Investing: Think time in market, not market timing

Experience the state of mind of a hypothetical market timer. Their thoughts, hopes, fears, basis for decisions, and actions along each leg of a typical market cycle.

Chances are that we have all experienced some of the reactions portrayed in this example. Many people will not only relate to this example, but also will still (today) be able to plot themselves at one of the stages portrayed in this example.

This chart illustrates some of the psychological issues (problems) associated with market timing.

As tempting as it may be to switch investments or move to cash in uncertain times we do not believe that investors should time financial markets. This is due to the forward looking nature of financial markets coupled with transaction costs and tax-related issues, not to mention the risks associated with market timing (which include the impact poor timing may have on your portfolio).

Market timing can be described as the process of positioning a diversified portfolio away from its long term strategic investment allocation for a short to medium term, in an attempt to add extra returns to the portfolio, by taking advantage of better performing investments and/or by avoiding poor performing ones.

The following adage sums up our view; "it is not market timing that counts, but rather the amount of time that you are in the market". Take this simple example where we have shown the effect on investment returns of missing some of the best trading days between January 1992 and April 2008, in all 4168 trading days.

Missing the best days – impact on returns
January 1992 – April 2008 Australian shares: Out of 4168 trading days

Number of best days missed	Time out of the market	Return (pa)	Value of $10,000 invested 1 Jan 1992
0	0.00%	17.7%	$64,170
10	0.24%	13.7%	$43,344
20	0.48%	11.3%	$33.786
30	0.72%	9.1%	$26,947
40	0.96%	7.2%	$22,032

Based on S&P/ASX All Ordinaries Accumulation Index

An investor who was invested in the Australian sharemarket for the full period between 1992 and April 2008 would have achieved annual returns of more than 17 per cent. But had they missed just 10 of the best trading days in the period, representing just 0.24 per cent of time out of the market, that return would have dropped to around 13.7 per cent per annum. Missing just forty of the best days during the period, or 0.96 per cent of time out of the market, reduces the annual return on the investment to 7.2 per cent per annum.

The above example illustrates that one of the biggest risks in attempting to time markets is potentially missing the markets best performing cycles.

Broad diversification across asset classes is the best way to guard against losses; not risky market timing based strategies. Attempting to time markets is akin to speculation. The combination of costs, taxes and the lack of timeliness of the execution increases the likelihood of losing money. Statistical evidence bears witness to this. Serious investing requires a long-term investment strategy and disciplined adherence to it over all types of market cycles.

It is therefore appropriate that one maintain a long-term investment strategy, as any deviation from it reduces the likelihood of an investor attaining their stated financial goals. Developing a sound long-term investment strategy generally involves initially identifying an investor's investment objectives or goals.

The next step involves the identification of that investor's risk tolerance or risk profile – this refers to one's tolerance for market fluctuations and the trade-off between this and the desire to maximise returns. This will determine the investor's strategic asset allocation. Once the strategy has been developed and implemented as agreed, then it will be this strategy that will ultimately guide the investor towards the fulfillment of their desired objectives. It is therefore imperative that investors not be distracted by short-term market movements or volatility. This has the potential to be value detracting for those who lack focus or discipline.

Naturally, a portfolio that comprises a long-term asset allocation strategy (with little or no tactical shifts) will invariably lead to exposure to some short-term market volatility (irrespective of the quality of the strategy). However this is essentially the price that must be paid for those that are seeking long-term return maximisation, providing that portfolio volatility falls within the investor's clearly defined risk band or constraints.

The ultimate risk, is of course, the long-term opportunity cost associated with an overly conservative strategy, or one of inferior quality, or poorly implemented.

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