

The Folly of Market Timing



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For many of us mere mortals timing the inflection points in equity markets is about as difficult as predicting the winner of next season's UEFA Champions' League, and I'd venture to say the latter is a little easier in comparison. The sobering truth is that very few of us investment professionals called the month, the quarter or even the year in which the market would eventually fall.

Despite the odds being stacked horribly against us, many of us still try to time the market, either consciously or subconsciously. The reality is that the best that most of us could manage was in assessing that the market was probably trading higher than it was worth from about the middle of 2006.

To compound our error, despite not calling the top, many of us now believe or hope we will call the bottom. This is caused, in part, by the erroneous belief that not having our capital in the equity market for fear of it falling further isn't the same as market timing, especially given that the market had fallen by more than 40% over the last 12 months to the end of February. In other words, we view a loss of 20% of our capital as being very different from the opportunity cost of missing out on a 25% rise in the market, even though their long term impact on our capital is equivalent.

In this piece we try to evaluate the potential costs of "mis-timing" the market. In doing so, we have analysed the performance of the FTSE/JSE All Share Index (ALSI) post any decline greater than or equal to 30%. There was no real science in choosing 30% except that it represents a loss of capital that most people would agree is substantial. We then looked at the real return generated by the ALSI over 1 year, 2 years, 3 years and 5 years post all major declines of 30% or more since 1925. The table below represents the findings of this simple analysis.

Holding period	Maximum	Minimum	Average	Pr. Loss	StDev
1	81.5%	-23.2%	17.8%	34.6%	27.6%
2	37.8%	-16.0%	17.6%	15.4%	14.2%
3	38.5%	-7.4%	12.1%	15.4%	11.0%
5	29.4%	-5.1%	8.2%	7.7%	8.2%

The table is read as follows:

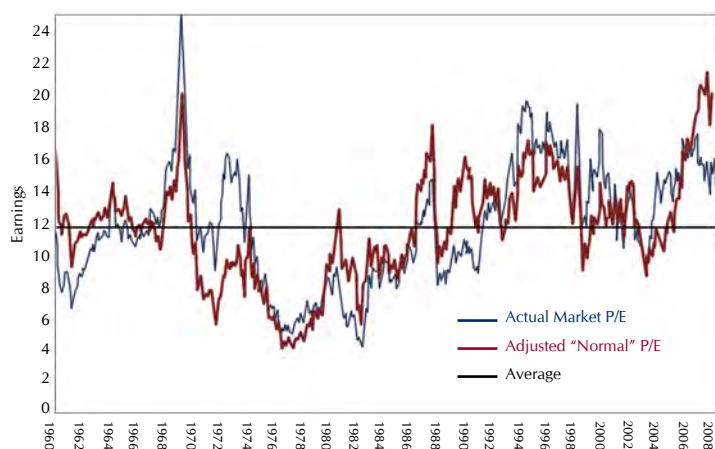
1. Maximum represents the highest compound annual real return achieved after a fall of more than 30% since 1925 over the various holding periods ranging from 1 year to 5 years;
2. Minimum represents the lowest real return on the same basis as the Maximum;
3. Average represents the simple average of the compound annual real returns over the various holding periods measured post a market fall of 30% or greater;
4. Pr. Loss represents the ratio of the number of negative return observations (post a market fall of greater than 30% over the various holding periods) versus the total number of

return observations. It's a crude measure of the probability of observing negative returns over the various holding periods, given a market decline of 30% or more;

5. StDev represents the standard deviation of returns.

It can be observed from the data that on average real returns achieved post a market decline of 30% or more are comfortably positive. It can however also be observed that there have been an uncomfortably high number of negative return observations during the twelve months after a major market fall - slightly more than one third to be exact. But this should not perturb those of us who purport to be long term investors. From the historic data, it would appear that on average investors gain much more than they lose from investing in equities post a major decline in equity prices.

Despite the clarity of the numbers on the page, I am not suggesting yet another rule of thumb: "buy the market after a fall in equity prices of more than 30%". On the contrary, our view is that the long term health of one's capital is best served by making long term investment decisions based on some rational and objective assessment of value. One such measure is the Price Earnings (PE) multiple of the ALSI (chart 1 below) based on trend earnings as opposed to actual reported earnings. This adjustment serves to smooth out the occasions where the market's earnings are unsustainably low or unsustainably high, and gives a much better indication of what the market has paid, and is currently paying, for "sustainable" earnings.



We consider this approach to be superior, at least for the average investor, trying to predict the exact point at which the market will turn positive or negative. This is because these points are driven

much more by market participants' mood than by any observable or predictable changes in fundamentals. Predicting the mood swings of an individual is challenging enough, let alone those of multitudes of market participants.

Turning back to the PE chart, one can observe the market's PE, based on trend earnings, at just below its long term average of 12. We interpret this to mean the market is fair to slightly undervalued. It is certainly not the dripping roast it was either in 2003 or 1998. The market would have to fall another 20% to be as undervalued on this basis.

The long and short of it is that the market is looking at least fairly valued and it has fallen by more than 30% over the last 12 months. This, to us, suggests it would be folly to be completely out of the market. However it is also true that there are still some dangers that are lurking around every corner, the least of which is a deteriorating economy which will lead to a fall in the very elevated earnings base of SA Inc. Global credit markets remain very tight and their loosening is necessary for any global economic recovery. Global risk appetite also remains subdued, which is necessary for capital to return to emerging markets. Given that the market is offering only modest valuations, and given the market's dramatic fall and the remaining dangers, we think investors should have a significant amount of their capital back in the market but keep some powder dry. This is so as to take advantage of opportunities the market may present as the market digests the evidence of a deteriorating global economy.