

KRAEMER, SCHWAB & CO. AG

Investment Management

„It's time in the market, not market timing that counts“¹

Whenever a crisis breaks out and the stock market suffers a correction, the inevitable questions arise: “should we not sell and buy later at cheaper prices? Don't you see how bad things are? Is it not very likely that things will get worse before they improve again?”

We would like to make a couple of comments on two topics: what does it really mean to go through a correction in the stock market for a portfolio and is it possible to time the market in and out.

What does a stock market correction mean for a portfolio?

When stock prices go down, most people think they are “loosing money”, and we all know how painful this feeling is. As long term investors, we argue that volatility in prices does not mean necessarily “loss”: if the price of a company is below its intrinsic value, no matter how low this price may go in the short term it would not imply any loss unless the stock is sold and temporary volatility crystallizes in a permanent loss. Temporary losses even of large magnitude have been and always will be inevitable in a stock portfolio. In the long run, the market is a weighing machine that reflects the fundamentals and the intrinsic value of businesses, hence undervalued companies will see their stock prices rise again. A portfolio of good companies undervalued before the correction started and with some dry powder in terms of cash and short term bonds will actually benefit in the long run from a stock market correction, as prices of existing portfolio holdings will recover while volatility allows to take advantage of very cheap prices to snap up bargains in the market.

On market timing

Between 80% and 90% of the investment return on stocks occurs around 2% to 7% of the time. A study from American Century Investments shows that an investment of USD 10'000 in the S&P 500 made in 1990 would have grown to 51'354 by 2005. Had you missed the 10 best stock market days in this period of 15 years your nest egg would have grown only to USD 31'994 (38% less than a buy and hold strategy!), and missing the 50 best days you would have lost money and be left with USD 9'030: **had you missed the best 2 months over a 15-year period, you would have lost money instead of multiplying 5-fold your initial investment.** A study from Sanford Bernstein & Co shows that from 1926 to 1993 the returns of the best 60 months (or 7% of the time) averaged 11%, while the remaining 93% of the time the average monthly returns were close to zero!

This data is pretty strong evidence of how difficult it is to time the market: trading in and out of stocks based on your opinion that markets will continue to go down or will rebound implies the conviction to be able to pick the 10 or 50 right days in a 15-year period, a pretty ambitious goal! On the other hand, staying out of the market has also substantial risk: inflation erodes our nest egg every single day, and over long periods of time, well selected stocks provide probably the best hedge against inflation. Intrinsic value of stocks grows quite steadily over time, without much volatility, but not so stock prices. Emotions and psychology can provoke major volatility and sudden moves up or down: as a long term investor, the real danger is not to go through stock market ups and downs, but to be out of the markets in those times when big upward moves occur. The inevitable cost of long term financial reward is to endure temporary market declines.

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¹ Source: „The little book of value investing“, Christopher Browne