



April 2008 – Dangers of Market Timing

It's tempting to think that a little market timing could insulate your clients from negative markets. But in reality, you could be exposing your clients to non-recoverable losses.

Strongly negative market performance over the last nine months has been difficult for all of us to confront after years of relatively low volatility and positive market performance (especially from riskier asset classes). The days when outsized results came easy and were attributed to advisor investment skill are a thing of the past.

Recent results, however, haven't just driven portfolio values down after years of ascent. Investor psychology has been further battered by daily headlines (e.g., Bear Stearns going under, rising layoffs, bankruptcies, and delinquencies, oil at \$115 a barrel, declines in real estate values, and the list goes on).

After an extended period of success, it is hard to go hat in hand and say, "Things haven't been going so well lately." Let's face it, it's easier and more fun to serve clients when they are making money and getting richer.

But history teaches us that those kinds of periods are inevitably offset by periods of challenge and negativity, which are usually shorter, more intense—and scary. It is difficult to deal with clients and sell them on the merits of relative out-performance in a negative market when that doesn't feed their family or make retirement planning any easier. Thomas Paine's enduring phrase "These are the times that try men's souls" should be saved in every advisor's brain to be relied on in times like these.

It can be alluring to think that "changing horses" or embracing market timing from a strategic approach could somehow perpetually insulate you and your investors from the personal impact of negative markets. This is mistaken thinking. There is little if any evidence that exists pointing to a systematic way to accomplish this.

There is, however, a preponderance of data showing that patient and diversified (equity) investors are rewarded with historic-like return premiums for participating in full market cycles. But those premiums change from cycle to cycle, and being realistic about returns as they relate to the actual time horizons of your clients is perhaps the most important value an advisor can bring to an investor—in other words, to inform them so they can think realistically. They need to know that the financial rewards of equity investing come in short bursts that cannot be timed or known in advance, as the chart below indicates.

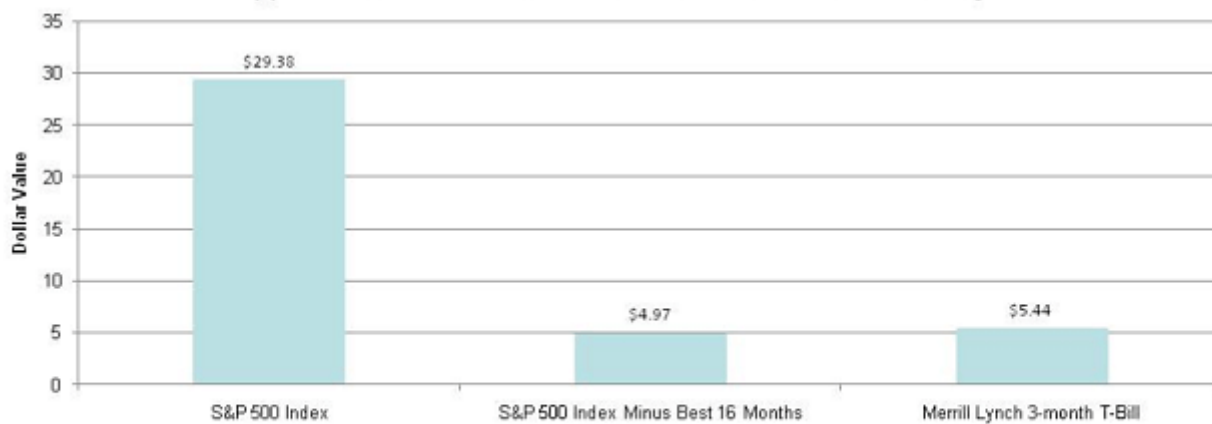


Dangers of Market Timing

Market timing is an attempt to maximize returns by forecasting future returns and deciding to be either out of the markets completely or fully invested.

- No one has advanced knowledge which time periods provide the most return
- Performance is volatile and missing periods of short-term performance can be costly
- The lesson is: hold for the long term to get the full benefit of owning an asset class

Hypothetical Value of \$1 Invested From 1980 Through 2007



Source: CMC EResearch

It is in times like these that we have to remind ourselves of the basic investment principles that should guide our work with investors. Time is a friend, for markets do mean-revert. Diversification is never out of fashion in managing performance risk. Maximizing the odds for client investment success is our basic job—not getting lucky with a market timing call.