



## MARKET TIMING ... AND PROBABLE OUTCOME

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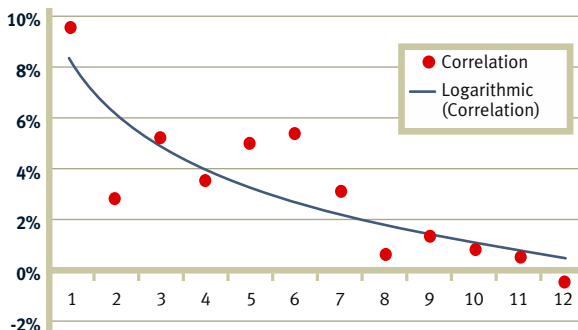
Knowing full well that portfolio returns are largely determined by strategic management, we are often tempted to interpret market signs to find ways of adding value.

- ▶ *Interest rates have bottomed and are poised to rise: Now's the time to reduce the duration of your bonds or add to your stock holdings!*
- ▶ *The market has plunged far enough and indexes are certainly undervalued: It's time to overweight in equities!*
- ▶ *A particular stock is down a whopping 80%: Buy more shares to reduce your average purchase cost and take advantage of the bargain before the price starts to climb!*
- ▶ *Experts expect the Canadian dollar to appreciate: Reduce your foreign content until the dollar reaches its fair value!*

In fact, these and other comments of this nature very rarely add value. Tactical positioning calls for the kind of mastery that even professional managers cannot fully achieve.

Advisors should not let themselves get sidetracked by things that matter little in the grand scheme of portfolio returns. It's more beneficial to allocate assets based on a client's profile and rebalance portfolios on a regular basis.

To illustrate how difficult it is to time the market, the S&P/TSX 10-year return, excluding the best 10 days, is often used to make the point. Imagine missing 10 business days out of a possible 2,000, we are told. From a strictly statistical standpoint, timing the market successfully under these circumstances would be nothing short of a miracle. As for the impact of missing only the best 40 days, pick up your calculators and work out the probabilities yourselves. (Be prepared for results with multiple decimals!) Unfortunately, the return over a short period has little correlation with returns over the different preceding periods. For example, the chart on the right compares the correlation of the S&P/TSX over one month with the returns for the preceding periods (1 month, 2 months, and so on, up to 12 months). Because a 10% correlation is not enough to make projections, additional indicators are necessary. Just like the expression "the end justifies the means," this example, illustrating the risk of missing out on the best days succeeds in dissuading many investors.

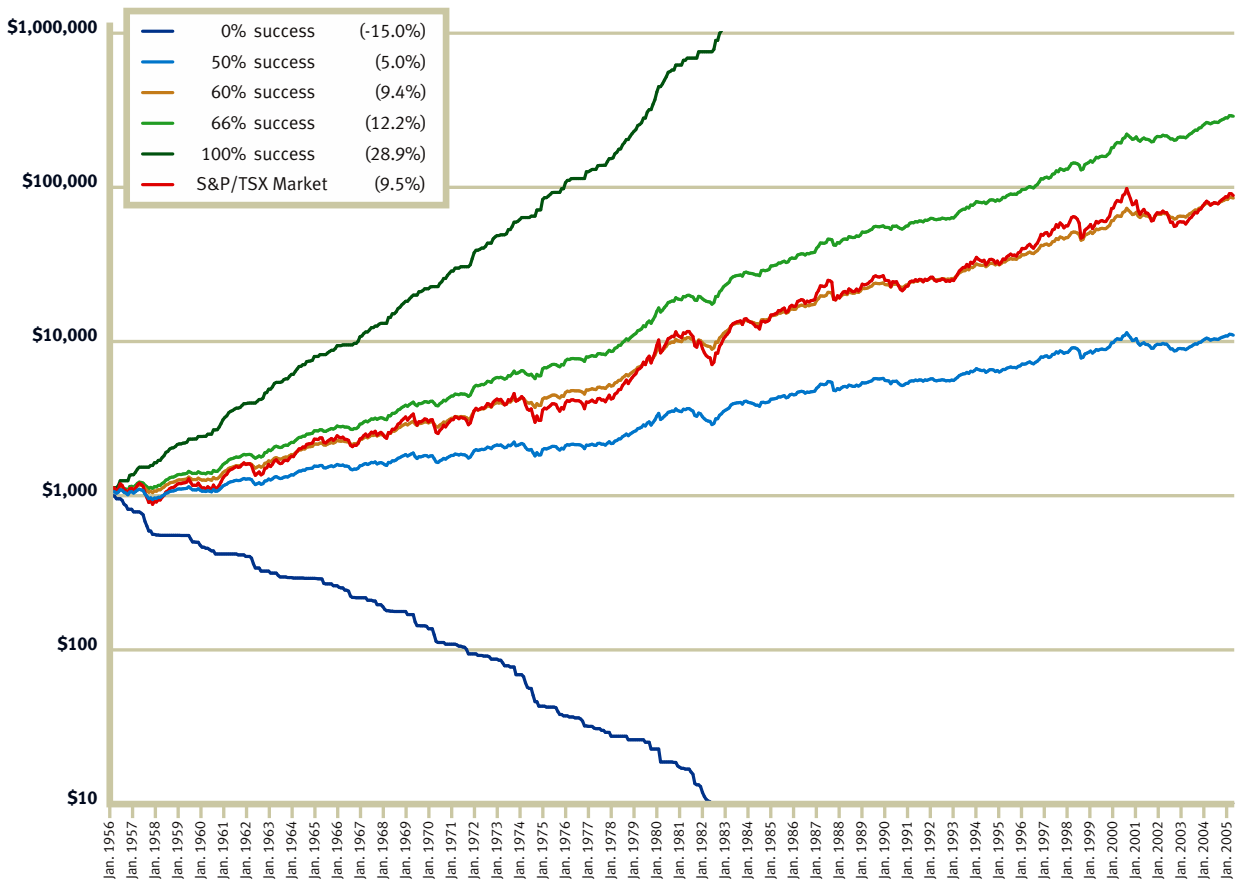


However, I think the risk of market timing needs to be presented in an entirely different manner. Let's examine the results of an investor who tries to get in or out of the market at the beginning of each month. If he feels that the return on equities will be positive, he gets into the market for the month. If he expects a negative return, he leaves the market with zero return for that month.

Had the investor applied this strategy with a 100% rate of success since 1956, he would have earned an extraordinary annualized return of 28.9%. It seems fairly obvious that no one has a recipe for an ever-winning formula. At the other extreme, the cumulative effect of making only bad decisions would represent a negative annualized return of -15.0%. This worst-case scenario is not any more realistic than its best-case counterpart.

Using a 50% success rate (assuming that we are wrong as often as we are right), the annualized return would be in the neighbourhood of 5.0%. This is not a great performance, however, as doing nothing at all would have generated a return of 9.5% (December 31, 2002). To beat the market, the success rate would have to be closer to 60%, i.e., being right six times out of 10.

What success rate would you need to outperform the market by 3% in the long run? Using the same approach, you would need a 66% success rate. In fact, being able to predict correctly two-thirds of the time would immediately rank you among the elite managers in the world. Such value added is significant, and anyone who could consistently deliver such performance would be ensured a prestigious job in the world of asset management. The following chart shows the growth in value of \$1,000 invested in 1956 assuming different success rates in monthly decisions. ▶



The conclusion? Quite simply, like baseball's big hitters who have a batting average of .300 (3 hits out of 10), the top managers stand out from their peers when they reach a success rate of 6 out of 10 (based on the parameters of the simple model developed to illustrate my point). The performance of institutional managers tends to be less volatile than that of the market.

If your success rate is 65% or better, you should send out your resumé: you'll be a shoe-in for one of the best paying jobs on the planet! Lower than 60%, and you'll be working for peanuts. Your only risk: getting poorer, especially as management fees are proportional to the frequency of transactions. In the world of investing, it's a fine line between being a hero or a zero. You're best to leave the decisions to the experts and worry only about rebalancing your portfolio rather than trying to beat the market.