Market Timing Techniques:

Its Use by Practitioners of Money Management

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Abstract

This study examines how practitioners actually manage money. We surveyed five thousand people asking them whether they use fundamental analysis, or technical analysis, or whether they let the markets do the work for them in an efficiency hypothesis approach. Most of them do not rely on the efficiency view, that is, utilize an index way to investing. The majority, by a wide margin, uses either fundamental, or technical analysis. Furthermore, we asked them whether they follow stock picking, or sector rotation, or market timing. The paper additionally elaborates on the detailed tools the practitioners consider in investing according to the market timing technique.

Keywords: Efficiency market hypothesis, Fundamental analysis, Technical analysis, Stock picking, Market timing, Sector rotation, GDP forecasting, Productivity, Fiscal policy, Financial conditions

1. Introduction

There are a few money management techniques practitioners use in the pursuit of successful portfolio management. The first is called top down, according to which money managers first consider present and forecasted economic, financial, legal, political, and social variables. They next examine the industry in which a particular firm operates. Third, they analyze the firm's prospects. Their decision depends on what their total analysis tells them from the top down method. The second technique is stock picking, in which the money manager disregards other variables and only emphasizes the issues of the individual firm (Bhatia.)

The third and last technique is market timing (Appel). Money managers in this camp consider the present and future conditions in three basic types of investments: cash, fixed income, and equities. They move money around based on where they think the economy will move and the security's price will be. If they expect economic growth will result, they increase their stock holdings and decrease their fixed income assets because equities will rise and fixed income will drop as a result of economic growth. If, on the other hand, investors project an economic decline, they will disinvest from equities and invest in cash and fixed income. Cash holdings will not allow them to lose, while fixed income investments will rise in value, since yields will decline. If money managers expect the price level to increase, they will disinvest, especially from fixed income as well as stocks, and invest in cash and real estate, but if they expect disinflation, then investors will move from cash into equities and even more into fixed income (Jasemi, Kimiagari, & Memariani).

The basic approach of market timing has three variations. One is the pure market timing approach, in which money managers attempt to project alterations in the economy without consideration for individual investments or sectors (Weigel.) The second variation of market timing includes the actions of the first, but in this case practitioners invest or disinvest in certain industries/sectors more than others. This approach is called sector rotation, as the financial management professionals do not pay attention to individual companies within an industry or sector. In the third flavor of market timing, practitioners also follow sector rotation and stock picking. Thus, if practitioners decide that GDP will expand, they shift money from fixed income to equities. Next, they decide that since an early bull market

will occur, they invest in sectors that do better in an early bull market. Finally, they choose several particular companies in the sectors they have already chosen. This third approach is actually similar to the top down technique described earlier (Crane).

The benefits of market timing can be quite profitable. Siegel (1991) has estimated that for every month for which money managers forecast that the economy will change and then invest appropriately, they receive one additional percentage point rate of return on their investments. Market timing, however, is a risky technique. First, if we use the simple approach, then we disregard analysis of individual firms and so we could then invest in several unprofitable companies. (Coggin, Fabozzi and Rahmann.) If we follow the second strain of market timing, then, in addition to the above weakness, we could exacerbate any losses by investing in the wrong industries/sectors. Finally, the third variation may have three drawbacks: the forecast may be incorrect such that the opposite may happen in the economy; sector rotation may occur into the wrong industries; and the cost is higher because we need to do all three approaches. (Chen, Chan and Mohan.)

2. Review of the Literature

The diverse techniques money managers use relate to whether the economy will decline or expand. Alterations in the gross domestic product follow alterations in the level of the stock market. Therefore, if we can foretell GDP developments sufficiently far ahead, we can foretell movements in the stock market because stock market movements occur earlier than changes in the economy. Of course, the difficulty lies in that forecasting the economy in order to predict movements in the stock market is contrary to evidence indicating that changes in the stock market foreshadow alterations in the economy. We do that nevertheless, since many techniques have been developed to forecast the economy and we now have more accurate tools to assist us in doing so (Moore & Cullity).

The usefulness of inflation is twofold. First, if inflation rises (falls), the GDP also rises (falls) as a corroborative indicator. Second, the inflation rate is a critical determinant of the discount rate. So, inflation rises (falls) foreshadow cost of equity rises (falls). These movements affect the price of equities, since they affect the present values of cash flows (Chen, Roll, & Ross).

Equally important as inflation expectations are financial conditions. Numerous studies have shown that monetary aggregates and inflation relate quite closely. Even though there is a debate about which is the cause and which is the effect, the unequivocal fact remains that they strongly correlate positively. If we can use the alterations of interest rates, we can understand the aforementioned relationship. Therefore, if interest rates decrease (increase) due to expansionary (contractionary) monetary policy, yields decrease (increase) and bond prices rise (fall) (Bhaduri & Saraogi). At the same time, the risk free rate in a CAPM context declines (rises) and so does the cost of equity: if the cost of equity falls (rises) ceteris paribus stock prices increase (decrease) (Dudley & Hatzius).

Productivity of labor should be an important component of equity value. Productivity increases (decreases) indicate economic growth (decline) because when GDP increases (decreases), employers delay in hiring (laying off) employees. Consequently, output per employee rises (falls). Productivity alterations also affect inflation expectations. If productivity rises (falls), without any commensurate change in the costs of production, then profitability rises (falls) for businesses. In the case of a rise in productivity, they may raise prices to raise profit, although they do not have to do so. In the second case, however, businesses have to raise prices to diminish the reduction in profitability, with the result being inflation.

We propose three choices which show the importance the foreign sector has on GDP. Exports minus imports is a component of GDP. If foreign income grows (declines), it will induce GDP to grow (decline). Foreign exchange rates should be chosen by the portfolio managers because they affect the competitiveness of the United States versus other nations and they influence net exports and GDP. The last variable relating to the foreign sector is trade issues. This answer refers to trade policies which help domestic producers and hurt foreign ones. Again, these policies will either expand exports (decrease imports) and enhance GDP, or they will do the opposite, thereby either helping or hurting economic activity and by implication affecting the stock market positively or negatively.

Money managers utilize indicators to foretell economic activity. They should choose leading, coincidental, and lagging indicators so they can invest their capital according to their expectations, respectively. Finally, they likely emphasize fiscal policy, since it is important as a component of the Gross Domestic Product and also of employment (Moore and Coolity).

3. Design of the Research

We want to discover the approaches which the people in the trenches take in actually managing portfolios. We have to use a survey instrument to understand their actions. The survey instrument we include at the end of the study.

There are three questions we ask them. The first is a question on whether they use fundamental analysis, or technical analysis, or the efficiency market hypothesis. The second question we want our respondents to answer, whether they use stock picking, sector rotation or market timing. Those, as we have already discussed, are three main ways of managing money. The third question we pose to the portfolio managers is to specify the exact technique they use, if they prefer market timing. We want to discover what the practitioners of portfolio management actually do in terms of market timing (Benson, Pope, & Faff).

Therefore, we sent a questionnaire to five thousand practitioners of money (financial advisors) and we asked them the three questions we mentioned above. We resent the questionnaire to the practicing money managers four times altogether. That is, we resent the survey to the people who did not respond the first time. If they responded the second time, we would resend it to those who did not respond the second time and so on. Pursuing the method we just described enhanced the response rate of our sample.

4. Results of the Study

We received five hundred and seventy (570) responses saying that they pursue fundamental analysis. Four hundred and thirty two of our respondents said they use technical analysis. Thus, a significant number of practitioners do not espouse the efficiency view and they believe they can do better than the averages by following diverse patterns of investment.

Second, out of the five hundred and seventy people eighty-seven percent chose the stock picking technique, sixty-eight percent follow the technique of sector rotation, and sixty-three percent pursue market timing. Obviously, money managers use a combination of market timing, sector rotation, and stock picking approaches, but their number one choice is stock picking.

Third, we asked them which specific tools do they use to forecast market turns. It is not surprising that portfolio managers' number one choice is forecasting GDP, at eighty-four percent, and business sentiment receives the next greatest vote, at eighty-one percent. There are two reasons for these particular results. First, business sentiment relates to real investment, an important component of GDP; second, real investment is volatile and causes volatility in the GDP. Consumer expectations receive the next largest vote, at seventy-eight percent. Consumption is by far the biggest and therefore the most important portion of GDP, such that turning points in consumption are turning points in the economy. An additional benefit in asking consumers about their expectations is that we can find out their mental state, which could indicate whether they will invest in the stock market. However, we have to be wary in dealing with sentiments because they sometimes do not translate into actions. (Fama & French, 1989).

The fourth most important choice is inflation, with sixty-nine percent (Reilly). As we have described inflation importantly influences discount rates, which in turn affect present values of financial assets. Financial conditions expectations receive the same emphasis indicating that our market does not differentiate between inflation and financial conditions.

Our respondents next valued productivity, at sixty-eight percent. As we have argued, productivity determines inflation and profitability, so it becomes crucial.

We next asked them a series of questions on the matter of the foreign sector and its effect on the technique of market timing. Money managers responded that they emphasize foreign growth rates, at sixty-one percent, foreign exchange rates, at fifty-six percent and trade issues fifty-two percent, respectively

5. Conclusion

Market timing is a widely followed investment technique. In this study we give evidence that it is used by itself, or in combination with sector rotation, and/or in addition with stock picking. Practitioners utilize diverse methods to forecast the economy and effectuate market timing. Several of the important methods they use are projecting GDP, through the usage of barometric approaches, projections of consumer actions, fiscal and monetary policies, productivity reports and foreign activity.

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APPENDIX

Question one

Which of the following Techniques do you Use?

1. Fundamental Analysis ---570--------
2. Technical Analysis ---432--------
3. Efficiency Market Hypothesis-----50------

Question two

If you use fundamental analysis, which technique do you use?

1. Market timing ----361----------
2. Sector rotation ----388----------
3. Stock picking ----496----------

Question two

If you use market timing as a technique, on which of the following do you put more weight in forecasting the economy?

1. Indicators

a. Leading ------188----------

b. Lagging ------177----------

c. Coincidental ------155----------

2. Inflation ------249----------
3. Productivity ------245----------
4. Fiscal policy ------159----------
5. Financial conditions ------249----------
6. Consumer expectations ------282----------
7. Surveys of business sentiment ------292----------
8. Forecasts of GDP ------303----------
9. International factors

a. Exchange rates ------202----------

b. Trade issues ------188----------

c. Foreign growth rates ------220----------