

C A M B R I D G E A S S O C I A T E S L L C

EUROPEAN MARKET COMMENT

THE PERILS OF MARKET TIMING

July 2004

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The Perils of Market Timing

The argument for market timing is quite powerful—in theory, of course. Successful market timing, defined here as aggressively shifting from equities to cash, and vice versa, to attempt to capture or miss the best and worst of times, can allow investors to earn substantial returns and avoid precipitous falls. It is in the implementation, however, where the case falls apart, for history has shown that it is difficult for a market timer to outperform a buy-and-hold portfolio.

As shown in Tables A-D, U.K. equity returns have tended to be concentrated in very short time horizons. Whether an investor participates in or misses only a handful of days or months can make an enormous difference for future returns. A small error in timing can be quite costly.

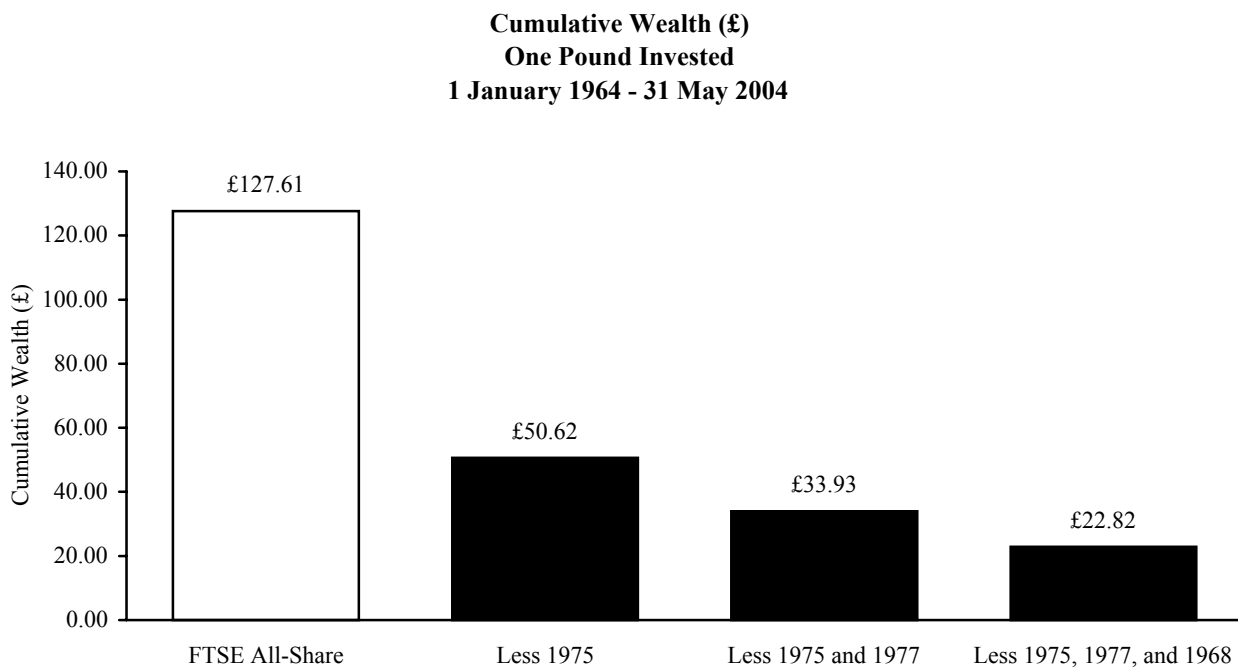
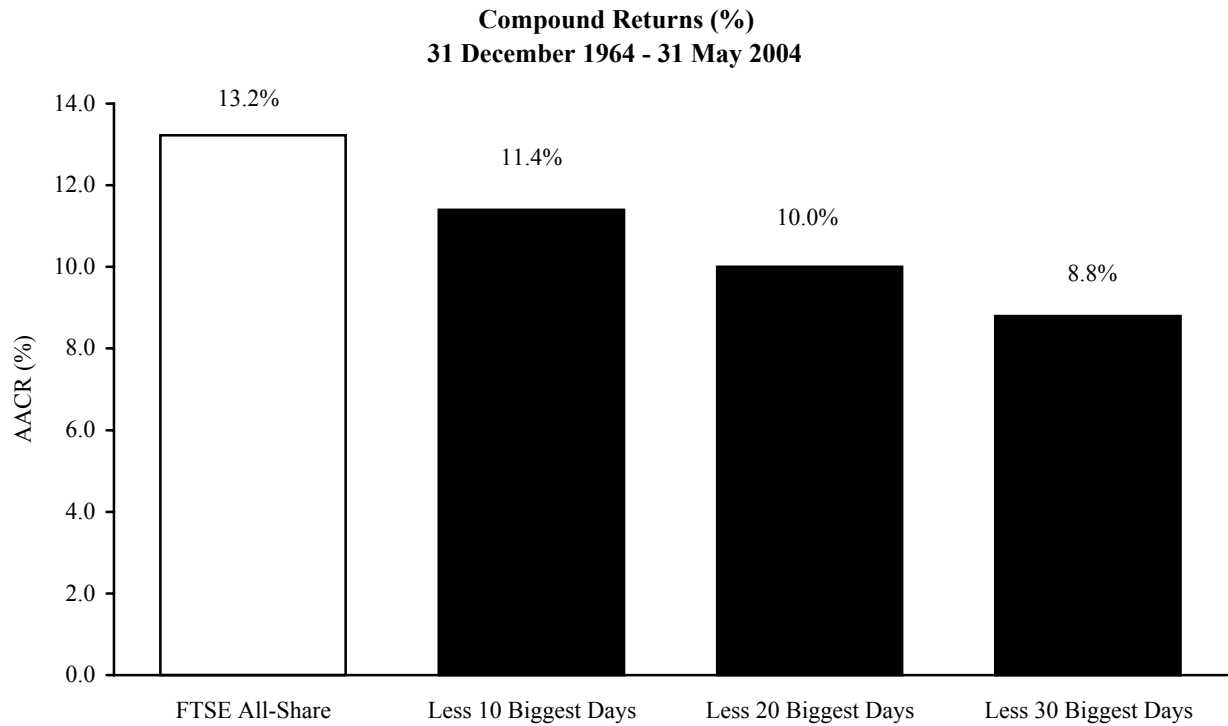
In the 10,284 trading days since 1964, when our daily data for the All-Share begin, the index posted an average annual compound return (AACR) of 13.2% through the end of May 2004 (Table A). Investors failing to participate in the ten *best*-performing days, would have lost nearly 2 percentage points of AACR, earning 11.4%; missing the largest 20 days would have produced a 10.0% AACR, while missing the best 30 days would have generated an 8.8% AACR. Investors missing the best year over this 40-year period would have seen a 10.3% AACR; top two years, 9.5%; and top three years, 8.6%.

Alternatively, potential returns would have been considerably higher if the *worst* periods were avoided over this 40-year interval (Table B). For example, investors that were out of the market in the ten, 20, or 30 worst days would have enjoyed an AACR ranging from 15.3% to 18.0%, which translates into cumulative wealth totals of £264.5 to £479.5 from a £1 investment at the start of the period.

Similarly, portfolio values would have changed dramatically for investors missing the best and/or worst years from 1900 to 2004 (Tables C and D). For example, an investment of £1 in U.K. equities in 1900 would have compounded at an average annual rate of 9.3% to reach £8,852.4 through December 31, 2003. Investors missing the *best*-performing year, 1975, would have earned only 8.4%, while their cumulative wealth would have grown to £4,044.7—less than half of that earned by buy-and-hold investors.

Given that returns tend to be concentrated in very short time periods, it begs the question whether the investor, or manager, has the skill to jump in and out of the equity market with enough consistency to outperform a buy-and-hold portfolio. Because the risk level of holding equities changes and investors can find the risks associated with holding them uncomfortable at times (e.g., when valuations are high relative to historical norms) it is sensible to limit exposure to any one type of equity investment. However, given the low probability of successfully timing the market, we would recommend instead that investors hold highly diversified portfolios of equities, and rebalance assiduously in order to mitigate the risk of any one position.

Table A

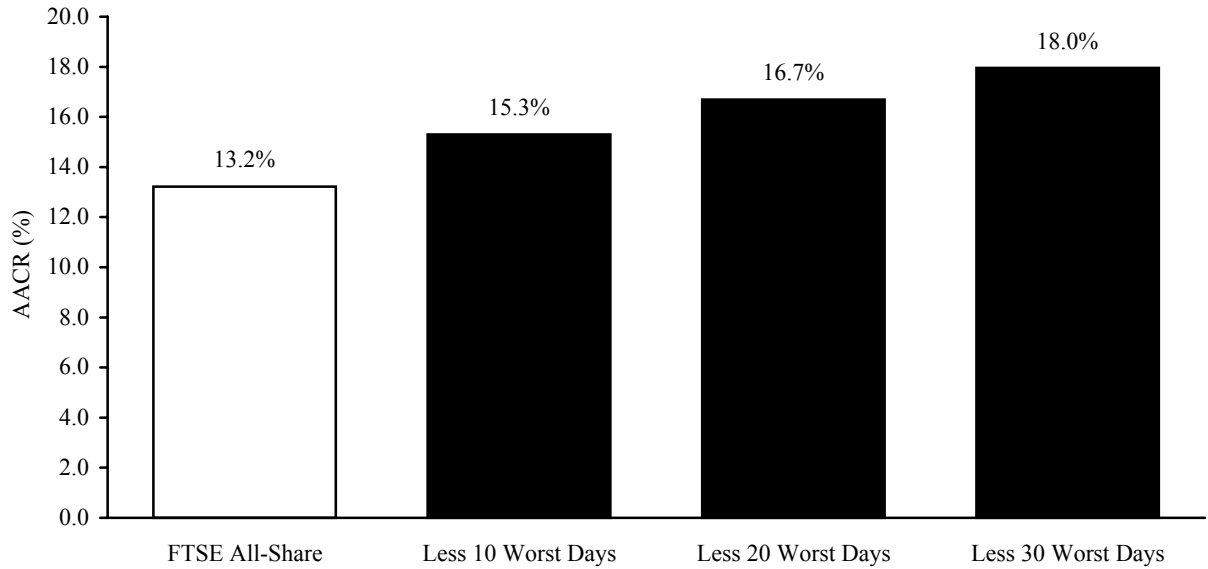
MARKET TIMING—MISSING THE BEST DAYS AND YEARS

Source: Thomson Datastream.

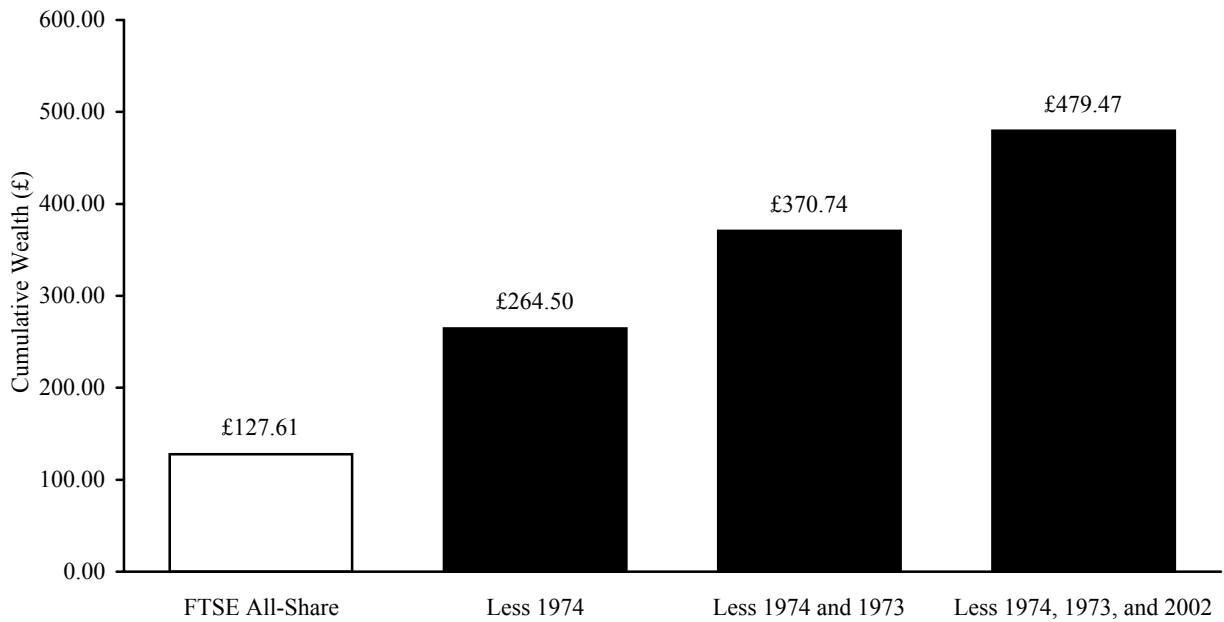
Table B

MARKET TIMING—MISSING THE WORST DAYS AND YEARS

Compound Returns (%)
31 December 1964 - 31 May 2004



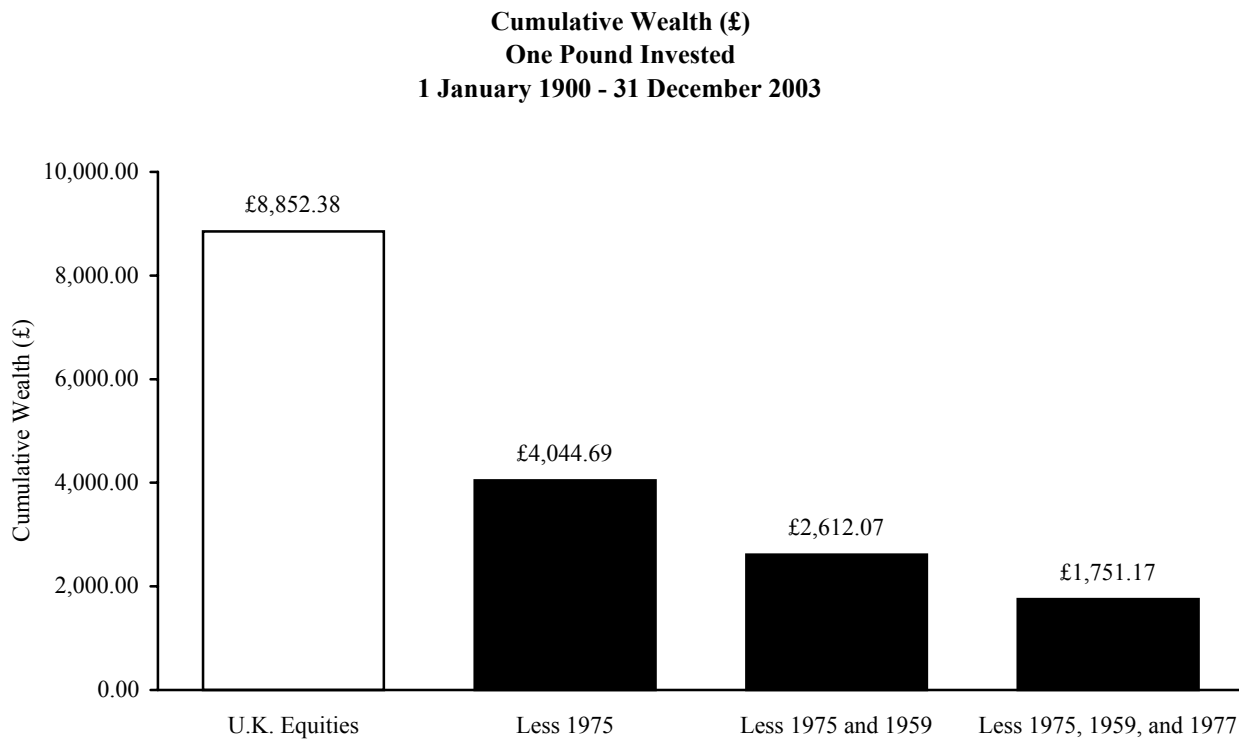
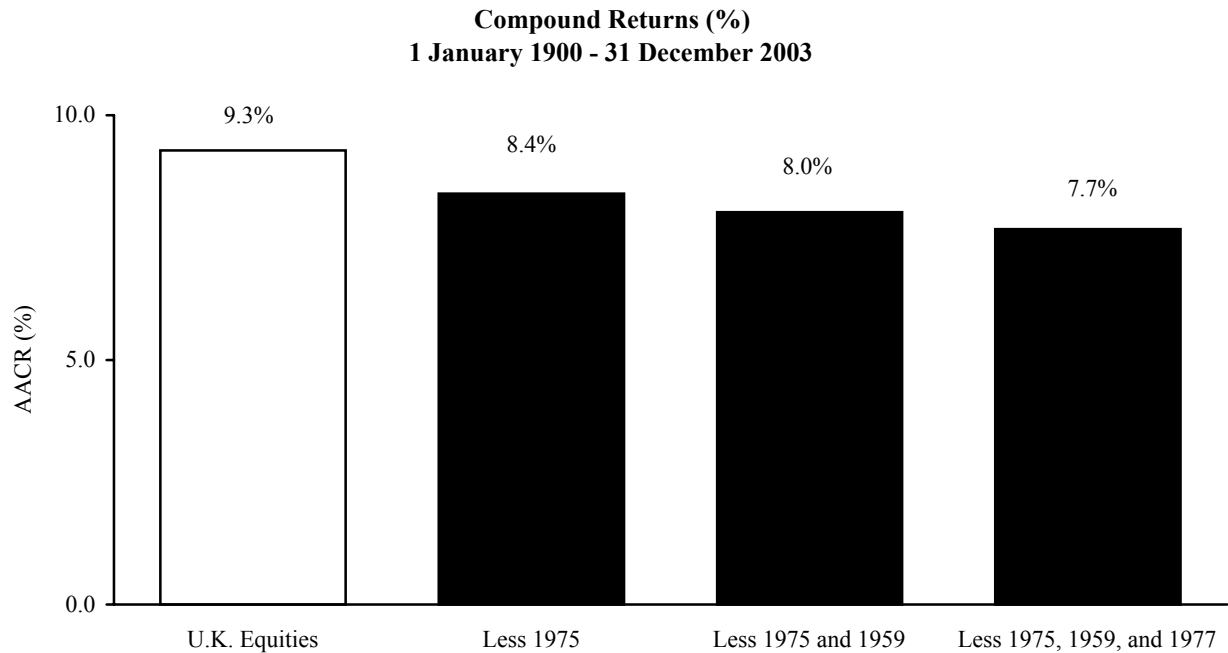
Cumulative Wealth
One Pound Invested
1 January 1964 - 31 May 2004



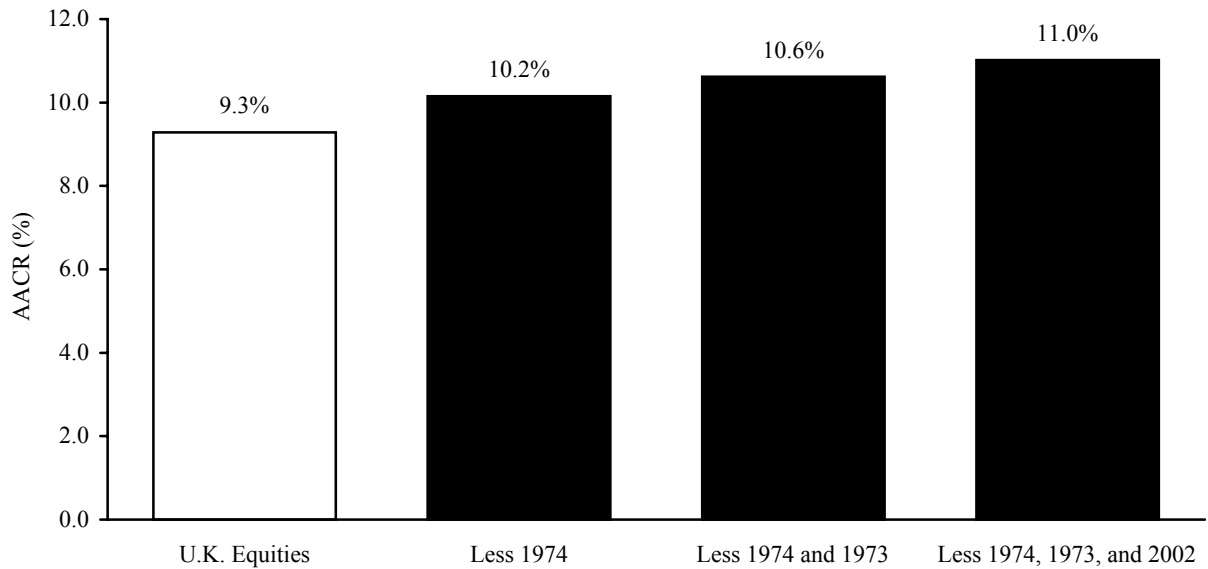
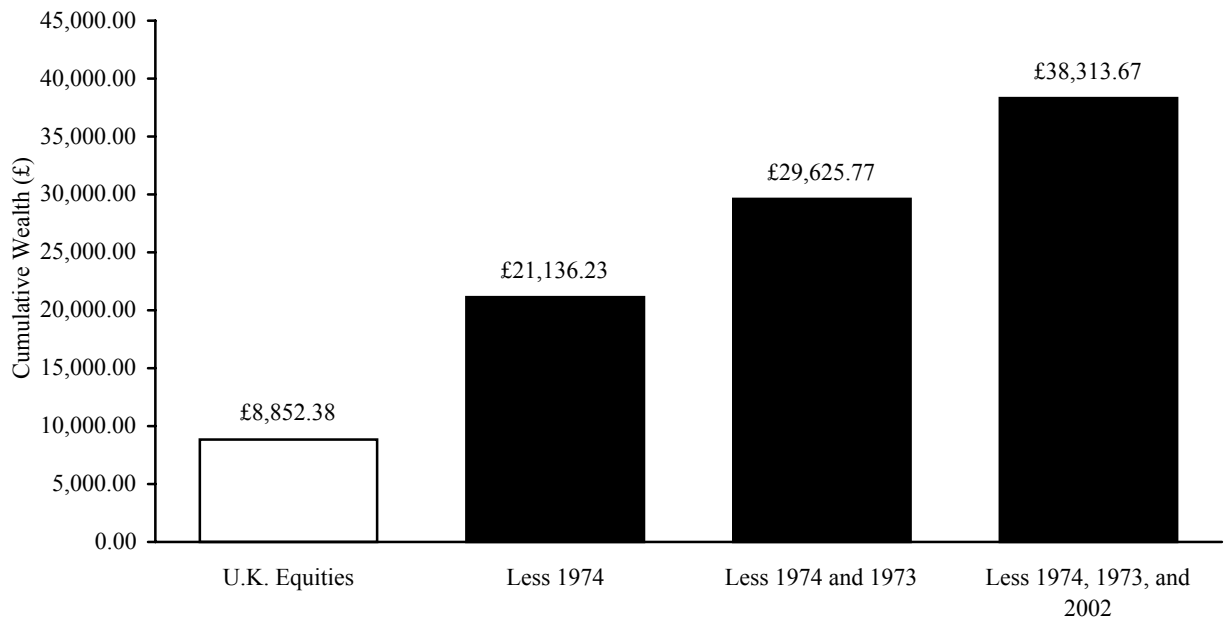
Source: Thomson Datastream.

Table C

MARKET TIMING—MISSING THE BEST YEARS



Sources: FTSE International Limited, Global Financial Data, and Thomson Datastream.

Table D**MARKET TIMING—MISSING THE WORST YEARS****Compound Returns (%)
1 January 1900 - 31 December 2003****Cumulative Wealth
One Pound Invested
1 January 1900 - 31 December 2003**

Sources: FTSE International Limited, Global Financial Data, and Thomson Datastream.