

# WEEKLY MARKET MONITOR SEPTEMBER 8, 2008

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## MARKET TIMING OR SWING BETTING?

Recently, the daily financial news has included a multitude of stories and prognostications about short-term market movements. These stories have largely focused on which current investments may provide investors with the best returns for tomorrow. More specifically, which stock, sector, style, region or asset class is about to tank, take off or move sideways? In fact, the very nature of active investing involves a belief that some assets or securities will rise faster than others. But just because this is true in theory doesn't mean that investors can successfully capture the returns associated with different market movements in reality. For this reason, TIAA-CREF's investment philosophy emphasizes security selection — picking the right stocks, bonds and properties on the real estate side — over trying to successfully time which asset class or index will outperform the market and when.

This week we will focus on market timing:

- What is involved in market timing?
- What can happen when you attempt it?
- Why it doesn't make sense for most investors.



When investors talk about market timing they usually mean one of two things:

- 1) Attempting to predict the future direction of broad markets (e.g., asset classes, geographic regions or investment styles) through the use of economic or technical indicators; or
- 2) Short-to-medium term switching/trading among mutual funds (or other investments) in an attempt to profit from changes in a particular investor's market outlook (perhaps based on point #1).

Market timing is a fundamental issue in investing, since most research seems to suggest that it is nearly impossible for individuals to successfully time the market for extended periods of time. On the other hand, certain investors (particularly some active equity managers) believe that it is possible to obtain extra returns by doing so.

Market timing requires an investor to have a strong opinion on at least two assets and to be able to predict with a high probability of success on which days or months one of those assets will outperform the other and vice versa. Simply put, the investor needs to know when to switch from one asset to the other, and when to switch back again.

The simplest illustration of market timing might be to imagine an investor who invests passively versus another investor who tries to outperform the market by switching in and out of cash depending on when the market is about to go up or down. Let's say that the first investor places \$100 in the Dow Jones Industrial Average (DJIA) at the beginning of 1900 and doesn't touch it until the end of 2006. In other words, the investment experiences all 29,190 stock trading days over the 107-year-period. As the following table shows, from 1900 to 2006, a passive investment in the DJIA returned an average of 0.02% per day or about 5.3% per year.<sup>1</sup>

However, on its best days, the DJIA had a much higher return than its overall average. Note that the best daily return during the 107-year-period was over 15% and the index's worst daily return was a breathtaking -22.6%. So an active investor who managed to avoid the worst day and benefit from the best day did much better than the passive investor.

**EFFECT OF MARKET TIMING ON RETURNS AND ENDING ACCUMULATION**

Dow Jones Industrial Average 1900–2006

TRADING YEARS	TRADING DAYS	MINIMUM DAILY RETURN	MAXIMUM DAILY RETURN	AVERAGE DAILY RETURN	STANDARD DEVIATION	AVERAGE ANNUAL RETURN
107	29,190	-22.61%	15.34%	0.02%	1.07%	5.30%

Source: Exhibit 1 from Estrada, Javier, *op.cit.*

1 Not including investment management expenses and transactions costs. All numbers cited are from Estrada, Javier 2008. Black Swans and Market Timing: How Not to Generate Alpha. *Journal of Investing*. Forthcoming.

Turning to the next table, we can now look at the effect on portfolio returns and ending accumulation values when we remove a number of good and bad market days.

**RETURN AND ENDING ACCUMULATION WHEN REMOVING BEST AND WORST TRADING DAYS**

Dow Jones Industrial Average 1900–2006

	<b>All</b>	<b>WORST 10</b>	<b>WORST 20</b>	<b>WORST 100</b>	<b>BEST 10</b>	<b>BEST 20</b>	<b>BEST 100</b>
Avg Daily Return	0.02%	-10.46%	-8.73%	-5.87%	11.10%	9.37%	5.92%
Ending Accumulation*	\$25,746	\$78,781	\$162,588	\$11,198,734	\$9,008	\$4,313	\$83
Change	N/A	206%	532%	43,397%	-65%	-83%	99%
Annualized Avg Return	5.3%	6.4%	7.2%	11.5%	4.3%	3.6%	-0.2%

\* Total accumulation at the end of 2006 from investing \$100 at the beginning of 1900.

Source: Exhibit 1 from Estrada, Javier, *op.cit.*

The table shows that the worst ten daily returns averaged about -10.5%, and the worst 100 daily returns averaged a nearly 6.0% drop. Similarly, the best ten daily DJIA returns averaged over 11.0% and even the best 100 daily returns averaged nearly 6.0% return. So a market timer who managed to avoid the worst days or participate in the best days, or a combination of the two, would have done very well indeed.

To see this, we can look at what would have happened to a passive investment of \$100 in the DJIA versus a similar active investment based on market timing. A passive investment at the beginning of 1900 would have grown to nearly \$26,000 by the end of 2006. In contrast, an investor who moved all assets out of the market prior to the ten worst performing days would have ended up with about three times that amount (almost \$79,000). Spectacularly, an investor who avoided the worst 100 market days would now have a nest egg that is over 400 times larger than that of the passive investor.

In contrast, an active investor who missed the best market days would have done rather poorly. Missing the ten best days over the 107-year-period would have left the investor with less than half of the passive investor's total accumulation. Missing the best 100 days would have nearly wiped out the entire nest egg.

So no matter how you look at it, a few trading days over the 107-year-period had an outsized impact on both total return and final accumulation figures. A passive investor would have experienced both the ups and downs of the market, while the active market timer, if successful, would have done much better or, if unsuccessful, much worse.

The remaining issue is whether it is possible for an investor to actually achieve some or all of the excess gains and/or avoid the excess losses. Clearly, in this example, we know that it would have been nearly impossible for anyone, even an investment professional, to know exactly which ten, 20 or 100 days to avoid the market completely or which days to be fully invested over the space of the 107 years. But could an active market timer get it right enough of the time to perform better than a passive investor? Are there longer periods when we can anticipate which assets will outperform and which ones won't?

We think this is unlikely for several reasons:

**When is the right time to get out of one asset class?**

Based on the preceding examples, it is pretty clear that an investor can't accurately predict on which individual days to be out of a risky asset class. If so, then we must also acknowledge how hard it is to do the same thing over longer periods of time — weeks, months or even years. In other words, for an investor to say he or she knows when to be out of the market is essentially an argument that he or she knows that one or more of the worst days will occur during that period.

**Which asset class to go to?** Getting out of an asset class implies knowledge as to where to invest the money. One option is the safety of a money market account, which will likely earn a positive return, but not necessarily one that will beat inflation over the long run. So any good market days we miss by being out of a risky asset will mean that we have to make up for them by hoping for more bad days in the market. Moving the money from one risky asset class to another instead is essentially predicting that the new asset class will experience fewer or milder down days than the original asset class in which we were invested.

**When is the right time to get back into the market?**

Similar to being out of the market, getting back in is essentially a prediction that one or more of the worst days won't occur when we are fully invested.

While some investors have been lucky enough to successfully time movements into and out of the markets or specific asset classes on one or more occasions, it is not something the average investor can do consistently enough to garner returns sufficient to beat passive investors. In fact, there is strong evidence that, the more an investor trades, the worse he or she does when compared to investors who trade less often. (This can also be true of some professional investment managers.) That is one reason that TIAA-CREF's investment managers focus on individual security selection and, for the most part, avoid market timing with asset classes, sectors or different geographic regions.

What should an investor do? The most important thing is to periodically check his or her asset allocation to ensure a properly diversified portfolio that fits his or her personal circumstances or needs, including an acceptable tolerance for risk. If there is a need to change the allocation or to rebalance back to the original allocation, then this should be done as a strategic, longer-term move rather than a tactical one that attempts to time when one asset class will underperform (and another outperform).

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