AMI INVESTMENT MANAGEMENT
Registered Investment Advisor

White Paper

Market Timing: The Rule and The Exception

April 2018

Michael D. Axel, CFA

Jacob D. Benedict, CFA

Ryan A. Kay, CFP®

Introduction

We tackle market timing in this white paper. Market timing refers to the attempt to time your exposure to the stock market based on forecasts for future stock market returns. We present both a rule and an exception based on the quote, "The young man knows the rules, but the old man knows the exceptions."

The rule is this: Don't try to time the market. It is difficult if not impossible to forecast stock market returns – especially short-term returns – with any accuracy. Although stocks will be volatile from year-to-year, the odds are high that *long-term* returns from stocks will outpace returns from less volatile assets like cash or bonds. So the investor is best served by investing as much of his portfolio as he can and is comfortable with into stocks, based on his own specific goals and risk tolerance, and attempting to ignore the short-term noise of the market. In 2012 Warren Buffett wrote:

> American business will do fine over time. And stocks will do well just as certainly, since their fate is tied to business performance. Periodic setbacks will occur, yes, but investors and managers are in a game that is heavily stacked in their favor…
>
> Since the basic game is so favorable, Charlie and I believe it's a terrible mistake to try to dance in and out of it based upon the turn of tarot cards, the predictions of "experts," or the ebb and flow of business activity. The risks of being out of the game are huge compared to the risks of being in it.[1]

The history of the stock market clearly shows that those investors who made a major commitment to stocks and simply stuck to their knitting through thick-and-thin came out way ahead compared to those who have tried to jump in and out of the market. The ride may be bumpy at times, but the long-term results have more than made up for the bumps. As Buffett wrote this past spring:

> I want to quickly acknowledge that in *any* upcoming day, week or even year, stocks will be riskier – far riskier – than short-term U.S. bonds. As an investor's investment horizon lengthens, however, a diversified portfolio of U.S. equities becomes progressively *less* risky than bonds, assuming that the stocks are purchased at a sensible multiple of earnings relative to then-prevailing interest rates.[2]

In other words, the probability is high that in the next several years, there will be days, weeks and years where stocks will materially underperform less volatile investments like bonds. But over an extended period of time, say one to two decades or longer, it is also highly likely that stocks will well outpace bonds and inflation. So for the truly long-term investor, the best course of action is to commit a material portion of their portfolio to stocks and try their best to ignore the short-term noise of the stock market, which is largely unpredictable.

[1] Buffett, Warren. 2012 Shareholder's Letter. Berkshire Hathaway. March 1, 2013.
[2] Buffett, Warren. 2017 Shareholder's Letter. Berkshire Hathaway. February 24, 2018.

But notice that Buffett added a qualifier at the end of the most recent statement: "assuming that the stocks are purchased at a sensible multiple of earnings relative to then-prevailing interest rates." Herein lies the potential exception. The vast majority of time, stocks are priced in a range of "fair value." This doesn't mean that stocks are guaranteed to perform well, but instead that we have no pre-existing reason to predict relative market returns to be above or below-average.

But every so often investors succumb to periods of irrational exuberance and bid stock prices up to dangerous levels. Ever since investment markets were established there have been occasional bubbles, beginning with Tulip mania in the 1600s.[3] More recent examples include the Nifty Fifty in the 1970s, dot-com darlings in the late 1990s and speculative real estate in the 2000s. (Perhaps cryptocurrencies like bitcoin will join this list.[4]) One could argue that these periods of speculative excess belong to a class of their own, fundamentally different from the usual noise of the stock market.

Can we protect our investment portfolios during these episodes? More specifically: If and when might we actively reduce or hedge our stock exposure over concerns that stocks are dangerously overpriced (i.e. there is a stock market bubble)?

To see the rest of this white paper please email Ryan Kay at ryan@AMIinvestment.com.

[3] Per *Wikipedia*: "Tulip mania was a period in the Dutch Golden Age during which contract prices for some bulbs of the recently introduced and fashionable tulip reached extraordinarily high levels and then dramatically collapsed in February 1637. It is generally considered the first recorded speculative bubble."

[4] In an editorial we penned on December 7, 2017, we suggested that bitcoin seemed to resemble other speculative bubbles. Since our editorial, the price of bitcoin has fallen by nearly 45% and is now down over 50% from its peak (www.coindesk.com through April 24, 2018). See "Investment versus speculation" by Jacob D. Benedict, CFA in the *Greater Fort Wayne Business Weekly*.