The Market Timing Question

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The Long Term Big Picture View

A perception that non market timers have of market timers is they time the market to increase performance. This is not why I time the market. I time the market to lower risk. Actually it is my opinion that timing the market usually lowers your performance. So why would I time the market and lower my performance? My portfolio represents my life's savings. Everything I have worked for over the last 60 years is at risk when my portfolio is at risk. I don't take this lightly. If your young and can rebuild, you may not see your risk as I see mine. You get my point, risk is my first and foremost consideration. Therefore I learned how to time the market. I built my first market timing model in 1994 and have honed that skill since then.

I time the market to avoid big prolonged "bear" (down) markets. What is considered a big prolonged bear market? The 1929 market crash and subsequent depression would be a big prolonged bear market. To further explain I need to define several profiles of bear markets.

a. Bear Profile One (P1), a correction (draw down in the market) of 0% to 10%.
b. Bear Profile Two (P2), a correction of 11% to 15%.
c. Bear Profile Three (P3), a correction of 16% to 20%.
d. Bear Profile Four (P4), a correction of 21% to 30%.
e. Bear Profile Five (P5), a correction of 31% to 90%.
f. Bear Profile Six (P6), a Melt Down correction of 91% to 99%.

Bear Profiles P1 through P3 don't bother me. If that is where the corrections to the market would end, I would not time the market. When you listen to the so called Investment Advisor Experts, their thinking does not go beyond P3. Their advise is to use "Asset Allocation" and diversification to protect your portfolio from market risk. They are correct for P1 through P3, but what about P4 through P6.

It's P4 through P6 that get my attention. So do I really believe we could have a "melt down" 90% to 99% drop in the market? You bet as they say! The Dow Jones Industrials dropped 88% from 1929 to 1932, and the NASDQ dropped 77% from 2000 to 2002. These would not be considered P6 melt downs. But I do not worry about a P6 melt down, my concern is really P4 and P5 which can really hurt your feelings, and have a significant impact on your portfolio.

I believe we will have a world financial melt down sometime in the future, probably not in my life time, but some time. Let me be clear, I am not an economist, Wall Street professional, nor do I have any other lofty financial background, so I may not be qualified to speak here. However, I am qualified to protect myself from stock market risk. At the present time we have world economic imbalances that in history provided the fuel for economic collapse. Just one current example, no society in the past has avoided this dire result that has gone to a fiat currency. A fiat

currency is one that is not backed by gold or any government hard assets. It is therefore concerning that today you can not convert your paper dollars into hard assets from the U S Government.

So what would cause this melt down? Just one example, the world is awash in US Dollars that have no backing. You think the Chinese, Tokyo, Malaysia, Germany, Russia, or any other sovereignty will not try to be the first out the door to sell their US Dollars if it should start to drop precipitously?

I am not a doomsayer so don't get me wrong, I'm a glass half full guy and will continue to put my money into the stock market. I just want to be as ready as possible for any big negative market swing. Whether I'm right or wrong about possible precipitous drops in the market doesn't matter, what matters is I protect myself against Bear profiles Four and above.

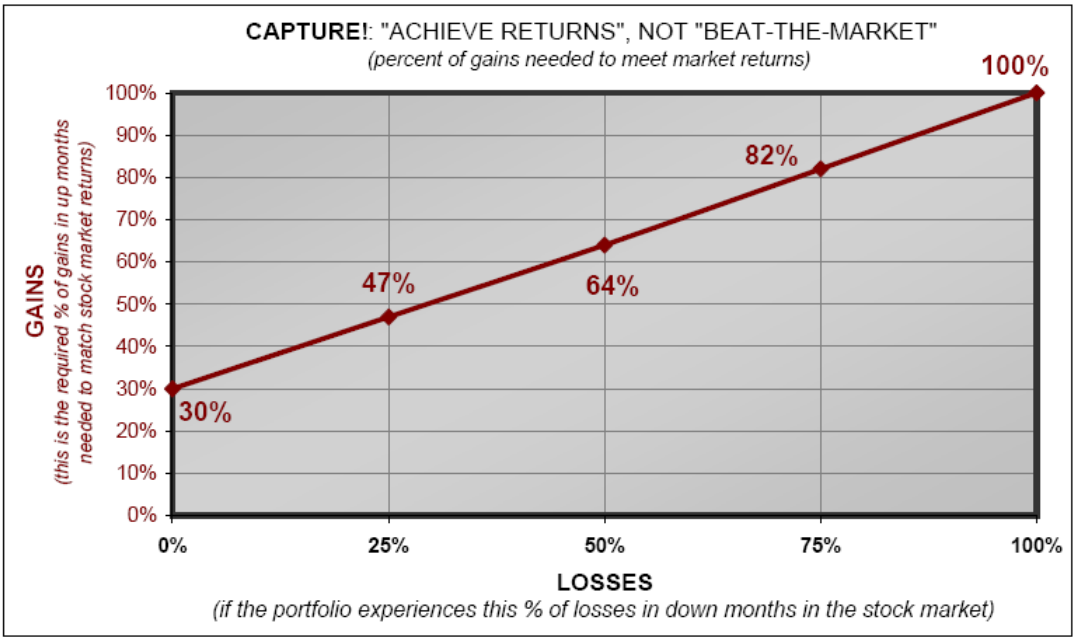
Recovering from Market Corrections

Investors are surprised when they discover from a loss of 50%, that it takes a return of 100% to recover to break even, so losses must be avoided as much as possible.

From Crestmont Research: http://www.crestmontresearch.com/

THE FIRST RULE

"Many have heard that the first rule of investing is "Don't lose money." That rule is important because losses have a disproportionate impact on compounded returns. Simple returns are the returns that occur each day or month. Compounded returns reflect the cumulative impact of gains and losses on prior returns and represent the kind of returns that we can ultimately spend. For example, if an investment is up +10% one year and down -10% the next, is the investor at breakeven over the two-year period? The result is 0% if we simply average the two years, yet the investor actually will be down by -1% in his account (on acumulative basis). This occurs regardless of the order of the gain and loss periods. It actually takes an +11% gain to make up for a -10% loss. Further, as the loss increases, it requires a greater percentage gain to restore the account to breakeven. For example, it takes a +25% gain to recover from a -20% loss and a +50% gain to recover from a -33% loss. As tech bubble investors have experienced, it will take a +400% recovery to offset the -80% decline that occurred in the NASDAQ."



The stock market is much more volatile than most investors realize. Two volatility gremlins--the disproportionate impact of losses and the friction loss from the dispersion of returns--significantly reduce the compounding of returns. Many absolute return-oriented investment strategies recognize this dynamic and seek to enhance investors' compounded returns by providing a more risk-managed and consistent return profile. "Capture" is one way to measure and illustrate the effectiveness and benefit of this approach. Whereas the 'relative return' investor (tracking stock market indexes) will generally experience 100% of the downside and 100% of the upside to achieve market returns, the 'absolute return' investor only needs a fraction of the upside when downside losses are limited. The graph above illustrates just how little of the upside is needed to match stock market returns over time and it demonstrates the way that many absolute return strategies exceed stock market returns without having to "beat-the-market" each year...

The Shorter Term View

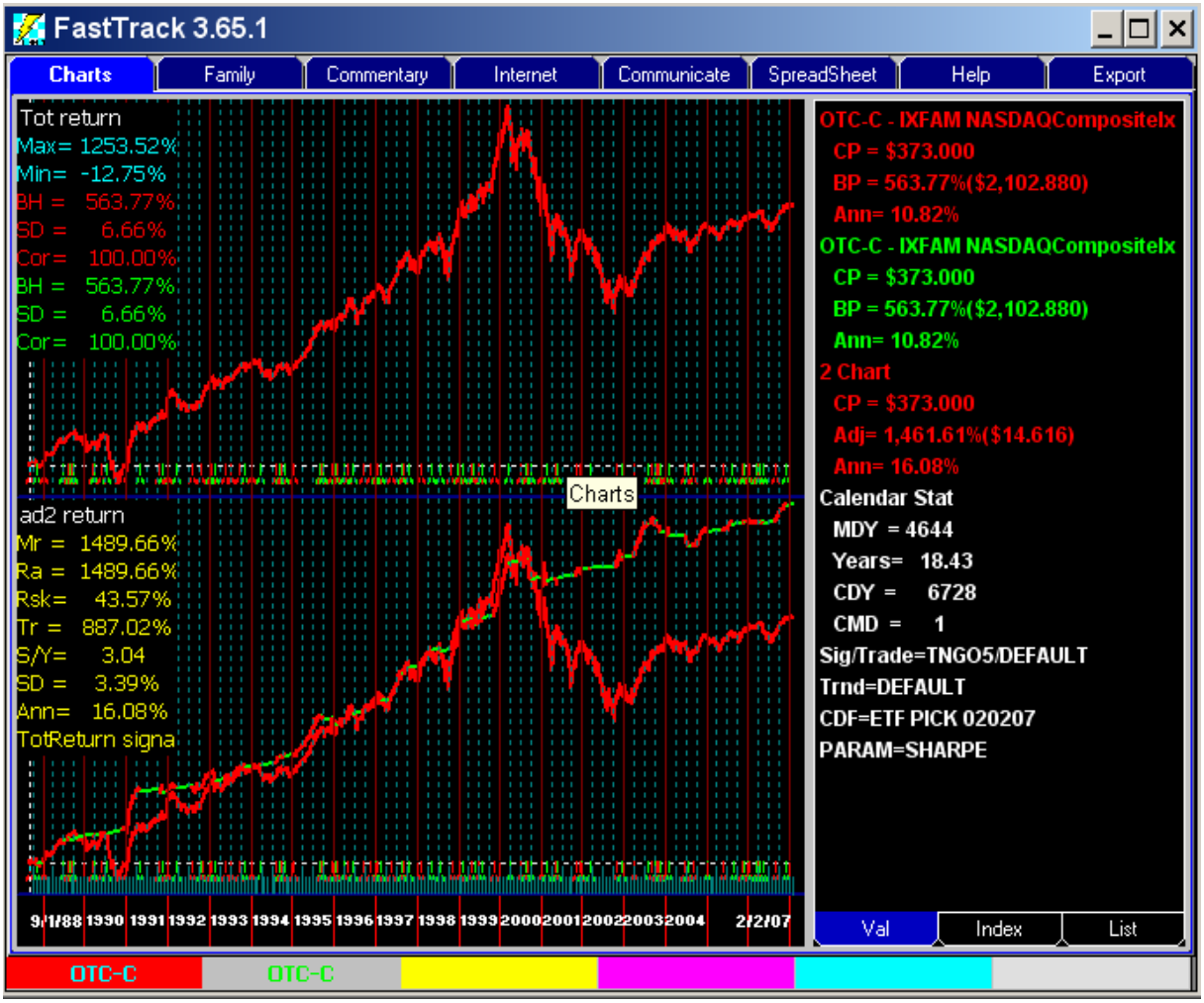
We would ultimately like to use a buy and hold investment approach. Over the long term the stock market goes up giving you a meaningful advance in your brokerage account. But this approach means you also participate in the significant market declines. This is unacceptable from a risk standpoint, because once in awhile we have a severe bear market which will wipe out a generation of investors and take years of recovery for those not wiped out. Depending on your investment time horizon, you may not have time to rebuild your wealth to the level prior to a severe bear market. At any rate, we want to concentrate on building wealth not rebuilding it. One way to do this is through market timing.

Although market timing has the good side as previously discussed, it also has a frustrating side. All sell signals are not a sign of a severe decline, some are false alarms and some are minor market corrections, these signals cause small gains or losses but they are part of the process. And when you do get a severe decline as in 2000 to 2002 it will keep your wealth in tack. We then make most of our money during the buy signals and save our money during the sell signals by “avoiding the significant declines” and “participating in the meaningful advances”.

Market timing is not perfect. Designing a market timing signal is always a series of compromises. They are not human, they are a series of mathematical formulas driven by market data that crosses predetermined thresholds. This data at times crosses the threshold before or after you want it to. So ideally you would like to move the threshold so that it gave you a “good” signal every time. Of course this is impossible, since you would have to know in advance what the market is going to do. Neither the best minds on Wall Street or in the world for that matter, know what the market will do in the future (so we have to learn to live in this “imperfect” market timing world).

There are many other aspects to successful investing, this article addresses only one aspect of risk (market risk), other aspects are addressed in subsequent parts of the web site.

For an illustration of market timing reducing market risk, I have included a few charts below.

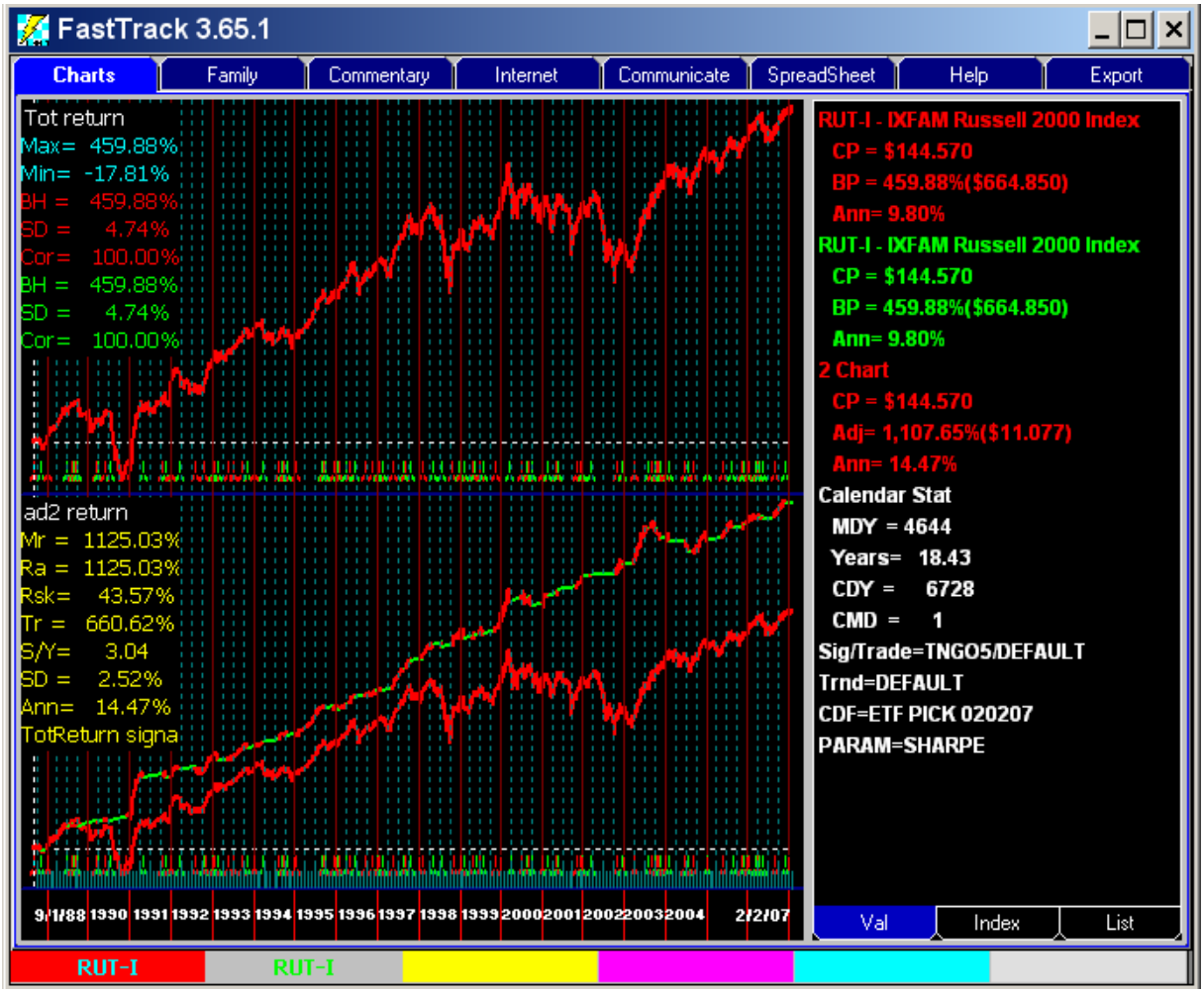


This is a chart of the NASDQ Composite for a period of 18.43 years which is timed by the Tango5 signal. You can see the dramatic difference in the lower chart, the red and green line is the timed equity curve. The green is when you are out of the market in money market (cash). The first statistic I will point out is called Rsk (in yellow stands for RISK) which is the time you are

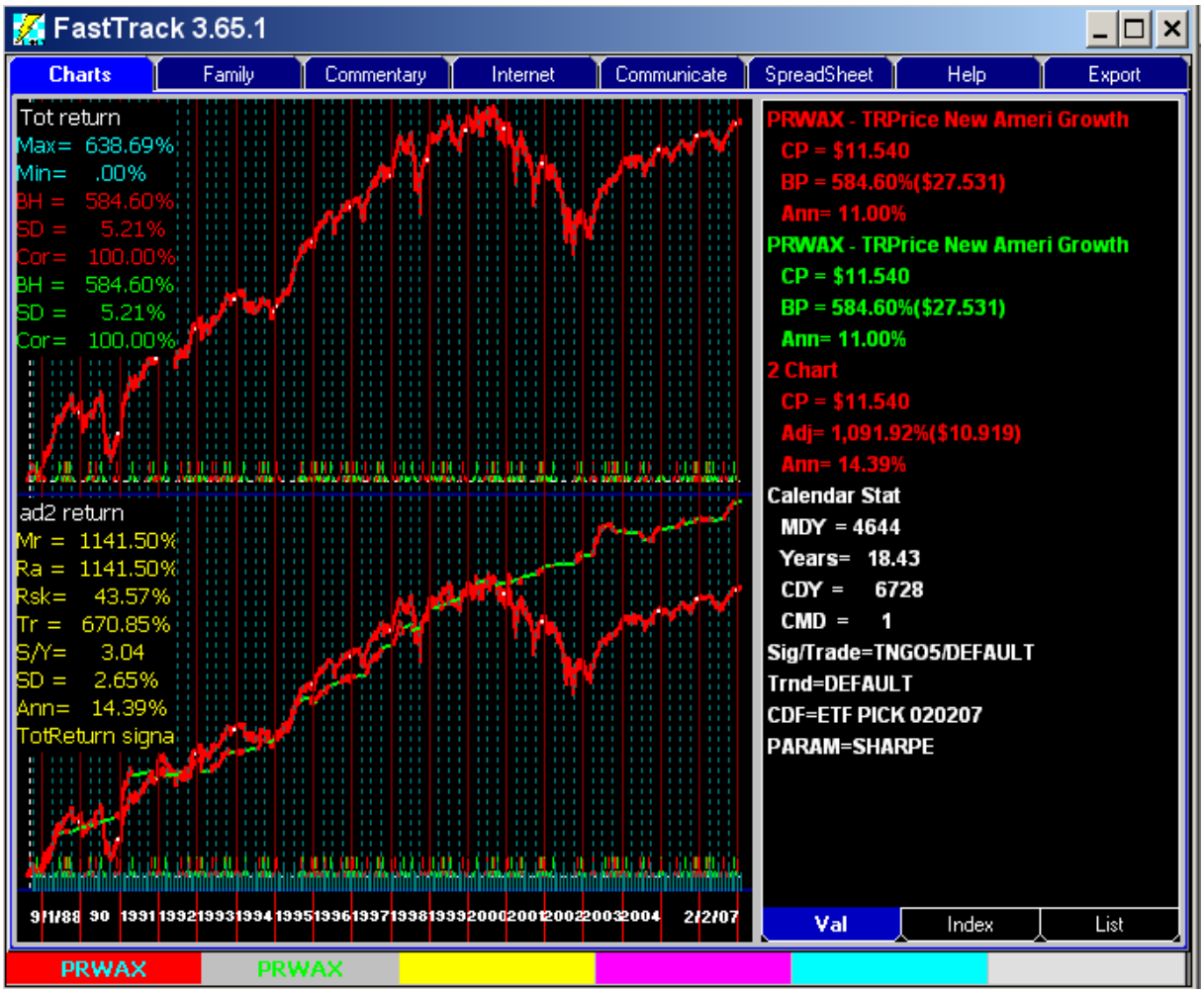
actually in the market with your money at risk. In this case you are in the market only 43.57% of the time.

Another measure of risk is SD (Standard Deviation in yellow on the lower chart) which is 3.39% based on the timed equity curve. SD (Red) on the upper chart is 6.66% based on the no timing equity curve. This means you have reduced your risk by 50% in SD just by timing the market.

Also on the upper right BP (in Red stands for Between the Poles or the total period of the chart) has a Total Return of 563.77% for the no timing equity curve. The 2 Chart, Adj (in Red adjusted for market timing) has a Total Return, over the same period, of 1,461.61% for the market timing equity curve. So the result is almost three times the profit at half the risk.



This chart is of the Russell 2000 small cap Index, and the definitions of the statistics are the same as above. The values are different, but you can see similar results.



Charts by www.fasttrack.net

This is a chart of TRPrice New American Growth fund, you can see the same results.

In this article I have referred to the term “market timing”, I prefer using the term “Managed Risk Investing” in place of market timing. Controlling market risk is really what is described above, but the investment community call it market timing. So I used the term “market timing” throughout this article so that the process described above will be understood by more people. In subsequent parts of the web site I refer to MRI (Managed Risk Investing) as our model to reduce and control market risk.