

WEALTHWISE

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Market Timing Can Be a Costly Gamble

Since the first U.S. stock market was formed by a group of New York brokers in 1792, investors have employed various strategies in an attempt to "time" it. Transferring assets in and out of equities based on a prediction of the direction and extent of the next price movement in the stock market is a practice commonly referred to as "market timing". Although many consider market timing an investment strategy, the extremely low odds of success suggest that market timing is more akin to gambling than to investing.

In 1994, Towneley commissioned a study by Dr. H. Nejat Seyhun, Chairman of the Finance Department at the University of Michigan, measuring the impact of short term stock market fluctuations on long term investment performance, and the implications for market timers. After analyzing historical data from the years 1926-1993, Professor Seyhun concluded that practically all of the market's gains or losses over decades occurred during only a handful of days or months, making market timing even more difficult and risky than previously believed. Over the past 11 years, the study and its findings have often been cited by other researchers in the field. In 2005, Towneley again approached Professor Seyhun and asked him to update his earlier work. The new study incorporates an additional 11 years of market data, from 1926-2004, and reinforces the earlier study's conclusions. Most notably:

- If \$1 was invested in the stock market in 1963, by 2004 it would have grown to \$75, reflecting an average annual return of 10.8%. But if the best 90 trading days are set aside (less than 1% of the 10,573 trading days during those 42 years), the return shrinks to a mere \$2.70.
- To compound their pain, those investors who missed the best 90 trading days endure almost as much market risk as a full-time stock investor over the same 42-year period. However, their average annual return is only 3.2% for the whole period —about half the return from a full-time investment in risk-free Treasury Bills.
- Just as missing the market's best days can devastate returns, avoiding its worst days can significantly boost returns. If the 10 worst trading days from 1963-2004 are eliminated, the cumulative return for the period more than doubles from \$74 to \$155. If one sidesteps the 90 worst days, the cumulative return soars over 2000% to \$1,694.

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Rebalancing Without Missing the Market

As Towneley's market timing study illustrates, missing only a few of the market's best performing days can devastate long-term returns. Investors who employ multiple portfolio managers risk being out of the market at the wrong time when rebalancing their overall allocation. It is not unusual for portions of separately managed accounts to sit in cash for several days or weeks as assets are transferred between managers and finally reinvested. Towneley minimizes this risk by utilizing an effective strategy which allows us to rebalance our clients' mutual fund portfolios generally within a 24-hour period. In this way, we keep our clients invested as much as possible to enable them to benefit from even small moves in the market.

Market Timing Can Be a Costly Gamble *(continued)*

- During the 79 years from 1926 through 2004, a \$1 investment grew to \$1,920 (an average return of 10.04% per year). However, 95% of that gain occurred during just 48 months scattered throughout the 948-month span. If the best 48 months are missed, the cumulative 79-year return tumbles to a paltry \$6.46, reflecting an average annual return below that of Treasury Bills. The investor who misses the best 48 months also endures 80% of the market risk assumed by investors who remain invested in stocks over the entire 79-year period.
- The monthly data indicates that a perfect market timer, one who always correctly anticipates market fluctuations, would have turned a \$1 investment in January 1926 into \$20 billion by December 2004. In contrast, an inept timer, one who always does the opposite of the perfect timer, would have turned \$100 million into \$1,000 over the same time period.

As the study illustrates, rewards for perfect market timing are indeed attractive, yet virtually unobtainable. In terms of the monthly data, consider a market timer who is right 50% of the time. The probability that he will execute a perfectly timed investment strategy is 0.5 raised to the 948th power – or nearly zero. "Because so very few trading days or months can make or break a strategy based on attempts to time the market, the study proves the best practice for investors is to remain invested in a diversified portfolio, regardless of market fluctuations," Towneley President, Tracy Kuntz, explained. "A strategy that includes a suitable asset allocation target, low cost investments, regular contributions and a long-term investment horizon, is your best bet for achieving your investment goals."

The foundation of Towneley's investment strategy is asset allocation that reflects each client's particular goals, needs and risk tolerance. The appropriate allocation for one investor may not be suitable for another, so Towneley creates a diversified portfolio just for you or your organization, after considering your time horizon, needs, goals, risk tolerance and other factors. A diversified portfolio should include exposure to several different asset classes and, in the case of mutual

funds, investment styles. Funds held for short-term goals belong in fixed income and cash equivalents. Funds held for the longer term need some equity exposure just to keep pace with inflation, and more to generate additional capital. Once your portfolio is properly allocated, Towneley periodically reviews and rebalances it as necessary to maintain your target allocation.

When reviewing your portfolio, don't overlook the impact that internal expenses, such as trading costs, commissions and mutual fund fees, can have on performance. Over time, even a small difference in investment expenses can have a huge impact on returns. Your best bet to minimize expenses is to invest in a diversified portfolio of no-load, low expense ratio mutual funds, a strategy pioneered by Towneley for its Multiple Mutual Fund Program clients.

Smart Investing: Dollar Cost Averaging

"Dollar-cost averaging" is an investment strategy designed to move cash into the securities market over time, rather than all at once, to minimize the impact of market fluctuations. The strategy can be used to invest a lump sum in the market, and for periodic contributions. To implement the strategy, invest a fixed dollar amount in one or more securities on a regular schedule, regardless of the share price. To make the process easy, set up automatic transfers from your bank account on a monthly basis. In months when prices are higher, your funds buy fewer shares. When prices are lower, you acquire more shares. Overall, this strategy helps you avoid the market timing urge, and makes saving for the future relatively painless.

averaging schedules for clients.

Probably the most difficult thing for investors to do is to stay the course when the market fluctuates widely. A properly allocated portfolio and an experienced, knowledgeable portfolio manager who is only a phone call away can help you resist the urge to move to cash when the market drops, or to overload on equities when the market surges. As Towneley's two market timing studies have made abundantly clear, the odds of successfully timing the market on a consistent basis are virtually zero. You're better off taking the bad days with the good days, rather than trying to guess which is which. ■

If you would like to receive a complimentary copy of the complete market timing study, please contact Robert Seaman at 800-545-4442 or rseaman@towneley.com.

Investment Policy Statements: Blueprints For Prudent Investing

All foundations, associations and other nonprofit institutions with assets to invest should have a written investment policy statement (IPS). An investment policy statement is a lot like a blueprint for the management of a portfolio. It spells out the roles of the various parties and the process by which the account is to be managed and monitored. A good IPS helps foster communication between advisor and client, and helps everyone to understand their duties and responsibilities.

In most states, the Uniform Prudent Investor Act or similar legislation obligates nonprofit and charitable organization boards of directors to invest their organization's funds in a reasonably prudent manner, or to delegate those investment responsibilities to a manager who will act in a like capacity. A properly crafted IPS can help board members discharge their investment obligations, and thus protect themselves from personal liability. In addition, a well-written IPS can aid fundraising efforts by providing a means for easily communicating the organization's investment policies to others.

To properly fulfill the Board's investment obligations, the investment policy statement should do the following:

1. Identify the organization's goals, needs, risk tolerance and time horizon;
2. Establish portfolio composition, asset allocation targets and performance objectives for the invested assets;
3. Provide guidance for monitoring and evaluating investment manager and portfolio performance;
4. Assign responsibilities among all parties involved with the investments.

Most IPS' begin with a statement of purpose. This statement generally acknowledges the Board's investment obligations and the mission and objectives of the organization itself. The IPS next identifies the parties, generally the Board, investment committee, consultant (if any) and investment manager, their responsibilities in the investment process, the identities of contact persons, and other relevant matters. Organizations should create a separate IPS for each investment manager, incorporating that manager's advice concerning portfolio composition, asset

allocation targets, risk tolerance and performance measures.

Many organizations include a spending policy in their IPS, particularly non-operating foundations subject to the IRS' 5% distribution requirement. Liquidity needs affect risk tolerance, asset allocation targets and performance, all of which should be identified in the IPS. Keep in mind, however, that asset allocation and security selection drive returns only so far. If the organization's spending needs exceed reasonable long term net return expectations, fundraising targets must be increased to ensure perpetual existence.

Asset allocation targets should be presented in a range, with the board or investment committee empowered to determine the exact allocation. This enables the board or investment committee, in consultation with the investment manager, to alter the mix of stocks, bonds and cash within the range without having to amend the IPS.

The IPS should address the investment strategy for each portfolio separately, and include discussion of diversification, risk/return expectations, asset classes, rebalancing and prohibited securities, if any. Establishing the benchmarks and criteria for

reviewing both portfolio and manager performance is also an important function of the IPS. Benchmarks should be realistic and a good fit for the investment portfolio or for the different asset classes within the portfolio. For example, the S&P 500 Index is not a meaningful measure of performance of a diversified portfolio invested in large, medium and small cap domestic stocks, bonds and international securities; although the index may be a good benchmark for the domestic large cap stock portion of the portfolio.

In addition to the broader concepts discussed above, the IPS can also address more specific issues, such as handling cash balances, investing large lump sums, socially responsible investing, and investment manager selection. To be most effective the IPS should allow as much flexibility as possible, yet also require that the board of directors or investment committee formally approve all investment policy changes before any changes are made to the institution's investment portfolio. ■



Focus Individual Investing with an IPS

Written investment policy statements are not just for foundations and other nonprofit organizations; individual investors can benefit from an IPS as well. A well-written, thorough IPS can help squelch the market timing urge by providing a purposeful plan for staying the course, particularly when emotions may nudge you to change direction. To be effective, however, your IPS must be personalized to reflect your particular goals, needs, risk tolerance and time horizon. An IPS designed for an

institutional client is not appropriate for an individual or a trust. For example, individuals and trusts have finite time horizons, whereas most institutions seek perpetual existence. Other issues such as tax sensitivity may be relevant for some individuals and trusts, but not for nonprofits or retirement plans which are usually tax-exempt. The investment professionals at Towneley can assist you in designing an investment policy statement that is just right for you.

Towneley's Multiple Mutual Fund Program: A Better Bet for Investment Growth

Towneley's Multiple Mutual Fund Program ("MMFP") is a better bet than market timing for growing your investment dollars. The MMFP offers less risk because portfolios are diversified and allocated among asset classes according to your needs, goals and time horizon, and rebalanced only when necessary. Our 35 years of investment experience have convinced us that a strategically designed portfolio of no-load mutual funds offers most investors greater diversification than individual stock and bond portfolios, with superior risk-adjusted returns. The MMFP provides a lower cost alternative to market timing because Towneley uses only no-load, low expense mutual funds and Towneley pays all trading costs.

Towneley's portfolio managers work closely with each client to understand the client's overall financial situation and to develop reasonable investment goals, which then form the basis for that client's portfolio design. Our investment professionals analyze thousands of mutual funds to identify the most efficient risk/reward combinations. To help manage risk, we create portfolios with a mix of funds that invest in different markets, such as domestic and international equities. Within a market, we may select funds that employ different strategies, including index funds and managed funds, value and growth funds, and large company and/or

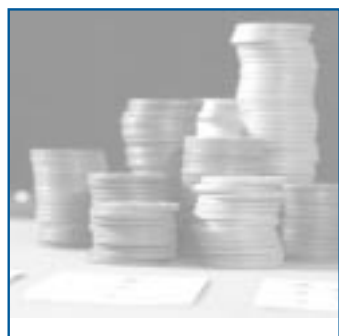
small company funds. The resulting personalized portfolio of 15-20 mutual funds exposes the client to more than 1,000 individual stocks and bonds and several different asset classes that rise and fall in value at different times.

As a fee-only registered investment advisor, Towneley does not accept commissions, 12b-1 fees or kickbacks. Our MMFP clients pay

only one fee for all of our services based on a percentage of assets under management. Towneley's fees are among the lowest available for customized investment management that also includes detailed quarterly and annual reports and access to financial planning assistance and advice for individuals and institutions.

Don't gamble with your financial future. To learn more about Towneley's Multiple Mutual Fund Program, contact Towneley Capital Management, Inc. at 800-545-4442. We will be happy to discuss how we can create and implement an investment strategy specifically designed for you or your organization. ■

*Coming in the Spring 2006 edition of WealthWise:
"The Next Generation of Global Investing".*



TOWNELEY CAPITAL MANAGEMENT, INC. INVESTMENT COUNSELORS

