



Don't Waste Your Time: A Tale of Two Markets

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Investment efficiency is about time. An efficient investment is one that uses time productively – little to no “down time”. An investment that is continuously exposed to stock market risk all year long, over several years, will typically experience “time wastage” of about 50%. In other words, such an investment is a waste of time about half the time.

Here's the proof. Since 1949, all of the appreciation of the Dow Industrials has occurred within the time period from November to May. A \$1,000 investment in the Dow only during this period (with no interest earned in the other six months) grew to \$82,666, without dividends (ending 2008). Conversely, a \$1,000 investment in the Dow during the period from May to November shrank to \$605, over 59 years. The table below shows the details.

Dow Performance

November 1 through Third Trading Day of May versus Fourth Trading Day of May through October 31 1949 - 2009

Start Bullish Period (Nov)	Percentage Gain	\$1,000	Start Bearish Period (May)	Percentage Gain	\$1,000	Start Bullish Period (Nov)	Percentage Gain	\$1,000	Start Bearish Period (May)	Percentage Gain	\$1,000
1949	14.1	1,141	1950	4.0	1,040	1979	0.1	7,469	1980	13.3	653
1950	16.9	1,334	1951	(0.3)	1,037	1980	5.2	7,856	1981	(12.3)	573
1951	(0.7)	1,325	1952	3.3	1,072	1981	0.2	7,874	1982	16.1	665
1952	3.3	1,369	1953	(0.9)	1,063	1982	22.3	9,628	1983	1.0	671
1953	15.3	1,578	1954	10.8	1,177	1983	(3.6)	9,285	1984	2.2	686
1954	20.0	1,894	1955	7.7	1,267	1984	3.3	9,591	1985	10.2	756
1955	13.0	2,140	1956	(6.6)	1,183	1985	30.5	12,519	1986	4.7	791
1956	3.7	2,219	1957	(11.4)	1,048	1986	24.5	15,588	1987	(14.7)	675
1957	4.6	2,320	1958	17.8	1,235	1987	2.1	15,923	1988	5.5	712
1958	15.2	2,674	1959	3.3	1,276	1988	11.4	17,739	1989	10.5	787
1959	(5.5)	2,526	1960	(5.0)	1,212	1989	1.9	18,081	1990	(9.4)	713
1960	18.7	2,999	1961	2.2	1,238	1990	20.3	21,757	1991	4.4	744
1961	(4.0)	2,878	1962	(12.7)	1,081	1991	9.5	23,815	1992	(4.0)	715
1962	21.8	3,504	1963	5.2	1,137	1992	6.9	25,460	1993	6.7	763
1963	9.5	3,835	1964	5.6	1,201	1993	0.5	25,578	1994	5.7	806
1964	6.8	4,095	1965	3.1	1,238	1994	11.9	28,622	1995	8.7	877
1965	(4.8)	3,899	1966	(11.8)	1,092	1995	15.2	32,971	1996	10.1	965
1966	11.1	4,332	1967	(1.9)	1,071	1996	19.6	39,447	1997	3.2	995
1967	4.5	4,527	1968	3.6	1,110	1997	22.9	48,487	1998	(6.1)	935
1968	0.7	4,558	1969	(10.7)	991	1998	27.5	61,823	1999	(2.1)	916
1969	(17.1)	3,779	1970	6.5	1,055	1999	(2.3)	60,384	2000	4.7	959
1970	24.1	4,688	1971	(10.5)	944	2000	(1.6)	59,424	2001	(15.9)	806
1971	11.3	5,216	1972	2.4	967	2001	10.3	65,523	2002	(16.1)	676
1972	(0.2)	5,207	1973	0.3	969	2002	1.6	66,573	2003	14.9	777
1973	(11.6)	4,605	1974	(21.3)	763	2003	5.2	70,036	2004	(2.7)	755
1974	28.6	5,920	1975	(2.3)	745	2004	3.6	72,531	2005	0.5	759
1975	18.0	6,985	1976	(2.2)	729	2005	9.2	79,202	2006	6.0	805
1976	(2.5)	6,809	1977	(13.0)	634	2006	9.6	89,811	2007	5.2	847
1977	1.3	6,897	1978	(4.4)	606	2007	(4.8)	82,666	2008	(28.5)	605
1978	8.2	7,464	1979	(4.9)	577						

(Source: Jay Kaepffel, *Seasonal Stock Market Trends*, Wiley, 2008)

The November to May period, which I will call the “productive zone” had average daily gains 27.4 times higher than the gains of the other six months, which I call the “dead zone”. The annualized return of the “productive zone” was 17.1%, whereas the annualized return of the “dead zone” was -0.4%. The Dow was up 80% of the time during the “productive zone”, but up only 50% of the time during the “dead zone”.

To be sure, the “dead zone” has contained some spectacular gains, but also contained about 85% of bear market losses since World War II.

Of course you might think that perhaps there is a way to forecast when the “dead zone” will be profitable and when it will not. Believe me, this is a vain hope. Market forecasting is notoriously inconsistent and almost always wrong. In over 25 years, I have yet to run across anyone who has a good record of forecasting the annual moves of the market.

Besides, successful investing is not about forecasting, but about repeated actions and long-term discipline. By taking greater risk in periods where the risk/return profile is strong and by avoiding risk in periods where the risk/return profile is weak, you can achieve a weighted average return over time that significantly outperforms a buy-and-hold continuous exposure to market risk.

There are several investment alternatives to the stock market “dead zone”. There are no-load, no transaction fee bond funds that focus on shorter-term government bonds. These funds rarely produce a negative quarterly return. If one were to accept slightly higher risk during the “dead zone”, intermediate-term government bond funds would be a logical choice. These funds also offer the prospect of pleasant surprises occasionally. When the stock market is falling or crashing, investors crowd into these funds for safety, producing sharp increases in prices for a short time. Since a high percentage of market crashes occur during the “dead zone”, this factor can boost returns significantly.

The largest and oldest fixed-income fund in the U.S. is the PIMCO Total Return Fund. It is an intermediate term fund managed by Bill Gross, one of the best in the business. This fund has averaged a 4.4% return during the “dead zone” over the past 20 years and a 3.1% return over the past 10 years (ending 2008).

What causes the “dead zone”? There has been a lot of research done on this phenomenon, but no consensus as to the cause. We know that it is global – about 36 developed markets worldwide have the same “dead zone”, many of which are more pronounced than in the U.S. My own opinion is that the summer produces a neglect of portfolio composition, both for individual and institutional investors. The approach of autumn brings renewed attention to investment management, which prompts a wave of selling, a delay while new investments are researched, then a period of reinvestment late in the year. This cycle is reinforced by investment analysts who typically revise their earnings estimates for the year during the summer and these revisions are almost always downward. Then, late in the year, the same analysts produce next year’s earnings forecasts, which again are almost always too optimistic. This prompts a wave of buying later in the year and through the early part of the next year.

Whether I’m right or wrong about this is largely beside the point. The fact of the matter is that this 60 year phenomenon is not a statistical accident and can be expected to play out in the future.

This means that investors who continue to be fully exposed to market risk during the “dead zone” of the future are throwing away long-term returns which, over time, could represent significant multiples of investment assets. If an investor can increase returns by 2% annually over the buy-and-hold rate, this would represent a 20%-30% annual return premium.

The argument for avoiding the “dead zone” is especially potent for IRA’s, retirement accounts, and other tax-deferred investment vehicles which have no concerns over taxation. If the shift to bonds for half the year doesn’t cost anything, and if such a move represents a long-term premium of 2%-4% per year, then what’s the reason for not doing it? In 2008, this policy would have avoided a loss of 30% or more, depending on the mix of mutual funds or index funds in the account.

If your retirement plan is a separately managed account holding individual securities, you’re still wasting money – maybe more than if you held mutual funds. The data is in and separate account managers did no better in 2008 than the average mutual fund. In the overwhelming majority of cases, separate accounts contain fewer securities than mutual funds and are, therefore, more concentrated and more volatile. This can work against you big time in market downturns.

If you’re still resisting this idea, ask yourself this: If someone proposed an investment to you that lost 40% of its value over 59 years, has been underwater since 1970, and has been down half the time, is there any chance that you would buy it?

Enough said.

