

Trying to time the market usually leaves you worse off

If the blood-letting on the stock market is tempting you to switch into cash, recent research on the negative effects of moving in and out of the market may convince you to stick with equities for the long haul. **Laura du Preez reports**

After sharp falls in the stock market, such as those that occurred last year, you may listen with envy to stories related by other investors who moved large investments out of the market just before the fall.

They will also recount tales of how they moved back into the market just before it recovered.

It may be that some investors are able to time the markets successfully, but the truth is that most people who try to time the markets get it wrong.

Prudential recently did some research that shows just how often attempts to time the markets erode your returns and deliver a lower long-term return than that earned by an investor who stays invested for the long road.

Clare Johnson, Prudential's quantitative analyst, used return data from 1986 to 2008 to simulate 100 million possible switches between cash and equities that you, as an investor, could have made.

In her simulations, Johnson used the All Share index (Alsi) returns as the returns you could have earned from equities.

The Alsi is the benchmark for many equity investments.

Johnson plotted the annual returns earned from each simulation and found that most of the simulations resulted in an annual return of between 9.75 and 11.75 percent a year over the 22-year period (see "The danger of switching" graph).

However, if you had invested 100 percent in the Alsi over the 22-year period, your annual return would have been 13.2 percent.

Only 8.7 percent of the 100 million simulated investment switches resulted in a return greater than the 13.2 percent you could have earned from staying invested throughout the period.

In its latest newsletter, Prudential says severe market volatility significantly increases the temptation to time the markets, with investors finding it almost impossible to watch their equity investments bleed while cash offers attractive returns.

But, as Johnson's research

shows, frequent switching erodes your total returns and seriously damages investment performance in the long run, Prudential says.

Johnson's simulations assumed the investor could perform up to 50 switches during the 22-year period and that the switches would cost 0.5 percent (the standard brokerage charge) per switch.

Some investors pay more for switches, especially when they incur initial costs and adviser fees.

MOSTLY POSITIVE

Asset managers are also pointing investors to a graph produced by Credit Suisse that shows the Alsi's annual returns from 1960.

The graph shows how in most years (35) the returns have been positive, and last year was one of only 14 years in which the Alsi's returns have been negative.

The 23 percent fall in the Alsi's return last year is an exception and ranks on par only with the return from the index in 1970.

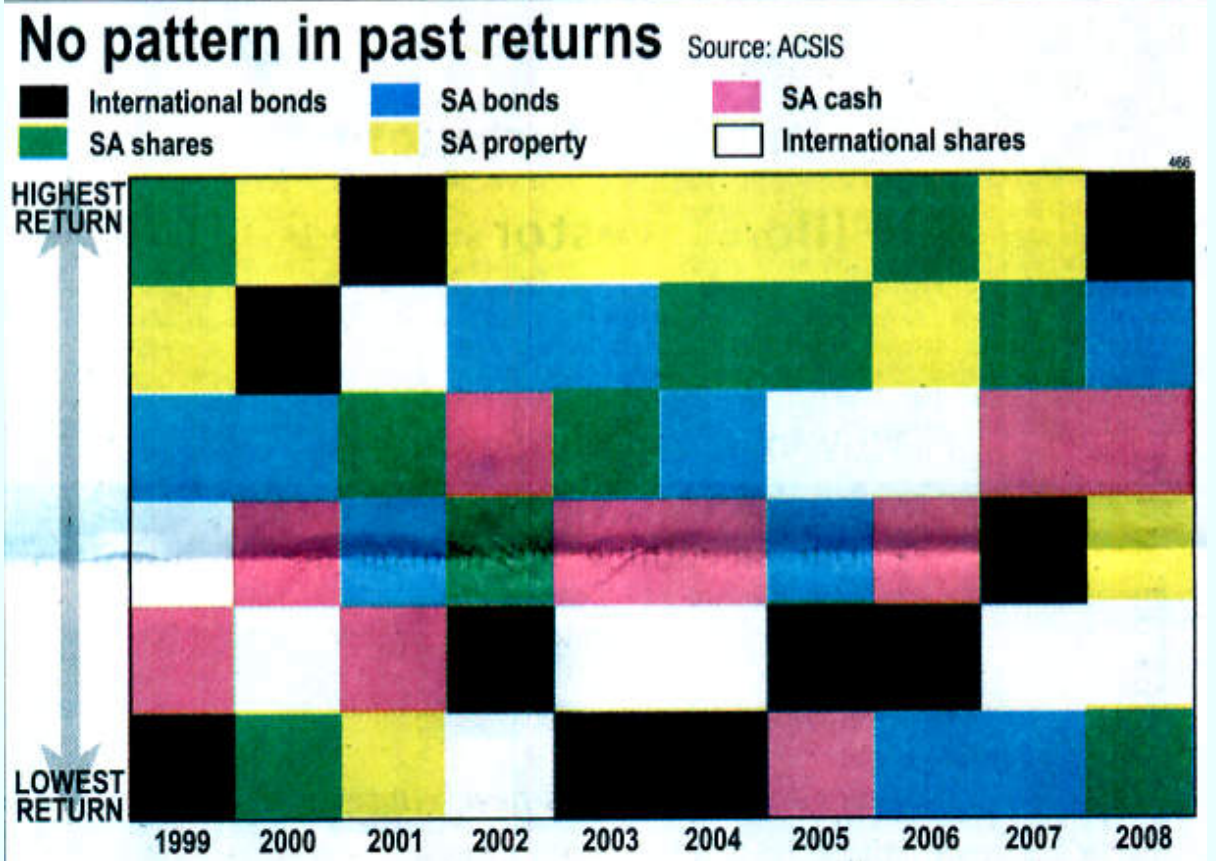
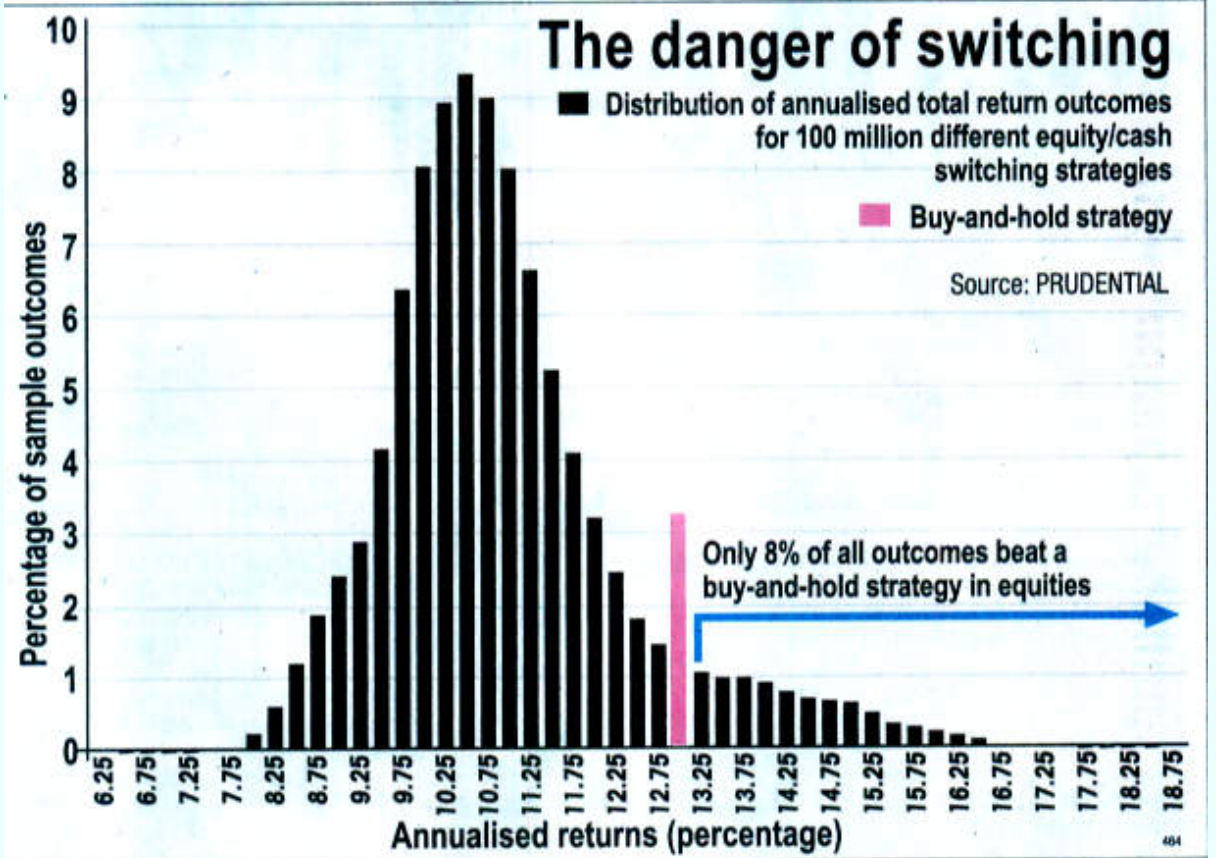
However, Andrew Salmon, an investment strategist at acsis, told a meeting of the acsis/Personal Finance Financial Planning Club this week that you should take note of the returns earned in subsequent years. In 1971, the market return was less than 10 percent, but in 1972 it exceeded 50 percent.

While the equity market is highly likely to recover significantly from its 2008 lows in the same way it did after the 1970 lows, it is difficult to call exactly when that will happen.

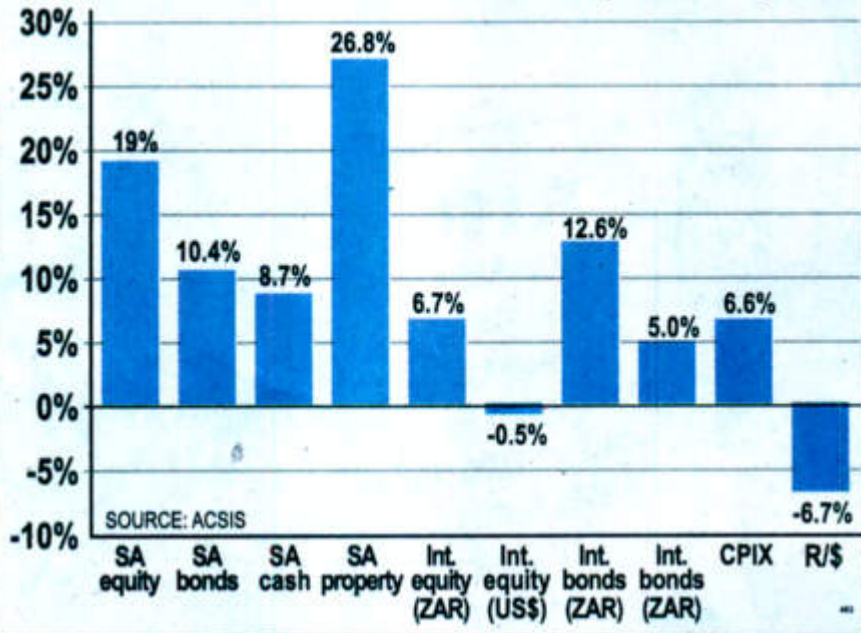
Investors who have stayed in the market will, however, benefit from the upswing whenever it occurs.

Acsis chief executive Andrew Bradley says there is no pattern in the way that asset classes move from high to low returns (see No pattern in past returns graph).

The graph not only supports the argument that it is difficult to time the markets, but also shows that because you can never be sure which asset class will return the best returns in any year, it is best to diversify across asset classes rather than put all your eggs in one asset class basket.



Annual asset class returns for the past five years



All Share index returns from 1960

