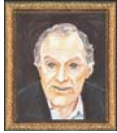




Step 4 ~ Time Pickers

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STEP 4 Time Pickers



“Market Timing is a wicked idea. Don’t try it—ever.”

- Charles D. Ellis, author of *Winning the Loser’s Game*



“O Fortuna! Like the moon everchanging, rising first then declining.”

- Carmina Burana, Lyrics from O Fortuna [The Goddess of Luck - the active investors’ only hope]



“There are two kinds of investors, be they large or small: those who don’t know where the market is headed, and those who don’t know that they don’t know. Then again, there is a third type of investor - the investment professional, who indeed knows that he or she doesn’t know, but whose livelihood depends upon appearing to know.”

- William Bernstein, *The Intelligent Asset Allocator*



“If I have noticed anything over these 60 years on Wall Street, it is that people do not succeed in forecasting what’s going to happen to the stock market.”

- Benjamin Graham, Legendary investor and author, Warren Buffett’s Mentor, *Security Analysis*, 1934



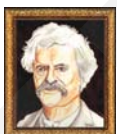
“Statistical research has shown that, to a close approximation, stock prices seem to follow a random walk with no discernible predictable patterns that investors can exploit. Such findings are now taken to be evidence of market efficiency, that is, evidence that market prices reflect all currently available information. Only new information will move stock prices, and this information is equally likely to be good or bad news.”

- *Investments*, Fifth Edition, p. 374, Zvi Bodie, Professor of Finance, Boston University School of Management, Ph.D. MIT. Co-authors include Alex Kane and Alan Marcus



“... most [stock pickers and market timers] should go out of business - take up plumbing, teach Greek...”

- Paul A. Samuelson, Nobel Laureate, “Challenge to Judgement,” *The Journal of Portfolio Management*, Fall 1974, p. 17-19 1974



“October is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August and February.” Also, “There are two times when a man shouldn’t speculate: when he can’t afford it, and when he can.”

- Mark Twain, (1835-1910), *Following the Equator, Pudd’nhead Wilson’s New Calendar*



“Hulbert’s conclusion: None of the newsletter timers beat the market [over a ten year period]. The average return was 11.06%. During the same period, Standard & Poor’s 500-stock index earned 18.06% annually...”

- Jeffrey M. Laderman - “Market Timing: A Perilous Ploy,” *Business Week*, March 9, 1998, Table of Results

“I tell investors to put a large portion of their stock investments in index funds.”

- Mark Hulbert, *Hulbert Financial Digest*, taken from an interview by Benjamin Mark Cole in *The Pied Pipers of Wall Street*

“The market is like watching a drunk walk a tight rope. You never know what’s going to happen next.”

- Arthur Cashin, CNBC Commentary, CNBC Television, November 21, 2003.

4.1 INTRODUCTION

Step 4: Understand that no one can pick the right time to be in or out of the market.

Time pickers, also known as market timers, believe they can predict the future direction of the market. In their efforts to time the market, they attempt to invest in stocks when the market is up and shelter their investments in cash, Treasury bills or bonds when the market hits a downturn.

Nobel laureate Robert Merton wanted to estimate what a clairvoyant time picker would earn. To that end, he calculated the value of being invested in the market during upturns and Treasury bills during market downturns. His findings show that investors who stayed invested in T-bills from 1927 through 1978 would have seen their \$1,000 investments grow to \$3,600. Meanwhile, in the broad market of the New York Stock Exchange (NYSE) Index, a \$1,000 investment would have grown to \$67,500 during the same period. A time picker with the vision to forecast all the months that the NYSE outperformed T-bills during the 52-year period would naturally invest in the market at the beginning of each of these months. According to this timing system, \$1,000 would have grown to \$5.36 billion. Now that is a real incentive to figure out how to pick the right times to invest. It also proves that if timers really had psychic powers that allowed them to see next month's market trends, they would grace the covers of *Forbes*, *Fortune*, *BusinessWeek* and *The Wall Street Journal*. But, they do not.

Is it possible that there are a few visionary timers out there? Sorry, but they just don't exist.

In 1978, the wealthiest individual on record didn't come close to these numbers. Wealth is not created by purposeful market timing. There may be cases where one got lucky for a while, but that is not a reliable strategy for long-term investors.

There are numerous time-picking purveyors who offer their visions of tomorrow through telemarketing, fax broadcasting, newsletters, e-mails, and Web sites. However, investors should be aware that these market-timing newsletters are not regulated by the SEC, whose job it is to protect investors. Estimates show that investors who flock like sheep to follow the market predictions of "expert timers" lose millions of dollars each month.

The landmark and definitive study of time pickers was conducted by John Graham of the University of Utah and Campbell Harvey of Duke University. The professors painstakingly tracked and analyzed more than 15,000 predictions by 237 market timing investment newsletters from June 1980 through December 1992. By the end of the 12.5 year period, 94.5% of the newsletters had gone out of business, with an average length of operations of about four years! The conclusion of this 51-page analysis could not have been stated more clearly. "There is no evidence that newsletters can time the market. Consistent with mutual fund studies, 'winners' rarely win again and 'losers' often lose again." This clearly indicates that the market's signals are inaudible to the thousands of time pickers claiming to clearly hear them. Any investment professional who speculates on the market's future should be relegated to the fortune telling parlor.

Jeffrey Lauderman wrote a *BusinessWeek* article dispelling the myth of market timing, a practice he called "a perilous ploy" and "a guessing game." His 1998 analysis included an inter-

view with Mark Hulbert, publisher of a service that objectively monitors investment newsletter performance. Hulbert's conclusion provided a knockout blow to all 25 newsletters he tracked. None of the newsletter timers beat the market. For the 10-year period from 1988 to 1997, the time pickers' average return was 11.06% annually, while the S&P 500 Stock Index earned 18.06% annually and the Wilshire 5000 earned 17.57% annually. Figure 4-1 tells the story.

The truth is, time pickers vacillate from near zero risk to high risk and then back to zero risk again. A more rational approach for investors is to match their risk exposure to their risk capacity. Once that match is established, the right time to be in the market is when an investor has money, and the right time to get out of the market is when an investor needs their money.

4.2 DEFINITIONS

The underlying assumption of all forms of time picking is that the pickers know news or information not known to millions of other market participants. For continued success, the picker must have a never-ending source of information not available to all other traders. No one can single-handedly possess such incredibly powerful and immensely valuable information.

Two concepts that support the idea that timers are unable to pick the right times to invest are the Random Walk Theory and the Efficient Market Hypothesis.

4.2.1 Random Walk Theory

The Random Walk Theory states that there are no discernible patterns in stock market prices. The logic behind the theory is that news moves the markets. News is both unpredictable and random

by definition. At the moment of public discovery, news rapidly becomes old. Since free financial markets are free of constraints, new information is continuously reflected in the prices of relevant financial instruments. Therefore, the world's markets move in a random and unpredictable manner. As an example of randomness, look at these market summaries from *The Wall Street Journal*:

JULY 24, 2002: The Dow Jones Industrial Average soared 488.95 points, or 6.4%, to 8191.29 Wednesday — their second-highest point gain ever — as bargain-hunting and short-covering provided a powerful antidote for the persistent sell off. The Nasdaq Composite surged 60.96, or 5%, to 1290.01.

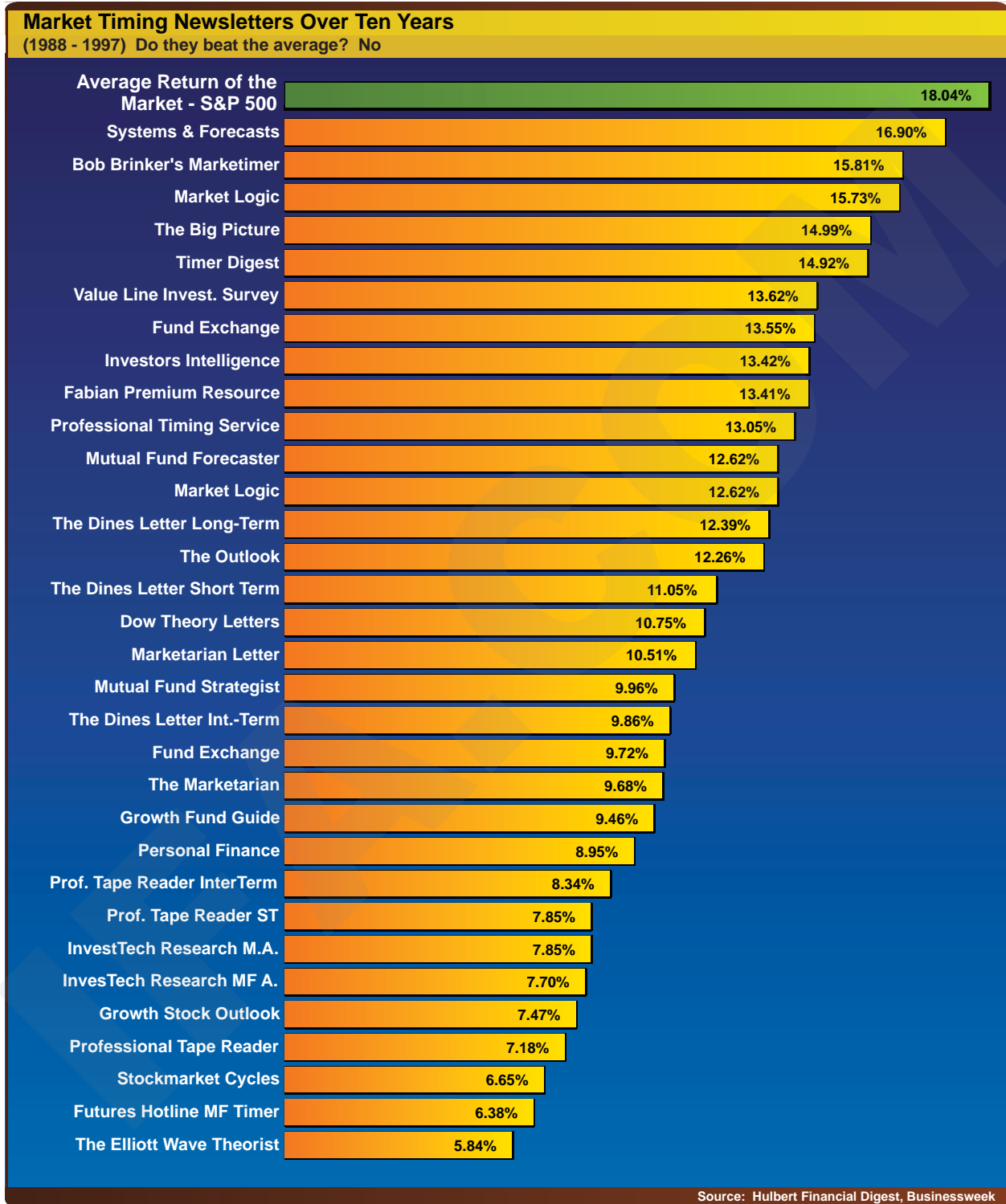
SEPTEMBER 19, 2002: U.S. stocks slid Thursday as investors were bombarded by bad news from EDS, Morgan Stanley and Merrill Lynch. Few analysts saw the EDS news coming. The Dow Jones Industrial Average fell below 8000, dropping 230.06, or 2.8%, to 7942.39, while the Nasdaq Composite Index sank 35.70 or 2.9%, to 1216.43.

SEPTEMBER 27, 2002: U.S. stocks moved lower Friday, weighed down by concerns about corporate profits and somber economic news. In late-afternoon trading, the Dow Jones Industrial Average fell 250 points, or 3.1%, to 7745, while the Nasdaq Composite Index slipped 13 to 1208.

NOVEMBER 27, 2002: U.S. stocks rebounded Wednesday, with an abundance of upbeat economic data helping push the Dow Jones Industrial Average up 255.26, or nearly 3%, to end at 8931.68. The Nasdaq Composite Index jumped 43.51, or 3.1%, to 1487.94.

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Figure 4-1



MARCH 13, 2003: Major U.S. stock indexes logged their biggest gains of the year on hopes for a delay in a possible war with Iraq. The Dow Jones Industrial Average surged 269.68, or 3.6%, to 7821.75 in heavy trading, while the Nasdaq Composite Index had jumped 61.54, or 4.8%, to 1340.78.

MARCH 17, 2003: U.S. stocks surged Monday on signs the U.S. will go to war with Iraq, a move some say will remove a level of uncertainty in the market. The Dow Jones Industrial Average was up about 239 points in late-afternoon trading, while the Nasdaq Composite Index was ahead roughly 3.2%.

MARCH 24, 2003: The Dow Industrials tumbled 307.29 points, or 3.6%, to 8214.68 Monday as investors began to worry that the war in Iraq could drag out longer than anticipated. The Nasdaq composite lost 52.06, or 3.7%, to 1369.78.

JULY 7, 2003: U.S. stocks surged Monday, with the S&P 500-stock index rising above 1000 as investors pinned hopes on a strong second-quarter earnings season. By midmorning, the Dow Jones Industrial Average was up 179 points, or 2%, to 9251. The Nasdaq Composite Index jumped 45 points, or 2.7%, to 1708.20, and the S&P 500 rose 18.20, or 1.9%, to 1003.90.

As a side note, the reason markets trend upward is that the sun shines on capitalism, as investors' cash provides the fuel to fund profitable ventures. Cash is injected into the market through the purchase of products, services, debts or equities. On average, this free market system works better than a central government controlled system. Communism still exists in only a few countries where there is a mentality similar to that of active investors. This mentality is based

on the falsehood that free markets do not reflect all information. Market speculators and communists both think they know more than the collective opinion of millions of voting market participants. They assume that they possess information that has not yet been picked up by the radar of all traders throughout the world. On the other hand, those who invest in index funds invest under the assumption that markets properly price assets and risk.

Rex Sinquefeld is a director of Dimensional Fund Advisors (DFA) and one of the world's foremost experts on the stock market. In 1995 he was asked to represent index funds investing in a debate with an active manager at a Schwab conference. After an eloquent review of the history of capital markets from Adam Smith to Eugene Fama, he threw down the gauntlet to a room full of active managers: "So who still believes that markets don't work? Apparently it is only the North Koreans, the Cubans, and the active managers," he said.

4.2.2 Efficient Market Hypothesis

The efficiency of communication has progressed as follows: horseback, slow boat, smoke signals, homing pigeons, flashing lights on navy ships, Morse code, telegraphs, telephones, radios, televisions, computer networks, and finally the Internet. With each step, information and news became cheaper, more accurate, and more rapidly disseminated.

The Efficient Market Hypothesis simply states that market prices accurately reflect all available information at all times. This leads to the conclusion that it is impossible to consistently beat the market averages. As Bachelier stated in 1900, the expected return of speculation is zero. The most recent studies by Richard Roll, a professor of finance at the University of

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California, indicate that new information is reflected in market prices within five to 60 minutes. Within that 60 minutes there are hundreds or thousands of traders all competing to profit from the information. If you are in charge of \$1 billion, a 0.1% annual gain is worth \$1 million per year. Consequently, managers of those funds are applying considerable resources to squeeze out every little gain from new information. For this reason alone, there is an absence of opportunities for one trader to consistently profit from all other traders who have access to the same information at the same time! In short, it is impossible for one person to consistently possess more knowledge than all the other traders combined.

Analysis for Financial Management, a book written by Robert C. Higgins, paints a vivid picture of how information is devoured by market participants: “Market efficiency is a description of how prices in competitive markets respond to new information. The arrival of new information to a competitive market can be likened to the arrival of a lamb chop to a school of flesh-eating piranhas, where investors are—plausibly enough—the piranhas. The instant the lamb chop hits the water, there is turmoil as the fish devour the meat. Very soon the meat is gone, leaving only the worthless bone behind, and the water returns to normal. Similarly, when new information reaches a competitive market there is much



turmoil as investors buy and sell securities in response to the news, causing prices to change. Once prices adjust, all that is left of the information is the worthless bone. No amount of gnawing on the bone will yield any more meat, and no further study of old information will yield any more valuable intelligence.”

4.3 PROBLEMS

4.3.1 Time Pickers are Fooled by Randomness

An important point for investors to understand about time picking is the Random Walk Theory, which states that nobody can consistently see what tomorrow will bring. Remember that news moves the market and is random and unpredictable by definition; therefore, the markets move in a random and unpredictable fashion—period, end of story.

This simple and easy to understand concept about the markets was first published more than one hundred years ago. Since then, virtually all subsequent academic studies detailing actual stock market data conclude that time picking is not likely to be a successful investment strategy. Unless, of course, the Goddess Fortuna is whispering stock tips in your ear. She may be the only antidote to market randomness and the active investors’ only hope. You can make your own luck by staying in the market at all times and owning a globally diversified portfolio of indexes.

From 1901 to 1990, the stock market return was approximately 9.5% per year. SEI Corp. completed a study in 1992 that showed in order to just equal this average annual return over this 90-year period, a time picker needed to correctly

select about 70% of the ups and downs of the market.

The study also showed that if time pickers called 100% of the declining markets and only 50% of the rising markets, they still were not able to exceed the return of the overall market during this period. To add a final blow, there was no consideration for the high short-term capital gains taxes or transaction costs involved in this highly flawed strategy. No wonder 95% of market-timing newsletters go out of business.

There’s more bad news for time pickers. For one thing, most of the gain achieved in a rising market is often concentrated at the beginning of its rise in highly concentrated surges. Because the markets go up on average, there are greater benefits to be in the rising markets than there are to avoid the falling markets. This additional tidbit is garnered from a New York University study completed in 1986. The study’s clincher was that it found no evidence that time pickers could successfully time either the beginning of a rising market or the end of a falling market.

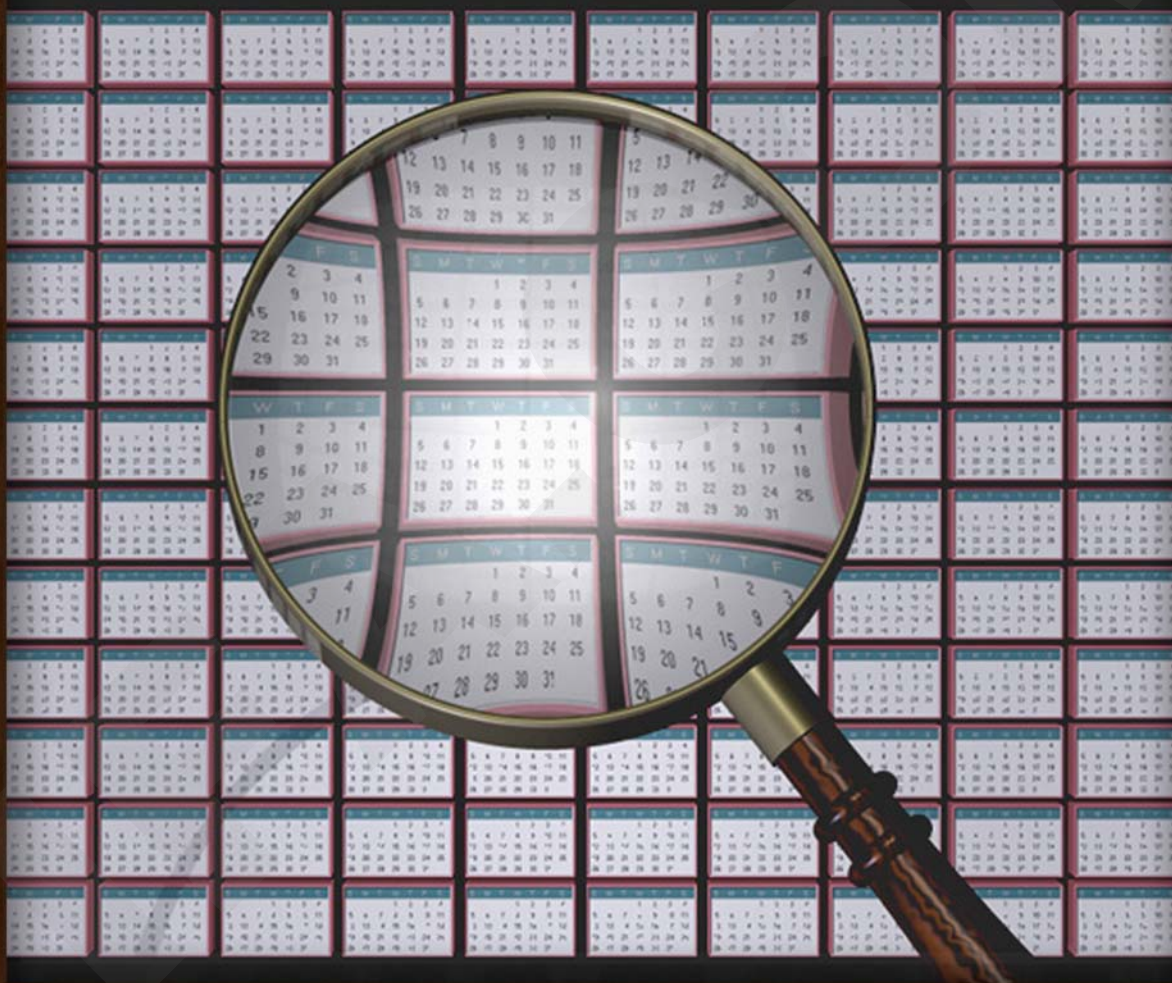
Another IFA study examined the 2,516 stock market trading days over ten years from 1997 through 2006. The data shows that during this period, the S&P 500 Index produced an annualized return of 8.4%. Therefore, a smart and prudent investor who invested \$10,000 in the S&P 500 at the beginning of 1997, and stayed fully invested was handsomely rewarded with a \$12,444 gain by the end of the 10 years.

However, if just 10 trading days with the largest gains were missed, the annualized return would have dropped from 8.4% to 3.4%. Instead of gaining by \$12,444, the investor would have ended with only a \$3,992 gain.



Figure 4-2

*Out of these 2,516 Trading days,
could you have found the 20 days
that made up 100% of the returns?**



**According to data from Standard & Poors, for the ten-year period 1997-2006,
the 20 days with the biggest gains accounted for 100% of the total gain.*

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Table 4-1

The Real Problem with Market Timing: Missing the Big Days				
10 Year Period (1997 - 2006)				
\$10,000 Invested in the S&P 500 from 1997-2006	S&P 500 Annualized Return	Value at the End of the Period	Gain	Contribution of Missing Days
All 2,516 Trading Days	8.4%	\$22,444	\$12,444	0.0%
Less the 5 days with the biggest gains	5.7%	\$17,360	\$7,360	40.9%
Less the 10 days with the biggest gains	3.4%	\$13,992	\$3,992	67.9%
Less the 15 days with the biggest gains	1.4%	\$11,546	\$1,546	87.6%
Less the 20 days with the biggest gains	-0.4%	\$9,640	-\$360	102.9%

Source: Yahoo! Finance

If the best 20 trading days were missed, which is less than 1% of the total number of trading days, the annualized return would have dropped to a minus 0.4%, yielding a loss of \$360. Thus, more than 100% of the return would have been lost in just 20 days, or an average of 2 days per year (see Table 4-1 and Figure 4-2). A random walk of any of the world's markets is impossible to predict.

The odds against success in picking the right times are overwhelming, and the odds become worse over time with the high taxes and fees associated with frequent trading.

4.3.2 Academic Studies Prove that Time Picking doesn't Work

Studies fill literature confirming the failure of market timing. All these peer-reviewed research papers share the same conclusion—forget timing the market.

In the paper titled “Selectivity and Market Timing Performance of Fidelity Sector Mutual Funds,” Wilfred Dellva, Andrea Demaskey and Colleen Smith concluded that there was negative timing ability among the Fidelity sector funds during the period from 1989 to 1998.

In 1998, Professors Connie Becker, Wayne Ferson, David Myers, and Michael Schill studied market timing in their paper titled “Conditional Market Timing with Benchmark Investors.” The academics found no evidence supporting the claim that funds have significant market timing ability.

Professor Wei Jiang presented his market timing studies in his 2001 paper, “A Nonparametric Test of Market Timing.” After spending countless hours combing through the results of 1,557 retail mutual funds and 210 institutional funds, Jiang concluded that timing ability on average is negative. Just as a side note, this paper lists 41 other academic studies in the reference section, providing further corroboration that market timing doesn't work.

Superstar academic William Goetzmann, along with Jonathan Ingersoll and Zoran Ivkovich, contributed their two cents with a paper titled “Monthly Measurement of Daily Timers.” The professors performed four tests of timing skill on a sample of 558 mutual funds, and concluded that very few funds exhibit statistically significant timing skill.

In another paper written in 2002 by Professors Michael Johannes, Nicholas Polson and Jonathan Stroud market timing was once again put to the test. The simple yet powerful conclusion of this paper was that market timing strategies performed worse than the buy-and-hold strategy in all cases examined.

Meanwhile, to illustrate the extreme concentration of stock market returns, Professor H. Nejat Seyhun carefully analyzed the 7,802 trading days for the 30 years from 1963 to 1993. Seyhun is the chairman of finance at the University of Michigan School of Business Administration, a position that is only obtained by highly dedicated and intelligent individuals who have spent many years learning how capital markets work. His conclusion provides a crushing blow to timers who think they can outsmart the market. A mere 90 days over 30 years contained 95% of all the market gains. That is an average of three days per year.

The academic evidence described above overwhelmingly proves that time pickers cannot consistently know where the market is headed. The idea that time pickers can predict market movements is nothing more than a fairy tale.

4.3.3 Time Picking Gurus

Even though financial academics widely accept the concept of market efficiency, Wall Street firms continue to pander their market timing predictions through their appointed gurus. Their strategy is to encourage their clients to trade more, even though academics conclude that trading is hazardous to the client's wealth.

The pied pipers of Wall Street do not have a good batting average. No Babe Ruths there. Smartmoney.com has been tracking these pundits dating back to 1997. Table 4-2 summarizes

Table 4-2

Batting Averages of Time Pickers	
Market Pundits	Batting Average
Abby Joseph Cohen	0.128
Edward Kerschner	0.136
Jeffrey Applegate	0.147
Thomas Galvin	0.147
Edward Yardeni	0.152
Laszlo Birinyi	0.157
David Jones	0.164
Richard Bernstein	0.183
Bill Gross	0.189
Tobias Levkovich	0.200
Edward Hyman	0.236
Average of all 11 forecasters	0.167

Source: Smartmoney.com

some of their batting averages. You can see that Ed Hyman, who is considered one of the best economists, has the best batting average with a 0.236. That is the equivalent of hitting an average double each time at bat or in the scoring system, a call that may win plaudits for accuracy, but not for insight and strong feeling. For example, the forecaster made a correct, but obvious and wishy-washy call about the direction of interest rates. For those who scored lower, it generally means a true dud of a pick or a mostly inaccurate prediction that might have one redeeming feature but that likely fails the degree of difficulty and or confidence tests. A batting average of 0.400 would indicate an accurate forecast that was difficult to make but still uttered with the utmost confidence.

Here are the averages as reported by Smartmoney.com, where the average batting average for all 12 forecasters was somewhere between first and second base, 0.166. Since an accurate call would yield an average of 0.400, the most respected and well-known market forecaster falls on the side of inaccuracy about 60% of the time and accuracy about 40% of the time.



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For further evidence of the heavy fog in crystal balls, let's take a look at results from 2003 and predictions about them. In that year, stock prices rose in almost every global market. Returns for U.S. small company stocks were particularly strong; the total return for the Russell 2000 Index was 47.25%, the highest annual return since inception of the index in 1979, according to Russell Analytic Service; and the total return for the CRSP 9-10 Micro Cap Index was in excess of 70%, the highest annual return since 1967, according to the Center for Research in Security Prices, University of Chicago.

However, investors seeking to capture market rates of return in 2003 would have had to ignore a large body of opinion, a sample of which appears below, suggesting that stocks were unattractive. Most of the quotations listed appeared during the first quarter of 2003 when stock prices were slumping and the outlook most uncertain. Year-to-date returns for the S&P 500 and Russell 2000 Indices did not turn positive until mid-April.

"It's going to be a difficult environment for stock investors. Don't count on the market to move up. To make money, you've got to select the right names." - Quotation attributed to David J. Winters. Source: Franklin Mutual Advisers LLC, "Brainwork from the Experts," *BusinessWeek*, December 30, 2002, p. 102. [From December 2002 to December 2006, the return of the S&P 500 was 62.46%, and for Index Portfolio (IP) 100 (see Appendix A) it was 145.54%.]

"I suspect that 2003 will end up being the fourth consecutive down year for the first time since 1932." - Quotation attributed to Jeremy Grantham of Grantham, Mayo, Van Otterloo & Co. Source: "Is the Bear Market over?" *Smart Money*, January 2003, p. 71. [From January 2003

to December 2006, the return of the S&P 500 was 72.62%, and IP 100 was 153.66%.]

"Many investors have become skeptics, inclined to sell and take profits when stocks rise, rather than buy in hopes of more gains." - Source: E.S. Browning, "Euphoric Burst, then it's Back to Usual Blahs," *The Wall Street Journal*, January 6, 2003, p. C1. [From January 2003 to December 2006, the return of the S&P 500 was 72.62%, and IP 100 was 121.91%.]

"War worries also are driving money back into Treasury bonds and even into the money market, despite the fact that both of those investments feature some of the lowest interest rates in years." - Source: E.S. Browning, "Stocks Drop, Wiping out January's Gains," *The Wall Street Journal*, January 23, 2003. [From February 2003 to December 2006, the return of the S&P 500 was 77.30%, and IP 100 was 158.81%.]

"I do not believe a long-term investor will make money in this market because it is a secular bear market." - Quotation attributed to Felix Zulauf of Zulauf Asset Management. Source: "On the Money — Roundtable Part II," *Barron's* (January 27, 2003). [From February 2003 to December 2006, the return of the S&P 500 was 77.30%, and IP 100 was 158.81%.]

"The fear is that it could be a long war and we could have a sustained sell-off because of it." - Quotation attributed to Tim Heekin of Thomas Weisel Partners. Source: "Fears of War with Iraq Send Blue Chips below 8000," *The Wall Street Journal*, January 28, 2003, p. C1. [From February 2003 to December 2006, the return of the S&P was 77.30%, and IP 100 was 158.81%.]

"According to a monthly survey by Merrill Lynch, global money managers are more risk-averse than at any time since the days following

the terrorist attacks of September 2001.” - Source: E. S. Browning, “Investment Pros Want No Part of Current Risk,” *The Wall Street Journal*, February 24, 2003, p. C1 [From February 2003 to December 2006, the return of the S&P 500 was 77.30%, and IP 100 was 158.81%.]

“Soaring energy costs, the threat of terrorism, and a stagnant job market have sent consumers’ spirits plunging to levels normally seen only in recessions. The Conference Board’s index of consumer confidence fell to 64 in February, the lowest since 1993.” - Source: Greg Ip, “Consumer Spirits Decline to Levels last Seen in ‘93,” *The Wall Street Journal*, February 26, 2003, p. A3. [From February 2003 to December 2006, the return of the S&P 500 was 77.30%, and IP 100 was 158.81%.]

“Mr. Grantham’s study of bubbles suggests that it takes them about as long to deflate as it did to inflate.... He says the Standard & Poor’s 500-stock index could fall more than an additional 20% from its current level.” - Quotation attributed to Jeremy Grantham of Grantham, Mayo, Van Otterloo & Co. Source: E.S. Browning, “A Party so Wild, the Cleanup Goes on,” *The Wall Street Journal*, March 3, 2003, p. C1. [From March 2003 to December 2006, the return on the S&P 500 was 80.02%, and IP 100 was 164.36%.]

“U.S. moves toward war against Iraq sent nervous Asian stock markets to lows not seen in years, even decades, threatening an already shaky regional economy.” - Source: Martin Fackler, “Nikkei Declines to Lowest Level in Two Decades,” *The Wall Street Journal*, March 10, 2003, p. C14. [From March 2003 to December 2006, the return on the S&P 500 was 80.02%, and IP 100 was 164.36%.]

“Investors continue to sour on stocks. So far this year, investors have made net withdrawals of \$11.3 billion from their stock mutual funds —

including a hefty \$3.7 billion just last week — according to AMG Data Services. - Source: Gregory Zuckerman, “Investors Rush to Buy Bonds, Fleeing Stocks,” *The Wall Street Journal*, March 11, 2003, p. C1. [From March 2003 to December 2006, the return of the S&P 500 was 80.02%, and IP 100 was 164.36%.]

“No rally may be enough to entice some investors back. ‘I don’t trust it anymore,’ says Polly Sveda of the market, ‘I never should have trusted it.’ There is plenty of evidence that a growing number of individual investors are shunning stocks.” - Source: Tom Petruno, “After the Fall,” *Los Angeles Times*, March 16, 2003, p. C1. [From March 2003 to December 2006, the return of the S&P 500 was 80.02%, and IP 100 was 164.36%.]

“This quarter is shaping up to have the worst ratio of negative warnings to positive outlooks since the third quarter of 2001.” - Source: Jesse Eisinger, Ahead of the Tape, *The Wall Street Journal*, March 31, 2003, p. C1. [From March 2003 to December 2006, the return of the S&P 500 was 80.02%, and IP 100 was 164.36%.]

“If we see 8% this year, that will be good.” - Quotation attributed to Edgar Peters of PanAgora Asset Management. - Source: E.S. Browning, “Trading Ranges Keep the Bulls in.” *The Wall Street Journal*, April 21, 2003. [From April 2003 to December 2006, the return on the S&P 500 was 78.29%, and IP 100 was 164.76%.]

“These stocks still are way ahead of themselves. I am not at all sure we have seen the bottom; I think we could see new, lower lows.” - Quotation attributed to John Rutledge of Evergreen Investments. Source: E.S. Browning, “Experts Duel over Fate of Bellwether Rally,” *The Wall Street Journal*, June 16, 2003, p. C1. [From June 2003 to December 2006, the return on the S&P 500 was 56.47%, and IP 100 was 121.91%.]

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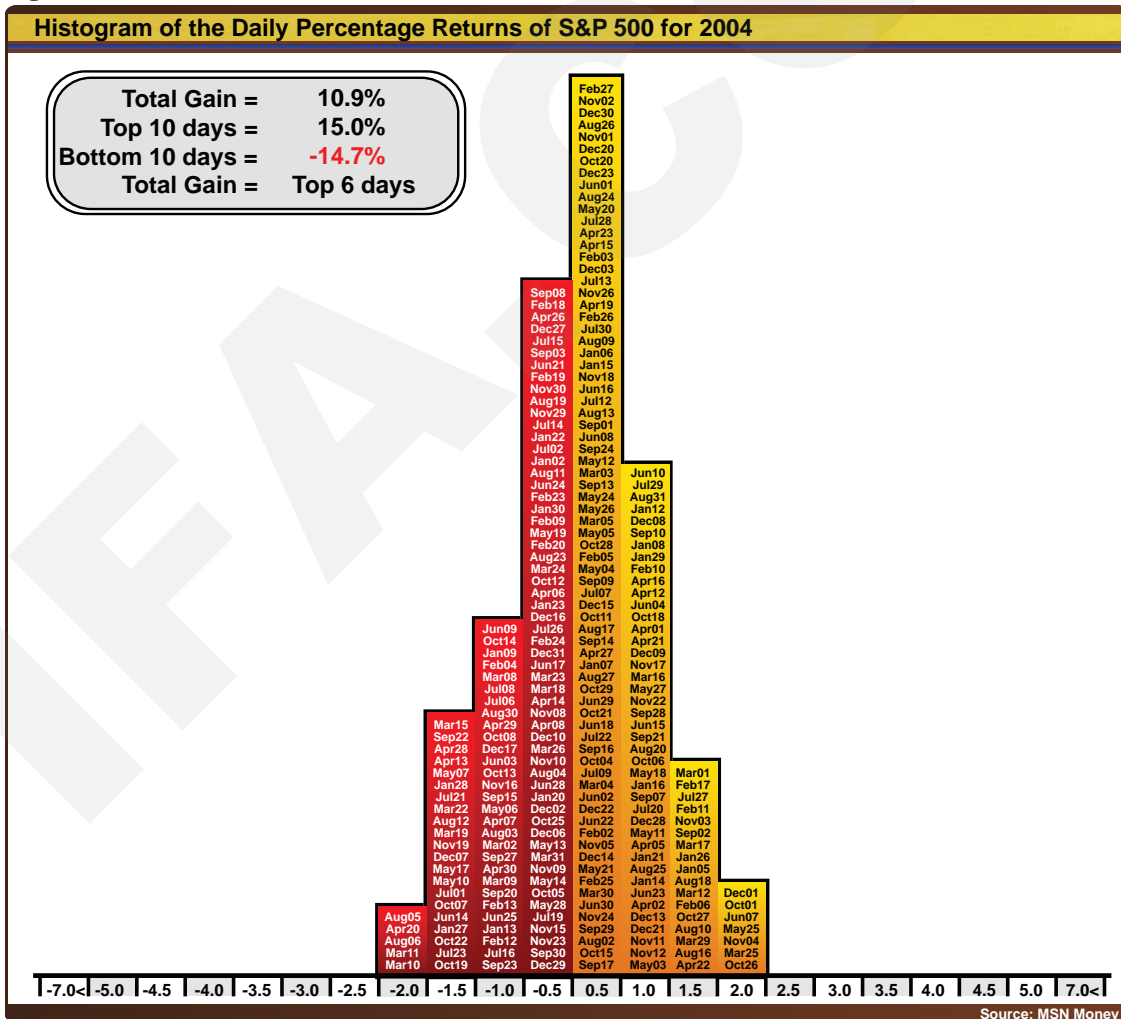
“Several important signals suggest that prices at best have topped out for the time being, and at worst are primed to move back down. Such signals ‘are classic signs of a market top,’ says Charles Biderman, president of market-research firm Trimtabs.com.” - Source: Jeff Opdyke, “Four Signs Stocks May Be Near a Peak,” *The Wall Street Journal*, June 26, 2003, p. D1. [From June 2003 to December 2006, the return on the S&P 500 was 56.47%, and IP 100 was 121.91%.]

“In our view, the quality of earnings of the S&P 500 from an accounting standpoint is the worst it has been in more than a decade.” - Quotation attributed to David Bianco of UBS Financial Services. Source: Henny Sender, “At

Earnings Halftime, Stocks Hear Mixed Messages,” *The Wall Street Journal*, July 28, 2003, p. C1. [From July 2003 to December 2006, the return on the S&P 500 was 54.57%, and IP 100 was 114.82%.]

“Even some bears now acknowledge that, when they warned people to stay away from stocks one year ago they were wrong. But they insist that now, after the market’s big gains, it is too late to buy.” - Source: E.S. Browning, “Stocks are Defying the Critics,” *The Wall Street Journal*, October 13, 2003, p. C1. [From October 2003 to December 2006, the return of the S&P 500 was 50.62%, and IP 100 was 94.93%.]

Figure 4-3



Step 4: Time Pickers

Figure 4-4

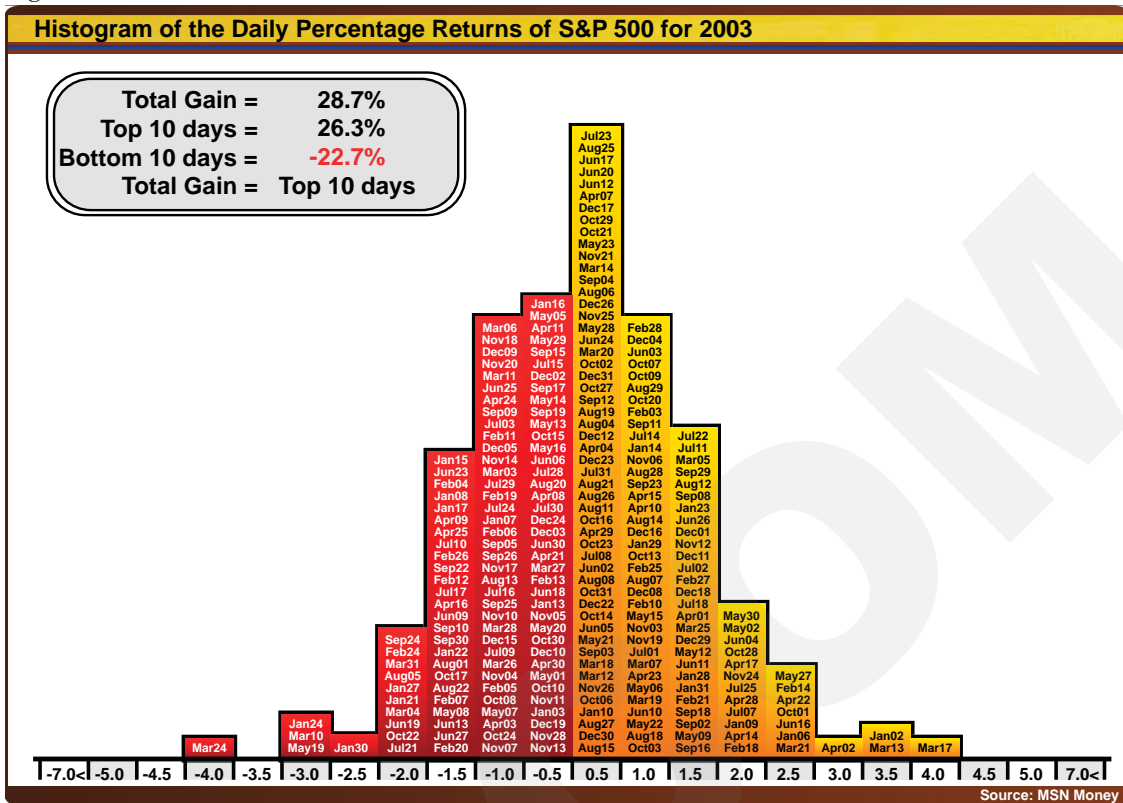
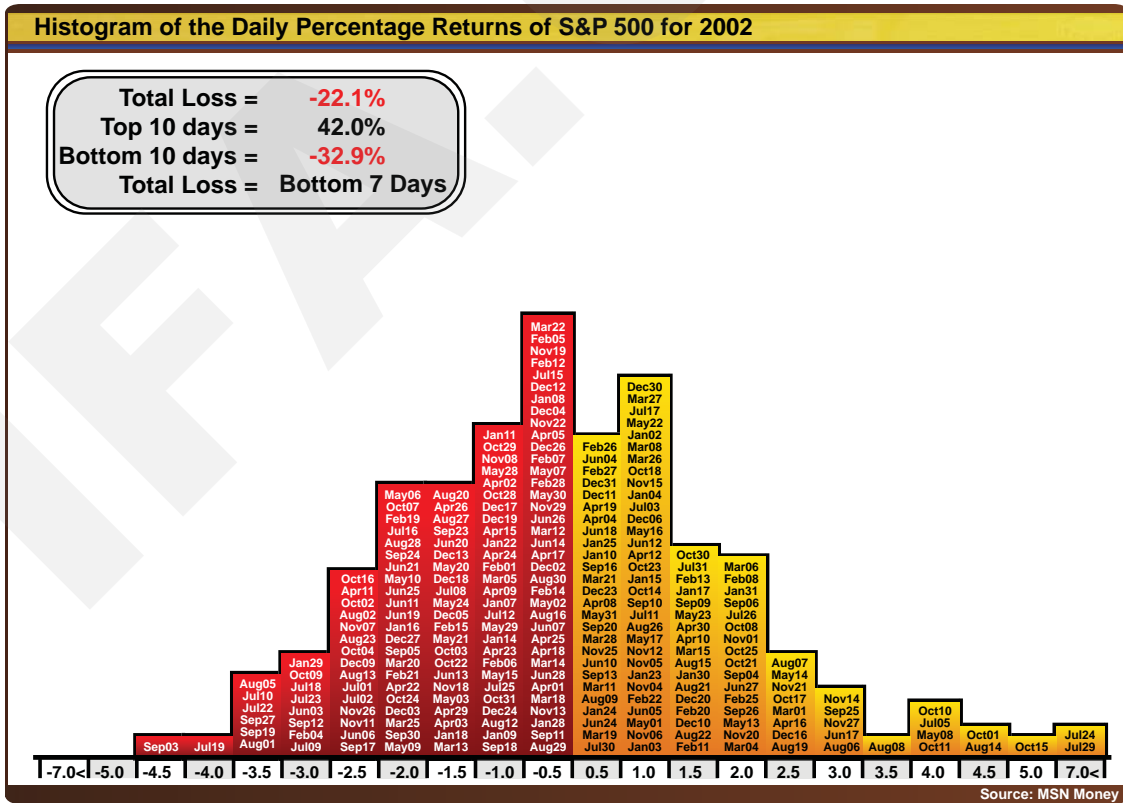


Figure 4-5



Step 4: Time Pickers

Figure 4-6

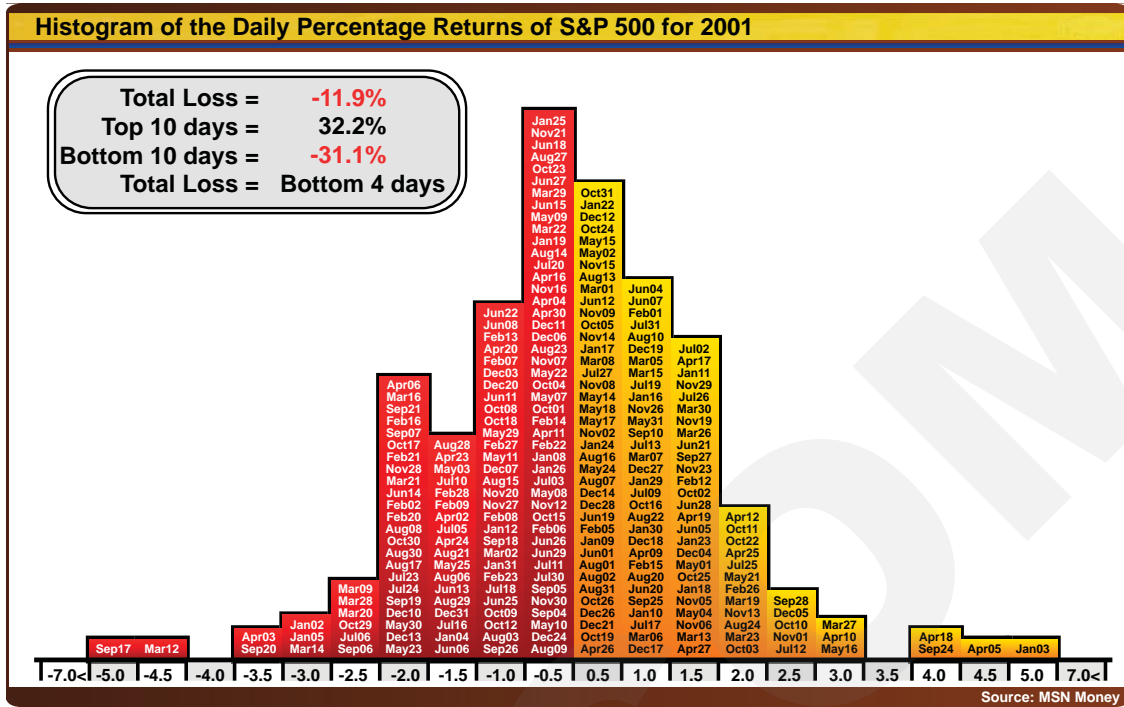
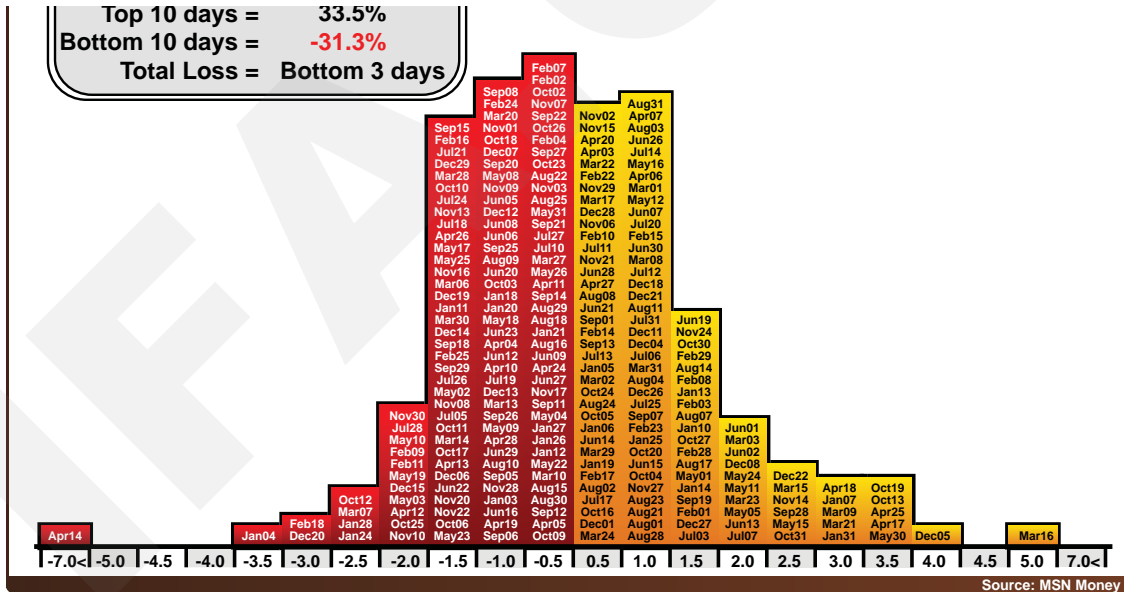


Figure 4-7



Step 4: Time Pickers

Figure 4-8

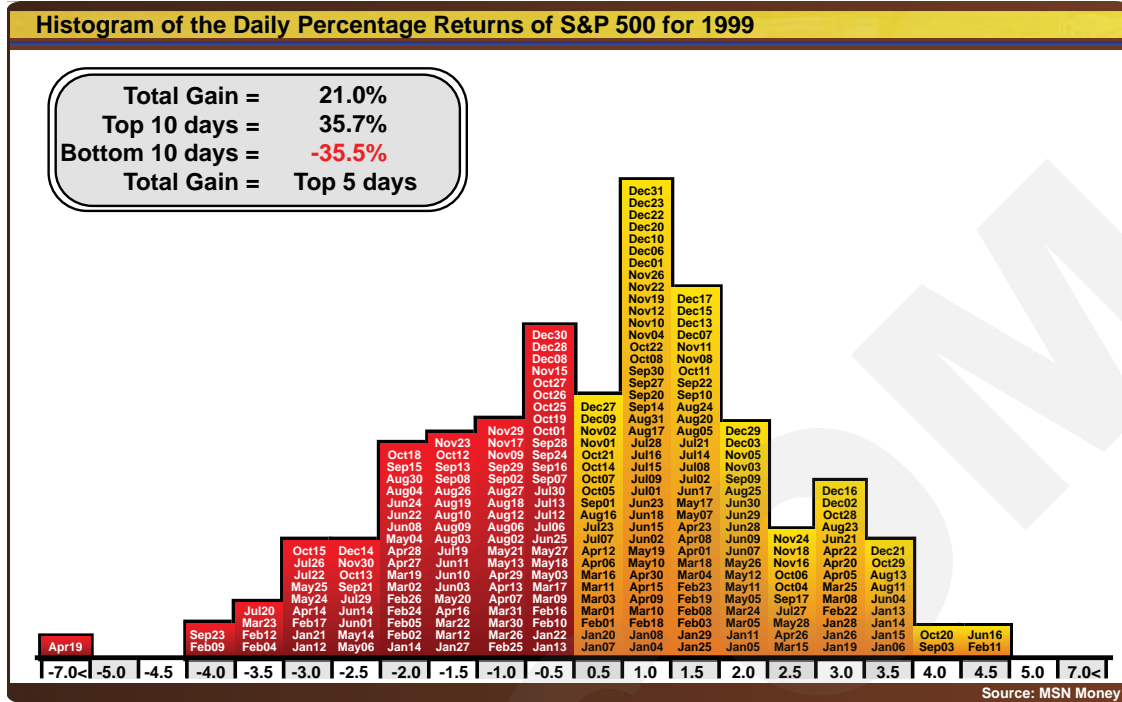
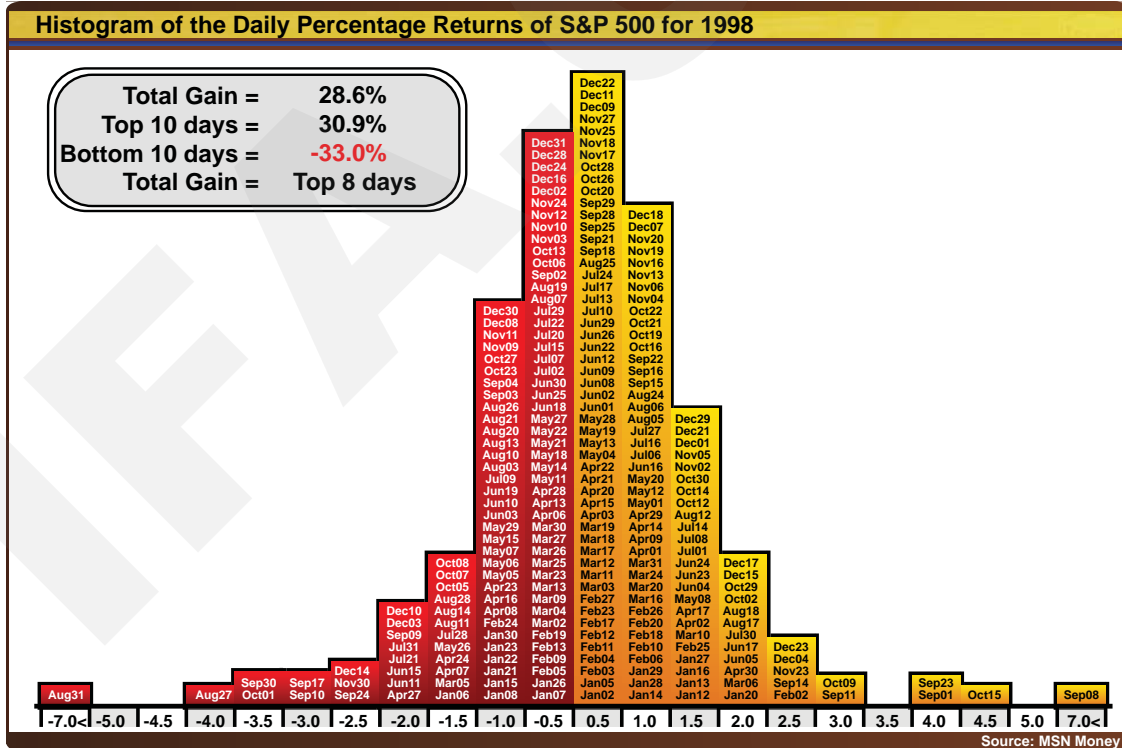


Figure 4-9



Step 4: Time Pickers

Figure 4-10

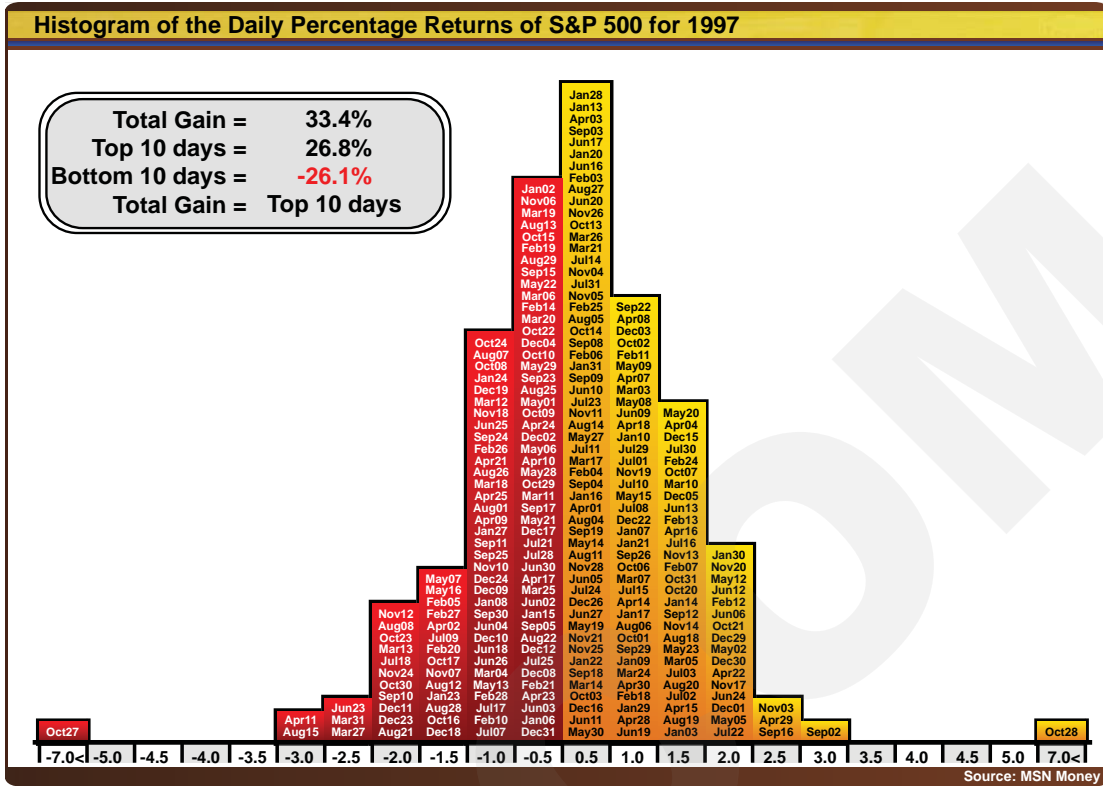


Figure 4-11

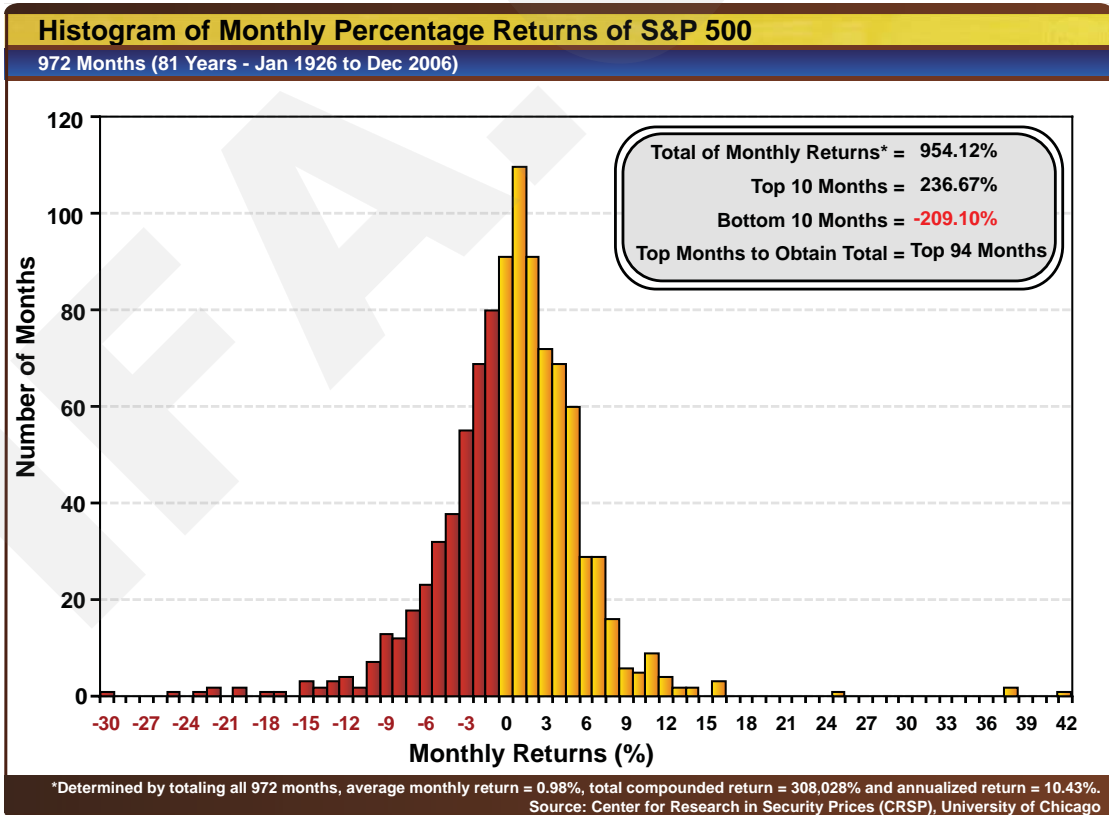
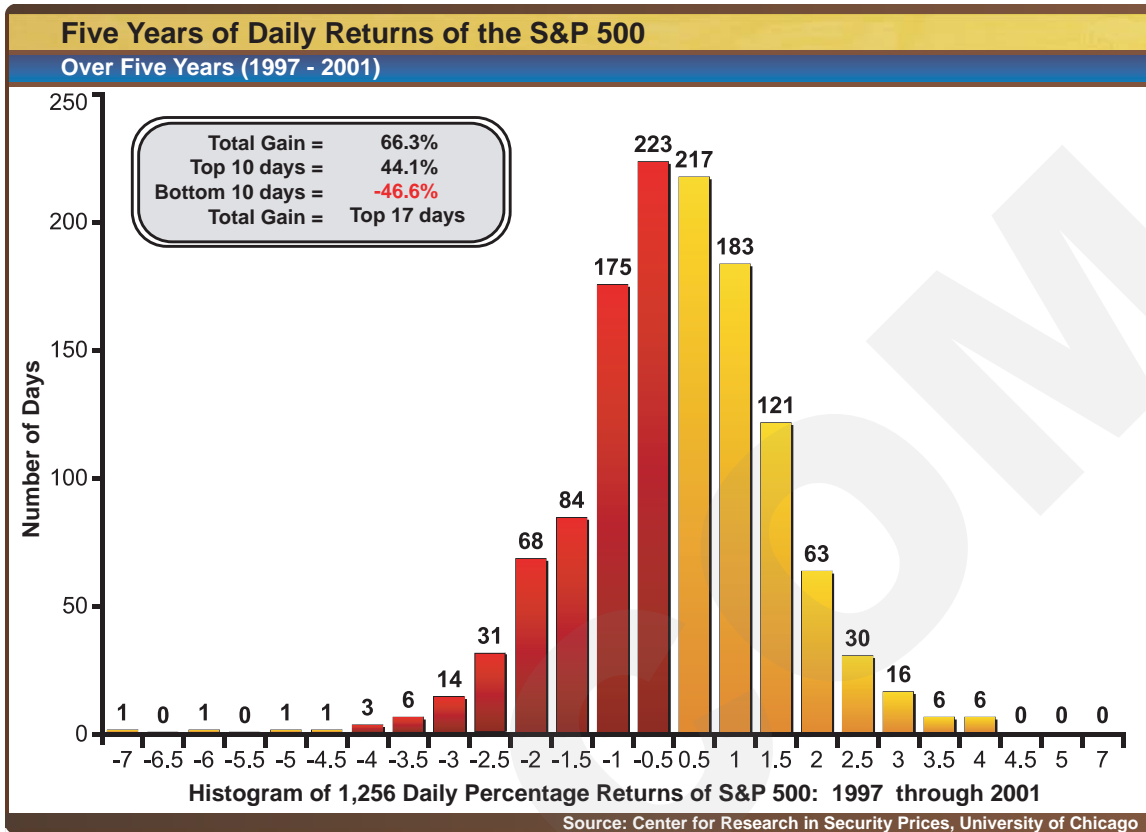


Figure 4-12

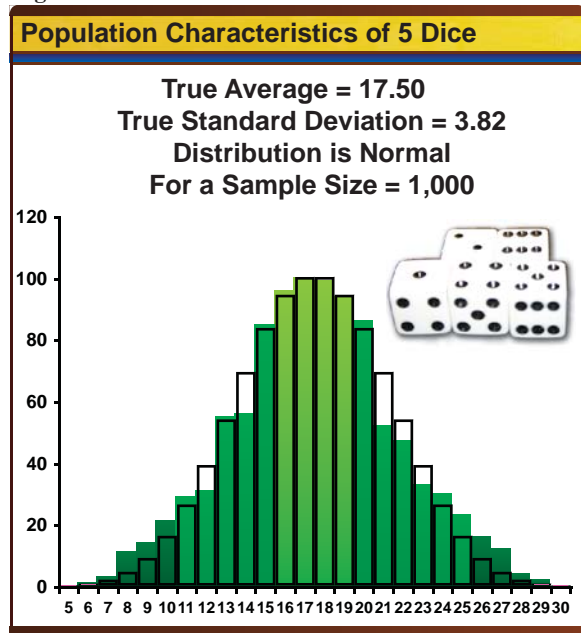


If the experts cannot get it right, then who can predict the direction of markets? Nobody.

4.3.4 Gains and Losses are Impossible to Identify in Advance

Figures 4-3 through 4-10 show the distribution of daily returns of the S&P 500 Index from 2004 back to 1997, obtained from the MSN Money Web site. The red days equal losses and the orange days equal gains. Note that every histogram is quite evenly distributed, which is to be expected from a random distribution. The display of a central distribution around the average is indicative of the randomness of the news that generates the random and unpredictable movements of the S&P 500 or any other index.

Figure 4-13



Based on these histograms, investors can see how difficult it is to find the randomly distributed days with gains or to avoid the days with losses. For each period, the large gains or major losses for the entire period are highly concentrated at the right and left tails, making it impossible to consistently identify them in advance. In other words, it is impossible for time pickers to consistently outperform the market.

Figure 4-11 shows the distribution of monthly returns of the S&P 500 for the 81 years (972 months) from January 1926 through December 2006. Figure 4-12 is a histogram of 1,256 days of S&P 500 returns for the period 1997 through 2001.

The distribution of five dice being rolled is seen in Figure 4-13. The characteristics of the average and standard deviation of a five dice roll are not the same as the S&P 500, but the concept of a central distribution around the mean is similar, as defined by the Central Limit Theorem.

Whether you are looking at daily returns over one year, 972 monthly returns, 1,256 daily returns, or 1,000 rolls of five dice, the distributions all look like bell-shaped curves generated by random events. Such distributions are indicative of random variables, such as the news that moves the markets or a roll of the dice. In both situations it is impossible to predict the sequence of future outcomes. However, the average and range of outcomes (standard deviations) provide valuable information for both wise investors and casino statisticians.

4.3.5 Time Pickers Pay More Taxes

Time pickers usually charge clients an annual fee of 2% to 3% of the value of their investment portfolios. These timers are nothing more than highly paid gamblers who bet with your money.

Some investors who time markets invest in market timing mutual funds, which often produce high trading costs. This timing strategy also generates short-term taxable capital gains for existing fund shareholders due to the liquidation of fund stock positions needed to pay off departing shareholders. This assumes they make a gain, which is certainly not guaranteed. Investors can avoid cost-generating, tax-creating moves made by managers and shareholders of active mutual funds by remaining fully invested in index funds at all times, especially mutual fund companies that restrict their shareholders to those who understand how the market works. DFA is one firm that restricts access to their funds. Only large institutional investors and clients of pre-approved investment advisors are allowed to invest in their funds. You might call it a group of really smart investors.

When investors move in and out of investments, they also create the possibility of paying a huge portion of their gains in taxes. For short-term gains, taxes can exceed 40% in some states. Even when time pickers are lucky enough to win, taxes significantly reduce their return.

4.4 SOLUTION

Here's the bottom line: the right time to be in the market is when an investor has money, and the right time to get out of the market is when an investor needs the money. The longer an investor can stay invested, the better. The investor who stays fully invested throughout market swings is there to capture those five to 10 days per year that contain the entire return of the year. There is no reason to believe that professional market timers can correctly identify those few days in advance.

Even though a buy-and-hold investor most likely experiences losses about one out of every three years over the long run, the losses of these fewer “down” years are far outweighed by the gains of the more numerous “up” years. For the 80 years from 1927 to 2006, the S&P 500 has averaged an excellent annual compound return of 10.3% with a range of plus or minus 19% two-thirds of the years.

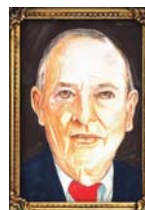
4.5 SUMMARY

The goal of a time picker is to obtain upswings of the market and avoid downswings. In other words, the goal is to get return without risk. But, risk is the source of returns; therefore, investors must subject their capital to risk. How else would they expect to make a profit? It is only a question of how much risk is right for each investor.

Time picking is beneficial only to financial firms who make money trading shares and selling this useless advice. The firms that charge top dollar for this advice ironically end up with sub-market returns. Market strategists, even those considered successful, have eventually fallen out of the limelight. The industry has created a world in which complicated ratios and mathematical formulas are paraded in front of the unsuspecting public in hopes of impressing investors with superior knowledge and skills. This elevates the analysts in the public’s eye and ultimately influences investors’ decisions on which firm to choose to handle their investments. Those engaging in time picking are sure to underperform the market average over the long term.

The stock market has experienced a healthy upward climb in value over the long run, which is precisely what makes time picking unnecessary. The best way for an investor to capture these returns is to remain fully invested at all

times, holding a globally diversified portfolio of index funds.



John Bogle

John Bogle notes, “In 30 years in this business, I do not know anybody who has done [market timing] successfully and consistently, nor anybody who knows anybody who has done it successfully and consistently. Indeed, my impression is that trying to do market timing is likely not only not to add value to your investment program, but to be counterproductive.”

In the end, time pickers have two critical decisions to make: when to get in the market and when to get out. Data now conclusively shows that there is no reliable timing method to help make either decision. It is time, not timing, that determines an investor’s return.

4.6 REVIEW QUESTIONS

1. What percentage of accuracy must a time picker maintain in order to be successful?
 - a. 60%
 - b. 40%
 - c. 70%
 - d. 30%
 - e. 15%
2. Who was the only successful time picker ever recorded?
 - a. John C. Bogle
 - b. William F. Sharpe
 - c. There are hundreds of successful time pickers.
 - d. There are no successful time pickers.
 - e. Harry Markowitz



Step 4: Time Pickers

3. The S&P 500 produced an annualized return of 8.4% in the 10-year period from 1997 through 2006. A \$10,000 investment that stayed fully invested throughout the entire decade grew to \$22,444. What would the end value be if an investor had missed the best 20 trading days?
 - a. 12.6% return or \$32,763
 - b. 9.3% return or \$24,333
 - c. 6.5% return or \$18,771
 - d. 3.9% return or \$14,661
 - e. a minus 0.4% return or \$9,640

4. The best lesson to learn from market timing pundits is:
 - a. Time pickers have no way of predicting the market, and are therefore valueless.
 - b. Be choosy when selecting time pickers and research their records thoroughly.
 - c. Companies do not report their earnings on a timely basis.
 - d. It is timing that determines an investor's return.
 - e. The largest brokerage firms have the best stock market predictors.

5. When 32 market-timing newsletter recommendations were tracked over a period of 10 years, how many of them beat the average return of the market?
 - a. 27
 - b. 13
 - c. 0
 - d. 19
 - e. 5