



ASSET ALLOCATION

One Reason Not to Avoid Market Timing

August 5, 1998

AQR Working Paper

From 1970–1996 the compound return on a portfolio of stocks mimicking the S&P 500 was better than the return from rolling over 1-month T-bills or from investing in long-term bonds. An investment in an “S&P 500 portfolio” of stocks for the full time period minus the stock market’s six best months, would have led to a return equal to that of long-term bonds. Being out of the stock market for the best 13 months would have led to T-bill return.

In others words, missing only 13 months out of 27 years (324 months) would have eliminated the entire return premium for stocks versus T-bills, while retaining all of the stock market’s risk!

Severe consequences of this type are often used as an argument against “market timing,” often by those with a vested interest in keeping investors in stocks. However, there is a problem with the above line of reasoning. Examining only the potential harm from timing is entirely one-sided. The potential benefits to timing are of similar magnitude to the potential losses.

This paper does not advocate market timing. In general, like all active management, market timing should be undertaken only to the extent an investor feels his skills overcome the hurdles. If investors believe they have no skill after hurdles (call this net skill), we believe they should not time the market at all. Investors with a small amount of net skill should only allow small deviations from the otherwise optimal passive market portfolio. Only for investors who truly believe they have a large amount of net skill (a presumably rare event) are large market timing bets rational.

This document is not intended to, and does not relate specifically to any investment strategy or product that AQR offers. It is being provided merely to provide a framework to assist in the implementation of an investor’s own analysis and an investor’s own view on the topic discussed herein.

This document has been provided to you solely for information purposes and does not constitute an offer or solicitation of an offer or any advice or recommendation to purchase any securities or other financial instruments and may not be construed as such. The factual information set forth herein has been obtained or derived from sources believed by the author and AQR Capital Management, LLC (“AQR”) to be reliable but it is not necessarily all-inclusive and is not guaranteed as to its accuracy and is not to be regarded as a representation or warranty, express or implied, as to the information’s accuracy or completeness, nor should the attached information serve as the basis of any investment decision. This document is not to be reproduced or redistributed to any other person. The information set forth herein has been provided to you as secondary information and should not be the primary source for any investment or allocation decision. Past performance is not a guarantee of future performance. Diversification does not eliminate the risk of experiencing investment losses.

This material is not research and should not be treated as research. This paper does not represent valuation judgments with respect to any financial instrument, issuer, security or sector that may be described or referenced herein and does not represent a formal or official view of AQR. The views expressed reflect the current views as of the date hereof and neither the author nor AQR undertakes to advise you of any changes in the views expressed herein.

The information contained herein is only as current as of the date indicated, and may be superseded by subsequent market events or for other reasons. Charts and graphs provided herein are for illustrative purposes only. The information in this presentation has been developed internally and/or obtained from sources believed to be reliable; however, neither AQR nor the author guarantees the accuracy, adequacy or completeness of such information. Nothing contained herein constitutes investment, legal, tax or other advice nor is it to be relied on in making an investment or other decision. There can be no assurance that an investment strategy will be successful. Historic market trends are not reliable indicators of

actual future market behavior or future performance of any particular investment which may differ materially, and should not be relied upon as such. Diversification does not eliminate the risk of experiencing investment losses.

The information in this paper may contain projections or other forward-looking statements regarding future events, targets, forecasts or expectations regarding the strategies described herein, and is only current as of the date indicated. There is no assurance that such events or targets will be achieved, and may be significantly different from that shown here. The information in this document, including statements concerning financial market trends, is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons.