

The Sound Investor Series #70

Dow Crosses 12,000 – What Do You Do Now?

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Headlines screaming: Dow at all time high - crosses 12,000 (although it fell back to 11,992 before the close). Now what do you do? My advice is - not much!

Many investors are wondering if it is time to jump into the stock market with both feet. Everything looks pretty good - we appear to be in the mist of a “Goldilocks Economy” - growth is slowing (but not too much) and recent inflation reports are less threatening.

There are even flickers of hope in the suspect housing market. Yesterday, housing starts were reported to rise for the first time in months. In addition home builders’ confidence, after falling for about a year, appears to have bottomed out. But it is hard to tell if this glimmer is the light at the end of the tunnel - or a train barreling down on us. If I was trying to sell a house, I would wish housing starts would halt until the current huge inventory is absorbed.

I would not be surprised if the stock market continues to rise. However, long term investors should resist any temptation to alter investment strategies based on short-term outlooks.

This advice is similar to mine last spring when it looked like the market was going in the other direction, (and in fact fell sharply in May and June). But knowing when to get out of the market and knowing when to get back in is really, really hard! Last spring my call that the market would fall was spot on, but you never read me telling investors when I thought it bottomed - because I just didn’t know.

Most investors have correctly called a market turn from time to time. But to make money at market timing, you have to call it correctly ALL the time, not just sometimes.

The market fell 8 percent from May to mid-June and almost everyone thought it was going even lower. Then over the next three weeks it rose almost 5 percent and any “timer” would have been tempted to jump back in. Subsequently, in just a week it fell back to its June low and most of us would have been selling again and cursing ourselves for buying the “suckers rally.”

In hindsight, the market bottomed, as it usually does, when “everyone hated it.” This happens because when everyone hates the market there is no one left to sell. Wall Street loves clichés and when markets go up in the face of bad news it is said to “climb a wall of worry” and that is what the market did all summer.

If you need another reason to avoid market timing, think about taxes. If you have gains; and sell and then buy in at the same level, you fall behind because after paying taxes you have less to reinvest in the market. This becomes an even bigger issue if your gains are short-term and taxed as ordinary income rather than at the preferential long-term rate of 5 or 15 percent. Due to taxes, market timers have to win just too breakeven.

The difficulty of timing the market also has relevance to individual stocks and why it is so difficult for active fund managers to outperform index funds. For an excellent analysis of the performance of actively managed funds check out S&P Indices Versus Active Funds Scorecard (SPIVA). (www2.standardandpoors.com and search for SPIVA.)

I realize S&P might have an interest in promoting index investments, but I have found their research to be top-notch. In particular, I like the fact that this report takes into account “survivorship bias.” “Survivorship bias” refers to the problem that weak funds are closed and their poor performance is ignored as if it never happened. A recent example is Columbia Funds. This firm closed or merged a number of weak funds and then advertised how well their (remaining) funds performed.

The third quarter SPIVA has just been released and confirmed that actively managed funds continue to lag behind their benchmarks and index funds’ performance. Seventy-one percent of large capitalization (cap) funds failed to keep up with the S&P 500. While mid-cap and small-cap funds performed even more poorly relative to their benchmarks.

In perhaps the most relevant statistics, the report compares the total return of the S&P 500 index to both S&P 500 index funds and actively managed large-cap funds on an asset weighed basis.

For the five years ending September 30, the S&P 500 was up an annualized 6.97 percent. Index funds lagged the index by 0.16 percentage points (ppt) with a return of 6.81 percent. Actively managed funds were another 0.74 ppt behind the index funds at 6.07 percent.

Putting some dollars on the numbers might help them make more “cents.” If an investor put \$100,000 into both an index fund and an actively managed fund - after five years the index fund would be worth \$4,749 more; over a ten year period the extra value is almost \$12,979.

Unfortunately, most investors (including me) need to prove to themselves that market timing doesn’t work. In order to keep the lesson from costing you too much, put a small amount of “play” money aside and keep the rest in low-cost index funds. Buy stocks and time the market with your play money and keep careful track of your after-tax performance. After a while, when you see the light, put whatever is left into the index funds and watch the ballgame or read a good book.

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