Chapter One

The Impossibility of Market Timing

"You can't time the market." This a well-known shibboleth, among the most basic tenets of serious stock market investors from Nobel Prize winning economists to your basic corner stock brokers. You cannot in advance tell when the market is going to go up or down based on some already known data. That is supposedly fundamental.

Just listen to the voices:

From David Swensen, chief investment officer of the mighty Yale University endowment, short and sweet: "Serious investors avoid timing markets."

From Mr. Swensen's close friend, investment manager and frequent commentator Charles Ellis: "There is no evidence of any large institutions having anything like consistent ability to get in when the market is low and get out when the market is high."

From one of our favorite commentators on stock market investing, William J. Bernstein, in his *Four Pillars of Investing:* the results of financial services and insurance companies picking times to buy stocks are and were ". . . awful . . . the performance of market timing newsletters . . . was even worse. . . ."

From William F. Sharpe, Nobel Prize winner, and his essay, "Likely Gains From Market Timing": ". . . a manager . . . should probably avoid market timing altogether. . . ."

From a seer named Larry E. Swedroe in his book, *What Wall Street Doesn't Want You to Know:* The odds against market timing are ". . . huge. . . ." Mr. Swedroe cites an article in *Fortune* of May 12, 1997 to the same effect: "No one knows where the market is going . . . That's the simple truth." (Although, as Mr. Swedroe points out, that does not stop *Fortune* from trying to show that it does.)

John Bogle, one of the smartest and most capable investment gurus of all time, head of the Vanguard family of funds for many years, says flatly: "Indeed, my impression is that trying to do

market timing is likely, not only not to add value to your investment program, but to be counterproductive."

Really?

How can this possibly be?

Market Timing is the concept that there are some times when indicators that can be read at the time say it is a better time to buy or sell than other times. Market Timing is the notion that an investor can look at certain data and have an idea, a good idea, that the market is overpriced or underpriced and is likely to go down or go up.

Now, at one level, it is simply preposterous to say that there should be and can be no Market Timing. After all, what moves the market every second of every day is a huge number of buyers and sellers deciding to buy or sell, sometimes buy *and* sell, that day. Usually, though far from always, they are buying individual stocks. But on many other occasions, they are buying indices or baskets of stocks second by second, altogether by the billions of shares every day.

In the aggregate, what is happening every day is that the mass of investors and speculators are Market Timing every second of every day. Obviously, they are making decisions about what to buy and sell and when to sell and buy it. This is, in itself, Market Timing.

Every day, when the stock market goes down on poor earnings rumors, or goes up on rumors of future rate cuts by the Federal Reserve, the traders are timing the market, guessing that now is a better time to buy or sell than some other time. So in a way, it makes no sense to say that Market Timing is not a helpful strategy or that no smart person does it—unless we were to say that the great bulk of investors are not smart. This may be true, but then we would have to go further and say that no one who traded on any day was smart or experienced, and that is saying too much.

Moreover, what about all of those clever hedge fund managers? They mostly make money by buying and by doing something only some of us ever do, selling short. But they often trade

frequently, blindingly more so than the individual Ma-and-Pa Kettle investor at home in Smallville. Every time they buy or sell short indices or exchange traded funds, they are timing the market, even if sometimes only over a very short time. Yet, this, too, is Market Timing. Are all of these people fools? Some of them make pretty good returns for fools.

Then there is a factor standing in the way of the Anti-Market Timers that is about as big as Gibraltar. If Market Timing is futile and meaninglessly foolish, then what about the basic concept of price? How can price be meaningless in terms of stocks, while it is meaningful everywhere else?

This is a crucial question, and it is the one that began us on this project. If price means something in terms of real estate or oil futures or bonds or cars or shirts, how can it be meaningless in terms of stocks? If there is a price that is a "high" price for an apartment building relative to its rental income, can it be that there is no such thing as a "high" or "low" price of a share of stock in terms of its dividends or earnings or book value or some other metric—maybe even in terms of its usual price? If natural gas is high or low in relation to coal or oil, can it be that stocks are not high or low relative to other investment classes or to their own earnings or dividends? Does the basic principle that price is king in markets have no application in stocks?

Supposedly, price tells us the supreme wisdom of the markets at any given moment in time, since it is the synthesis of all of the available data about a stock's prospects at any given moment. But we know that price changes on a dime; price is like a hummingbird constantly maneuvering and changing position in the universe. Can it be that the price is unattached even over long periods to any kind of gravity of earnings or book value or past prices of the stock or of markets generally? Can it possibly be that a stock price is simply a totally random artifact not connected with anything else on earth? In that case, why have prices at all?

But if price does matter in relation to shares of stock, as it does in everything else on earth—including labor—then how can

it be that all prices are of equal predictive value? Is there not some number that will, over long periods at least, tell us the likely course of stock price movements? If we can be fairly sure that a rental apartment property that is selling for a much higher multiple of rental revenues than it ever has in the past is poised to fall, or is at least less likely to go up greatly than when it was cheaper, why is the same thing not true for stocks?

Or, to put it as simply as possible, we asked ourselves, could it possibly be that there is no such thing as "cheap" or "expensive" when one talks about buying or selling stocks, but there is for everything else on earth? And if shares of stock can be cheap or expensive, cannot markets themselves, the aggregate of all stocks, be cheap or expensive? And if they can be cheap or expensive, does this not have some presumptive value about the likelihood of stocks going up or down?

Asking ourselves these questions led to our preliminary research. We looked at years in which the earnings yield of stocks—the amount the total Standard & Poor's 500 earned as a numerator and the price of the aggregate S&P 500 as the denominator—was abnormally low, say below 5 percent (that translates to a price/earnings ratio of 20 or above) and calculated how well the market had done 5, 10, and 20 years afterward in the postwar period. We then compared those gains or losses with similar periods in which the beginning point showed stocks to be "cheap," namely when the earnings yield was above 10 percent, or a price/earnings ratio of 10 or below. We found that in general, over long periods of time, gains were starkly higher if the beginning point showed stocks to be "cheaper" in terms of having a higher yield of earnings.

This led us to make much more extensive studies of the effects of buying stocks when they were "cheap" or "expensive" by a series of other metrics. The results were quite consistent. The prices of stocks indeed could not be timed (at least, not by us) in any meaningful way in the short run. Price movements were more or less random over periods of months and even of a year or

more. They were not closely connected with other metrics we could find.

But in the long run, over many years, the "cheapness" or "expensiveness" of stocks by the measure of earnings yield, dividend yield, price-to-book value, even to the usual moving average of the price, had a great deal to do with superior results in terms of return on investment. Investing in stocks generally in this past century has been a good thing to do over long periods. But we found that buying when stocks were "cheap" led to far higher returns than when they were "expensive." By any of several measurements, total long-term return on stocks was greatly enhanced by "timing" the market, or buying when stocks as a group looked to be cheap. Returns over long periods were still good if the investor bought consistently no matter whether stocks were high or low by our measurements. But they were far better if the investor bought when shares were at certain buying points suggested by their price relative to other easily ascertainable numbers.

In the chapters that follow, we show how Market Timing turned out relative to simply (and not foolishly) buying consistently month-by-month for a period of decades. We think the results are startling. We also point out how some degree of measurement of stock prices, coupled with an attempt to buy when stocks are cheaper rather than more expensive, can save investors from genuine catastrophes over the shorter run (and remember that, as Mr. Keynes said, "In the long run, we are all dead"). We discuss which of our measurements yielded the best buying results.

Then we discuss why for most of the twentieth century clever people could manipulate the data to make it seem as if Market Timing did not work. *Hint:* It all has to do with who is picking the beginning and ending points. We then attempt an analysis of what role *macro* factors such as earnings growth or shrinkage, long- or short-term, interest rates, dividend levels, bond rates, and other interest rates play in exactly why timing the market in the simple ways we suggest works so well.

Or, we should say, we talk about why Market Timing has worked so well over the past century. It is always possible that we are in new territory and playing by new rules that render all previous guidance obsolete. But usually belief in a "new paradigm" goes before an immense fall. The past is an imperfect guide, but it is the best—and only—one we have.

Have a look at what we say and draw your own conclusions.

One note in the beginning: Have we lived by our own rules? Do we eat our own cooking? Yes. How have the results been? Not by any means perfect, but a whole lot better than if we had not invested by them. We have made some money in a very difficult investment climate using these rules. Much more important, we have avoided *losing* a great deal of money by following these rules, at least so far. The future is another country, but we have history on our side. We do not claim these tools will make you rich overnight. They definitely will not help you make a fortune in the short run and they will not make you a fortune in the long run unless you *consistently* invest a lot of money by them. We certainly do not claim that this is "black box" rocket science. This book is just about the enduring power of price and letting it save you from a myriad of problems.

But that is not a small thing. Warren Buffett likes to say that the number one rule of making money is not to lose money and the second rule is to remember the first rule. We would add a further thought: In investing and in handling money generally, the key is not to do anything genuinely brilliant and to avoid doing something really stupid. We hope this book helps. It has certainly helped us.