Why Do Indexers Not Try to Time Markets?

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Three reasons why indexers do not try to time markets are arithmetic, behaviour and effectiveness.

Arithmetic

First, we need an assumption. Some of the most successful long term investors in history (John Templeton, Warren Buffett, etc.) seem to agree that it is hard to make successful investment decisions. Such investors find that generally the probability of being right is about 55%. So the probability of being wrong is about 45%.

When these successful investors get one right, they like to stay with it for as long as possible. They spend their time managing the ones that did not work out.

To time a rise or a drop in the market, an active investor needs to make two decisions and get them both reasonably correct. She needs both to get in and to get out at reasonably the right time. The probability of getting both correct is 55% times 55%, which is about 30%. So for the active market timer, the probability of timing a shorter-term move in the market is about 30%.

An indexer who relies on rebalancing, only makes one decision to buy or sell an asset and has that 55% chance of the decision being perfect. This involves experience and judgment but is based on the fact of the asset weight in the portfolio, not on a prediction.

With 55% compared to 30%, the odds are in favour of the indexer.

Behaviour

What happens to an active investor who gets the first of his two trades correct? He tends to become overconfident and anxious. For the active investor, the process is only half way through. Now the second decision has even higher stakes, with the same probabilities.

What happens if this first trade goes badly? Typically, admitting it was a mistake is not in the first set of responses. Ambiguous explanations and justifying excuses are common.

Few active investors perform well under these conditions. Many active investors, even if they make a successful first trade, are either too eager or reluctant with their second trade. This is in addition to the probabilities being against them on each trade.

What happens to an indexer who makes a buy or sell to rebalance and the market then demonstrates that the trade was not perfect? In a taxable account, gains or losses may have been realized. So in a taxable account, every rebalance decision must consider tax consequences.

In a non-taxable account a rebalance trade moves the asset closer to its index target, which is the assigned job of an indexer. If the indexer makes a good rebalance trade, even if in hindsight there was a better trade, she has done her job and continues happily working for the investor.

Quoting Bob Seawright from his “Above the Market” blog, “the legendary investor Peter Lynch famously emphasized, “Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves.”

Charles Kirk expresses it similarly: “Far too much money has been lost by those constantly preparing for and fearing the worst, than simply doing their job to focus on what is actually happening in the market, not what they fear will happen instead.”

The great Peter Bernstein explains: “Even the most brilliant of mathematical geniuses will never be able to tell us what the future holds. In the end, what matters is the quality of our decisions in the face of uncertainty.”

Effectiveness

Without question, buying an asset “at the top” before “a correction” hurts, especially if the money is needed in the shorter term. But investing is for assets that will work for the investor over a longer horizon. Usually five years is used as a minimum, and often the time horizon is indefinite.

Consider “The Crash of 87” in the following graph of the US stock market for the years 1986 through 1989. Notice that really the entire period from January 1, 1987 to late October that year, is the anomaly. This market was unusually strong during that period, and in October the “crash” “corrected” that.

Speculating on the rise or the fall might have been profitable, or might not have been, but it was unnecessary.

Other time windows and other markets show similar behaviour; markets go up and down. Better outcomes result from tracking those markets, and rebalancing without prediction, than come from betting on a prediction.

Another graph now, with a less positive slant, emphasizes this. An indexer, without ever guessing the direction of the market, would have been selling small pieces to rebalance in the first half (at higher prices on average), and buying to rebalance in the second half (at lower prices on average).

Selling at higher prices and buying at lower prices tends to lead to a better outcome.

Since March 9, 2009, the start of the recent "bull market", the S&P 500 reached a maximum gain of about 250% this summer. Along the way, it experienced the following drawdowns.

Was it necessary or wise to try to time any of them?