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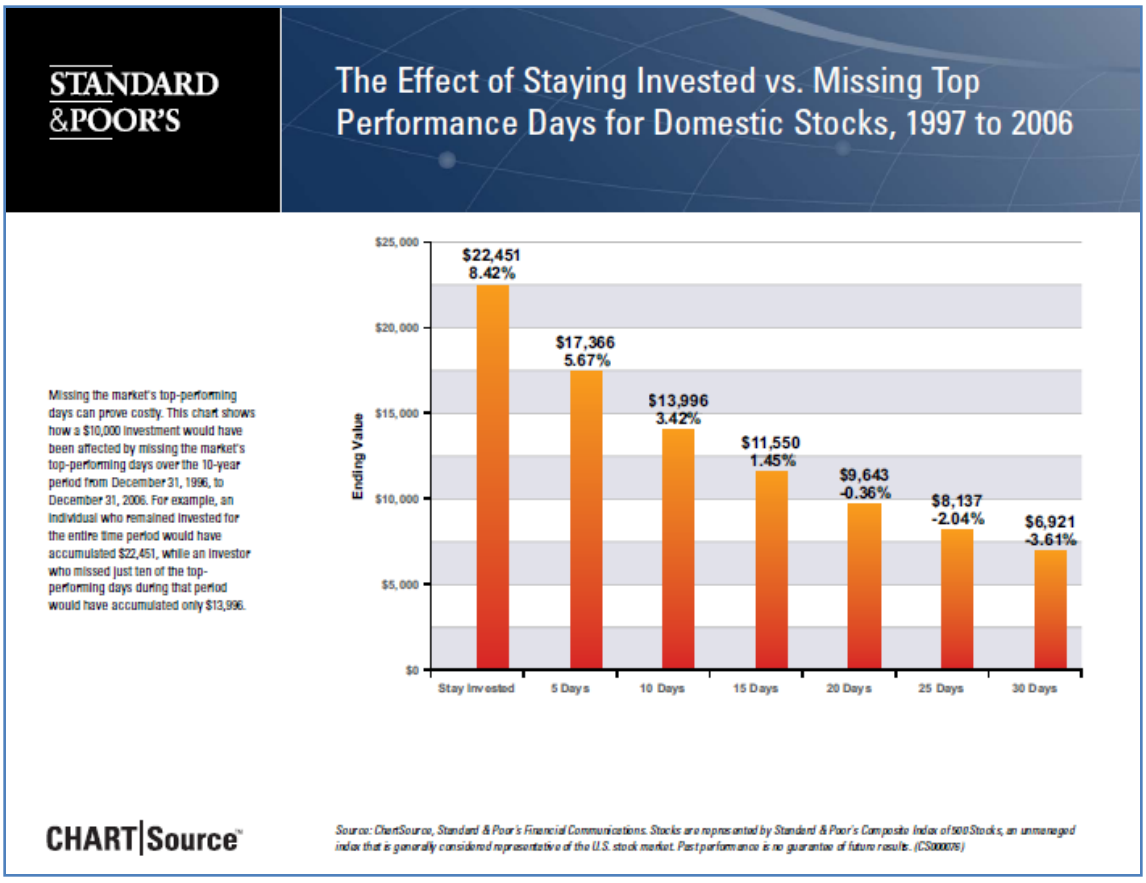
Lies, Damned Lies, and Investment Performance

Mark Twain said "There are three kinds of lies: lies, damned lies, and statistics." His point was that through the judicious selection of data, statistics can be manipulated to prove just about any point a person wants to make. If this is true (and I wouldn't want to argue with Mark Twain), investment performance falls firmly into the same category.

Timing the Market vs. Time In the Market

Arguments for and against the loosely-defined "market timing" is an area that takes the most liberties when it comes to quoting investment performance numbers. If I want to make a case for a buy-and-hold strategy, I can argue that pulling money out of the market could cause an investor to miss a big market day. A quick search on Google reveals a long list of websites and articles that follow this general theme: *If you had invested $10,000 at such and such a date and kept it invested, you could now retire early and send your kids and grandkids to Harvard. But if you missed the [10 best months/best month each year/5 best days each month/etc/etc], your investment would now be practically worthless. Obviously, Time In the Market is better than trying to Time the Market.*

A typical example is a chart from Standard & Poor's Financial Library shown below. This chart can be found all over the web in articles arguing against market timing.



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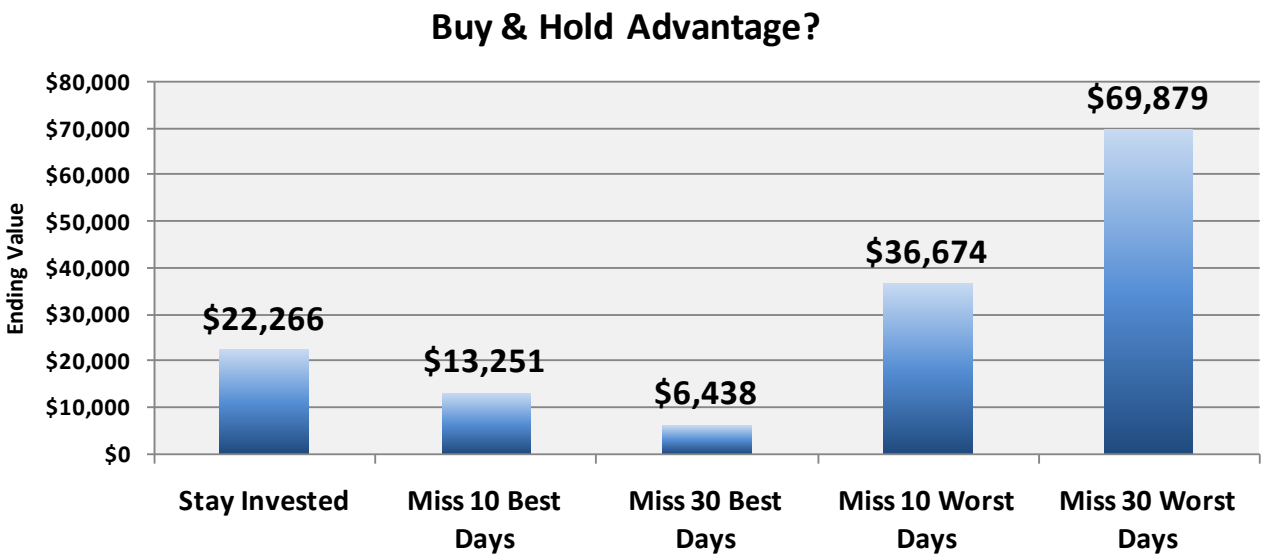
The chart is pretty impressive, showing a $10,000 investment growing to $22,451 with a buy-and-hold approach, and shrinking to $6,921 if your timing system was so bad that you missed the 30 best days. The conclusion stated on the left side of the slide says "Missing the market's top performing days can be costly". But isn't creating a system that only misses the best performance days somewhat arbitrary? If arguing ***against*** a timing system that somehow manages to miss the best performance days is valid, then arguing ***for*** a system that misses the worst performance days should be equally valid. The problem is that missing the worst days is even more impressive. The results of the $10,000 investment are shown below.



The point here is not to argue for market timing (I'll do that in other articles), but to recognize that setting up an arbitrary and ridiculously bad straw-man performance system and then using it to justify a strategy would certainly make Mark Twain skeptical.

Historical Return Of the Stock Market is x%

The superior long-term performance (or lack of performance) of stocks is often used to justify portfolio allocations, indexing, actively-managed mutual funds, etc. After all, U.S. stocks have returned an average of 10.3% per year. Or they have been flat for over 4 decades when adjusted for inflation and excluding dividends. Or they have underperformed bonds. All of these statements are true in the right context and with enough disclosure. The long-term performance of stocks is a wonderful and dangerous tool because there are so many degrees of freedom with which to play. If I want a good long-term number, I can start my performance analysis in 1908 and end it in 2007. However, if I start in 1929 and end in 2008, I get a very different number. Going back to using stock performance to justify the buy-and-hold argument, the DJIA has had a couple of periods that work very well to support buy-and-hold. From 1943 to 1962, the DJIA had an average return of about 8.2%, and from 1982 to 2000 the return was around 12.9%. However, 1900-1943 (2.3% annual return), 1962-1982 (2.4% per year), and 1996 to 2009 (0%) could all be used to argue the exact opposite point. I recently saw a chart of the DJIA adjusted for inflation and excluding dividends. When looking at the market this way, the market is currently at about the same level it was in 1966. Even more interesting was that you could draw a straight line on the chart between 1929 and 1992. This data could be used to justify market timing, or a bond portfolio, or real estate investing…you

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name it. Now many may argue that you can't disregard dividends (although lately there are an awful lot of dividends being cut), and that the definition of inflation is up for interpretation, but however we massage the data, it can still be used to justify practically any argument…just like statistics.

How Should We Use Performance?

The only data we have to go on is past performance, so obviously we can't throw out the data simply because it can be easily manipulated. However, an awareness that data can be selectively chosen to justify our own biases is important, especially since this can be done subconsciously. In severe bear markets, it is easy to point back to the latest bull market and convince ourselves that things will quickly get back to "normal" if we just hang on a little longer. If normal is defined as consistent 10.3% returns, there are long periods in the market that don't support this. It is also easy to use the most recent market performance to justify staying away from traditional investing, as evidenced by the number of complex annuity-like products that seem to be springing up. The key thing is to maintain a good dose of skepticism whenever performance data is used to justify an argument, and always ask "does this make sense". Ignoring the best market performance days but including the worst days to "prove" a point should raise some red flags.

By Jerry Verseput, CFP®