MARKET TIMING DOES NOT WORK

I cannot recall the number of debates I have had with private investors, fund managers and stock brokers over the last 16 years about market timing. Despite the vast amount of evidence to the contrary, there are still large groups of investors of all types who think that it is possible to time the markets. This means they think they can take their money out of the market before the crash and re-invest again at or near the bottom after the crash. History has proved that it is often possible to make the first decision but the second decision is almost always impossible.

WHAT IS MARKET TIMING?

In theory, market timing is a simple concept, especially as it relates to investing in shares. You simply sell your shares when they become expensive and wait for the markets to fall before buying them back again. There are many ways to judge when the market is expensive, the most common one is the look at the PE ratio of the whole market. Over the long term, the PE ratio for the JSE should range between 12 times to 16 times. When the PE ratio climbs above 16 times, you can argue that the market is becoming expensive and when it drops below 12 it is becoming cheap. As an example, when the JSE is at a PE ratio of 20 it means that you will need 20 years of current profits from the shares in the JSE to pay for the current price of all the shares in the JSE. As you can appreciate, 20 years is a long time and only the bravest investors would be willing to take a 20 year view on any investment.

You can also use the average dividend yield of the JSE to figure out whether it is cheap or pricey. Over time, the Dividend Yield will range from 2.5% to 3.5%. This means that the dividend income you generate per R100 invested in the JSE will range from R2.50 to R3.50. If the dividend income is above 3.5%, you can argue that the JSE is becoming **cheap** whilst a dividend yield of less than 2.5% is **expensive**.

Some investors also use the index value of the market as a judgement of value. So, when it gets to a level of 33,000 it is expensive and when it drops to 18,000 it is cheap. This is a very poor measure of value for long term investors but has some relevance for short term trades.

WHY TIMING DOES NOT WORK

It is reasonably easy to figure out when the market is becoming expensive and I like to use the PE ratio of the market when making my own judgements. Unfortunately, markets can become very expensive and they can stay expensive for many years. If you sell out of the market early, you could miss out on great returns for a few years which would be very costly. In addition, more than 50% of the total returns that investors get from the JSE are from re-investing dividends. If you are not invested in for a few years, you will not earn dividends so you are hamstringing your potential growth. This is one of the reasons why investors who never sell their quality shares generate such great long term growth – just look at Warren Buffett's track record as an example.

The choice to sell your shares in an expensive market is not the most difficult decision you will have to make. Determining when to buy back in again after a market crash is the most difficult decision. Research by Nedgroup Investments shows that you need to be very accurate in your purchasing decisions to be a successful market timer. If you missed the 12 best days out of the last 10 years in the

JSE, your return would be half the return of someone who had bought the index and remained invested through all market conditions. Unfortunately, the best days happen during the darkest days of a market crash. During the Financial Crisis there were days when the market jumped 2% or 3% in a single day usually because the market had dropped severely the day before. As an investor, you had to be ready to buy shares when there were fears that the financial system would collapse and we had no certainty that capital markets would functioning again in the near future. To date, I have not met anyone who sold out of the JSE at 33,000 and bought in again at 18,000 because there was so much uncertainty at that time.

WHAT SHOULD YOU DO

I suggest that you focus on your own financial position. If you prefer to trade shares frequently (not a strategy I recommend) then rather follow a few specific shares and trade them when they reach a particular price level. Alternatively, you can determine an appropriate amount of your assets that you want to allocate to shares e.g. 50% of your capital and then you buy or sell shares depending on how your allocation looks at the time. For example if you start with 50% in shares and the stock market booms, you should sell shares regularly so that you always have 50%. If the market crashes you should start buying so that your total invested in shares remains at 50% and does not shrink. I find that this type of strategy allows you to make rational decisions in difficult times and limits the market timing decisions which might cost you money.