First Quarter 2019 Commentary

After last year's fourth quarter market rout that saw stocks fall into bear market territory, stocks mounted a strong comeback in the first quarter. Fueled by new expectations that the Federal Reserve would hold interest rates at low levels for the time being, U.S. stocks had their largest quarterly gains in nearly a decade. The S&P 500 and the Dow have recouped almost all of the losses they suffered in late 2018; as we write this in early April 2019, the S&P 500 is back to within 1% of its all-time high. After all was said and done, the S&P 500 gained 13.6% in the first quarter, which outpaced the 11.8% return for the Dow Jones Industrial Average.

Let's Talk About Market Timing

One fundamental question in back-and-forth times like these is whether it is better to ride out these crazy swings while staying invested, or would you be better off selling out before the market swoons and then buying back in once the dust has settled? Those who think they can get the better of it by selling out at the right time then buying back in at the right time are, appropriately enough, referred to as "market timers."

As an example, let's say that you had invested $100,000 right at the tip-top highest point that the U.S. stock market has ever been. Even after the rough journey we've all been through recently, as we noted earlier you'd still have almost $99,500 in your account. That's not too bad.

But what if you were one of the lucky ones? What if you had bought at the top, but then got nervous in late November and sold all of your stock holdings? Let's say you decided to get out just before Thanksgiving last year. Then you smiled to yourself as the market continued to fall from that point until Christmas Eve. Sure, your portfolio was still down a little more than 10% at that time, but hey at least you weren't down 20% like everybody else.

Then the bottom hit and things started to rally. You took that as a sign that things were on the rebound, so perhaps you bought back into the market in late December. Since that time, the market is up about 16%, which means that you would actually be ahead of where you started back in September. In other words, a 10% drop followed by a 16% gain would mean that you'd be about $4,500 up on your original investment.

Emotions Can Get In the Way

Well, that sounds like an awesome outcome, right? Up $4,500 instead of down $500? Investing is easy! But the question is, how would you know *when* to get out as things were declining, and *when* to get back in once they started their new upswing?

The stock market has a lot of built-in feedback loops. When prices are dropping, all the headlines on CNBC or the Wall Street Journal are usually pretty dire. Tariffs and trade wars, ballooning

deficits, political gridlock, slowing housing market, etc., etc. And when prices are rising, the headlines usually turn positive, too: earnings stronger, unemployment lower, or “this stock could be the next Amazon!”

So if you are going to try to become a market timer, then you’re going to want to set some simple mathematical rules for yourself to follow, so that you don’t get caught up in the gloom or hysteria. Perhaps you’ll set up a rule that, any time the S&P 500 drops by at least 10% from its most-recent high point, you’ll sell. Then, once it’s bottomed out and has then risen by at least 5% from its most-recent low point, you’ll buy back in. Our example above, in fact, exactly follows that simple protocol.

Sell In May, Then Go Away?

Let’s look at another historical example to see how this would have played out. Let’s say you bought the S&P 500 on a random day in the past: February 26, 1966, a little over 53 years ago. The S&P 500 stood at 91.14 that day, just a little under its recent all-time high of 94.06 reached on February 9 of that year.

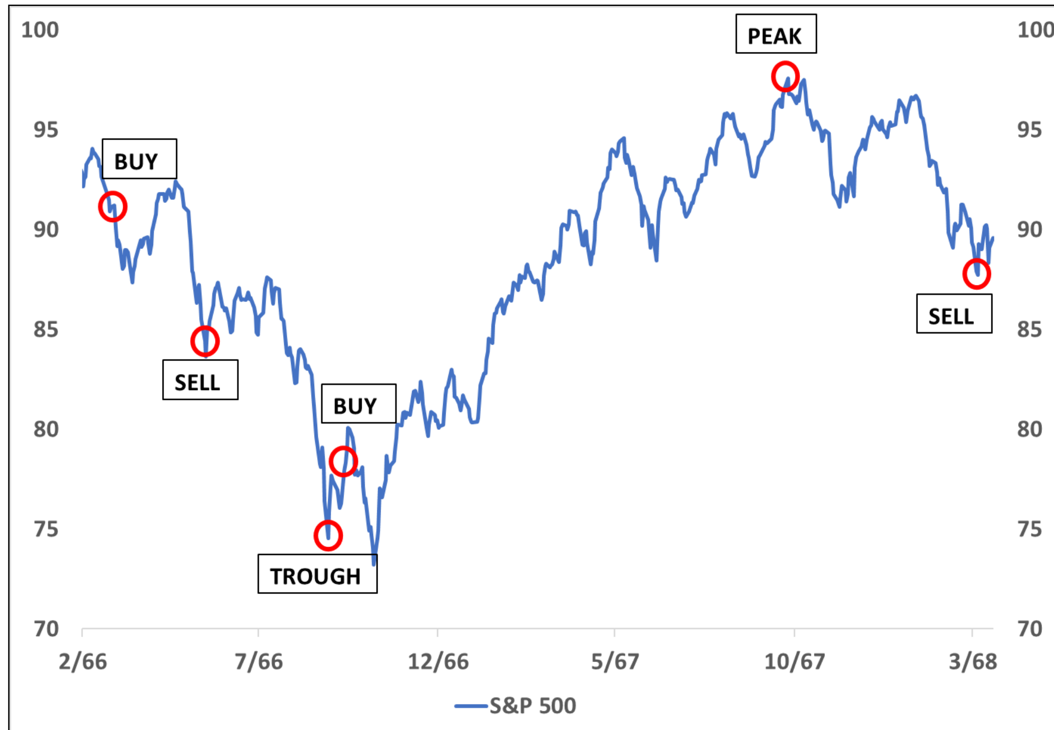
From that point forward over the next few months, stocks mainly drifted lower week by week. On May 16, 1966, the S&P 500 closed at 84.41, or 10.26% below its previous peak level, triggering a sale at that point. From a $100,000 starting portfolio on February 26, we would have $92,616 after selling on May 16.

Then we sit and wait for things to improve. On July 8, less than two months later, the S&P closed at 87.61, which is 4.76% higher than its recent low point. Alllllmost good enough for us to buy back in, but not quite. So we continue to wait.

And good for us, too, because then stocks start drifting lower again, with the S&P falling all the way to 74.53 by late August. On September 13, 1966, the S&P closed at 78.32, which is 5.09% higher than that, so we buy back in at that point.

Which is good, because after a brief stumble stocks began to go on a tear, eventually rising to 97.59 by the following September. Then they drift lower again, eventually closing at 87.72 in March 1968. That is 10.11% lower than the September 1967 high, so we sell.

We have gotten in, gotten out, and then done it all again, so let’s put it all together to see how we did. First we’ll look at it in a chart:



source: Yahoo! Finance, Inkwell analysis

Then we'll look at it in a table:

Month	S&P 500 Close	Action	Gain/(Loss) from Previous Low/High	Portfolio Value	Notes
	94.06	n/a			peak
Feb '66	91.14	BUY		$100,000	
May '66	84.41	SELL	(10.26)%	$92,616	
Aug '66	74.53	n/a			trough
Sep '66	78.32	BUY	5.09%	$92,616	
Sep '67	97.59	n/a			peak
Mar '68	87.72	SELL	(10.11)%	$103,732	

source: Yahoo! Finance, Inkwell analysis

By following this sell-when-down-at-least-10%/buy-when-up-at-least-5% system, an investor would have ended this time frame with a portfolio worth $103,732. Whereas a buy-and-hold investor would have bought in at 91.14, held on until 87.72, and their portfolio would therefore be worth $96,248 (i.e., $100,000 x 87.72 ÷ 91.14).

So there you have it: buy-and-hold netted you a value of $96,248, whereas market timing achieved $103,732. That's a big enough difference to matter, even after factoring in capital gains taxes.

Case Closed?

Well, heck. This system worked in a randomly-selected period from the late 1960s, and it worked over the last few months. It seems like we have found the Holy Grail of investing! Let's all adopt this easy market-timing system, and then we'll be wealthy beyond our wildest dreams!

Not so fast.

The only reason that these two examples worked is that the second buy price was lower than the first sale price. However, if the second buy price is higher than the first sale price, then a market timer is going to miss out on the return earned by a buy-and-hold investor in that interim period.

When Attempting to Avoid the Bad Stuff, You May Be Missing Out on the Good Stuff

Perhaps an example will help us see this more distinctly. Let's go back to the beginning of our daily S&P 500 data, which is January 1950. The S&P was at 16.66 at that point, and quickly rose to 19.40 by early that June. Then it suffered a swift correction, declining to 17.44 later that same month—a decline of 10.10%, which would have triggered a sale. The market continued to fall from that point, going all the way down to a trough of 16.68 by July 17, almost where we started. Just three days later, the S&P hit 17.61, which is 5.58% higher than that trough and therefore triggered a buy.

In other words, a market timer would have sold his investment at 17.44, only to buy it back less than a month later at 17.61. He therefore missed out on that gain of 0.17 that a buy-and-hold investor would have earned. Sure, that amounts to only a missed 1%, but there are several other instances in history of missing out on similar-size or even larger gains.

In June 1953, a market timer following this formula would have missed out on a 4.9% advance. Then in October 1955, he would have missed out on a 5.2% gain. One of the worst examples is during the October 1974 bear market, when a market timer would have sold and then bought back one week later, missing out on a gain of 8.9%.

The bottom line is that, yes a market timer can save himself some pain like he would have in 1966-68 or 2018-19, but he is also going to miss out on a lot of good stuff like in 1953 or 1955 or 1974. Which leads us to two important points: (1) how is anyone going to be able to know ahead of time whether this time will be a good one or a bad one?, and (2) over time, the good stuff is going to far out-weight the bad: from 1950 through 1982, covering a 32-year period that roughly matches what each of us experience over our investing careers, a buy-and-hold investor would have earned a total pre-tax return of 544% whereas a market timer would have earned just 354%.

Conclusion

You knew this was coming, and we shouldn't even need to spell it out. But, of course, we will anyway: if something seems too good to be true in investing, it is. It just is. There are no free lunches. Market timing doesn't work. No one who has found some secret sauce to investing is going to tell you about it in an "absolutely no obligation" seminar, or sell it to you online for $49.99. Investing is hard and requires a lot of patience. But keep in mind these words of wisdom from Warren Buffett: "The stock market is designed to transfer money from the active to the patient."

We thank you again for the trust you have placed in us to manage your hard-earned assets, and we look forward to reporting to you again in three months.

Sincerely,

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