Session 30

Market Timing: Setting the table

Test

1. Looking at US market history, a good market timer would have generated higher annual returns over time than a good stock picker.
    a. True
    b. False
2. Which of the following explain return differences between active money managers?
    a. Entirely stock selection differences
    b. Entirely asset allocation differences
    c. Mostly stock selection differences
    d. Mostly asset allocation differences
    e. About half from security selection and half from asset allocation
3. One of the measures of the return enhancement from market timing is to look at the returns you would generate, if you were able to avoid investing in the market in the 50 worst months. How much of a return improvement did a study by Shilling find for investors, from being able to do this?
    a. Almost no change in returns
    b. A very mild improvement in annual returns (<2%)
    c. A moderate improvement in annual returns (2-5%)
    d. A significant improvement in annual returns (>5%)
4. One cost of market timing is that you may miss some of the best years in the market by choosing to be out of the market in those years. According to a study by Bill Sharpe in 1975, what percentage of the time would you have to be right, in telling a good market year from a bad one, for market timing to pay off?
    a. < 50% of the time
    b. About 50% of the time
    c. Between 50-65% of the time
    d. Between 65-80% of the time
    e. Between 80-100% of the time
5. If you decide to incorporate market timing into your investment philosophy, which of the following would you expect in your investing?
    a. Lower transactions costs and less taxes than if you did not time markets.
    b. Lower transactions costs and more taxes than if you did not time markets.
    c. Higher transactions costs and less taxes than if you did not time markets.
    d. Higher transactions costs and more taxes than if you did not time markets.

    Explain why.

Solution

1. Looking at US market history, a good market timer would have generated higher annual returns over time than a good stock picker.
    a. **True**
    b. False

Explanation: A good market timer would have earned much higher returns than a stock picker by avoiding investing during periods when the market is down.

2. Which of the following explain return differences between active money managers?
    a. Entirely stock selection differences
    b. Entirely asset allocation differences
    c. Mostly stock selection differences
    d. Mostly asset allocation differences
    e. **About half from security selection and half from asset allocation**

Explanation: While an early study suggested that almost all of the variation (>90%)came from asset allocation differences, more recent studies suggest a more even break, with 40% from asset allocation and 60% from stock picking.

3. One of the measures of the return enhancement from market timing is to look at the returns you would generate, if you were able to avoid investing in the market in the 50 worst months. How much of a return improvement did a study by Shilling find for investors, from being able to do this?
    a. Almost no change in returns
    b. A very mild improvement in annual returns (<2%)
    c. A moderate improvement in annual returns (2-5%)
    d. **A significant improvement in annual returns (>5%)**

Explanation: The Shilling study concluded that the annual return would have increased from 11% to more than 19%, if you were able to avoid the worst months of the market.

4. One cost of market timing is that you may miss some of the best years in the market by choosing to be out of the market in those years. According to a study by Bill Sharpe in 1975, what percentage of the time would you have to be right, in telling a good market year from a bad one, for market timing to pay off?
    a. < 50% of the time
    b. About 50% of the time
    c. Between 50-65% of the time
    d. **Between 65-80% of the time**
    e. Between 80-100% of the time

Explanation: The Sharpe study concluded that you had to be right about 70% of the time for market timing to pay off.

5. If you decide to incorporate market timing into your investment philosophy, which of the following would you expect in your investing?
    a. Lower transactions costs and less taxes than if you did not time markets.
    b. Lower transactions costs and more taxes than if you did not time markets.
    c. Higher transactions costs and less taxes than if you did not time markets.
    d. **Higher transactions costs and more taxes than if you did not time markets.**

    Explain why.

    Explanation: If you try to time markets, you will trade more frequently (as you sell stocks ahead of market downturns and buy them ahead of market upturns), which will increase both transactions cost and taxes.