All About MARKET TIMING

THE EASY WAY TO GET STARTED

Everything You Need to Know About Timing Your Investments, *Including*:

- Five simple market timing strategies
- Beating buy-and-hold with less risk for long-term investors
- Profitable investing in bull and bear markets

LESLIE N. MASONSON

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The Easy Way to Get Started

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ALL ABOUT MARKET TIMING

The Easy Way to Get Started

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DEDICATION

To my beautiful wife Marilyn, the love-of-my-life, who has brought out the best in me.

To my wonderful children, Dan and Amy who have achieved their own successes.

To my confident son-in-law, Seth Reese, who has brought dedication, skill, and perseverance to a challenging profession.

To all investors all across America.

May you all benefit from the research and strategies in this book to find a smarter way to invest.

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FOREWORD

Market timing is not a fun vocation or avocation. It is tough and ugly. I know this well, because I've been a market timer in the trenches since 1983, both as an investor and as an advisor.

Timing requires thick skin and iron resolve. Because it is not understood, market timing is almost universally scorned on Wall Street.

Yet market timing is an important tool for investors. When it is used consistently over long periods of time, timing can dramatically improve returns while it reduces risk, as Leslie Masonson has demonstrated repeatedly in this book.

If this book is studied by the establishment financial media, it can help to reduce a tide of misguided negative articles about timing. Too many financial writers have discovered they can easily "prove" that timing doesn't work and can't possibly work. However, those authors rarely specify any measurable definition of what would be necessary for a strategy to qualify as one that "works."

I've found that timing is 100 percent successful at reducing market risk, by periodically getting investors out of the market. Every day your assets are in a money market fund, that's a day they are not at risk in the market. If timing keeps you on the sidelines 25 percent of the time, timing has reduced your risk by 25 percent.

Results from timing almost never look like returns from a buy-and-hold approach. This can be disconcerting and upsetting. But to a long-term investor, this noncorrelation amounts to a form of diversification.

Why do so many people believe that timing doesn't work? I believe the answer is twofold. First, most investors who undertake market timing are not prepared for the rigorous discipline it requires. They quickly become discouraged when they discover that timing systems are statistically "wrong" much more often than they are "right."

Second, market timing is misunderstood. No investing rule is more fundamental than this: Don't invest in something unless you understand it. I think the reason timing disappoints so many investors is that they don't understand it.

Masonson's book will help remedy that. He has put together the information and the tools that investors need to make timing work for them. He has taken a complex topic and made it accessible for real people.

The biggest problem facing most investors is that they need the potential growth they can get from owning equities—while at the same time equities are quite volatile—too much so, for most people.

As far as I know, there are only two solutions that make sense. One is to allocate as much as necessary of a portfolio to fixed-income funds. This brings stability, but at the cost of the long-term returns of equities. The second solution, the topic of this book, is market timing.

As this book shows, mechanical market timing makes it possible for investors to achieve the returns they need at lower volatility. And that makes it easier for those investors to stay the course.

Almost all my own investments are governed by market timing. Even if I could "know" that I could get a better long-term return without timing, I am just not comfortable with a buy-and-hold approach. I have worked hard all my life to accumulate assets, and I'm simply not willing to passively let the market (which, in effect, is all other investors) take them away.

This book is for investors who share my conservative approach, who believe, as I do, that hanging onto their money is as important as making it grow. In this excellent guide, those investors will find everything they need to determine if timing is for them—and if they have what it takes to be successful.

Paul Merriman

Paul Merriman is founder and president of Merriman Capital Management in Seattle, and is author of two books on investing.

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Writing a comprehensive book on market timing would not be possible without the expertise and involvement of many individuals and firms. Even with their assistance, I take full responsibility for any inadvertent factual errors in the book.

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INTRODUCTION

> If you don't know who you are, the stock market is an expensive place to find out.
>
> *George Goodman*

Did your investments get crushed in the last stock market crash?—No, not in 1929—in 2000 to 2002. Most investors got a rude awakening when they opened their year-end statements for each of the past three years—because 2000 to 2002 was only the second time in history that the market was down three years in a row.

Are you confused by the daily gyrations of the stock market? Are you upset that you lost a bundle in the past three years? Are you ready to give up on the stock market, and cash in at any price? If so, then join the club, since almost everyone is in the same boat. The talking heads on the business shows continually profess a bullish stance, no matter what the market is doing. Ignore their opinions. No one knows where the market is going tomorrow, let alone in the months and years further down the road. Just because the stock market has averaged an annual return of nearly 10.2 percent since 1926 does not mean that you can expect that rate of return to continue in the coming year or the next 5 years. Just because you may not be retiring soon does not mean that you can afford to ignore what is going on in the stock market.

If you have been investing since 1982, or perhaps since early 1995, you were probably ecstatic with your returns through the first quarter of 2000. Since then, the market has dramatically and swiftly reversed direction, and it has dropped faster than it rose. Did you sell at or near the top and put the proceeds into cash? You probably did not. Did you sell after your stocks or mutual funds fell 10 percent, then 20 percent, then 30 percent, and perhaps 90 percent in some cases? Probably not, since you thought the market would come back, as it always has.

Perhaps you followed the widely touted buy-and-hold approach. And if you are like most investors, you have no game plan for cutting your losses or taking your profits. Lacking an investing strategy and blindly following the buy-and-hold approach can lead to financial ruin. It can wipe out years of investment profits in a short time, and it can take years for your portfolio to recover, if ever. Don't fall for the buy-and-hold ruse, even though 99 percent of financial professionals tout it. This is the same crowd that tells you that dollar-cost averaging is a sound investment approach. Check it out for yourself. Has your own dollar-cost averaging worked for you?

It's great when stock prices are rising, but not so great when they continue to fall. One of the most critical rules of investing is *never* average down. It is a loser's game. Think about all the unfortunate and uninformed investors who still own Amazon, Dell, Cisco, EMC, AT&T, Eastman Kodak, Xerox, WorldCom, and Palm. Those investors got killed by continually buying more shares on the way down—or by holding on to their original shares bought at much higher prices.

IS THERE A BETTER APPROACH THAN BUY AND HOLD?

Is there a smarter way to handle your investments, to protect your profits, and to steer clear of bear markets before they decimate your portfolio? Yes. The approach is called market timing, and it works, no matter what you've heard to the contrary. This book contains compelling data on successful market-timing approaches that beat the market indexes over decades. The strategies are simple so that you can use them yourself with little work. And for those of you who prefer to have a market timer do the work for you, you'll be interested in the information provided on top-performing market-timing newsletters and market-timing advisors.

After reading this book you will understand both sides of the buy-and-hold myth and why market timing is a more sensible, risk-averse, and unemotional approach to investing in the stock market.

I do not recommend that investors buy individual stocks, ever! Stocks are simply too risky for the average investor. With the accounting scandals, SEC investigations, crooked corporate financial officers, managed earnings, and earnings targets missed by only a penny, why should you take a chance on picking the wrong stock or the right stock at the wrong time and taking a big hit? It is much more prudent, and far less risky, to invest in appropriate index funds, sector funds, or exchange-traded funds.

My objective in writing *All About Market Timing* is fourfold. First, I want to provide you with the rationale and facts indicating why market timing is a superior investment strategy compared to the ever-popular buy-and-hold strategy. Second, I want to provide you with profitable market-timing strategies that are simple to understand and easy to implement. Third, I want to help you avoid future bear markets and protect your principal. And last, I want to help you to maximize the returns that are possible to realize on your investment assets, both in good times and in bad.

WHAT IS MARKET TIMING?

Market timing can be defined as making investment buy and sell decisions using a mechanical trading strategy which employs one or more indicators and/or proven strategies. The objective of a successful market-timing system is to be invested in the market during up trends and to be either in cash (or in a short position) during down trends, especially during brutal bear markets. Market timing can be applied to all types of investments including stocks, stock and index options, mutual funds, bonds, and futures. This book therefore focuses exclusively on using timing with index funds, sector funds, leveraged funds, and exchange-traded funds. It is your choice as to which of these investments you prefer to work with because the timing principles remain the same for each of them.

Market timing is aimed at taking your emotions out of the investing equation—or at least minimizing their impact. This objective is critical to your success. Investor psychology has been studied for years, and the "herd instinct" is rampant. This urge to follow the herd plays right into your hands, because the crowd (whether individual investors or investment advisors) is characteristically wrong at *major* stock market tops and bottoms. This situation will always be with us, because the emotions of dealing with investing—fear and greed—will never change.

Market timing is not a perfect investing approach; there is no such thing. Market timing cannot predict when the market will change direction. But, if you use a reliable market-timing system and follow its signals, then you will exit the market when it begins to turn down and you will re-enter the market when it begins to turn up, all in time to maximize and protect most of your profits. A study of the performance of professional market timers by *MoniResearch Newsletter*, an independent monitoring service, found that 92 percent of the 25 timers it followed outperformed the market averages in 1987 when the DJIA dropped by 23 percent on Black October, and 96 percent did so during the declines in January 1990 and August 1992.

And in the latest time period for the year ending in September, 2002, 88 percent of classic market timers monitored beat the S&P 500 Index. Over the last five years ending on the same date, 63 percent beat the buy-and-hold strategy. And for those Nasdaq timers competing against the Nasdaq Composite Index benchmark, the numbers were even better, with 79 percent beating that index over five years, and 84 percent over the one-year time frame. These results are confirmed by *Timer Digest* publisher, Jim Schmidt, who found that 65 percent of the 100 market-timing newsletter services that he tracks beat the S&P 500 benchmark in 2000, 45 percent beat it in 2001, and 80 percent beat it in 2002. That's precisely what market timing is all about—reducing losses when a bear market strikes.

BEAR MARKETS ARE A RECURRING PART OF THE INVESTING CYCLE—YOU MUST BE PREPARED TO DEAL WITH THEM

Future bear markets will arrive like clockwork, every three to four years, on average. Avoiding these slumps is the key to protecting your hard-earned capital. Unfortunately, most investors have no clue as to the market's future direction, how the stock market really works, or how to minimize their losses. Therefore, it is not surprising that investors suffer the consequences when a bear market sneaks up and mauls them.

From 1950 to 1999, there were over a dozen bear markets, with the average one lasting 397 days, resulting in a loss in value of 30.9 percent. The average recovery period to reach the previous high was about 622 days (1.75 years) based on the S&P 500 Index.[1] Assuming the last bear market ended on October 9, 2002 the S&P 500 Index dropped 49.1 percent drop from its top on March 24, 2000 to its bottom on October 9, 2002 which lasted 941 days.

Similarly, from the market top in 2000 to the bottom on October 9, 2002, the Dow Jones Industrial Average dropped 37.8

percent (the actual top was January 14, 2000), , and the Nasdaq Composite Index cratered a whopping 77.9 percent.

There will definitely be future bear markets, and if we are in a secular (long-term) bear market, then this current bear market may not have ended in 2002. Therefore, the key to investing is to preserve your capital at all costs. That means you should take prudent actions to avoid bear markets and not be invested in stocks when they occur. If you do not exit the market to protect your hard-earned money, then your profits (if there are any) and even your principal will quickly shrink. How much can you lose in the next bear market? The crash of 1929 wiped out 86 percent of the value of investors' portfolios, and the investors required 25.2 years to break even (not counting dividend reinvestment). Since then, there have been 19 bear markets, with an average loss of 33 percent, which took an average of 3.5 years to regain those losses. Not only are bear markets deadly financially, they can and do inflict significant emotional harm as well.

Intelligent investors know that bear markets are inevitable, and therefore you should either step aside, into cash or, depending on your level of risk tolerance, you should short the market using mutual funds that are specialized for investing in bear markets or exchange-traded funds. The experts tell you that no one can time the markets with consistency. Guess what? The experts are wrong again, as you shall see. This book will provide you with the information you need so that you don't have to guess or make an investing decision based on emotion or someone else's opinion of where the market is headed.

In late July 2002, Lawrence Kudlow, co-host of the *Kudlow & Cramer* show on CNBC, jokingly said that he and co-host Jim Cramer had called the 2001–2002 bear market bottom seven times, and that they will eventually get it right! But this is no joke. You can't afford to depend on someone else's guesses. You need to make your own investment decisions which you can do if you stick with the time-tested indicators and strategies which you will learn about in this book.

BEAR MARKET LOSSES ARE REAL NOT ILLUSORY

Many investors, and especially those over age 55, who have less time to recoup their stock market losses than those in their twenties and thirties, may never recover the losses they suffered in the 2000–2002 bear market. Consider the following statistics from AARP:[2]

- More than $7 trillion—equal to $25,000 for every man, woman, and child in America—went down the investment drain in the last three years.
- $700 billion in retirement savings were decimated.
- A dollar invested in a Standard & Poor's 500 Stock Index Fund in March 2000 was worth about 55 cents as of August 2002.

FORGET ABOUT DOLLAR-COST AVERAGING IN A BEAR MARKET

Dollar-cost averaging is another popular investing strategy bandied about in the canyons of Wall Street. Catherine Voss Sanders wrote an article entitled "The Plight of the Fickle Investor" in the Morningstar Investor (December 1997), and she stated: "Because emotions and hype can get in the way of smart investing, systematic dollar-cost averaging is a sound strategy. …[I]n most cases, the dollar-cost averager is going to beat the willy-nilly investor."

To the contrary, *never* use dollar-cost averaging in a *bear* market, since it puts you on the wrong side of the trade when the market is tanking. It is the traders who are right when they say *never average down*. Take the advice of Richard Russell (*Dow Theory Letters*, 1984):

> Averaging down in a bear market is tantamount to taking a seat on the down escalator at Macy's.

Imagine buying Corning at 113 (split adjusted) on September 1, 2000, and buying more shares each month as it tanked, so that you could lower your cost basis. Corning hit a low of $1.10 on October 8, 2002. Guess what? How in the world can you ever recoup that kind of a loss?

Dollar-cost averaging in a bear market is a strategy for dummies, not for intelligent investors. That goes for stocks as well as mutual funds. There is no guarantee that your stocks and mutual funds will return to their March 2000 highs any time soon, and throwing good money into a declining fund makes no sense to me. Remember that hundreds of funds go out of existence or are merged into other funds simply because of their poor investment performance.