MARKET TIMING-
THE LURE OF PERFECTION

Investing is very simple. You want to buy low (at the bottom) and sell high (at the top). The ideal investment would be graphed as follows.

Note that this graph has a steady progression straight up from bottom to top. Unfortunately, investments never have such a smooth progression. The second graph is more emblematic of reality.

Price changes are the reasons behind the ups and downs of the graphs. Changing prices are the result of changing economics, government regulations, and specific business operational results and the markets perceptions and reactions to these events. The ability to 'bottom tick and top tick' the changing prices requires nothing more than understanding the interactions of the economic, government and business activities and understanding the markets reactions to these events; easy enough!

Over the thirty years we have practiced our profession, we have had the good fortune to follow the thoughts
and prognostications of many a market pundit. There has never been a shortage of styles, methods or explanations as to why it is a good time to buy or sell any market or investment. Neither has there ever been a consensus as to whether it is a bullish time to buy or a bearish time to sell. This includes some inflection points that in the rear view mirror look so obvious that you wonder if ‘Tulip Mania’ hadn’t struck the markets again. Yet with all of it we have yet to identify any method or any person whose prognostications are consistently timed near the tops and bottoms. Some have become famous for individual timing calls (and some infamous) but consistency in timing calls is an elusive thing.

We paraphrased the following from Howard Marks in the last newsletter, “Being humble, disciplined, resourceful and working hard are the essential elements of successful investing and wealth accumulation. Varying degrees of aggressiveness, timing and luck will be bonuses to the process.” We would speculate that the first set of characteristics (humility, discipline resourcefulness and hard work) account for 80% and the second set (aggressiveness, timing, and luck) account for 20% of the formula in a long-term investment plan.

If we are right and timing is some fraction of only 20% of the success of investing why do so many put so much effort and weight on its importance? So why is there such a fascination with the timing of the markets?

First, it appears to add a lot of value to the process. Buying at the low protects against loss since it cannot go lower. And selling at the top preserves all the gains and additionally protects against the next inevitable down. This would be compounding on steroids.

Second, if it is accomplished it allows the investor to have minimum emotional fatigue. Buying low and selling high is the ‘Emotional Wonderland’ of the investor. What worries would you have if you always bought low and sold high; other than making your estimated tax payments on time.

Third, if you can get this element of investing right the other elements are not necessary, especially humility. However the then ensuing lack of humility won’t favor your continued success in market timing!

After, thirty years of observing the markets we are convinced our ability to accurately pick tops and bottoms, short-term, intermediate-term, long-term or any other term is limited. The real difficulty with timing in the equity markets is the speed at which the moves happen. You can be up or down 15% or 25% before you can bat an eye. Other markets may move slower but the elusiveness of the tops and bottoms is there nonetheless.

We have often stated that if we were to be reasonably invested within +/- 10% of the so-called bottoms and taking reasonable profits within +/- 10% of the tops success would be inevitable. Our value orientation and investing instincts are probably more attuned to being
early on the buy side and the sell side. That is to say we are buying on the way down and selling on the way up.

In a recent commentary, Jeffrey Gundlach of Double-Line described his firm’s approach to buying (or selling) into the market. “So you need to average your way back into the market. I often describe how we get back into the markets as ‘saucer shaped,’ we average back in. Now it is true that you end up making 80% of your money in bonds (and stocks) during 20% of the time, but do not rush back into the market because fixed income always rises more slowly than it falls.” (Parentheses added by us.)

This is true for all markets in all assets. One manager’s analogy described it best when he said that the air comes out of a balloon much faster than it goes in. Catching the markets tops and bottoms is like catching the balloon as the air is let out and it flies around the room in a spasmodic fashion.

In managing investor behavior and investments the timing aspect is most dangerous and difficult when it is an all or nothing proposition. In hindsight, and as it relates to timing, the biggest mistakes we have seen made by investors is when they go to all cash or are all in and the timing is poor. Inevitably these decisions are emotionally based and fear or greed is the prevailing and dominant force. And because fear is a much greater motivator for most people, the vast majority of these all or none decisions are sales and they are made near market lows. The consequence is that much of the air has been left out of the balloon. And by the time the investor makes a decision to invest again, when he/she feels better, a significant part of the subsequent market advance has already happened and they have left a lot of their potential recovery behind them.

We guard against the all or nothing decisions in our investment strategy and counsel against such moves with clients. Our investment process protects against this with the asset class diversification and our periodic rebalancing. We also confirm client’s overall risk tolerance level periodically. If needed adjustments to the proportion of higher volatility assets with lower volatility assets will be recommended.

We are beginning to sense some of the characteristics of a market top; e.g. lack of volatility, retail money flows are positive for the first time, valuations appear full, limo drivers and the average investor are talking stocks again. It is probably not a time to back up the truck and fill it with risk assets. ‘Saucering’ out of some profits, both from stocks and bonds, seems more prudent. We will continue to invest in those areas we feel offer the best risk/reward for your capital. We will also keep the portfolios balanced for your capital. And we will continue to evaluate alternative investments, including cash, as the inevitable changes in the economy and markets avail themselves.
Invest directly in an index.

A diversified representation of commodity markets as an asset class. It is not possible to invest directly in an index.

The Dow Jones-UBS Commodity Index aims to provide broadly diversified representation of commodity markets as an asset class. The NASDAQ Composite Index is an unmanaged index of all stocks traded on the NASDAQ over-the-counter market. The Dow Jones Industrial Average is an unmanaged index of 30 widely held securities. The Wilshire Real Estate Securities Index measures the performance of publicly traded U.S. real estate securities. The Barclays Capital U.S. Corporate High-Yield Bond Index covers the universe of fixed-rate, non-investment grade corporate debt of issuers in non-emerging market countries. Eurobonds and debt issues from countries designated as emerging markets are excluded. The Barclays Capital Long-Term Municipal Bond Index is comprised of those securities included in the Municipal Bond Index that have maturities greater than 22 years. It is not possible to invest directly in an index.

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