The Hazards of Market Timing

"Do not use market timing. It only costs you money!"
David Dreman

One of the biggest mistakes investors make is trying to time the market. The concept of "market timing", by moving into the market as it is rising and out of the market when it is falling is extremely appealing. Unfortunately, there is overwhelming evidence this strategy does not work.

Studies on Market Timing

Virtually every study of market timing concludes that it results in lower returns. A review of four studies underlines how damaging this strategy can be.

- A study of 100 U.S. pension funds who engaged in market timing found that not one fund improved its return as a result of market timing. In fact, 89% of the funds lost as a result of market timing and their losses averaged 4.5% over a 5-year period.
- A study by Hulbert Financial Digest found out of 131 investment newsletters offering advice on market timing (and a 5-year track record), only 5 newsletters beat the overall market.
- A study by David Dreman of 186 mutual funds engaged in market timing over a 12-year period found the market timers had a return of 384% vs. a market return of 734%. In other words, market timing cut returns almost in half.
- In another U.S. study, investors earned only half of the market return, and in a Canadian study, investors earned only 60% of the market return. The major reason for this dismal performance was attributed to mistakes investors made in trying to time the market.

Why Market Timing Does Not Work

It's a simple concept but why doesn't market timing work?

1. Market Moves Are Very Sudden

Significant moves in the market occur over very short time periods. For example, a study by Peter Lynch found that, over a 40-year period, if you were out of the market for the best 40 months (only 8.3% of the time) your annual investment return dropped from 11.4% to 2.7%. Even missing big daily moves in the market can have a huge impact on returns

2. The Market Is Very Unpredictable

One of the most fascinating things about the stock market is its randomness. What makes the market so unpredictable is it moves well in advance of economic events. All the current information about the economy, social trends, politics, and news on individual stocks is already "in the market" and is widely known by sophisticated investors who are the major buyers and sellers. The only news which moves the markets significantly is unexpected news; hence the unpredictability of the markets.

3. The Market Moves Upwards 70% Of The Time

This is probably the most compelling reason for not trying to time the market. Is it smart to bet against the market when the odds are more than 2-to-1 against you?

4. Market Timers Must Be Right 3-Out-Of-4 Times

Many people have success in timing the market one, two, or even half-a-dozen-times but unfortunately these short-term successes do not persist over the longer term. Even if you are successful getting out of the market at the top, how successful will you be getting in at the bottom? And how often are you going to see the market move higher after you have gotten out of the market?

A study by Novel-laureate William Sharpe concluded that market timers must be right 75% of the time to be successful. Given the unpredictable nature of the markets, the chances of someone being right 75% of the time over the long run are very improbable.

The results of the studies concluded: market timing can significantly reduce investors' returns. The lessons of the market are clear. You never know when the market is going to move and you have to be there when it does!