Yes, You Can Time the Market!

Ben Stein and Phil DeMuth

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For Alex and Julia

Preface

Yes, You Can Time the Market! grew out of a series of lunch conversations between the authors at the Piazza Rodeo in Beverly Hills and on the bike path in Santa Monica in 1997 to 2000. Ben Stein insisted that the stock market was too high. Phil DeMuth countered that, while it might *seem* high, this was an opinion without practical significance. As everyone knew, ". . . you cannot time the market. . . ." During the palmy days of the unending bull market, there was no need for Market Timing. It was simple enough to just buy a stock or a mutual fund that was heading for Neptune and go along for the ride. Then the stock market started dropping like an anvil off a cliff, and the subject merited closer investigation. How had people come to accept the notion that the price of the market was irrelevant, when price applied so ruthlessly everywhere else?

There was this to consider: The field of Market Timing had become the province of short-term fortune-telling cranks, which gave the whole endeavor an unsavory reputation. When analyzed, their typical investment strategy fell apart like a cheap suit, making them easy targets for finance experts to set up and then demolish.

But when we shifted to the long term, the data revealed that fundamental stock market valuation metrics clearly showed when the market was over- or underpriced. All that we had to do was use the tools of technical analysis—the chart and the moving average—and add to them fundamental criteria like the dividend yield or the price/earnings ratio. It seemed astonishing that Wall Street, with all its MBAs and high-priced talent, had missed something so obvious. Possibly this was because these measures tell us nothing constructive about where the stock market will be tomorrow or next month, but only years from now. They were not short-term selling tools.

If the stock market can be said to be priced high or low for an investor with a long-term perspective, then it follows that there are better and worse times to buy and sell stocks. We hope this book helps you find them. It summarizes a colossal amount of data, and we hope to have scored some runs and hits along with any errors. More broadly, we hope that it will re-open the debate on the usefulness of Market Timing to investors everywhere.

BEN STEIN
PHIL DEMUTH

About the Authors

Ben Stein has had one of the most diverse careers known to man. He is the son of the world-famous economist and policy advisor, Herbert Stein. He received a BA with honors in economics from Columbia in 1966, and worked as an economist for the Department of Commerce. In 1967, he entered Yale Law School and graduated as valedictorian of his class in 1970. While at Yale, he studied corporate finance under distinguished professors Henry Wallich and James Tobin. Ben Stein is known to many as a movie and television personality, especially from *Ferris Bueller's Day Off* and from his long-running quiz show, *Win Ben Stein's Money.* But he has probably worked more at personal and corporate finance than at any other subject. He has written about finance for *Barron's* and the *Wall Street Journal* for decades. He was one of the chief busters of the junk bond frauds of the 1980s, has been a long-time critic of corporate executives' self-dealing, and has written two self-help books about personal finance. He frequently travels the country speaking about finance (www.benstein.com).

Phil DeMuth was valedictorian of his class at the University of California at Santa Barbara in 1972. He went on for his masters in communication and doctorate in clinical psychology. A psychologist with a longstanding interest in the stock market, he has written for the *Wall Street Journal* and *Barron's* as well as *Human Behavior* and *Psychology Today.* His opinions have been quoted on *theStreet.com* and *Fortune* magazine. He is a registered investment advisor and president of Conservative Wealth Management in Los Angeles, California (www.phildemuth.com).

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Chapter One

The Impossibility of Market Timing

"You can't time the market." This a well-known shibboleth, among the most basic tenets of serious stock market investors from Nobel Prize winning economists to your basic corner stock brokers. You cannot in advance tell when the market is going to go up or down based on some already known data. That is supposedly fundamental.

Just listen to the voices:

From David Swensen, chief investment officer of the mighty Yale University endowment, short and sweet: "Serious investors avoid timing markets."

From Mr. Swensen's close friend, investment manager and frequent commentator Charles Ellis: "There is no evidence of any large institutions having anything like consistent ability to get in when the market is low and get out when the market is high."

From one of our favorite commentators on stock market investing, William J. Bernstein, in his *Four Pillars of Investing:* the results of financial services and insurance companies picking times to buy stocks are and were ". . . awful . . . the performance of market timing newsletters . . . was even worse. . . ."

From William F. Sharpe, Nobel Prize winner, and his essay, "Likely Gains From Market Timing": ". . . a manager . . . should probably avoid market timing altogether. . . ."

From a seer named Larry E. Swedroe in his book, *What Wall Street Doesn't Want You to Know:* The odds against market timing are ". . . huge. . . ." Mr. Swedroe cites an article in *Fortune* of May 12, 1997 to the same effect: "No one knows where the market is going . . . That's the simple truth." (Although, as Mr. Swedroe points out, that does not stop *Fortune* from trying to show that it does.)

John Bogle, one of the smartest and most capable investment gurus of all time, head of the Vanguard family of funds for many years, says flatly: "Indeed, my impression is that trying to do market timing is likely, not only not to add value to your investment program, but to be counterproductive."

Really?

How can this possibly be?

Market Timing is the concept that there are some times when indicators that can be read at the time say it is a better time to buy or sell than other times. Market Timing is the notion that an investor can look at certain data and have an idea, a good idea, that the market is overpriced or underpriced and is likely to go down or go up.

Now, at one level, it is simply preposterous to say that there should be and can be no Market Timing. After all, what moves the market every second of every day is a huge number of buyers and sellers deciding to buy or sell, sometimes buy *and* sell, that day. Usually, though far from always, they are buying individual stocks. But on many other occasions, they are buying indices or baskets of stocks second by second, altogether by the billions of shares every day.

In the aggregate, what is happening every day is that the mass of investors and speculators are Market Timing every second of every day. Obviously, they are making decisions about what to buy and sell and when to sell and buy it. This is, in itself, Market Timing.

Every day, when the stock market goes down on poor earnings rumors, or goes up on rumors of future rate cuts by the Federal Reserve, the traders are timing the market, guessing that now is a better time to buy or sell than some other time. So in a way, it makes no sense to say that Market Timing is not a helpful strategy or that no smart person does it—unless we were to say that the great bulk of investors are not smart. This may be true, but then we would have to go further and say that no one who traded on any day was smart or experienced, and that is saying too much.

Moreover, what about all of those clever hedge fund managers? They mostly make money by buying and by doing something only some of us ever do, selling short. But they often trade frequently, blindingly more so than the individual Ma-and-Pa Kettle investor at home in Smallville. Every time they buy or sell short indices or exchange traded funds, they are timing the market, even if sometimes only over a very short time. Yet, this, too, is Market Timing. Are all of these people fools? Some of them make pretty good returns for fools.

Then there is a factor standing in the way of the Anti-Market Timers that is about as big as Gibraltar. If Market Timing is futile and meaninglessly foolish, then what about the basic concept of price? How can price be meaningless in terms of stocks, while it is meaningful everywhere else?

This is a crucial question, and it is the one that began us on this project. If price means something in terms of real estate or oil futures or bonds or cars or shirts, how can it be meaningless in terms of stocks? If there is a price that is a "high" price for an apartment building relative to its rental income, can it be that there is no such thing as a "high" or "low" price of a share of stock in terms of its dividends or earnings or book value or some other metric—maybe even in terms of its usual price? If natural gas is high or low in relation to coal or oil, can it be that stocks are not high or low relative to other investment classes or to their own earnings or dividends? Does the basic principle that price is king in markets have no application in stocks?

Supposedly, price tells us the supreme wisdom of the markets at any given moment in time, since it is the synthesis of all of the available data about a stock's prospects at any given moment. But we know that price changes on a dime; price is like a hummingbird constantly maneuvering and changing position in the universe. Can it be that the price is unattached even over long periods to any kind of gravity of earnings or book value or past prices of the stock or of markets generally? Can it possibly be that a stock price is simply a totally random artifact not connected with anything else on earth? In that case, why have prices at all?

But if price does matter in relation to shares of stock, as it does in everything else on earth—including labor—then how can