

## The perils of market timing: How managed futures can smooth the ride

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Investing can be nerve-wracking, especially when volatility reigns, as today. With the daily financial news driving vicious swings in stock, bond, commodity and currency values, it is easy to forget that holding a diversified portfolio and keeping a long-term perspective are the only ways to survive.

As legendary investor Peter Lynch once said, “The real key to making money in stocks is not to get scared out of them.”

A recent study lends credence to Mr. Lynch’s precept. It shows that over the 25-year period ended in mid-2007, the Standard & Poor’s 500 stock index had an average annualized return of 10.7%, turning a \$10,000 stake into almost \$140,000. If, however, an investor were out of the market on just the 30 days when the S&P 500 had its greatest gains — out of a total of 6,300 trading days — his or her investment would have grown to only about \$45,000.

The perils of being a nervous investor are even more dramatic when one looks at the 10 days that saw the greatest rise in the S&P 500.

Three of those occurred in the two weeks following Black Monday in October 1987, and four came during the 2001-02 bear market. Two others came in late 2002 at the beginning of the stock market recovery.

Skittish investors would have garnered little benefit from these profitable days, as they were likely on the sideline, nursing their financial wounds. Long-term diversified investors, by contrast, would have maintained their investment during those chaotic times and reaped the market’s substantial rewards.

Clearly, stocks are only one component of a diversified portfolio. Peter Lynch’s “stay invested” admonition applies to an investor’s entire portfolio, and is especially pertinent to managed futures.

An investor may look at a sustained period when managed futures underperform equities and consider liquidating his or her managed futures holdings. Similarly, during periods of sustained positive re-turns, a managed futures investor may feel that he or she has “had a good run lately” and consider taking profits.

In either case, the investor would be making a mistake.

Managed futures, as measured by the CASAM/ CISDM CTA asset-weighted index, gained 43% from 2003 through 2007. Missing just the best eight months in that period, however, would have virtually wiped out the entire gain.

Because it is impossible to discern market tops and bottoms without the benefit of hindsight, market timing is extremely difficult.

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Academic research has confirmed the futility of this pursuit. Again and again, studies have shown that assembling a diversified portfolio of minimally correlated assets is key to financial performance; maintaining this diversification through all market cycles is absolutely essential.

It has been 25 years since the late John V. Lintner of Harvard University in Cambridge, Mass., studied the potential role of managed futures in a portfolio. His research concluded that the returns of managed futures funds were largely uncorrelated with either stock or bond performance and that portfolios containing managed futures funds had better risk-reward ratios than conventional portfolios.

Much has changed over the past 25 years in markets generally, and managed futures specifically, but Mr. Lintner's conclusions continue to be reinforced by subsequent studies. Among recent studies, the Center for International Securities and Derivatives Markets at the University of Massachusetts in Amherst, Mass., found that "managed futures offer risk and return opportunities not easily accessible with investment in traditional as well as other alternative asset classes."

In the 2001-05 period, for example, managed futures offered higher returns with less volatility than the S&P 500. Over that period, the CASAM/CISDM CTA asset-weighted index returned an annualized 7.65%, with an annualized standard deviation of 8.22%; the S&P 500 gained just 0.54% annualized, with a standard deviation of almost 15%.

The value of holding managed futures as part of a diversified portfolio is in evidence during both bear and bull stock markets.

From 1983 through 2007, the S&P 500 declined by more than 5% in 21 of 300 calendar months. Managed futures lost money in just four of those 21 months.

In all four cases, the losses were much smaller than the stock market benchmark.

When the S&P 500 gained more than 5% in a calendar month, which it did in 47 months, managed futures lost money in only 18 of those 47 months.

Borrowing an insight from Mr. Lynch, the best course in investing in managed futures is to allow one's portfolio to garner the full benefit of this unique asset class and "not to get scared out of them".

Past performance is not indicative of future results. The risk of loss exists in futures trading.