MISTAKE #1

Market Timing

Boy, do I have an investment for you! It has earned about 10 percent per year over the last 88 years and has gone straight up. Check it out (see Figure 1.1)!

Now, what if I told you that return was real? More intriguing is that it is readily available to you. It's just waiting for you to participate. What is this incredible, magical investment? Well, it's something you may have heard of: the stock market.

If you are like most Americans, this sort of return seems like a dream. In fact, according to DALBAR, over a 20-year period ending December 31, 2010, the average stock market investor has earned 3.27 percent per year while the S&P 500 Index has returned 9.14 percent. Every time DALBAR repeats their study, the conclusion is the same: Investors' stock portfolio returns regularly lag behind the stock market return by a very wide margin.

Market timing is the idea that there are times to be in the market and times to be out of it. Some people attempt to "protect" their money by exiting the market when they sense a downturn coming or load up on high-risk stocks when they anticipate a recovery.

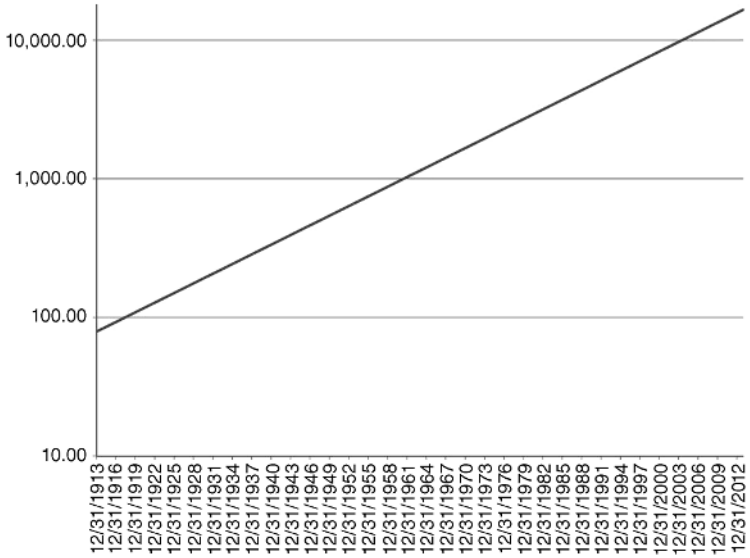
Let's get one thing straight right out of the box. Market timing doesn't work. It just doesn't. And don't tell me you don't market time either. Have you ever said or thought anything like this:

"I have cash on the sidelines and I am just waiting for things to settle down."

"I have a bonus but I'll wait for a pullback."

"I'll invest after [insert lame excuse here; some choices: the election, the new year, the market corrects, the debt crisis passes, Congress works out the budget, the Cubs win the World Series, or whatever]."

FIGURE 1.1



Source: Data from S&P Dow Jones Indices, LLC 2014.

All of that is market timing.

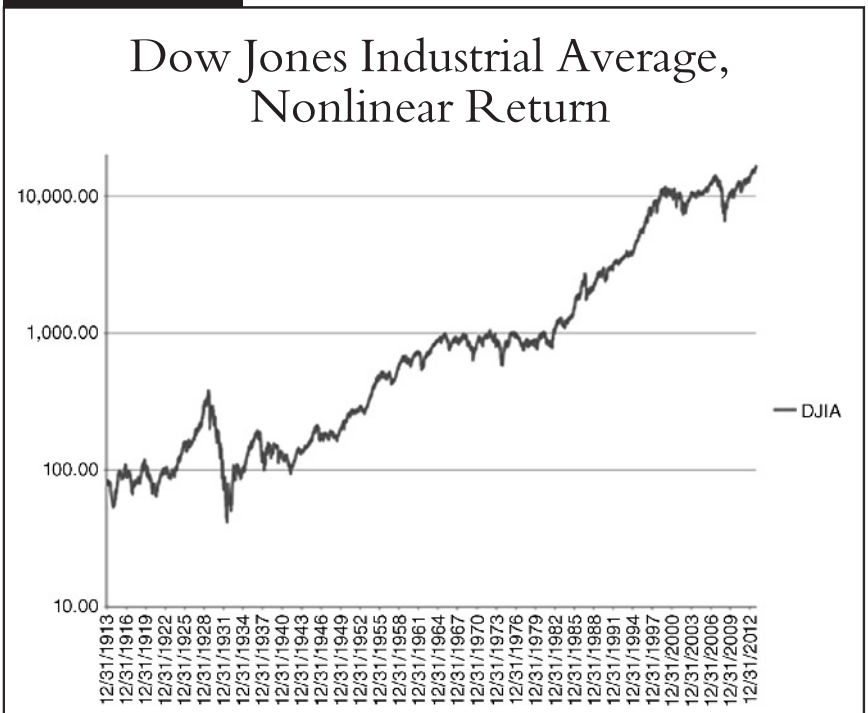
Why would anyone want to get in the way of an investment that has perpetually produced such fantastical* returns?

Quite simply, it is because the stock market doesn't go up in a straight line. Drawn as the returns actually happened, the graph looks like the one shown in Figure 1.2.

That still doesn't look so bad when we look at it from here, with the full benefit of hindsight. Of course, living through it is a completely different matter. Imagine the emotional turmoil you would have gone through during the Great Depression, the feeling of inertia and futility you would have had to endure through the 1970s, or the panic in 2008 (actually, you likely don't need to imagine that one!). With investing,

*Yes, it is a word! "Fantastic" didn't seem adequate enough to describe how great an investment stocks have been.

FIGURE 1.2



Source: Data from S&P Dow Jones Indices, LLC 2014.

even a few weeks can seem like forever, especially when the market is moving against you.

To be clear, there are many "markets." The graphs we have looked at so far represent the Dow Jones Industrial Average, an index of 30 large U.S. companies with a history allowing us to go back more than 100 years. Today, the more common index is the S&P 500, which is an index of 500 large U.S. companies, like Microsoft, ExxonMobil, Google, Procter & Gamble, and GE. While there are thousands of stocks, the largest 500 make up about 80 percent of the entire market capitalization. This is because companies like McDonald's, in the S&P 500, are hundreds of times larger than say, the Cheesecake Factory.*

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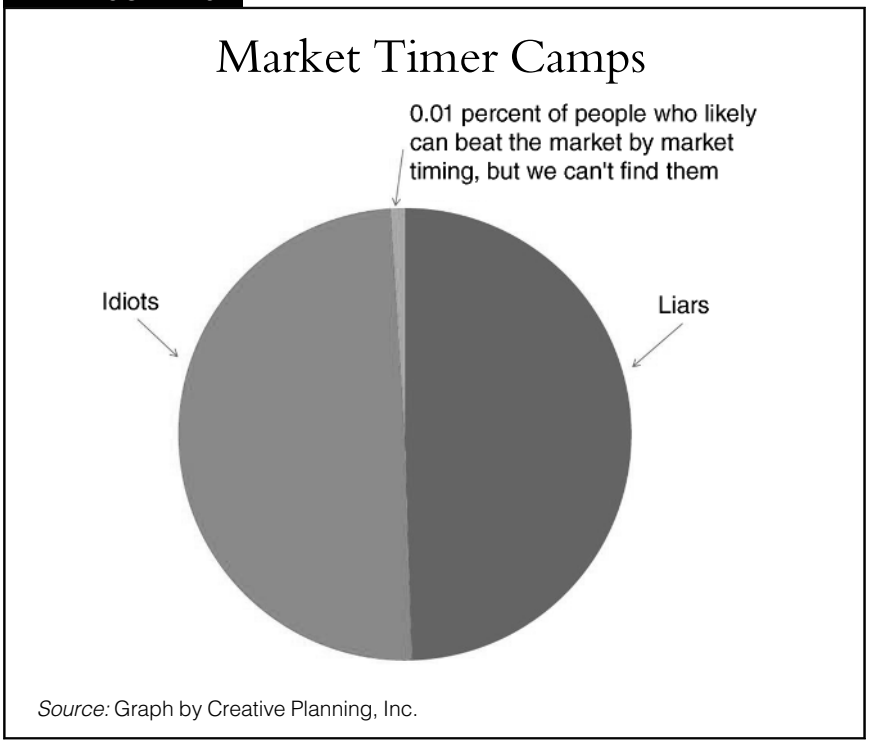
*Clearly, market capitalization is not a reflection on whose desserts are better. More on that later.

Just so no one thinks I am selecting the most awesomest* investment ever as an example, the same holds true for small U.S. stocks, international stocks, and emerging markets stocks. The point being, all broad markets have done the same thing: Go up. A lot.

All of this looks pretty good, right? But to get these returns, you need to avoid making the first big mistake: market timing. This isn't as easy as it sounds because there are lots of people who are encouraging you to make this mistake. Among them are prognosticators on TV, market timers, your buddy at work, your brother-in-law who "jumped out right before the last crash," and the majority of the financial services industry.

This group of market timers can be divided into two camps, as illustrated in Figure 1.3.

FIGURE 1.3



Source: Graph by Creative Planning, Inc.

*Yes, I realize that this is actually not a word.

Now, that chart isn't scientific. I don't really know what percentage of market timers are incompetent and what percentage are dishonest. I do believe though, that market timers fall into one of these two camps, and both are dangerous. Let's take a look at both groups.

The Idiots

What to do when the market goes down? Read the opinions of the investment gurus who are quoted in the WSJ. *And, as you read, laugh. We all know that the pundits can't predict short-term market movements. Yet there they are, desperately trying to sound intelligent when they really haven't got a clue.*

—Jonathan Clements

There are perfectly honest investors and advisors who really believe they can time the market. They believe they know something that no one else knows, or that they see something that no one else sees. They often will tell you they got it right before, and maybe they did—once. These folks are often like the friend of yours who tells you "I killed it, baby!" when he returns from Vegas, but conveniently leaves out the five times he lost. They forget their bad decisions and remember their good ones. They may be well intentioned, but ultimately they cause harm to their portfolios and to the portfolios of anyone who listens to them. These folks need to get educated, to learn the folly of their ways. Luckily, you will soon be able to spot these people, avoid them, and maybe even save them from themselves.

The Liars

There are three kinds of people who make market predictions. Those who don't know, those who don't know what they don't know, and those who know darn well they don't know but get big bucks for pretending to know.

—Burton Malkiel*

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*Burton Malkiel wrote a revolutionary book on this subject called *A Random Walk Down Wallstreet*. He is an advocate of using indexes at the core of a portfolio and active management in certain spaces "around the edges," a philosophy with which I agree.

Unfortunately, many financial advisors know very well that the market can't be timed, but their living depends on convincing you they can "get you out" with their "downside protection." This is the easiest sale in the financial advisory world. *There is nothing a prospective client wants to hear more than the pitch that they can participate in upward movement of the stock market but avoid the pullbacks*. There will always be people who want to hear this, and as long as those people exist, there will be tens of thousands of professionals at the ready to sell them snake oil.

I have also found that many financial advisors have been exposed to all the information they need to change their point of view away from market timing, but a big paycheck makes it hard to accept the facts. Much like a cult member finding definitive proof their founder is a fraud, the financial advisor can find the reality too much to accept and simply remain delusional and ignorant. As Descarte said, "Man is incapable of understanding any argument that interferes with his revenue."*

The prognosticators in the media also are eager to give you big, bold market calls. I have been on several national business channels, including CNBC and FOX Business. Prior to the show, the producer always asks me for my thoughts on "where the market is going." They are disappointed every time when I answer that over the short run "I don't know." That doesn't make for the most exciting guest in the world. One national cable network even branded me "The Time Machine" advisor because I kept prefacing my advice by saying I had no idea what would happen in the short run but was very confident about the long run. The graphics were quite amusing with my head sticking outside of a time machine that looked mainly like an old-school phone booth.†

In short, if you want to get clients and be on TV, the easiest path is to sell market timing. The financial services industry rewards the deliberate delivery of misinformation.

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*Also a very smart guy, but reading his books will teach you nothing about investing.

†My brother-in-law will never let me forget it.

Why Is It So Hard to Beat the Market?

In an efficient market, at any point in time, the actual price of a security will be a good estimate of its intrinsic value.

—Eugene Fama

There are many reasons market timing fails to work, and there are many reasons investment managers will try to tell you they can do it. Let's start by looking at the big picture, then work our way through the investment gurus and their actual results.

Efficient Markets

The efficient market hypothesis was developed by Nobel Laureate Eugene Fama. This investment theory can be summed up like this: It's tough to beat the market because markets are efficient at incorporating all relevant information. Since a bunch of smart people (and not so smart people) all know the same thing about any given security, it is impossible to have a sustainable edge that will allow you to beat the market return.

Where there appear to be patterns that the market can be beat, it is almost always due to the investor taking on additional risk. For example, there is evidence that small company stocks perform better than large company stocks over long periods of time, and this is very likely because they are riskier (more volatile).

While it is not my point of view that the markets are perfectly efficient, the evidence is fairly overwhelming that it is efficient enough to kick a market timer's butt.* Regardless, it gives us a premise from which all the rest of the evidence will follow.

Being a Little Better Than the Market Isn't Good Enough

Why is it so difficult to go in and out of the market repeatedly with success? The problem is that many investors think you simply need to be

*Technically speaking.

right more than 50 percent of the time, when in fact, an exhaustive study by Nobel Laureate William Sharpe* definitively concluded that the investor must be right 69 to 91 percent of the time, depending on market moves (Sharpe 1975). Good luck with that.

The Evidence (Research and Stuff)

The evidence against market timing is overwhelming.

This brings us to a comprehensive study by Richard Bauer and Julie Dahlquist (2001). In what may be the most exhaustive study ever done on market timing, the researchers examined over 1 million market timing sequences from 1926 to 1999. The conclusion: Holding the market outperformed over 80 percent of market timing strategies (Bauer and Dahlquist 2001, p. 38). That's a lot of scenarios run over a long period of time with one overwhelming conclusion. That doesn't seem to square with what many people do, what we hear from the masses, the media, economists, investment managers, newsletters, and your friends. Let's look at each.

The Masses Get It Wrong, Over and Over Again

We do not have an opinion about where the stock market, interest rates, or business activity will be a year from now. We've long felt the only value of stock forecasts is to make fortune tellers look good. We believe that short-term market forecasts are poison and should be kept locked up in a safe place, away from children and also from grown-ups who behave in the market like children.

—Warren Buffett

For the average investor, there has been spectacular mistiming of the market. At the bottom of the 2001 bear market, investors moved a then record amount of their money from stocks to cash. They then re-entered the market when it recovered. At the bottom of the 2008/2009 crisis, investors broke the record for stock market withdrawals, moving their money to cash in record numbers. Today, the market is up over

*Yes, at some point we will cite people who aren't Nobel Laureates.

100 percent from those levels. Investors had mistimed the market perfectly, breaking records both ways, both times at exactly the wrong time.

The Media Get It Wrong, Over and Over Again

The typical investor is getting their financial information from the media. It's important to note that the total sum value of all the information provided from the media regarding market calls is zero. Actually, it is less than zero because if you follow the guidance of the media on market calls, you are likely going to create a negative, rather than a neutral, result. Let's take a look at some examples:

"The Death of Equities." August 13, 1979, *BusinessWeek*—just prior to the biggest stock market run up in history.

"The Crash. . . . After a wild week on Wall Street, the world is different." November 11, 1987, *Time*—the market proceeded to rocket 31 percent over the next 12 months.

"Buy Stocks. No Way!" September 26, 1988, *Time*—just before the greatest 10-year run in market history.

"Will you be able to retire? With stocks plummeting and corporations in disarray, American's financial futures are in peril." July 29, 2002, *Time*—the market was up 21 percent from July 2002 through June 2003.

The media's job is not to inform you; it is to get eyeballs. Eyeballs lead to advertising revenue. That means they need people to read stuff and view stuff. Telling everyone things are going to work out just fine doesn't get eyeballs the way feeding into fear does. That doesn't just explain financial news; it explains most of the news.

Economists Get It Wrong, Over and Over Again

If you are going to predict, predict often.

—John Kenneth Gailbraith

Forecasts may tell you a great deal about the forecaster, but they tell you nothing about the future.

—Warren Buffett

He who predicts the future lies, even if he tells the truth.

—Proverbs

Economists have shown no ability to predict the direction of the economy. There are simply too many variables, many known and some unknown, for anyone to do so with any sort of sustainable accuracy. History provides us with two great anecdotes to this point. On October 15, 1929, Irving Fisher, whom Milton Friedman declared the "greatest economist the United States has ever produced," asserted that "stock prices have reached what looks like a permanently high plateau." The following week, the market crashed, taking us into the Great Depression and beginning a free fall that would eventually see the Dow lose 88 percent of its value. It would be nearly 80 years before another stock market fall would come close to that one. Of course, there was a high profile economist making a bold prediction just prior to the turmoil. On January 10, 2008, Ben Bernanke stated "the Federal Reserve is currently not forecasting a recession."* Unfortunately, the economy didn't listen, as a few months later the economy slid into the worst recession since the Great Depression, taking the stock market down more than 50 percent along the way.

Some economists have gained quite a bit of notoriety with their bold predictions. Bolder, it seems, is better. Harry Dent has become a quite popular economist despite his wildly unsuccessful market calls. It seems the more hyperbolic the predictions, the more attention he garners. In his 2006 book, *The Next Great Bubble Boom*, Dent wrote, "The Dow Jones Industrial Average could reach as high as 35,000 or 40,000 by late 2008 or 2009. . . . This continues to be our forecast . . ." (Dent 2006, p. 44). Of

*Now, ponder this for a moment. The Federal Reserve is arguably run by the best economic team on Earth. If they can't predict what is going to happen, and they control interest rates which drive at least part of what happens, how are you, your buddy, or your financial guy going to predict what happens?

course, we all know that the market fell into free fall in what turned out to be the greatest pullback since the Great Depression, bottoming in March of 2009. Almost stunning in its unfortunate timing, Dent came out with a new book in, you guessed it, 2009 called *The Great Depression Ahead* (Dent 2008). In this book, Dent predicted that the recession would become a depression and the Dow Jones Industrial Average would drop to 3,800. He strongly advocated that investors take any 2009 bounce in the market to sell all of their stocks and real estate and move to cash. This would be funny if it weren't so sad. Dent relentlessly promoted these books and was given a podium on financial networks to promote his forecasts. Both books were best sellers. Unfortunately, anyone following the "Boom" book went in at the wrong time and much, much worse, anyone following the "Depression" book sold out at the worst possible time.

In advertisements in May 2013 on his *Survive & Prosper* website Dent wrote, "I see the Dow Jones Average winding down, week after week . . . before ultimately dropping as low as 3,300. And there's nothing you or I, or any politician or government, or any team of monetary experts can do to stop the Dow Jones Index from dropping. . . . But here's the good news, extraordinary wealth can be made by knowing the future. In *Survive & Prosper*, my free e-letter, I'll show you my economic analysis and demographic research that proves the DOW is about to make a historic drop. . . . I will show how predicting and profiting from the future is a SCIENCE and is easier than you might have imagined" (Dent 2013). This guy, like just about everyone selling their ability to time the market, is nothing but a charlatan.

Despite making spectacularly wrong prediction after spectacularly wrong prediction, AIM partnered with him to start a mutual fund tracking his advice, the "AIM Dent Demographic Trends Fund." It quickly gathered $2 billion in assets, largely due to the publicity that surrounds Dent. It quickly lost 80 percent of its assets due to terrible performance. Dent said it was due to the fund not taking all of his advice. Dent may have a harder time explaining the performance of the "Dent ETF," which was launched on September 9, 2009, and was run by "HS

Dent Investment Management" until they resigned on June 2, 2012. On his website, www.hsdent.com, Dent calls his methodology "the ultimate economic forecasting tool for asset protection and growth" (Roth 2012). So how did the ETF perform while he managed it? During their tenure, it lost 12.9 percent. Over the same time period, the U.S. market was up 42.7 percent and the bond market was up 18.2 percent. It is very difficult to lose this much money during a bull market. It's almost impossible to do, even if you try. Despite being so wrong so many times, Dent still has his followers and gets plenty of media airplay. Extreme predictions have no problem finding airwaves.

Most economists cannot forecast the market correctly, and the evidence bears that out. However, occasionally, an economist does make what appears to be an accurate forecast. One such economist is the now famous Dr. Nouriel Roubini, the Chairman of Roubini Global Economics. Roubini, now known as the ominous "Dr. Doom,"* warned the public about the coming recession prior to it occurring. However, according to the Economic Predictions Research Project as published on the Wall Street Economists Institute website, Dr. Doom actually predicted a recession in 2004 (incorrectly), 2005 (oops, no recession), 2006 (sorry, still no recession), and 2007 (you guessed it, still no recession). If you followed Dr. Doom's advice, yes, you would have been out of the market prior to the 2008 drop, but you also would have been out of it for the four years prior and a few years after. All in all, you would have far less money following Dr. Doom's predictions than had you done nothing!

At an International Monetary Fund meeting in 2006, Dr. Doom was quoted as saying:

> My analysis has been based on circumstantial kind of observations. . . . I said the probability of a recession is "70 percent." If you ask me where I

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*You have officially hit it big as an economist when you have a nickname. Dr. Roubini is Dr. Doom. Marc Faber, another high-profile doomsday permabear, also has a nickname. It's also Dr. Doom. It seems that the longer and louder you are about how bad things are about to get, the more likely you will get a nickname, albeit not an original one.

> got that number: just out of my nose,* I will be very honest about that. I think if you would have said "50 percent" you would look like a wimp, it means you are not sure. So if you have the guts of believing there is going to be a recession, you should say something higher than that, and that is where the "70 percent" comes from. So my model is like a "smell test. . . ."
>
> —NYT *Roubini Article, IMF Transcript*

Translation: Dr. Doom, perhaps the most celebrated economic forecaster of our time, is basically saying his guesses are based on a "smell test" and he inflates his hunches to appear more confident.

I can't make this stuff up. Seriously!

Again, it would be funny if the financial media didn't elevate him and let his opinions about market movements carry such weight and go unchallenged. If a viewer saw Dr. Doom explain his outlook while the financial network showed his former predictions alongside a running ticker, perhaps he wouldn't carry quite the weight he does, and instead elicit an eye roll. Unfortunately, all people hear is that Dr. Doom predicted the 2008 recession and then listen carefully, and often act upon, his newer, ominous (as is almost always the case) predictions.

Now, I know what you're thinking: "Well, Dr. Doom might be the most famous economist to predict the crisis, but his failure to correctly predict almost anything else isn't indicative of economic forecasters in general."† Well, thanks for bringing that point up. Let's take a look at the entire field of economic forecasters who, like Harry Dent and Dr. Doom, make strong predictions.

Fortunately, I don't need to spend time researching to figure this out. Oxford economist Jerker Denrell and Christina Fang of New York University looked at all the predictions in the *Wall Street Journal*'s Survey of Economic Forecasts from July 2002 through July 2005 (Denrell and Fang 2010). They then narrowed their search to isolate the group of

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*My personal opinion is that he got it right out of somewhere else.

†Or you could be thinking, "Hey, it's time for a sandwich break." Hey, I'm not a mind reader!

economists who had proven to be the most successful at predicting unlikely outcomes. To do this, they defined an "extreme" prediction as one in which the economist's outlook was either 20 percent higher or 20 percent lower than the average prediction. Now, these economists appear to be darn good at predicting things. After all, they are taking positions where they stand alone, or in the minority, and have been proven right.

Well, not so much. Denrell and Fang then looked at the other predictions of this group and found that these economists, the ones with the best success rate at predicting "extreme" events, actually had a *worse* record overall. In other words, the more crazy the prediction an economist makes, the more likely he is to hit a home run every now and then, but the more likely he is to strike out far more than normal. Is this the type of person you want to get investment advice from?

Here's the deal: The more certain a forecaster is of their prediction, the less likely they are to be right, and the more likely their prediction is a derivative of showmanship. When it comes to investing, the bolder the prediction, the less valid the source. If you care about your financial well being, the data strongly suggests you would be far better off ignoring it.

Joe Stiglitz, a Nobel Prize–winning economist,* has said that economists get it right "about 3 or 4 times out of 10" (Weber 2011). With those odds, I'll pass. You should too.

Investment Managers Get It Wrong, Over and Over Again

Sure it would be great to get out of the stock market at the high and back in at the low, but in 55 years in the business, I not only have never met anybody that knew how to do it, I've never met anybody who had met anybody that knew how to do it.

—John Bogle, founder of Vanguard

There are literally thousands, if not tens of thousands, of financial advisors claiming to have "market indicators" that help them time the

*Here we go again with the Nobel Prize guys.

market. The most well-known among this group is Ken Fisher. Ken is one of the largest investment managers in America and a popular *Forbes* columnist. He claims to be able to beat the market by "identifying information not widely known" by others, according to Fisher Investments Philosophy. While Ken uses direct marketing and a legion of marketing representatives to promote his private portfolio management service, they rarely mention the publicly available mutual fund they run. The Purisima Total Return Fund consists of securities chosen by Ken and his team, presumably following his tried and tested strategy for success. According to Morningstar, through January 1, 2014, this fund ranks below average in its peer group over every time period: 1 year, 3 years, 5 years, 10 years, and since inception.

In September 2007, Ken wrote in his column: "This is a phony credit crunch . . . a few months from now we will be wondering what the fuss was about" (Fisher 2007). Perhaps Ken's boldest prediction came in January 2008, as the market began its downward spiral. Ken wrote in his column: "Let me make you a solemn promise for 2008 . . . America should do well in 2008—better, at any rate, than people expect. . . . My advice is to stay fully invested on a global basis, with stocks like these. . . ." (Fisher 2008).

Of course, what followed was the biggest single calendar year loss the stock market had seen since the Great Depression, and in 2008 the Purisma Fund run by Fisher's team was down 42.95 percent, far worse than the S&P 500.

Let's be clear though—while Ken Fisher is one of the biggest market timers, he is not alone in his inability to consistently time the market correctly, or even enough to outperform. As Don Phillips, the managing director of Morningstar said: "I can't point to any mutual fund anywhere in the world that's produced a superior long-term record using market timing as its main investment criteria" (Britton 2011).

While Ken Fisher was wrong about 2008, Peter Schiff nailed it. As early as December of 2006, investment advisor Peter Schiff predicted the coming economic crisis. However, the Economic Predictions Research Project as published on the Wall Street Economists Institute website puts

that in context. Below is a list of Peter Schiff's major predictions from 2002 through 2012:

May, 2002—The DOW will drop to 4,000—DID NOT HAPPEN.

December 16, 2006—Interest rates and inflation will go higher—DID NOT HAPPEN.

December 16, 2006—There will be inflation in 2008 and 2009—DID NOT HAPPEN.

December 16, 2006—U.S. equities will crash—HAPPENED! This is the prediction he is known for getting "right."

Predicted repeatedly prior and during the crisis: Buy foreign equities and commodities—DID NOT HAPPEN and a big "oops." It turns out that while he was right about the U.S. market, his solution was not so right. Foreign equities actually sold off far more than U.S. stocks, down over 43 percent. Peter Schiff invested his clients per his recommendations and they sustained the brunt of the crash.

January 16, 2009—At a minimum, the dollar will lose another 40 to 50 percent in 2010—DID NOT HAPPEN.

January 2, 2009—U.S. stocks are heading a lot lower in 2009, 2010, and 2011.—DID NOT HAPPEN—over this time period, U.S. stocks were up approximately over 40 percent!

September 9, 2009—Gold will go to $5,000—DID NOT HAPPEN.

September 9, 2009—U.S. dollars will go close to zero—DID NOT HAPPEN.

January 12, 2010—Buy commodities like gold—HAPPENED, except they later crashed with his clients still in the asset class.

August 26, 2010—We probably won't make it to 2012—DID NOT HAPPEN.

December 31, 2010—U.S. markets will crash like dominos and many bad things are bound to happen in 2011—DID NOT HAPPEN.

To sum it up, Peter Schiff did make a major market prediction, *but* his solution didn't work and most of his other predictions have been dead

wrong. I concur with Todd Sullivan of Seeking Alpha, who wrote "had you placed bets on Schiff's market calls, you lost everything you wagered" (Sullivan 2008).

The bottom line is this: There are tens of thousands of investment managers who claim to be able to market time. Some are famous and some are not. They all have one thing in common though: None of them can do this effectively and repeatedly. The odds of getting it right over time are extremely low, and only a fool would play such a game with the markets. An even bigger fool would pay someone else to gamble with their money this way. The odds are so stacked against the market timer that any long-term outcome other than colossal failure is rarely avoidable.*

Newsletters Get It Wrong, Over and Over Again

The only way to make money with a newsletter is by selling one.

—Malcolm Forbes

Tens of thousands of Americans subscribe to a variety of market timing newsletters. These Americans are paying a fee and spending a lot of time to increase their chances of underperforming the market.

In 1994, John Graham and Campbell Harvey, analyzing data provided by Mark Hulbert,† conducted what many consider the most comprehensive study on the ability of newsletters to predict the market (Graham and Harvey 1994). They looked at over 15,000 market timing calls from 237 newsletters over 13 years. The conclusion was overwhelming: 75 percent of the newsletters produced negative abnormal returns. Basically, following the advice of most of these letters created negative performance!

Some of the newsletters, like the once famous *Granville Market Letter*, produced an average negative annual return of 5.4 percent. The *Elliot*

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*Rule #1 of investing: Avoid colossal failure. Colossal failure is bad.

†Mark Hulbert runs a service that tracks newsletter predictions and performance.

Wave Theorist letter, a favorite of doomsday fanatics, produced a negative annual return of 14.8 percent.* During the same time period the S&P 500 earned 15.9 percent per year, outperforming a full three-quarters of the newsletters.

You might ask, well what about the one-quarter that did match or beat the market? It seems impossible, but the study actually overstates the performance of market timing newsletters. Had the study accounted for fees, transaction costs, and taxes, the underperformance would have been even worse! Finally, the authors took their study further, checking to see if winners keep on winning. The conclusion is clear: "Winners rarely win again."

The authors are harsh and definitive in the conclusion of their study, saying "There is no evidence that the letters can time the market."

Mark Hulbert's own research shows that the few that do outperform the market in any given year are not the same in future years (Snider 2014). In other words, a good year has no predictive value looking forward. His data on market timing letters specifically provides an even more dismal outlook: His data shows that not a single market timing newsletter has beaten the market over the long run (Snider 2014)!

Your Buddy

Only liars manage to always be out during bad times and in during good times.
—Bernard Baruch

Of course, we all know that one guy—the one who "had a feeling" about when to get out of the market.† He is like your buddy who tells you about the times he won in Vegas but forgets to include all the times he lost. There is no doubt that some people get some market calls right.

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* Isn't it interesting how the doomsday fanatics end up losing their money despite their desperate attempts to save it?

† Your buddy says stuff like this: "Dude, the market is so overvalued. Anyone can see that!" or "The charts made it so easy to know when to get out before the last correction."

There will always be people who do. However, in order to be successful, they need to be right about when to get out *and* when to move back into the market. More importantly, they need to do this *repeatedly*. In all likelihood, the person who got it right this time has tried it many times in the past, and will continue to do so in the future. *The odds are extremely high this person will ultimately fail.* In my entire career, I have personally never seen an investor exit the market near a top and enter it again near a bottom. Not once. And whoever does do it needs to do it over and over to succeed. Do you really think your buddy can do something even the pros can't do? The statistics, the probabilities, and not to mention plain old common sense, say no.

Strategies That Don't Sound Like Market Timing but Are Market Timing—Oh, and They Don't Work, Either

If you are ever talking with an advisor who tells you he doesn't market time, ask some further questions. Often, they will try to sell you what you want to hear, which is market timing, but packaged in a different way. They will say things like "downside protection," "asset-class rotation," "tactical allocation," "style rotation," and "sector rotation." They will say all sorts of things that imply they can regularly predict when to move from one part of the market to another. All of this is market timing and the evidence is overwhelming that it does not work.

Asset-Class Rotation

An asset-class rotation strategy attempts to select the ideal time to move from one asset class to another. The "sale" here is usually "downside protection." When marketed, advisors often sell the idea they will own stocks while the market is going up, but will shift to cash before it goes down. In his 1984 article, "The Folly of Stock Market Timing," Robert Jeffrey examined annual switches between stocks and cash and concluded "the potential downside from market timing exceeds the potential upside by a wide margin" (Jeffrey 1984).

Going forward, any time you hear "asset-class rotation" or "downside protection strategy" your BS meter should be beeping loudly.*

Tactical Asset Allocation

Tactical asset allocation funds attempt to beat the market by moving from one broad asset class to another. In February 2012, Morningstar compared 210 tactical asset allocation portfolios against a 60 percent stock/40 percent bond Vanguard portfolio. The conclusion: "With a few exceptions, they gained less, were more volatile, or were subject to just as much downside risk as a 60 percent/40 percent mix of U.S. stocks and bonds" (Ptak 2012). In other words, tactical allocation provides a wilder ride for a lesser return.† No thank you!

Style Rotation

With this strategy, an advisor is selling the idea they can move from one style of investing to another at optimal times. Common style rotation strategies include moving from value stocks to growth stocks or attempting to move from large dividend paying stocks to small stocks at the right times. Same deal—the evidence supports that this doesn't work.

Sector Rotation

A sector rotation strategy promises outperformance by moving from one sector to another at the right time. For example, a money manager may move from financial stocks to health care stocks, depending on where they see the economy going. Again, this is just market timing under another name and the evidence is this doesn't work either.

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*If you haven't noticed, part of being successful at investing is having a really good BS meter. We are talking really advanced. Off the shelf won't do it. There's just too much BS out there to survive without anything but the best.

†The irony of these strategies is that they often create more volatility and deliver a lesser return, which is the exact opposite of what the investor is attempting to accomplish.

What Smart Investors Have to Say on Market Timing

The market timing Hall of Fame is an empty room.

—Jane Bryant Quinn

Among the great investors of all time, none of them advocate market timing. J. P. Morgan, who dominated finance in his time, was asked by a young investor what the market would do. J. P. Morgan replied, "It will fluctuate, young man. It will fluctuate." Benjamin Graham, the father of modern investing, advocated against market timing, saying in 1976, "If I have learned anything over these 60 years on Wall Street, it is that people do not succeed in forecasting what is going to happen in the stock market." John Bogle, the founder of Vanguard, the largest fund company in the world, has said repeatedly that he finds market timing impossible and futile. Warren Buffett, who has been peerless in modern-day investing, has mocked market timing repeatedly, often citing it as simply the stupidest thing an investor can do. He has many thoughts on the subject including "Forecasters exist to make fortune tellers look good" and, more to the point, "I have *never* met a man that can time the market."

Knowing All This, Why Would Anyone Market Time?

Wall Street never changes, the pockets change, the suckers change, the stocks change, but Wall Street never changes, because human nature never changes.

—Jesse Livermore

Knowing that media, economists, newsletters, investment managers, and just about everyone else has not effectively timed the market, and having seen what legendary investors have to say about market timing, why would anyone try to time the market? Reasons for both the investor and "professional" selling market timing are the same: ignorance, greed, or both. Investors want to believe there is someone who can get in before the market goes up and get out before it goes down. None of the other

investment strategies, even if they can lessen losses or increase gains, sound nearly as appealing. And if people want it, someone will sell it and try to keep a straight face doing so. To make it easier to sneak by you, the advisor may not call it market timing, but instead use code for market timing. Upton Sinclair once said: "It is difficult to get a man to understand something when his salary depends on not understanding it." For as long as we are alive, there will be thousands of advisors selling market timing. You can count on it.

To survive market turmoil without getting pulled into the market timing mistake, one must understand the frequency of major market moves, especially corrections and bear markets.

Corrections

Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves. . . .

—Peter Lynch

A stock market correction is coming. Guaranteed.

That is quite a statement since I just spent a few thousand words talking about how market timing is practically impossible. So, how can I make such a prediction? I can make it because stock market corrections happen all the time. They are a given. Predicting one is like saying, "It is going to rain sometime this year."

Let us start with the definition of a "correction." It is simply a stock market drop of 10 percent or more. If the market drops a total of 20 percent, we change the name from correction to "bear market."

How frequently does a correction occur? Using the year 1900 as a starting point, corrections happen approximately every year. This means if you are around age 55 and reading this letter, you can plan on experiencing about 30 or more corrections.

Why not get out of the market once it drops 10 percent to avoid a further drop into bear market territory? The reason is that most corrections never officially become bear markets. Historically, the average correction is a drop of 13.5 percent. Most corrections last less than two months, with

the average length of a correction sitting at just 54 days. Less than one in five corrections turns into an official bear market.

Knowing this, it does not make sense to go to cash whenever a correction occurs. In fact, with odds like that, it is a rather illogical decision to convert to cash once the market drops 10 percent. You would basically be moving to cash right before the typical bottom. Imagine how badly you could screw up your portfolio if you reacted to even a few of these corrections.

Predicting stock market corrections and bear markets is a sport of sorts. To make matters more difficult, sometimes corrections happen for a reason and sometimes they do not.

We know it is a fact that corrections happen all the time. We know that most corrections do not evolve into bear markets. We also know that every single correction in history has given way to a full recovery. It seems completely ridiculous to panic and go to cash. The math is against you, the evidence is against you, and the natural bias of the market is against you—all three are going to get together and do serious damage to your portfolio.

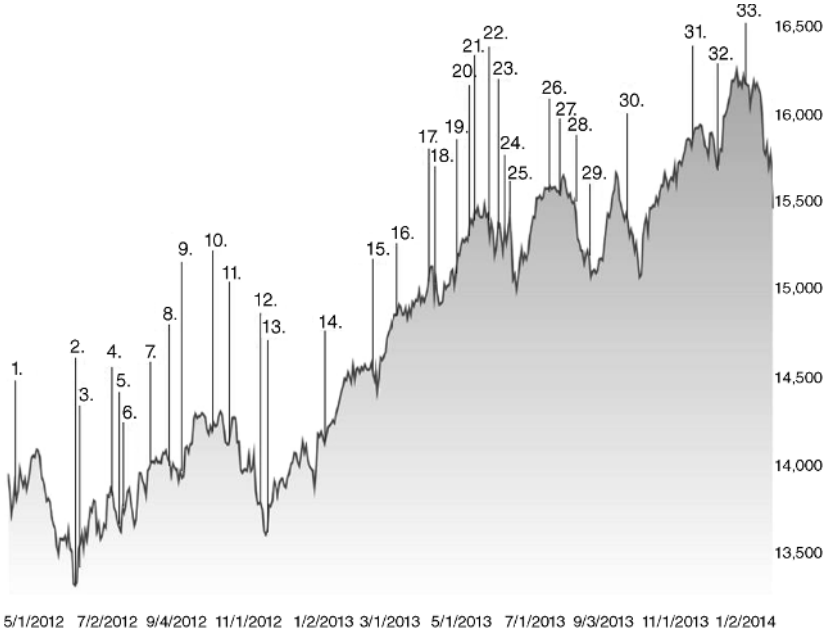
It is fun, however, to watch market prognosticators make themselves look spectacularly silly predicting a correction. Figure 1.4 shows just a small sampling of predictions from the pros during a recent two-year period—the market refused to correct for them, despite their confident proclamations. Enjoy.

The following are some corresponding market prognosticators' correction predictions from Figure 1.4:

1. "Market Correction Ahead," Bert Dohmen, Dohmen Capital Research Group, March 7, 2012
2. "Stocks Flirt with Correction," Ben Rooney, *CNNMoney*, June 1, 2012
3. "10 percent Market Correction Looms: Dig In or Bail Out?" Matt Krantz, *USA Today*, June 5, 2012
4. "A significant equity-price correction could, in fact, be the force that in 2013 tips the US economy into outright contraction," Nouriel Roubini, Roubini Global Economics, July 20, 2012

FIGURE 1.4

Market Prognasticators' Correction Predictions



Source: Graph by Creative Planning, Inc.

5. "Prepare for Stock Market Crash 2013," Jonathan Yates, money-morning.com, July 23, 2012
6. "Dr. Doom 2013 Prediction: Roubini Says Worse Global Economic Turmoil Approaching; Five Factors to Blame," Kukil Bora, *International Business Times*, July 24, 2012
7. "Watch Out for a Correction—or Worse," Mark Hulbert, MarketWatch, August 8, 2012
8. "We think we are set up for an 8–10 percent correction in the month of September," MaryAnn Bartels, Bank of America Merrill Lynch, August 22, 2012

9. "It's Coming: One Pro Sees Big Stock Selloff in 10 Days," John Melloy, CNBC, September 4, 2012
10. "Warning: Stock Correction May Be Coming," Hibah Yousuf, *CNNMoney*, October 4, 2012
11. "I'm going around town telling my hedge fund clients that the U.S. economy is headed into recession," Michael Belkin, Belkin Limited, October 15, 2012
12. "Fiscal Cliff Blues May Lead to Correction," Caroline Valetkevitch and Ryan Vlastelica, Reuters, November 9, 2012
13. "Why a Severe Stock Market Correction's Imminent," Mitchell Clark, Lombardi Financial, November 14, 2012
14. "By summer, we get another crash," Harry Dent, Dent Research, January 8, 2013
15. "A Stock Market Correction May Have Begun," Rick Newman, *U.S. News*, February 21, 2013
16. "Sluggish Economy May Signal Correction," Maureen Farrell, CNNMoney.com, February 28, 2013
17. "I think a correction is coming," Byron Wein, Blackstone, April 4, 2013
18. "Markets Long Overdue Correction Seems to Be Starting," Jonathan Castle, Paragon Wealth Strategies, April 8, 2013
19. "5 Warning Signs of a Coming Market Correction," Dawn Bennett, Bennett Group Financial Services, April 16, 2013
20. "Stock Market Warning Signs Becoming Ominous," Sy Harding, StreetSmartReport.com, April 22, 2013
21. "Don't buy—sell risk assets," Bill Gross, PIMCO, May 2, 2013
22. "This may not be the time to sprint away from risk, but it is the time to walk away," Mohamed El-Erian, PIMCO, May 22, 2013
23. "We're due for a correction soon," Byron Wein, Blackstone, June 3, 2013
24. "Doomsday Poll: 87 Percent Risk of Stock Crash by Year-End," Paul Farrell, MarketWatch, June 5, 2013

25. "Stock Shrink: Market Heading for Severe Correction," Adam Shell, *USA Today*, June 15, 2013

26. "Don't Be Complacent—A Market Correction Is On Its Way," Sasha Cekerevac, Investment Contrarians, July 12, 2013

27. "For Two Months, My Models Have Told Me That July 19th Would be the start of a Big Stock Market Sell-Off," Jeff Saut, Raymond James, July 18, 2013

28. "Signs of a Market Correction Ahead," John Kimelman, *Barron's*, August 13, 2013

29. "Correction Watch: How Soon? How Bad? How to Prepare?" Kevin Cook, Zacks.com, August 23, 2013

30. "I Think There's a Decent Chance Stocks Will Crash," Henry Blodget, *Business Insider*, September 26, 2013

31. "5 Reasons to Expect a Correction," Jeff Reeves, *MarketWatch*, November 18, 2013

32. "Time to Brace for a 20 Percent Correction," Richard Rescigno, *Barron's*, December 14, 2013

33. "Blackstone's Wien: Stock Market Poised for 10 Percent Correction," Dan Weil, Moneynews.com, January 16, 2014

Bear Markets: An Overview

The key to making money in equities is to not get scared out of them.

—Peter Lynch

A bear market is coming. Guaranteed.

I know, I know. I just said that about corrections. Well, it's true about bear markets too. Bear markets don't happen nearly as frequently as corrections, but they also happen all the time. A bear market is defined as a stock market decline of 20 percent or more.* Bear markets occur every

*Ten percent and 20 percent are just numbers, but in real life, when experienced, they elicit quite different reactions. If a correction feels unsettling to you, a bear market will make you want to curl up in a ball and cry for Mommy.

FIGURE 1.5

Bear Markets: How Often, How Long, and How Severe?

Bull Market Top	Bear Market Bottom	Number of Days Duration	% Decline in S&P 500
05/29/1946	05/17/1947	353	–23.2%
04/06/1956	10/22/1957	564	–19.4%
12/13/1961	06/26/1962	195	–27.1%
02/09/1966	10/07/1966	240	–25.2%
12/03/1968	05/26/1970	539	–35.9%
01/11/1973	12/06/1974	694	–45.1%
09/21/1976	02/28/1978	525	–26.9%
04/27/1981	08/12/1982	472	–24.1%
08/25/1987	12/04/1987	101	–33.5%
07/16/1990	10/11/1990	87	–21.2%
07/17/1998	08/31/1998	45	–19.3%
03/24/2000	09/21/2001	547	–36.8%
01/04/2002	07/23/2002	210	–32.0%
10/11/2007	03/09/2009	512	–57.6%

three to five years, depending on how far back you want to look. There have been 34 bear markets from 1900 to 2014, including 14 since 1946. The four bear markets from 2000 on have been jarring for investors with all sorts of crises assaulting the markets. The average bear market decline is 33 percent and more than one-third of bear markets have suffered drops over 40 percent. The average bear market lasts close to a year with almost all of them lasting anywhere between eight months and two years (see Figure 1.5).

Bear Markets Happen for Different Reasons, but the Outcome Is Always the Same

The four most expensive words in the English language are: "This time it's different."

—John Templeton

Bear markets occur when a lot of people think things are going to be really bad for a really long time. If we know that every bear market has given way to a bull market, then why would anyone ever panic and go to cash? The reason is that each bear market tends to happen for a different reason than the one before it. Looking at recent bear markets, we have everything from a computer-driven crash, to a tech bubble, to a terrorist event and war, to a liquidity crisis. Because each drop is driven by a different set of facts, investors panic thinking that in fact, "This time is different." While the actual set of facts driving the bear market may be different, the outcome is always the same: The economy finds a way to move on. Every single time. No exceptions. The next time we go through a bear market, remind yourself of all the things we have been through in the past 80 years. If the economy can survive all of this, it can likely get through the next bear market:

1940s World War II

1960s/1970s Vietnam War

1970/1980s Hyperinflation

1970s/1980s Commodity Crisis

1980s Real Estate and Banking Collapse

1980s Emerging Markets Crisis

1987 Flash Crash

1990s Asian Contagion Crisis

2000 Tech Bubble Bursts

2001 9/11 Attack and Subsequent Afghanistan and Iraq Wars

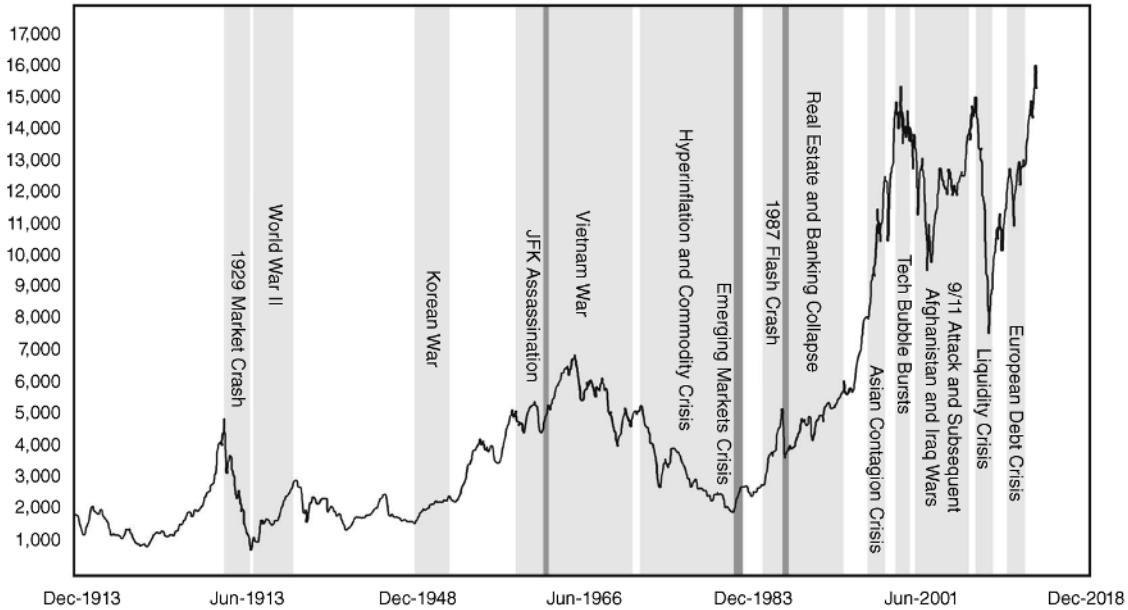
2008/2009 Liquidity Crisis

Figure 1.6 shows what it looks like against the market.

And keep in mind that the previous list is by no means all inclusive. There are many distractions along the way that will cause prognosticators to predict the next bear, whether it is a downgrade of the United States, a "fiscal cliff," a budget debate, an election, or whatever happens to be the news cycle of the day.

FIGURE 1.6

Dow Jones Industrial Average and Bear Markets



Source: Graph by Creative Planning, Inc.

Bear Markets Are Not Predictable

Here's the thing though: Bear markets are not predictable. No one on earth has consistently and repeatedly predicted bear markets. Remember, to exploit a bear market, you need to know when to get out, know when to get back in, and then do it again. I can't find the guy who's done that. You're not going to find him either. He's Santa Claus. You might want to think he exists, for a while you believe he exists, there comes a point where you know enough to know he doesn't exist but you can't admit it yourself, and then finally, maybe you will accept it. Also like Santa Claus, there are a lot of people running around pretending to be that guy you want to believe in so badly.*

When Bear Markets "Turn," They Make People on the Sidelines Look Silly

Now, you might acknowledge that you can't possibly get out and back correctly and repeatedly, but you may be thinking: "I'll at least get out and wait for things to settle, miss a small part of the recovery, then jump back in." This too, is likely not possible. When bear markets give way to bull markets, they often first have several false starts, but when they "turn" for real, *they tend to do so quickly and furiously*, leaving most market timers sitting with their hands firmly under their derrières. Figure 1.7 illustrates this point.

The Market Is Volatile—Get Used to It

You get recessions. You get market declines. If you don't understand that is going to happen, then you won't do well in the markets.

—Peter Lynch

Sometimes a year goes by without a correction or bear market. Sometimes the market ends the year with a solid return, and in the

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*I am pretty sure that with the book's opening graph, I eliminated the chance of anyone reading this book who still believes in Santa Claus.

FIGURE 1.7

Bear Markets:
How Quickly They "Turn"

Bear Market Bottom	Next 12 Months (S&P 500)
6/13/1949	42.07%
10/22/1957	31.02%
6/26/1962	32.66%
5/26/1970	43.73%
10/3/1974	37.96%
8/12/1982	59.4%
12/4/1987	22.40%
9/21/2001	–12.50%
7/23/2002	17.94%
3/9/2009	69.49%

rearview mirror it looks easy. That is very rarely the case. *The market trades in very wide ranges*. Since 1980, the market has had an average intrayear decline of 14.4 percent, *but still ended with a positive return 26 of the past 34 years*! (See Figure 1.8.) The market moves around a lot. Accept it, embrace it, learn to love it. If you can't do that, well then, at least get used to it!

You Can't Wait for Consumers to Feel Good

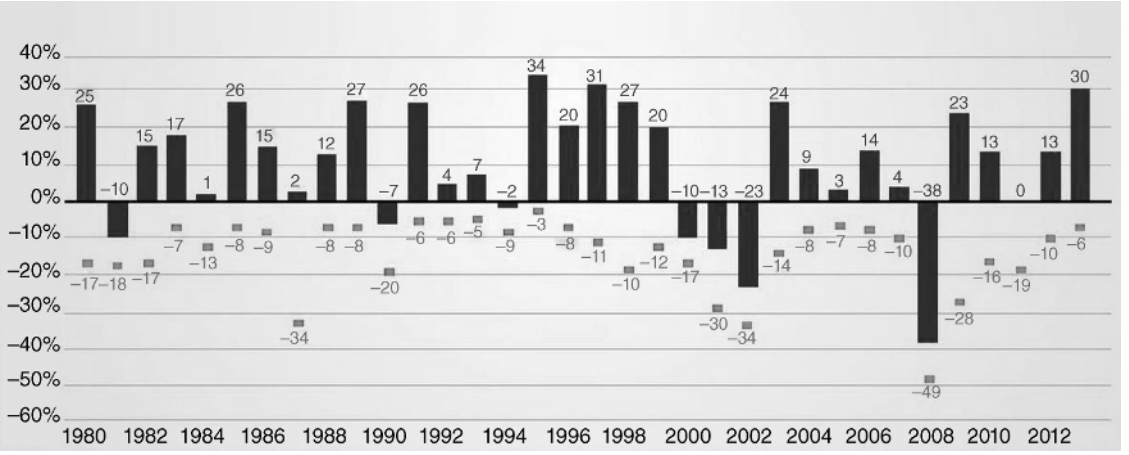
Bull markets are born on pessimism.

—John Templeton

You not only can't wait for things to "settle," you also can't use consumer confidence as an indicator. You might notice that during bear markets, commentators often talk a lot about "consumer confidence." They do this because the consumer drives a lot of the economy. If the consumer doesn't feel good, he likely won't spend money. If the consumer doesn't spend money then companies can't make money. And if companies don't make money, the markets likely won't recover. This is simply not true, primarily because the market isn't looking at

FIGURE 1.8

S&P 500 Intrayear Declines versus Calendar-Year Returns



Sources: Data from Standard & Poor's, FactSet, J.P. Morgan Asset Management. Returns are based on price index only and do not include dividends. Intrayear drops refer to the largest market drops from a peak to a trough during the year. Data as of 12/31/2013.

FIGURE 1.9

When the Consumer Gives Up

Consumer Confidence <60%	Next 12 Months (S&P 500)
1974	+37%
1980	+32%
1990	+30%
2008	+60%

today. The market is always looking at tomorrow. It cares less where the economy is today and more about where it is headed.

Bull markets tend to emerge when investors are *feeling the worst* about the future outlook. The University of Michigan regularly measures consumer confidence. Figure 1.9 shows how the stock market performed the 12 months following each time consumer confidence was less than 60 percent.*

Learning to Accept the Bear Markets

If you are 55 years old, you can expect to live through about seven or so more bear markets. Do you really want to freak out every time? Are you really going to navigate through each one? No, you're not, because you know better! There is one great thing that all bear markets have in common: 100 percent of the time, they give way to bull markets. Not 50 percent of the time, not 75 percent of the time, not 99 percent of the time. 100 percent of the time! Why do so many people mess with those

*My kids like to play the "opposite game" where you say the opposite of what you mean. Much of the market information that is intended to help investors, like the consumer confidence data, actually works the opposite of how commentators choose to reference it. We will see more of this later in the book when we look at Morningstar ratings.

odds? It makes no sense. But alas, for most, investing isn't about common sense. It's about emotions and the perception of control. More on that later!

Miscalculating the Risk of Market Timing

So, we have now established that market timing is dumb and doesn't work. You might be thinking though, "What's the big deal? So what if I miss some gains in exchange for safety?" This is the main objection to simply investing rather than market timing. The answer is quite simple. The risk of being out is far greater than the risk of being in.

Let's say you have a $25,000 bonus and you are deciding between investing and waiting for some arbitrary event to happen that will make you feel better about investing. If you invest all at once, one of three things will happen: The market will go up (hurray!), it will go sideways (very good—you get dividends!), or it will go down (still not a big deal because this is *temporary*). If it goes down, we know two things: First, we know you are going to collect dividends, which is better than what you get from cash, and second, we know the market will go back up. The downside is simply temporary—no big deal!

Now, if you wait in cash, the market can do the same three things: It can go up (you don't look so smart and lose a lot of money), it can go sideways (sorry, no dividends for you while you sit in cash), or it can go down (if you were too scared to go in today, are you really going to feel better in the middle of a correction? Be honest with yourself. We both know the answer is "no"!). Now, here's the rub. If you are in cash and the market goes up, you may have permanently lost the opportunity to capture the upside. For example, the Dow moved quickly from 10,000 to 16,000. Yes, it may go back down, but will it go back to 10,000? Maybe, but maybe not. If it doesn't go back down to that level, the investor sitting in cash will never be able to capture that return again. Being on the sideline often results in *permanently* missing the upside. On the other hand, if someone invests today, the worst thing that can happen is *temporarily* participating in the downside. Big difference.

But What If I Am Perfect?

Oh come on, really!? Well, there is always someone who thinks they can be perfect, that all the data and evidence don't apply to them, that they can find a way to make it happen. Let's take a look at just how much better off "that guy" will be if he is perfect. The Schwab Center for Financial Research evaluated five decisions available to an investor who has $2,000 in cash to invest once a year for 20 years (Riepe 2013):

1. Leave the money in cash.
2. Invest all at once each time.
3. Take the cash and dollar cost average into the market over the year, buying 1/12th each month.
4. Accidentally invest all of the money at the worst possible day every year (buying on the single day the market was the highest every single year).*
5. Fortuitously invest all of the money on the best possible day each year.† This is our Mr. Perfect. He always sits on the cash until the market is at the absolute lowest each year and then invests all the cash.

The results are nothing short of remarkable (see Figure 1.10). The perfect market timer ended up with $87,004, and right behind him in second place is the person who simply invested the money as soon as they received it (Riepe 2013).

Now, assuming you are in agreement that you are not going to invest all the cash you get on the single best day you can every single year for 20 years, investing the cash right away seems like a pretty good idea. Everything else provides various degrees of losing. Losing isn't fun, especially when it is so easy to win.

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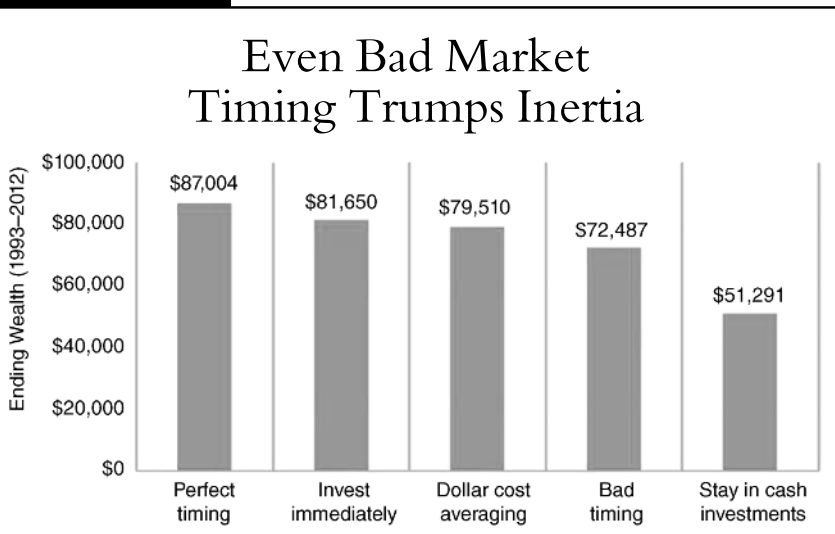
*Wow, this person is unlucky! Or is he?

†I love this guy because he doesn't exist. He spends a lot of energy trying to convince you he is for real though.

FIGURE 1.10



Source: Graph from Riepe 2013.

Lump Sum Investing versus Dollar Cost Averaging

In the previous section we cover why, if you find yourself getting money each year, you should invest it all at once instead of over time. Surely, the advice is different if we are talking about a huge sum of money, right?

Surely dollar cost averaging instead of lump sum investing spreads out the risk? After all, it's a common recommendation given repeatedly by financial pundits and advisors to invest a lump sum over time. The answer is no, not really. It does however have legitimate psychological considerations that we will discuss in a minute.

First, what is a lump sum? A lump sum is when you get a boatload of money all at once. Examples are a large cash inheritance, proceeds from the sale of a business or real estate, a large gift (lucky you!), winning the lottery (super lucky you!), or a once-in-a-lifetime bonus. Lump sum investing refers to taking this lump sum and throwing it all into the market, all at once. Sounds crazy, right? Surely it's better to dollar cost average, which means investing in the market over time, such as investing 1/12th each month for 12 months.

Vanguard conducted a study comparing lump sum investing to dollar cost averaging (Shtekhman, Tasopoulos, and Wimmer 2012). They used an example of an investor who found himself with a million dollars in cash to invest and who ultimately wanted to be in a 60 percent stock and 40 percent bond portfolio. The researchers compared the impacts of lump sum investing to dollar cost averaging over 6, 12, 18, 24, 30, and 36 months. They also looked at the impact of this comparison in various markets, looking at the United States, United Kingdom, and Australia. They then examined the impact of both strategies over 10-year rolling periods, going all the way back to 1926. Finally, they repeated the study for a variety of portfolios, ranging from 100 percent bond all the way to 100 percent stock.

The conclusions are definitive. For an investor working their way to a 60/40 portfolio and holding it for 10 years, *67 percent of the time they ended up with more money by investing the lump sum as opposed to dollar cost averaging over 12 months*. This result persists across the three countries (see Figure 1.11).

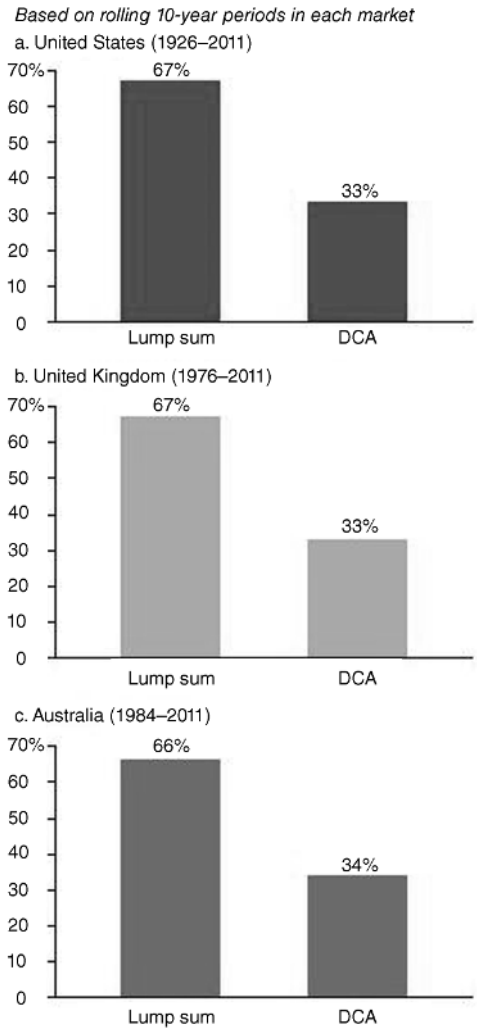
Furthermore, lump sum investing's advantage was even more significant when compared to dollar cost averaging over longer periods of time (see Figure 1.12). For example, in the U.S. market, lump sum investing did better about 90 percent of the time when compared to dollar cost averaging over 36 months. At the end of the day, all the money is getting invested and is invested most of the time. The only period that is different is the period an investor is dollar cost averaging into the market.

So why does lump sum investing perform better than dollar cost averaging most of the time? The answer is simple: Bonds and stocks perform better than cash over time, and dollar cost averaging leaves some of the investor's money in cash during the entry period.

So you should always lump sum invest, right? Well, that depends on one important thing: you. Yes, the data is overwhelming that lump sum investing is better than dollar cost averaging most of the time. However, just because something is statistically in your favor doesn't mean it is right for you. One big factor to consider is the potential for regret.

FIGURE 1.11

Relative Historical Probability of Outperformance Using 12-Month DCA and a 60 Percent Stock/40 Percent Bond Portfolio

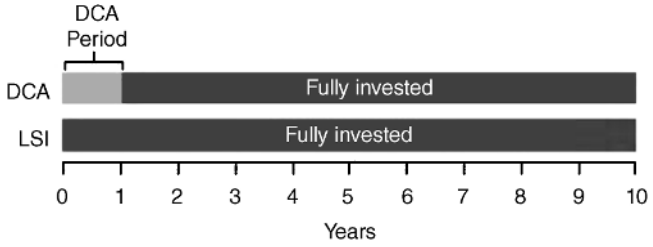


Note: Each portfolio consists of a 60 percent allocation to the local equity market and a 40 percent allocation to the local bond market.

Source: Graph from Shtekhman, Tasopoulos, and Wimmer 2012, 3. Vanguard calculations based on benchmark data.

FIGURE 1.12

Dollar Cost Averaging Example



Source: Graph from Shtekhman, Tasopoulos, and Wimmer 2012, 2.

We are all familiar with regret. We may regret something we said or something we didn't say, a risk we did or didn't take, the one that got away, or some other decision we did or did not make.* Psychologists have extensively studied the impact of regret on decision making, and this research has expanded into the behavioral psychology of investing. One motivating factor for investors is fear of regret. This is the subconscious or fully conscious emotion that keeps us from selling a stock that is way up ("If I sell it, it may still go up and I'll regret it."), from selling a stock when it is down ("If I sell it, it may recover and I will regret it."), and from buying into the market when it is at an all-time high ("If I buy in, it may go down and I will regret it."). Fear of regret drives a lot of our personal decision making, and is a prevalent factor in investor decision making.

Let's go back to you and assume you have had a lifetime event leaving you with a pile of cash to invest, and you are facing the lump sum investing versus dollar cost averaging decision. If you are the type of person who plays the statistics, doesn't get emotional about market movements, and won't experience major regret if the market crashes the day after you invest, then lump sum investing is for you, and you will likely be better off for it.

*Right now, I am regretting eating a second helping of ice cream.

If you are the type of investor who will freak out if there is a market event (pick one—flash crash, tech bubble, 9/11, financial crisis, European debt crisis, etc.) the day after you invest, then spread it out a bit, and ease in over six months or so. Yes, you are most likely giving up some upside, but you will also be more likely to avoid regret and stick with the plan. In the end, the main point is to get invested—that's 90 percent of the game. The other 10 percent is getting invested as quickly as possible.

If you are going to dollar cost average, *commit to a calendar*, and invest as planned. For example, commit to investing 1/6th of the funds the first Monday of every month until you are fully invested. Otherwise, you may fall into the paralysis trap of seeing how you feel about the market each month, and sometimes hold back your investment. This is a loser's game.

The stats say to lump sum invest. The investor concerned with regret or willing to give up upside to avoid a short-term hit should consider dollar cost averaging. Both should have a plan to invest and stick to it.

Learning to Fly

I'm learning to fly, but I ain't got wings.

—Tom Petty

There comes a time when the baby birds need to leave the nest, take that jump, and learn to fly. Many investors have tried that before, only to land flat on their faces. Back in the nest, they struggle looking for a time to "take the jump" again.

If we look back though, there is no example in history of the stock market taking a dollar from anyone. Someone who had no idea what they were doing and simply bought the S&P 500 would have made huge profits over the past 10, 20, or 30 years. Truckloads of money have been lost, however, by investors making mistakes with their portfolio, or by using advisors who have made market timing or security selection mistakes. It is hard for most to believe that had an investor bought into the market at any time in history, they would have more money today than if they stayed in cash.

Let's take a look at the unluckiest investors:

The one who invested right before the 1987 crash: S&P 500 at 334

The one who invested right before the early 1990s recession: S&P 500 at 363

The one who invested the day before 9/11: S&P 500 at 1,096

The one who invested the day of the 2007 stock market high: S&P 500 at 1,526

All of these unlucky individuals did much better than the bird that stayed in the nest, waiting for the "right time" to take the jump. *As of April, 2014, the S&P 500 is at 1,878, but that does not include dividends, which averaged over 2 percent along the way and is the equivalent of approximately 300 more points since 2007.* Even the investors who went in at the worst possible times are far ahead of the "investor" sitting in cash, waiting for things to "settle down."

Many are scared off by the headlines that "the market is at an all-time high." Well, that is often true but it happens all the time. If that sounds too scary a time to enter the market, the odds are high you will never be comfortable.

The reply to this argument, of course, is that it is always better to enter after a market corrects or crashes. However, no one knows when that will happen, or more importantly, how high the market will go before it corrects. If the Dow goes from 15,000 to 16,000 then drops back to 15,000, what have you accomplished in this scenario by sitting in cash other than missing out on dividends? Also, I have yet to find the investor who is nervous at Dow 15,000 but feels super-fantastic about investing at Dow 13,000. If you are nervous when things are too good, you aren't going to feel better about investing when things don't look so hot.

For the disciplined investor, the time to invest is always today, and that is only because yesterday is no longer an option. You are ready to fly with the markets when you have knowledge to serve as your wings.

Avoiding Mistake #1—Market Timing

The evidence is overwhelming that market timing does not work. Academic research shows it, studies based on real-world managers substantiates it, the masses get it wrong, the media gets it wrong, economists get it wrong, investment managers get it wrong, and so does just about everybody else.

Market timing can be black and white, like going to cash and back to stocks. Often you are market timing and don't realize it ("I'll hold onto my bonus until the market settles."). Sometimes market timing is promoted by a money manager or financial advisor using coded language like "asset-class rotation," "downside protection," "tactical asset allocation," "style rotation," or "sector rotation." It's all market timing. Part of protecting yourself from this mistake is recognizing it.

Corrections are going to happen. Bear markets are going to happen. Bad things happen. No matter how nervous you get, no matter how bad things appear, the bear will give way to the bull. These corrections and bear markets will happen many times in your life, you can't predict them, and you will do more harm to your portfolio than good by trying to navigate your way through them by trading.

If an advisor tries to sell you any of these strategies, say "see ya later" and continue your search for another advisor. *If you are currently paying an advisor to do any of these things, know that you are willingly paying money to someone to increase the odds of your portfolio underperforming*. The research shows the pros can't do it. The odds are pretty darn high that you, your buddy, or your advisor can't do it either.