Can You Avoid Market Declines?

By Gil Hanoch, February, 2009

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Have you ever met anyone that sold stocks before a major decline? It could make you jealous and you may regret not doing so yourself. This article provides tools to measure success in such a strategy, and estimates how common or easy it is.

What are the Results of Avoiding Declines? The following table compares the returns of two diversified QAM portfolios, with their returns given successful and failed attempts in avoiding down months. A successful attempt is characterized by avoiding all down months, while failure is characterized by missing all up months.

Attempt to Avoid Declines - Simulated Returns 1970-2009			
Portfolio	**Failed**	**No Attempt**	**Successful**
Long-Term Component	-35%	17.2%	59.6%
Extended-Term Component	-43.3%	21.1%	83.6%

Stock portfolios tend to change directions frequently. Therefore, avoiding declines requires frequent buying and selling, resulting in higher transaction costs and very high tax costs.

How do you Measure Success?

1. Measure the performance of all investments, including any cash or other investments held to counter the increased risk of market timing (when compared to passive investing).
2. Measure performance over a period of 20-30+ years, for some statistical reliability.

Success should result in total performance substantially greater than 20% per year (Long-/Extended-Term Component performance + the increased costs). Here are two rules of thumb to find if the performance is around 20%:

1. Did you double your money every 4 years over and over again over the past several decades?
2. Did every $1 you invested 26 years ago grow to over $100?

Since people typically experience much worse performance, they are likely to know that the answer to both questions is "no".

Why is Success in Avoiding Declines so Rare? The appeal of avoiding a major decline like the one of 1973-1974 or 2008 is so big that many people are tempted to sell before such a decline, or part-way into it, hoping to buy back in the early stages of the recovery. It is very difficult to identify peaks and troughs, because of the following characteristics of stock returns:

1. **Return patterns are not consistent**: Any pattern that you may identify in returns in some period is likely to fail in another one. Missing a mere few days in the bottom and top can erase the full benefit of successful market timing.
2. **Markets go up and down frequently on different scales**: Both up and down periods include many fluctuations of various magnitudes. This makes reversals on the large scale impossible to differentiate from a small scale fluctuation, until long after the fact.

3. **Stock prices tend to precede the economy by 6-12 months**: Any information about the current economy is distant history for the stock market.
4. **Stock prices are unreliable in the short run**: Stock prices frequently deviate from the true value of the business, sometimes substantially. Only when extending the measurement over years and decades, the prices become more reliable.

These characteristics lead to a failure in avoiding declines, for a combination of two of the following:

1. **Selling too early**: After a few years of exceptional growth, you expect a decline and sell. The portfolio goes on to grow by 100%+ before the next decline, while your money is in cash.
2. **Selling too late**: You wait to make sure there is a true substantial decline, and sell only after a 20%+ decline. Since most declines are not greater, you typically sell near the bottom.
3. **Buying too early**: After a steep decline, the portfolio jumps by 10%-20%. You take it as a sign for the beginning of the recovery and buy. The portfolio turns to decline further.
4. **Buying too late**: After a steep decline, you want to be sure to buy only when it is clear that we are in the recovery phase. You wait for a big gain, in the range of 50%-100%, or until the media is more positive about the economy. Since the stock market tends to precede the economy by 6-12 months, you are that much too late. Since steep declines tend to be followed by 50%+ gains in less than a year, you miss great gains.

Here is a very common reason you can expect to fail with market timing, even if you got most things right: The stock market crashes, and after some time, it seems like the economy is going to go into a deep recession. People on the news predict a substantial recession, so you sell. You see the portfolio decline and you feel very successful about avoiding the continued decline. As you track the economy, you tell yourself: it is so clear that things are going to get much worse before they get better. Suddenly, your portfolio goes up and up, while the economy is still in a real decline. You keep expecting the portfolio to crash, to reflect the declining economy, but it doesn't. Then the economy starts recovering, and after realizing that things are looking much better, you buy back your portfolio at a higher price than your prior selling price. This is a direct result of the stock market reflecting the predicted future of the economy – not the current state.

Summary

Avoiding portfolio declines is very appealing. The idea of having some control when your portfolio suffers a substantial decline may be even more appealing than the increased long-term returns that could ultimately result.

Impressive long-term returns are the result of keeping the money invested through all the worst declines. When you try to time the market to avoid declines, you reject the impressive 15%-20% returns (as simulated historically), and instead make a bet on returns that can be as high as 50% or more, but also can be -30% or less per year. This activity is appropriate only for a true speculator, and even then the odds are very much against you.