Market Timing and Risk

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The stock market is up 70% from its lows one year ago. Investors do not seem to appropriately appreciate ongoing economic challenges. Stocks are not priced to excite the disciplined value investor. Accordingly, some investment advisors may direct clients to completely exit stocks and stay in cash to avoid "risk." Such a move is something that our clients will likely never see us do. We believe that market timing attempts should be avoided in nearly all cases, considered only if a severe valuation discrepancy exists (such as the NASDAQ in 2000 or REIT's in 2005). David Swensen, chief investment officer of Yale University, writes:

> Explicit market timing lies on the opposite end of the spectrum from disciplined portfolio management practices. J.M. [John Maynard] Keynes wrote in a Kings College Investment Committee memo that "the idea of wholesale shifts is for various reasons impracticable and indeed undesirable. Most of those who attempt to, sell too late and buy too late, and do both too often, incurring heavy expenses and developing too unsettled and speculative a state of mind." Deliberate short-term deviations from policy targets introduce substantial risks to the investment process…Market timing, by definition a bet against long-term policy targets, requires being right in the short run about factors that investors reasonably deal with in the long run. Making concentrated bets against the institution's [or individual's] adopted asset allocation, market timers run the risk of inflicting serious damage by holding a portfolio inconsistent with long-term objectives.

Investment advisors typically give three justifications for avoiding stock market exposure completely, all of which leave the disciplined investor unsatisfied:

1. *The market is in some kind of "technical trend" that suggests it won't move higher in the short to intermediate term*. We view technical analysis in the same light as astrology. Yale Economist Burton Malkiel writes:

   > The past history of stock prices cannot be used to predict the future in any meaningful way. Technical strategies are usually amusing, often comforting, but of no real value…Using technical analysis for market timing is especially dangerous. Because there is a long-term uptrend in the stock market, it can be very risky to be in cash. An investor who frequently carries a large position to avoid periods of market decline is very likely to be out of the market during some periods where it rallies smartly.

   In fact, a study by a professor at the University of Michigan found that 95% of the significant market gains over a thirty year period came on 90 out of roughly 7,500 days in the market. Missing any number of these days would be detrimental to long-term portfolio returns.

2. *The economic picture is cloudy and investors should wait until it is clearer before investing in the stock market*. When the picture becomes "clear," it is usually too late to benefit. In reality, though, investors are never graced with such periods of forbearance. Should investors have rushed into the stock market in 2000 or 2007 because economic growth "looked" robust? Warren Buffett writes:

   > The future is never clear, and you pay a very high price in the stock market for a cheery consensus. Uncertainty is the friend of the buyer of long-term values.

3. *Stocks are too expensive*. We are much more sympathetic with this line of reasoning, although we don't follow it to the conclusion of avoiding stocks altogether. Right now, stocks are trading between 16.0x and 20.0x earnings, depending on your estimate of "normal earnings." Both figures are above the historical median since the 1880's. This certainly gives us caution about the level of stock prices. But it is difficult to use macroeconomic figures like

the PE ratio on the S&P 500 to determine individual investment decisions. Bottom-up analysis is a much more robust approach (see below). Additionally, estimated annual stock returns of 5-8% over the next 7-10 years compare favorably with yields on bonds, at just 2-4% on quality issues, and cash, which barely yields 0.25%.

Stocks are much more expensive than they were twelve months ago. To say we avoid market timing is not to say that we don't alter our portfolio allocations based on observed data. We simply think that a move completely out of stocks and into cash, instead of decreasing risk, actually increases risk to the *long-term* investor. The move may turn out to be prescient – it wouldn't surprise us to see the market selloff this summer. But over the long run we believe that the economy will continue to grow, corporations will continue to create shareholder value and the stock market will continue to increase. We recognize that we cannot predict when the market will rise and fall nor do we believe that anyone else can. Warren Buffett writes:

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> In 75% of those years [the last 44 years], the S&P stocks recorded a gain. I would guess that a roughly similar percentage of years will be positive in the next 44. But neither Charlie Munger, my partner in running Berkshire, nor I can predict the winning and losing years in advance. (In our usual opinionated view, we don't think anyone else can either.)

Long-term investors are better served by maintaining a core exposure to stocks and avoiding market timing calls that have a history of destroying portfolio value. We believe the following methods are much more effective than market timing in controlling risk:

1. Create portfolios that are diversified by asset class. Long-term portfolios that include only stocks and bonds forego the opportunity to increase returns and decrease risk by including asset classes that exhibit comparable returns to and low correlations with stocks and bonds. Investments in fields such as real estate, commodities and absolute return vehicles like managed futures and arbitrage can protect portfolio value without sacrificing return.

2. Employ a bottom-up approach to investing. We mentioned above that the valuation of the S&P 500 is not currently encouraging. But we don't invest in the S&P 500 – we invest in individual stocks that we believe are undervalued. Top-down, macroeconomic calls are incredibly difficult, if not impossible, to get right. But a bottom-up approach allows us to focus on an observable variable – the price of a stock relative to its cash flow and projected growth – and act accordingly. We believe that our current portfolio contains stocks that are undervalued. In particular, quality blue-chip stocks continue to appear relatively underpriced. Jeremy Grantham, a well-known value investor, and his firm project that while large cap U.S. equities will only return approximately 5.8% over the next 7 years, U.S. high quality stocks will return 11.4%. Take Wal-Mart (WMT) as an example – from 1993 to 2005, Wal-Mart never traded below an average annual PE ratio of 18.0x. It now trades for just 13.5x 2010 earnings estimates with a dividend yield of 2.0%. While Wal-Mart won't hit a home-run in terms of earnings growth and investment returns in the future, the shares look much more attractive than cash.

At this point, we continue to own stocks that we believe are priced for less than their intrinsic worth. The "margin of safety" has narrowed considerably over the last year, but still provides a superior return profile to bonds and cash. If the market does respond to above-average valuation levels by selling off, we will be buyers of equities at increasingly attractive levels. For the time being, though, we believe investors should avoid drastic shifts away from long-term allocation targets.

Sincerely,

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