Timing The Market Vs. Time In The Market

Only a few months ago, when the Sensex was languishing at around 3,000 levels, if you had asked the typical investment advisor as to when to invest in the stock market, his response would been something along the following lines:

"The outlook is not clear... There is political uncertainty... Stock prices will fall even further... Wait till the market bottoms out... Wait till liquidity improves... Wait till the elections are over... Wait till FII's come back in the market..."

In other word's "wait and watch." This "wait and watch" advise turned out to be a very expensive advice, as most investors found out as they watched the Sensex rise to 4,700 levels, while they firmly held on their cash.

Most stock-market investors have one common desire: they want to get in at the bottom and they want to get out at the top. In other words, they want to enjoy the ecstasy of participating in a bull market, while avoiding the pain of suffering a bear market. Doing just that, looks so simple, if one looks at the historical charts of individual companies or stock-market averages. All an investor had to do was to buy at the bottom and sell at the top. If he had done this successfully for just five years, he would have become very, very rich! There is only one problem with this "simple" methodology: Hindsight and foresight are not the same.
Is it sensible to delay one's stock-market investments in anticipation of a fall in stock prices? I think not.

There is compelling academic evidence, only some of which I present below, that proves that "wait and watch" approach to the stock markets is very expensive. Much of this evidence is based on studies done on American stock markets, but the conclusion drawn from these studies apply equally well to the Indian markets.

A study conduced by the Vanguard Mutual Fund Organisation of the U.S. analysed stock market returns during several decades and the impact on those returns if a few best months were excluded. For example, the annual return on stocks over the decade ended December 31, 1992, was +16.2%. However, if an investor had been out of the market during only four best market months, he would have earned an average annual return of +11.3%. Therefore, if he had the misfortune to miss just four months in that 120-month period (if he was out of the market just 3 percent of the time), he would have enjoyed a gain of +191%, but if he had simply bought and held common stocks for the full period, he would have achieved a gain of +348%.

An analysis of monthly investment returns of the S&P 500 from 1926 to 1993 by Sanford Bernstein & Co. showed that out of 816 months which comprised the entire 68-year period, the returns in the 60 best months, or a mere 7% of the time, the average return was only 1/100 of 1% per month.

In a study by Nicholas-Applegate Capital Management covering a 10-year period from 1983 to 1992, comprising of 2,526 trading days, the compounded annual return for the S&P 500 was 16.2% per year. However, the investment returns on the 40 best days, a mere 1.6% of the time, accounted for 12.6% of the 16.2% annually compounded rate of return. Without those

40 days, the annually compounded rate of return over the 10-years period falls to 3.6%. Picking the 40 best days out of 2,526 is a lottery no on will win.

Implications

All the above studies came to one conclusion: Although, over the long-term, stocks do far better than bonds and cash equivalents, the superior stock market returns do not accrue in a uniform manner. Rather, they can be traced to a few periods of sudden bursts of strength. Moreover, the timing and the duration of these periods i.e. bull markets cannot be predicted accurately in advance.

This means that *a disproportionate percentage of the total gain from a bull market tends to occur very rapidly at the beginning of a market recovery. If an investor is out of the market at that point of time, he is likely to miss too much of the action. The lesson for investors is clear: You have to be there "when lightening strikes."*

To quote Robert Jaffrey, a financial economist: *"The rationale for being a full-time equity investor is not that there are more positive real return periods than negative ones in most time frames, but rather that most of the "positive action" is compressed into just a few periods."*

Our own studies conducted on the Indian market shows that Jaffrey's statement applies to the Indian market too. Over the last 9 years, there have been only a handful of days when the stock market rose by more than 5% in a single day. If you were out of the stock market on those days then your long-term returns on equities got hammered. The recent phenomenon of the sudden rise in the general levels of Indian stock prices, is a confirmation of the conclusions drawn from the studies cited above. The lesson is clear: investors should focus on the time they remain invested in the market, rather than trying to time the market.

Note

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