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No, You Almost Certainly Can't Time Markets

Researchers find that professional investors are only marginally less bad at it than retail.

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A recently published paper from Willis Investment Counsel, an advisory firm in Gainesville, Georgia, argued that investors lose 1 to 2 percent in annual returns from attempting to time the market. Willis studied timing leakage — the difference between the theoretical return of a fund or portfolio compared to what an investor actually earns. Investors time the market when they don't give a particular strategy enough time to work out; they overreact to volatility or other news; or they succumb to an irrational need to act and shift their portfolios, as per the study's definition.

[II Deep Dive: Not One Ivy League Endowment Beat a Simple U.S. 60-40 Portfolio Over Ten Years]

Willis cited Research Affiliates' findings that investors in mutual funds lose almost 2 percent annually from leakage, or 22 percent of their total annual return. Institutional investors lost just fractionally less — 0.17 percent — than their mainstream counterparts.

A number of academics reviewed the paper, including accounting Professor Ilia Dichev of Emory University. Willis drew on research from Morningstar, the Vanguard Group, Research Affiliates, and others.

"I'm not saying tactical asset allocation is bad, but I'm raising the question of whether it deserves to be the industry standard," said paper author and firm founder Bob Willis in a phone interview with Institutional Investor. Willis pointed out that market timing — which is often thought of as big moves in or out of the market as a whole — is just as often simple formulaic changes such as rebalancing or selling short-term bonds and buying longer duration fixed income.

"In theory it sure makes sense, but in reality, it's not working," said Willis. He added that the paper's findings are worrying because complex asset allocation has become standard for high-net-worth advisors and institutional consultants. They frequently use JPMorgan's well-known asset allocation table as a sales tool demonstrating that no one can predict an asset class's performance in any given year, so investors should hold all of them. The colorful chart, included in JPMorgan's yearly markets guide, shows the fluctuating annualized returns and volatility for a long list of investment categories over more than a decade.

"Software has made portfolio construction scalable and litigation proof," Willis pointed out. "How can you be faulted for using this?"

Timing leakage also plagues passive investing. Investors in small-cap value index funds lost 2.03 percent in annual returns for the 10 years ending March 31, 2018 from timing leakage, according to Morningstar data Willis cited. That means investors didn't get the fund's advertised return, because they may have bought the fund at a market high or sold at a low point. Investors in large-cap growth index funds lost 1.62 percent. In emerging markets, where investors experience more volatility that can cause them to buy or sell at the wrong times, investors lost 3.50 percent to leakage.

Willis said investors have been fleeing actively managed funds in favor of passive largely because active managers have failed to beat their benchmarks. But Willis argues in the paper that to be successful with passive, investors need to hold on to their funds through market cycles.

That's not what they're doing. Willis cites Vanguard's own statistics showing that the famous S&P 500 index fund has annual timing leakage of 2.02 percent, or 26 percent of the fund's total return. Between October 31, 2005 and October 31, 2015, a period that included the financial crisis, the fund delivered returns of 7.73 percent. But t he average investor in the fund only had a 5.71 percent return during the time period.

"There's nothing magic about an index fund, because investors are human," Willis said.

Morningstar's tactical asset allocation funds category exemplify the problem. From March 31, 2008 and. March 31, 2018, investors in the funds, designed to market time, lost 1.95 percent annually from leakage, or a whopping 40 percent of the total return.

"We believe having money on every horse in the race is unnecessary and leads to excessively switching horses and replacing bets," wrote Willis in the paper.