

Bad Timing?

(The September and October newsletters are adapted from a speech given by Bill Berg, Sigma's president, on September 23 at the fall retreat of The Financial Planning Association of Oregon and Southwest Washington. This month, we discuss the dangers of investment professionals being too wedded to their theories and the perils of market timing systems.)

One day a few months ago, the phone rang and the caller asked if I would speak at this conference. Showing an astonishing degree of naiveté, I agreed to speak before inquiring about the subject. When I discovered that my topic was “Tactical Asset Allocation,” I was quite disappointed. My disappointment turned to anger when the caller opined that “that is what you guys at Sigma do.” In a western movie, this would be the saloon scene in which the piano player stops and everyone scatters from behind the two guys facing one another so as to avoid being struck by a stray bullet.

You see, when I hear someone say “tactical asset allocation,” I believe the odds are high that they really mean “market timing,” and I certainly do not believe that we at Sigma are market timers. On the other hand, somebody at the FPA must be under the impression that we are tactical asset allocators. Perhaps I was incorrect in assuming this was synonymous with market timing. I decided to dust off a couple of my old textbooks to make sure I understood the definition.

The books describe tactical asset allocation as a counterpoint to strategic asset allocation. My textbooks inform me that the steps in strategic asset allocation include the following: (1) define the asset classes you want to use; (2) make your capital market forecast; (3) estimate the return and risk for each asset class and the cross-correlations between asset classes, (4) “optimize” these inputs to determine an initial portfolio; and (5) monitor and rebalance as needed. Gosh, that sounds like a lot of crystal-ball gazing to me. I have no idea what stocks are going to do tomorrow, next month or next year, and I cannot begin to think about how to estimate cross correlations between assets without just extrapolating the recent past. A review of history, however, tells us that

those correlations are not static – they can vary all over the place.

This was depressing – I thought Sigma was engaged in strategic asset allocation, but we do nothing like all the fortune telling implied in the textbook. Madame Cleo we are not. The textbooks go on to say that tactical asset allocation starts with strategic allocation but then assumes the client’s risk tolerance is constant and places additional emphasis on the capital market forecast. “Holding the client’s risk tolerance constant” is described in contrast to the natural inclination for investors to reduce stock market exposure after a decline. In other words, without holding the risk tolerance constant, the adviser would sell stocks after they went down. Hmmm...we do not seem to be getting anywhere. If the market goes down, did not the market already reduce your equity allocation automatically? Should you really be selling something that is cheap after holding it when it is expensive? Maybe we lack the sophistication implied by the textbooks, but we try to buy low and sell high, not the reverse. If attempting to buy low and sell high is what tactical allocation is, maybe we are doing it.

We try, not always successfully, to buy low and sell high; many textbooks suggest a different course.

My overall impression from the textbooks was akin to reading a manual written by Tiger Woods on how to play golf. First, address the ball at the tee, coil the club head back and bring it down through the ball with a combination of flexibility, grace and power that will push the ball, straight and true, over 300 yards down the

fairway. Next, take a shot with the appropriate iron and the appropriate strength of swing to place the ball in the hole on the green. In the unlikely event that the ball does not go in the hole, tap it in with your putter. Well, thanks a lot, Tiger, but all that does not help me.

Unfortunately, the textbooks do not seem to be of much help in the real world. When you survey the scene in our industry, you see all types – it is a little like the bar scene in the original *Star Wars* movie. There are unapologetic market timers, index investors, active managers, planners relying on mean variance optimizers and Monte Carlo simulators, value investors, growth investors, fundamental investors, chartists, Elliot Wave theorists, “Sell in May and go away” seasonality buffs, Fibonacci nuts, Gann Anglers and Kondratiev cycle acolytes. (*Look around*) Is there anyone here I have missed? No wonder our clients and prospects are confused!

Many professionals in our industry are so caught up in their approach that they may forget what it is they are trying to accomplish for their clients. This brings to mind a passage in the book *Accidental Empires* by Robert Cringely. Cringely compared Microsoft chairman Bill Gates and the Emir of Kuwait on the one hand and Steve Jobs of Apple and Sadaam Hussein (after the first Gulf War in 1991) on the other. Both Gates and the Emir wanted to dispense their brand of justice in a sedate, static world. Jobs and Hussein wanted to give speeches to adoring crowds and fire their gun in the air – it matters little to them if they won or lost their respective wars, just as long as they could assure their fanatical followers that they are better than the other side. People so wrapped up in Kondratiev waves, growth stocks, seasonality or remaining pure to index investing run the risk of being in the latter category – they can lose many clients (who in turn may fall prey to the worst elements out there in the wilderness of our industry) as long as they can continue to feel mentally and morally superior. A more pragmatic approach is what clients really want – they do not care much about our theories, no matter how wedded we are to them.

A Thought Experiment

So let us step back for a moment and think about what it is we are trying to achieve in our careers. Are we trying to help our clients, or are we trying to protect our theories against other theories? Let us assume that your approach, whatever it is, does not include tactical asset allocation. Many people fitting that description have their eyes and ears closed to evidence to the point that they consider themselves smarter and morally superior to anyone who uses active management, market timing, tactical asset allocation or what have you. And they may be right, in a theoretical sense, but the question is whether they would rather be “right” (however they define that within their cult) than do well by their clients.

This is not behind anything that Sigma does, but let us do a thought experiment. You are sitting in your office and a button appears on your desk. By pushing it, you could assure yourself that you could engage in an “active” strategy, buying and selling investments at whatever frequency you find pleasant, and you would have performance after costs and taxes identical to whatever strategy you are employing now. Most clients want the “fun” of account activity, of hearing you pontificate about what the Fed will do with interest rates, the impact of Congress eliminating the estate tax and prospects for earnings growth. Does it not follow that more of your clients will be able to stick to your “correct” strategy by providing them with the entertainment they want? Would you push the button?

If the market is efficient, how can so many investors be doing so poorly for so long? Where's Darwin when you need him?

Let us face the facts – most of the people in this room know that the majority of our clients and prospects want us to be doing something active, if only for entertainment purposes. We know that investors want this, in part, because of the evidence that they participate in destructive behaviors when left to their own devices. Many of you are familiar with the results of the

Quantitative Analysis of Investor Behavior Study by Dalbar, Inc., showing that investors underperform the instruments in which they invest by something in the range of eight or nine percent per year. People would not engage in such massively destructive behavior unless they were getting something out of it – and we can see that they certainly are not getting investment results. Their behavior must be directed at a different need. In fact, this is one of the arguments against a perfectly efficient market – if it is so darn efficient, how can people be doing so poorly for so long? Where's Darwin when you need him?

Unfortunately, in the real world, pushing that button does have costs, in the form of lower returns. Without promoting any specific approach to investing, however, it is clear that an investment plan, however well thought out, is of little use to the client if the client cannot follow the plan. For a theory to be useful, it has to be robust in the real world. This is like the difference between philosophy and religion. Philosophers may claim that we do not need religion because we are just trying to come up with the “rules” for living, and philosophy can derive those rules. Those on the religion side of the argument can point out that anyone can come up with the rules; the trick is to follow the rules.

Pragmatist philosophers would say that “truth” simply is what works. Now, you have to be careful in justifying something by saying that normal conceptions of “truth” can be sacrificed for the good of the client – this is the rationalization of every criminal in our profession and most

tyrants in world history. It is not something you want just to accept automatically. Nevertheless, having your mind made up in advance, so you are not willing to look at contrary evidence, is wrong-headed as well.

Most of what Sigma does is based upon academic theory, but we also realize that theory has its limits. Would our clients be happier following an “incorrect” investment strategy that accomplishes their retirement goals, or a “correct” strategy that they cannot live with and will abandon at the worst possible moment? They are then tossed to the wolves out there, instead of following your advice, advice that you (by definition, I hope) believe is correct. When we lose a client like that, it brings to mind a Jacques Cousteau nature show, where the old, sick seal is separated from the herd and Jacques said something like “Sadly, there can now be but one outcome.”

The history of investment theory is littered with discarded models that, in their day, had passionate, true-believer followers.

Everyone knows the way to lose weight is to have a sensible diet and engage in moderate exercise. Borders Books still manages to sell 400 different diet books on its shelves, even though everyone knows the answer for free, because the real answer is boring. It is much more interesting to buy a book claiming that eating 12 grapefruit a day is the ticket. If you follow what it says

in almost all of those books, you will lose weight. Even though Borders is across the street from my office, however, I cannot walk there without passing people who need to be on a diet. Their problem is not that they do not know the way to Borders; their problem is that they cannot follow the rules.

None of this is to praise active managers or market timers, just to remind ourselves that we are in this profession to help our clients, so we had better be pragmatic and keep an open mind. The history of financial theory, along with every other social science and natural science, is littered with discarded models that, in their day, had passionate, true-believer followers. We should all be humble and occasionally look behind us to see what is gaining on us.

Market Timing and its Pitfalls

We at Sigma have had clients prod us to be active in market timing, and I will describe some of the reasons we demur. Most market timers that advertise historical performance for their “systems” are, to put it kindly, being unrealistic. My first job in the investment business was with a firm that published a market letter. There is apparently reciprocity in the newsletter business, and we had just about every major market letter carefully filed in the firm library. Each night I would take home all the back copies of a particular newsletter and figure out the “trick” they were using – because they usually had a way of making it look like their performance was better than it actually was. For example, one prominent letter had a pendulum graphic, the pendulum swinging back and forth from major market low to major market high, showing quotes from the market letter. The pendulum implied that the adviser was bearish at every high and bullish at every low, and it was true as far as it went. What the pendulum did not tell you, however, was that the adviser turned bearish early in the bull market, or turned bullish a month after the major top, so people following his advice would have done very poorly. The adviser carefully selected past quotes that made him look prescient, but the actual results of his followers would have been dreadful.

There are varieties of similar tricks – I list just a few:

1. Is the system impossible in practice? A common trick in short-term models is that signals are generated after the market close, but trades are assumed to be effected at the closing price. Your first opportunity to act on the signal might be after a price gap up or down the next day.
2. Is the reported performance real-time or back-tested? You can mine the data to come up with a system that looks great in the past that has no predictive power going forward. Many expensive software programs do this. Other timing systems are constantly optimizing inputs – so you always have a perfect system for the previous period, but with doubtful value in the future.
3. Does the system account for commissions, slippage, taxes, negative draw-downs or changes in the relevance or quality of the data the system uses? Many timing systems look better than they should because they assume away real-world costs. On the draw-down issue, you can also show great historical performance in summary fashion that might hide the fact that your \$1 million investment got down to \$10,000 before having a dramatic recovery – how many of your clients, how many of *you* could live through that kind of roller-coaster? In addition, sometimes the data changes in quality. For example, if you follow an indicator based upon trading volume, does program trading affect it, when a lot of the volume may have nothing to do with ordinary investors?
4. What behavior does the system expect from the investor – and from you? What is the frequency of trading – if you take a day off and miss a signal, is the system blown? Can you last through 30 whipsaws, short-term losing trades one after another, before a big winner?
5. Does the system violate the fallacy of composition? Something may work if you are the only one following it but may be disastrous if everyone else is too. You can easily make it through the exit door of a crowded theater in case of fire – unless everyone else is trying to get to the same exit. In the early 1960s, a professional dancer named Nicholas Darvas published a book modestly titled *How I Made \$2 Million in the Stock Market*, the first book I ever read on the market. It was a best-seller (in other words, I was not the only dope reading it) and part of his system relied on placing stop loss sell orders at a price just below the recent low for a stock. When his legion of followers all placed their stop loss orders at the same price, however, the orders were all triggered at once and the stock they were selling would gap down in trading, so nobody would actually get the “right” price suggested by the system.
6. Watch out for relying on charts – our brains find order where there is none. This is hard to believe until you analyze a system yourself, but it is quite creepy when you do it and realize what is happening. You can look at a chart with up arrows for buys and down arrows for sells, and your brain focuses on the good signals (e.g. buying near a low and selling near a high), filtering out the not-so-good signals. So you can conclude that a system is great from the chart, but a check of how it would actually affect your bank account can be quite different.

Many timing systems are based upon data mining, but what worked yesterday might not work tomorrow.

7. Does the model have a rationale to show causation or correlation, or is it just coincidence? If I have a foolproof system that times the market based upon the number of strikeouts by the Boston Red Sox, would you have confidence that it would work in the future? Every January, we are subjected to talking heads discussing the Super Bowl indicator, predicting that the market will do well if a team from the National Football Conference wins. It is good entertainment for some people, but I fail to see that the track record is more than coincidence.
8. Are you relying on one indicator? Aside from the fact that times change and indicators tend towards entropy, we also need to guard against the cognitive problem of wanting the world to be simple. Most timing services rely on a “magic indicator.” This is great for marketing, but it blots out the rest of the world – in particular, other indicators with similarly good track records that might currently be recommending the opposite of the “magic” indicator. We subscribe to services with thousands of indicators, many with quite impressive track records. Impressive, until you realize they are in conflict. One indicator is alluring – 15,000 indicators are just confusing.

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A Timing Example

Let us look at an example of how this might work in the real world. One of the services we subscribe to publishes an indicator that is, in turn, a composite of 57 different optimized indicators. The indicator’s chart shows that from 1979 through late August 2003, it generated profits of over 33 percent per year, versus a buy and hold return of under 9 percent a year, with 56 percent of signals profitable.

However, the calculation of this indicator depends on end of day data. The buy and sell signals are not generated until well after the market close, but the performance assumes you bought at the close. If we assume a one-day lag (for example, a buy signal generated after the close of Monday’s trading would be executed at the closing price Tuesday), the 1979-2003 returns fall to 22 percent annually.

This indicator was first created in 1994, however, with the components “optimized” in 1998 – the signals from the 1980s were all a result of back testing. This is significant. If we look at real time performance since the optimization in 1998, the performance just equals a buy and hold strategy, even though you are assuming no costs, no taxes and the ability to buy on the close of the signal day. Only 36 percent of the signals were profitable. If you adopt the more realistic posture of buying and selling with a one-day lag, the annual average return is negative, much worse than a buy and hold strategy.

Most timing systems are based upon explicit or implicit assumptions that cannot hold true in the real world. Most timing systems are created to attract new customers, not to make money in the market.

Sigma provides investment management and consulting services for individuals, corporations, trusts, endowments and retirement plans. If you would like our help, call us at (503) 419-3938 or e-mail us at info@sigmainvestment.com.