time usually leads to a shift in the phase of the business cycle. However, investors in this period were told things like "It's different this time," or "If you're a long-term investor, you should just ride out any 'bumps' along the way." Later, as stocks sold off, investors were told, "Don't worry. Your investments will come back." In other words, you bought and now you need to hold. As we will discover, however, there are serious problems with holding investments through bear markets.

Suppose for a minute that we were lucky enough to have avoided taking a 70% loss on our investments in the bear market of 2000-2002, and instead we had a portfolio loss of "only" 25%. A 25% loss to an entire portfolio is still not acceptable. The chart to the right demonstrates what percentage gain is required to break even after experiencing a given percentage portfolio loss. For example, notice that if the portfolio loss were 25%, a 33% gain would be needed just to reach the portfolio value prior to the 25% loss. In other words, if an investor's portfolio is worth \$100,000 and then takes a 25% portfolio loss, he is left with a portfolio valued at \$75,000. To get back to \$100,000 would require the portfolio to gain \$25,000 on \$75,000. That's a 33% gain. A loss of 70%, by comparison, would require a daunting gain of 233%. The point is *not* that the portfolio will never return to its prior value – it very well could. Rather, the problem with substantial portfolio loss is the *length*

Portfolio Loss	Percentage Gain Needed To Break Even
20%	25%
25%	33%
30%	43%
40%	67%
50%	100%
70%	233%

of time it typically takes to get back to the original portfolio value. If the stock market as a whole has averaged 10% per year, a loss of 50% (which requires a subsequent 100% gain to break even) would take eight years to make up. Add to this the two years it took to lose the 50% and we are now looking at a 10-year period where our portfolio does absolutely nothing! If we allow a portfolio to take a 25% loss, we are looking at a five-year period of stagnation. As of the end of 2008 we were approaching 9 years and the Nasdaq, as we mentioned was still down close to 70%. Most people invest for a reason – retirement, a child's education, a boat, or even simply to give to heirs. Whatever the reason may be, few count on 5-year, 10-year or even longer periods where there is no growth at all.

Because it may take years to make up losses, it becomes imperative to avoid them wherever we can. For this reason, simply buying and holding an investment indefinitely is rarely a good idea. So, why are brokers and financial planners so intent on having you hold onto losing investments through devastating bear markets? There are two reasons. First, the mainstream financial industry believes that markets cannot be timed. Second, they don't think it's necessary if they construct the "appropriate asset allocation" strategy for their clients. We will first address "timing the market."

Number of Best Days Missed	Return Falls To	\$1,000 Grows To
0	7.00%	\$54,155
10	5.74%	\$26,922
20	4.88%	\$16,629
30	4.05%	\$10,405
40	3.57%	\$7,921

It's well documented that most of the long-term performance of an asset class is determined by the performance of that asset *over just a handful of days*. This has led to the market adage "It's not *timing* the market that matters, but rather, *time in* the market." The chart to the left, or something like it, is usually shown to investors who ask their advisor why they can't time the market to avoid huge losses in bear markets. For this example we will look at the period from 1950 thru 2008. This period includes the crash of 1987, the bear markets from 2000 to 2002 and 2008. During this period, the S&P 500, an unmanaged index of 500 stocks, had an annual return of 7.00%.¹ This is the annualized return you would have earned if you had bought a share of the S&P 500 in 1950 and held it through 2008. The chart shows why you should *not* time the stock market. If an investor had missed the best ten days

1. Reuters Data, March 2009.

in these 59 years because he had been in cash, his average return would have fallen from 7.00% annually to 5.74% annually. Please note that the 7.00% annualized return figure represents "0 best days missed." *Missing none of the best days is the buy-and-hold performance.* You did not try to time the market – you simply bought the S&P 500 at the beginning of 1950 and held it through 2008. You would have been holding the S&P 500 for *all of the best days* because you would have been holding the S&P 500 every day. In the previous chart, as well as the next two that follow, the first line that includes 7.00% assumes you are fully invested for the entire period and therefore miss no days of the market, good or bad.

If, from 1950 thru 2008, this investor had missed the 40 best days of the S&P 500's performance, his average return would have been only 3.57% annually versus the 7.00% which could have been achieved by staying fully invested in the market at all times. If the investor were fully invested from 1950 thru 2008, a \$1,000 investment made in the S&P 500 index would have grown to \$54,155. Had the investor missed the 40 best days over those 59 years, that \$1,000 investment would have grown to only \$7,921. The moral of this story seems simple enough. If by timing the market, an investor misses some of the best days to be in the market, his long-term return could be reduced by a considerable margin. The traditional investment community will use this analysis to advise investors to avoid timing the market. However, as you will see shortly, this is an extremely one-sided view and one that we do not espouse.

Number of Worst Days Missed	Return Increases To	\$1,000 Grows To
0	7.00%	\$54,155
10	8.75%	\$141,034
20	9.78%	\$245,963
30	10.69%	\$400,308
40	11.44%	\$596,245

While at first the above analysis may seem compelling, it begs the question, "What if I had missed the *worst* days of the stock market over the same time frame?" After all, nobody tries to time the market in order to miss the *best* days. They're trying to avoid the *worst* days. It's unlikely that the mutual fund industry, stockbrokers, or financial planners are prepared to answer that question. The results of missing the worst days over the same time period are to the left. If an investor had been in cash for the 40 worst days from 1950 thru 2008, he could have dramatically increased the average annual return over simply buying and holding the S&P 500. It is important to realize that market-timing is based on the complex behavior of market participants. Since it's extremely difficult to model human behavior, it's highly doubtful anyone will be able to time the market perfectly. **Still, the chart on the previous page assumes *complete incompetence* in timing the market while the first chart to the left assumes *perfect* market-timing. Neither scenario is very realistic. Market-timers are likely to miss both good and bad days.**

Number of Extreme Days Missed	Return Increases To	\$1,000 Grows To
0	7.00%	\$54,155
10	7.46%	\$69,753
20	7.60%	\$75,322
30	7.64%	\$76,992
40	7.87%	\$87,325

Therefore, the most intellectually honest comparison would look at what the performance would have been had the investor missed the best *and* worst days from 1950 thru 2008. We call these best and worst days "*extreme days*." If an investor had been able to avoid the 40 worst market days for the S&P 500 from 1950 thru 2008, but had to miss the 40 best market days to do it, *the investor's performance would still be better than the buy-and-hold performance.* An annualized return of 7.87% would have been achieved, growing a

\$1,000 investment to \$87,325 in 59 years. Interestingly, the annual return does not vary much whether you miss 10, 20, 30 or 40 extreme days. Again, buy-and-hold would have resulted in only 7.00% per year. This contradicts the view that the investor is better off holding through thick and thin. In fact, **this indicates the exact opposite – any average timing strategy would be better than buying and holding stocks in this period.**

Please note that any timing strategy seeks to *avoid only the bad days*. The intention of a timing strategy is to be *fully invested for the best days*. Still, it is comforting to know that even if the 40 best days would have been missed in order to avoid the 40 worst days, the investor still would have been better off than holding through thick and thin.

The second reason that brokers utilize the buy-and-hold methodology is that they view asset allocation as the best strategy for minimizing risk. The goal of asset allocation is to maximize return relative to the level of risk the investor is willing to take. The word "risk" is used here to denote "deviation" from average annual return. Once the client gives the broker or planner his/her tolerance for risk, a portfolio of mutual funds or similar investments is constructed that will maximize return on that risk, given historical returns and deviations of those investments.

As many investors have seen, buying and holding a portfolio constructed using the asset allocation strategy is flawed and can lead to inferior performance for extended periods of time. The best way of avoiding inferior market performance is to time the market. Again, even an average timing system would have outperformed a strategy of simply buying the market and holding it indefinitely. Timing the market correctly should be the endeavor of every investor.

Conclusion

The mainstream investment industry uses a buy-and-hold paradigm and this exposes investors to risk they are not expecting or wanting. Buying an asset without first having an idea about what must transpire in order to dispose of it is a dangerous practice. Again, the chart on page 2 shows why all losses should be avoided. The buy-and-hold paradigm leads to your broker telling you to be patient when the market drops 25% as it will surely "come back." And it probably will come back, but a 25% loss requires a 33% gain to break even. On average, this will take three or four years. The best way to avoid these drawdowns in your portfolio is to time the market. Our discussion shows that timing the market is preferable to buy-and-hold even if it means missing the best "up" days to avoid the worst "down" days. How can you time the market? First, you must understand the business cycle and how different asset classes behave in each phase of the cycle. Second, you must understand how to interpret supply and demand conditions for a variety of investment options. Then, you will be in a position to time the market. Will you be able to buy at every bottom and sell at every top? No. You must simply catch a majority of the big moves when you're right and sell quickly when you are wrong. And, by the way, you *will* be wrong at some point. Investing is a game of probabilities, not certainties.

Butler, Lanz & Wagler believes that buying and holding any investment indefinitely is a mistake, and potentially disastrous. All investments can lose their value. We must monitor every investment and be prepared to get out of it if conditions dictate.

Butler, Lanz & Wagler understands that if the markets can go up, down or sideways, our methods had better be able to take advantage of all of these environments. We routinely go short, go long and get into cash – whatever the markets (or, more precisely, our systems based on the nature of markets) tell us to do.

So what can Butler, Lanz & Wagler do for you? There's only one way to find out - schedule a time to come in and talk to us about your situation. Call (913) 696-1919 for a free one-hour consultation where we'll talk about whatever it is you'd like to talk about. There are several advantages to coming into our offices and discussing what it would be like to have a professional money management firm handle your investments:

- (1) It's free, so you'll pay nothing to check us out.
- (2) It's confidential – we won't sell your name or pester you if you decide we are not a good fit.
- (3) You'll have an opportunity to go over our money management style in much more detail.
- (4) It's your opportunity to interview us. Ask us whatever you want.
- (5) We can give you our opinion on how you're currently situated in the markets versus where we would have you positioned.

So now you know some of the problems with buy and hold investing and how market timing may benefit your portfolio. You also know how Butler, Lanz & Wagler can overcome these limitations. To learn more about what we can do for you, simply call (913) 696-1919 and schedule a one-hour consultation.

Now there's absolutely no reason **not** to call. When you come in for your appointment, be sure to ask us what we have been doing over the past year to protect our clients' assets in this difficult environment. You'll get to learn how we manage money in more detail to see if it might be a fit for you. Again, please give us a call at (913) 696-1919 and we can set up your free one hour consultation. We look forward to meeting you!