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WHEN TIMING THE MARKET WORKS FOR INVESTORS

With markets at a peak, it might appropriate to time the market.

By: Barbara Friedberg - January 23, 2020

Market timing has been given a bad rap with the buy-and-hold crowd. This might be due to the abundance of research suggesting timing the market is nearly impossible. But there are times when timing the market works for investors. Many folks may not even realize that they are already timing the market.

In its purest form, market timing is an investing strategy that buys and sells securities based upon clues as to future market performance. In contrast with a buy-and-hold investor, the best market timers attempt to beat the markets. There is a group of investors, called traders, that professionally or privately abide by market timing and employ a variety of tactics to frequently trade in and out of the markets, for profit.

But market timing might not be binary: You either time the market or you don't. There might be ways for ordinary investors to time the market successfully. Here are a few instances when to time the market:

- Stock picks.
- Using valuation metrics.
- Picking asset classes.
- Timing with moving averages.

Stock Picks

"Instead of trying to anticipate which way the entire market is going to move, you are better served trying to identify the catalyst that can jump-start a particular company," says Jack Murphy, chief investment officer at Levin Easterly Partners in New York.

A long-term investor can evaluate a company's fundamentals, understand the growth drivers and determine if the company's valuation is fair or undervalued. Strong balance sheets and competitive advantage are important. If an investor can identify a catalyst that will propel a stock forward, he or she can take a contrarian view, time the purchase of an individual stock and make a profit, he says.

Using Valuation Metrics

The best market timers understand valuation.

"You can certainly estimate fair value for any asset and determine whether its current price is close to fair value, far above, far below, or somewhere in between," says Steven Jon Kaplan, chief investment officer of True Contrarian Investments.

The Shiller P/E ratio, also known as the cyclically adjusted price-to-earnings ratio, or CAPE ratio, computes the price-earnings ratio of a company or market by dividing the price by the average earnings for the last 10 years, adjusted for inflation. This smooths out the impact of economic cycles on the metric. By comparing the average CAPE ratio with the current P/E ratio, investors can assess whether stocks or the market in is over-, under- or fairly valued.

Currently, the CAPE ratio is 31.72. That's in contrast with the average metric of 16.69. In comparison, the minimum and maximum ratios are 4.78 (from December 1920) and 44.19 (from December 1999.)

Kaplan believes that with the CAPE ratio nearly double its historical average, it's wise to time the market and sell most U.S. assets. In reality, this is a somewhat drastic approach for the ordinary investor.

This doesn't mean that the market can't go higher, or that it will drop next month, but that eventually, the market is likely to revert to the mean P/E ratio. In other words, at some point, the market will drop in value and investors will lose a portion of their U.S. investment value.

Picking Asset Classes

Specific investment strategies and asset classes differ in their popularity. James Solloway, chief market strategist at SEI Investments, prefers to use asset classes to time the market.

When a particular asset class, such as small-cap stocks, has delivered a period of outstanding performance, reducing exposure to this asset class and using the proceeds to buy another asset with different characteristics can help reduce the level of risk in a portfolio," Solloway says.

This strategy of market timing could work with sectors, such as technology or real estate. For example, during the recent U.S. bull market, international stocks have underperformed. A market timer might review valuations of various international or country-specific markets and uncover undervalued sectors to buy.

Market Timing With Moving Averages

Jeff Klauenberg, founder of Klauenberg Retirement Solutions, abides by rules driven market timing. A popular market timing strategy among market timers uses the 200-day moving average, or DMA, to signal when to make portfolio adjustments.

A moving average shows the overall price trend for a stock or a particular market. Professional investors and technical analysts may use the 40-day and 200-day moving averages to define medium- and long-term trends.

When the shorter-term moving averages, such as the 50-day moving average, cross over the 200 DMA, this indicates a change in the long-term market direction, Klauenberg says.

For example, consider the SPDR S&P 500 ETF Trust (SPY), which is currently trading at $331. On Oct. 2, 2019, the fund's price chart dipped below it's simple moving average. Had it continued for more than a day, investors might have considered this a sign that the S&P 500 was due for a price drop.

Like many signals, the signal of the 50 DMA crossing the 200 DMA may signal a change in market direction from a bull to a bear market or vice versa. Other market timers might use the 100 DMA average crossing the 200 DMA to offer longer-term trend data regarding when a market reversal is in the works.

In practice, if the 50-day moving average moves below the 200-day moving average, investors might take this as an indication that stocks will be trending down and sell.

Like all forward predictions, there's no certainty that this indicator is reliable all the time. Like all investment strategies there are proponents and detractors. Regardless of one's thoughts about technical analysis, using moving averages will not guarantee future market direction.

Currently, the U.S. stock market is overvalued when compared with historical norms. Cash can be an ally in a market timing strategy. Although no one knows when the market will reverse course, or what will be the catalyst, it's likely that at some time in the future there will be a drop in investment values.

Smart investors, who maintain a cash cushion, can time the markets so that after a decline in prices, the best market timers can buy up stocks on sale.

Ultimately, many ordinary investors are unknowing market timers. Rebalancing an asset allocation is a form of market timing. The common investment management strategy of determining a ratio of stock investments to bonds, like 60% to 40% and then rebalancing back to those percentages when stocks or bonds deviate from their desired ratio, is a form of market timing. When stocks outperform, investors will sell the overvalued asset and buy more of the undervalued.

Timing the market can be an effective tactic in certain circumstances. Unfortunately, since even the best market timers don't know the future, it's difficult to perfectly buy low and sell high every time.