February 12, 2004

The Delicate Question, Which?

Jump In, or Wade In to the Market?

Jeff Troutner, TAM Asset Management, Inc.

You have finally decided to sell all those leftover growth stocks from the 90’s or you’ve been sitting on a pile of cash for too long. You are now faced with a “timing” issue. Stocks have been up dramatically the past three quarters—after melting down over the prior three years—and there’s still enough doom and gloom in the air to make even the most diehard pessimist positively giddy. Do you grit your teeth and jump in to a fully invested position or do you wade in slowly over the course of, say, the next four quarters?

This has become a very common question posed by individual investors, even as they have chosen to embrace a more rational investment strategy centered on broader asset class diversification, lower costs, and more patience. The fact is, the past 9 years (1995-2003) have seen some of the biggest up and down markets of the past 77, causing too many investors to hesitate in committing fully and immediately to a new strategy.

After strong up markets like those from 1995-1999 and 2003, the normal reaction for an investor sitting in cash is to believe that they won’t continue and that maybe it’s better to wait for a “correction.” The normal reaction to down markets like 2000-2002 is to believe that they will continue and that maybe it’s better to wait for better economic news, more global stability, or greater optimism. Both reactions can be very costly to long-term investors. The question is how costly?

Good versus Bad Market Years

One way to start answering this question is by looking at the number of up and down markets that have occurred in the past. Using calendar year data from 1927-2003, we find that the total stock market (CRSP 1-10 Index) had a positive return 73% of the time (56 out of 77 years).

We also find that 12 out of the 15 best stock market years either immediately preceded or immediately followed down market years. And the really good years preceding a down market usually followed many other very good market years—any one of which could have caused investors to think that “this could be the top” (remember Greenspan’s “irrational exuberance” comments in 1996?).

It could be argued then that the up markets you really didn’t want to miss were those that occurred when optimism and pessimism were running at their highest levels. Therefore, being concerned about markets that have soared either “too high” or fallen “too low” to the extent that they delay your entry into the market is likely to reduce your long-term compound rate of return dramatically.

continued on back...
The Benefits of Balanced Diversification

By studying past market returns, we also find that a better balance among asset classes can improve an investor's odds of realizing a positive return in any given year. For example, a 65/35 stock/bond portfolio\(^1\) brought the percentage of positive years to 75% while also increasing the annual return and reducing volatility and downside risk. A 100% stock portfolio\(^2\) with better balance among large, small, growth, and value stocks (U.S. only) dropped the positive-year percentage slightly from 73% to 71% and experienced more volatility and downside risk, but the annual return increased by 2.5%.

The advantages of a more balanced asset class portfolio became particularly notable during the most recent market decline. Since March 2000, the S&P 500 and CRSP 1-10 Index are down 22.0% and 21.5% respectively through the end of last year, while the balanced 65/35 and 100% stock portfolios are up 26.1% and 15.8% respectively.

Jump In, or Wade In?

Now that we’ve seen that the stock market is up much more often than it’s down and that asset class diversification improves the odds and the expected return, let’s look specifically at the potential cost of wading in over four quarters.

Looking at the 1927-2003 period again using the balanced portfolios, we find that jumping in beat wading in about two-thirds of the time. Furthermore, we find that the average annual cost of wading in ranged from 3.6% to 5.9% (this is a one-year cost since the "wader" is fully invested after one year).

Since most investors are concerned with investing just prior to a severe market drop, let’s look at those markets in isolation. For all 21 down years since 1927, an investor would have saved between 2.7%-4.3% by wading in. It’s interesting to note, however, that isolating the ten worst years did not change the numbers significantly (2.8%-4.4% average return advantage for the wader).

Now let’s put fear aside for a moment and consider opportunity costs. On average, wading in to an up market would have cost between 6.6%-9.8% in lost return. If we isolate just the top-10 up markets, the numbers rise significantly to 13.8%-20.5% of lost return!

Considering that this exercise is directed at long-term investors and the odds are overwhelmingly in favor of jumping in versus wading in, it seems to me that trying to avoid a 4% “timing” cost during a down market is not worth the risk of missing the much higher returns of the more frequent up markets.

If we take just the last four calendar years as an example, we find little to no advantage in wading in the first year (2000) and as much as a 5.4% advantage to wading in the third year (2002). But how many investors do you think stayed in cash or waded in during what turned out to be a significant up market in 2003? My guess is a lot. And the cost to these investors ranged from completely missing the 2003 returns (a 28%-43% potential cost!) to a wade in cost ranging between 6.5%-9.3%.

Behavioral Considerations

The example of the last four years brings up a whole host of behavioral issues that should also be considered by the wade in investor. For example, what system of wading in should you use? A quarterly-on-a-specific-day strategy or a wait-till-the-market-drops-another-10% strategy? And how much do you move in at each trigger point?

A question I usually ask investors is: What is the likelihood that you will commit to your trigger point if the market drops another 10% and the doom and gloom just got thicker? Will you have the stomach to pull the trigger or will you find an excuse to put it off? For example, last year a wade in investor would have either felt pretty good about the 3.2% market drop in the first quarter or hesitated with their next installment. In any case, the “down market insurance” turned out to be very expensive as the market had a blazing second quarter (+15.4%) and finished the year equally strong.

I believe the conclusion investors should draw from this exercise is that market timing in any form is much more likely to cost you money in the long-run. How much depends on how often and to what degree you choose to engage in it. You would be better off by putting your long-term investment money to work immediately and leaving it alone, except to rebalance occasionally or reallocate among the asset classes if, and only if, your investment objectives change.

\(^1\)65/35 Stock/Bond portfolio is 35% Five-Year U.S. Gov’t Bonds, 19.5% DFA U.S. Large Co., 19.5% DFA U.S. Large Value, 13% DFA U.S. Small Micro Cap, and 13% DFA U.S. Small Value.

\(^2\)100% Stock portfolio is 30% DFA U.S. Large Co., 30% DFA U.S. Large Value, 20% DFA U.S. Small Micro Cap, and 20% DFA U.S. Small Value. Both portfolios use index data prior to actual DFA fund inception. Please contact us for more specific sources and description of data.

A more detailed “position paper” on this topic with the 1927-2003 returns data as well as global balanced portfolios since 1970 is in the works and should be available soon upon request.

Thanks to Truman Clark of Dimensional Fund Advisors (DFA) for his help in some of the number crunching.

For those interested, the title of this article refers to a much more serious decision sometimes faced by those marooned on the ocean or faraway place, namely, who gets eaten first! It is derived from a line in the poem The Yarn of the Nancy Bell that reads, “Then only the cook and me was left, and the delicate question, ‘Which of us two goes to the kettle?’ arose, and we argued it out as such.” Tradition usually dictates drawing lots, a game of chance you obviously wouldn’t want to lose. Since I hate to see investors cannibalize their long-term returns, I prefer to help them increase their odds, as this article attempts to do.