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The Siren Song of Market Timing: Why Trying to Time the Market Can Hurt Your Portfolio

You are being targeted. There is nowhere to hide. If you follow financial news - reading print, surfing the internet, or watching television – the threat is everywhere. Headlines, clickbait, and cliffhanger commercial breaks all promise to give you the secrets. It could be an article about "the top stocks to buy now" or an interview with "the manager who saw the last crisis coming." The media knows that the more salacious the hook, the larger the audience draw.

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Many of these purported experts are recommending strategies based on market timing. The allure of market timing, which seeks to exit the market in bad times and enter for the good times, is that it tempts with the reward of stocks (higher returns) without the risk (loss of value). However, the reality of the situation is that risk and return are directly related. You cannot have your cake and eat it too. If you want to earn the higher returns that stocks have historically provided over bonds and cash, you must accept the higher volatility that comes with stock ownership. If you could earn a stock return with low risk, why would anyone accept lower returns from bonds or cash, which also have low risk?

There are a couple of common instances where the siren song of market timing grows louder: when the market declines or when the market is trading at a high.

MARKET DECLINES

When stocks fall, the uncertainty can be scary. In the moment, it is not known if the declines will continue. And, if there is another leg down, how long will it last? How much more will stocks drop? Nobody knows. This uncertainty makes buying stocks at such times difficult. Our instinct is to wait until things "calm down."

One issue with waiting until it feels comfortable investing is that big up days and big down days often appear at the same time.

Trying to avoid the bad days means the good days will likely be missed as well. And not participating in just a handful of those up days can greatly impact a portfolio's value. The fear of possible loss from investing is replaced with the actual loss from not investing. A common saying in the investment industry is that success comes from time in the market, not timing the market.

It can be hard to invest or stay invested when markets are declining; 2022 provided a recent example. The S&P 500 fell 25% in the first three quarters. No one knows what the future holds. But we do know how markets have historically performed after such declines.

To be clear, there is nothing magic about -25%. It is merely a point of reference. The declines above range from -57% to -25%. The duration also varies from 1 month to 21 months. Trying to call the bottom is futile. However, staying invested has meant capturing the subsequent powerful recoveries.

MARKET HIGHS

While stock owners are pleased when the market is up, those with funds (or additional funds) to invest may be apprehensive. The thinking can take the form of statements like "we're due for a pullback," "the market has risen too far/too fast," or "I don't want to invest at the market high."

Again, it's interesting to look at historical data. How do returns compare when investing at a record high versus waiting for a pullback to "buy the dip?"

Investing after a market high has historically provided a similar return as trying to find an attractive window to buy – without the stress.

Market highs are not to be feared. It's useful to think about what is driving stock prices up. Employees go to work every day with the goal of doing better. This improvement may mean a more efficient process or a better product. The end goal is to grow and operate at a profit. As the company grows in size and value, owners of the company's stock participate in its appreciation through a claim on its net assets and earnings.

Fear can arise that stock prices are too high relative to the company's value. But every trade needs a buyer and a seller. Stocks must trade at a price where there is a positive expected return to the buyer, or else there would be no trade.

Reaching record highs is common and expected. For the 94-year period ending 2020, the S&P 500 index produced a new high in more than 30% of monthly observations. Further, if markets weren't on a continual march to new highs, why would one invest?

At Trust Company, we believe that markets set prices at fair levels that reflect publicly available information. As a result, we don't try to outsmart the collective wisdom of global market participants. Past results and current information are not items to which we have exclusive access. We don't pretend to have any better guess about the future than the next investment manager.

The result of these views is that we don't advocate making drastic changes in one's asset allocation or trying to time the market. Rather, we make a plan based on a portfolio's unique objectives and constraints. If those inputs change, then we might edit a portfolio's asset mix. If nothing changes, however, we stick to the plan in good times and bad.

Diversifying ensures that the various investments that make up a portfolio do not move in lockstep. From there, rebalancing instills discipline. Assets that have done well on a relative basis are sold, and assets that have lagged are bought.

Following a plan avoids the challenge, stress, and cost of trying to time the market. It is not enough to call a market top and get out. You need to decide when to get back in. This applies in reverse as well. Spotting a market low is nearly impossible at the time when things often seem darkest. Even perfect timing exposes the investor to the need to plan his or her subsequent exit. In other words, you need to be right twice at something nearly impossible to achieve once.

Focusing on controllable factors is another of our investment tenets. One such item is trading costs. Exiting a position with a gain in anticipation of a market decline can expose an account to capital gain taxes, which erode the investment return. Inactivity has a cost, too. Sitting in cash waiting to buy stocks has an opportunity cost. Stocks have a higher expected return than cash, so staying parked in the latter can hurt a portfolio as well.

So, the next time you are targeted with a market timing pitch, turn the page or the channel or close your browser. Instead, have a plan and stick to it, harness the power of the markets to try to outperform instead of out-guess, and control what you can. Then you will set the target – on a successful investment experience.

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