

MUTUAL FUND PROSPECTOR



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Academic Alley – “Equity Style Timing”

I recently read an interesting study related to the allocation strategy I use to manage the Prospector’s model portfolio. The study was done by two employees of General Motors Investment Management Corporation, Duen-Li Kao and Robert Shumaker. The study, “Equity Style Timing” appeared the Jan/Feb 1999 issue of the Financial Analysts Journal.

Without delving into all the methodology and statistical formulas, I would like to share some of the major findings of the study. I encourage interested readers to pick up a copy from their local library for some light summer reading at the beach <grin>.

The authors were quick to point out there have not been many studies on what drives cyclical style return differences or whether and how tactical style allocation can be effectively achieved. This statement reinforces my notion, that the Prospector’s strategy of market style trend following, is not widely practiced or even studied by market researchers.

I found the following statement very intriguing. “Timing strategies based on size, style and market have been attractive to investors as potential sources of added value.” In their study, Kao and Shumaker set out to determine what the benefits of equity style timing would be to investors successfully employing a “perfect” timing system.

Academic studies like this one, often show what the “excess returns” (performance beyond the average market return) could be, if an investor had the benefit of perfect foresight in making investment decisions. The results show there are significant opportunities for excess returns, if an investor can successfully invest in the correct market style at the right time.

The study looked at three types of style timing: size (large cap vs small cap), style (value vs growth) and market (stocks vs cash). Kao and Shumaker analyzed market returns for the period of January 1979 through June 1997.

They looked at performance if an investor made perfect timing decisions every month and every year. As you would predict, making the correct investment decision every month increases returns substantially compared to once a year.

The results show perfect size selection by market cap could add 20%-27% annually to market returns with monthly decisions and 7%-10% with annual decisions. Granted, these are perfect decisions, but the excess returns are phenomenal! Annual excess returns of 7%-10% would make Peter Lynch look like a rookie stock picker!

Perfect, value versus growth, selections would garner higher market returns, 24%-34% with monthly decisions and 8%-11% with annual decisions. The

perfect world of market timing does the best of the three styles with returns of 48% and 15% with monthly/annually decisions. Next month I’ll report on some recent, actual market timing results. (Hint - this doesn’t work.)

The results of this study demonstrate the substantial opportunity associated with style allocation strategies, however, capitalizing on the opportunity remains a work in process.

Two final thoughts...First, it is a proven fact, index funds provide superior long term returns. Second, equity style timing offers a substantial opportunity to outperform the market averages.

Follow the Nuggets!

Benefit of Equity Timing Strategies

Size	Large Cap	Small Cap
Monthly	20.8%	27.3%
Annual	7.0%	10.4%
Style	Value	Growth
Monthly	24.6%	34.5%
Annual	7.8%	11.4%
Market	Mkt/Cash	Bonds
Monthly	48.2%	43.2%
Annual	15.4%	12.6%