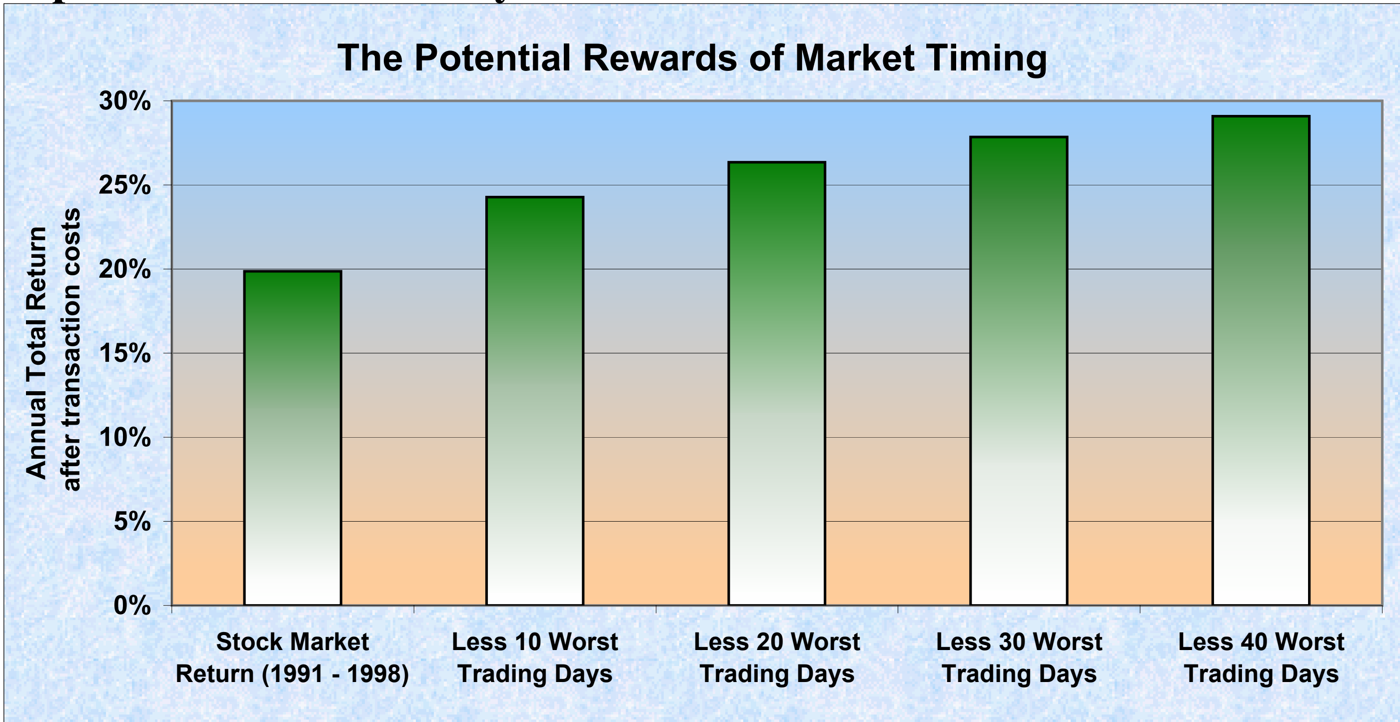
April 2004 Commentary

MADISON FINANCIAL ADVISORS



Market Timing - Tempting, but Impossible in Practice

Many investors are intrigued by the idea that it is somehow possible to invest when the market is in a bull phase and hibernate when the market goes into a bear phase. In fact, there is a large industry dedicated to producing publications that advise investors on exactly when to buy and sell.

A study titled "A Market Timing Myth" by John D. Stowe (Journal of Investing, Winter 2000) examines the potential benefits and risks of market timing. The study, which covers the period from 1991 to 1998, found that an individual who remained invested in the stock market during these years received an **annual return of 19.9% per year**.

Stowe then calculates market returns after eliminating the best and worst ten, twenty, thirty, and forty days of market performance out of the entire 2,023 trading days. The author calculates the returns of each strategy, after assuming trading expenses of 1%. Because an active strategy has costs, these costs must be considered. In addition, since a market timing strategy will likely convert most of the market's gain from long term to short term, such a strategy will have a very significant negative tax impact. Any negative tax impact is not included in these figures.

The results of Stowe's study are as follows (also pictured in the chart above):

- If you were able to identify the ten worst days, your return improved to 24.3%. This is a 4.4% annual improvement in return over a buy and hold strategy.

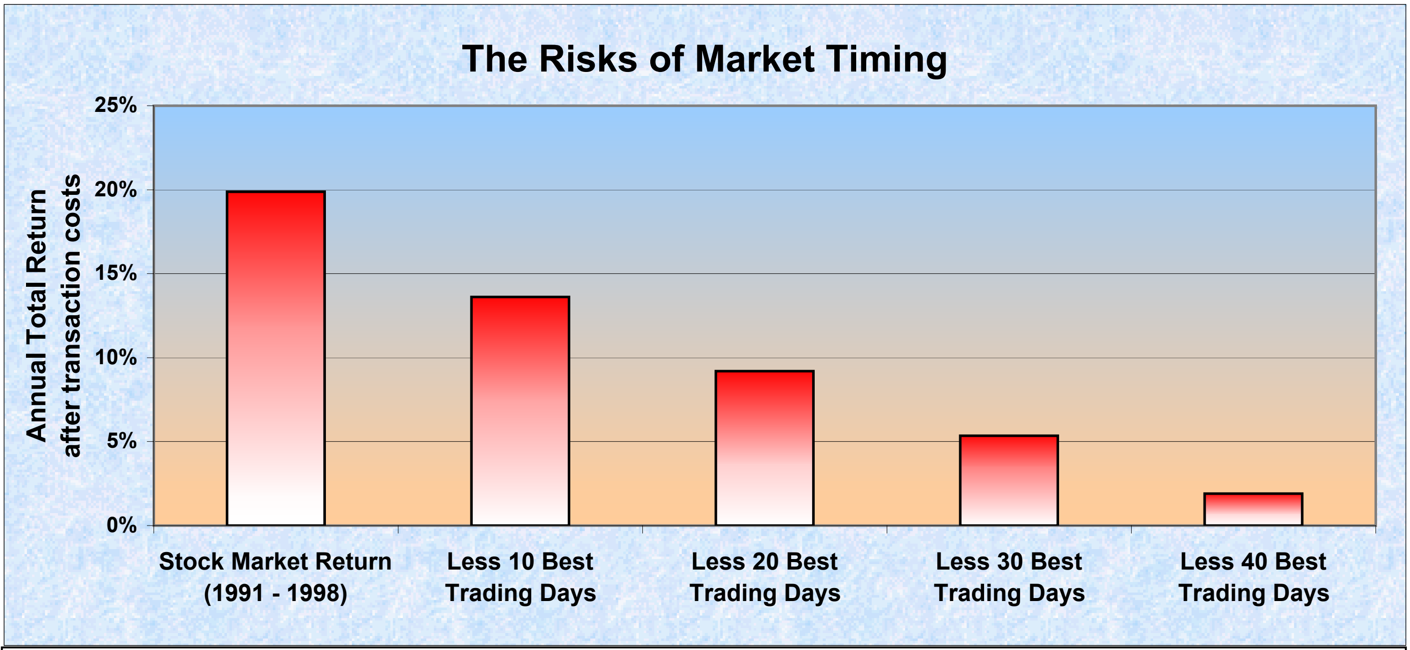
- If you were able to identify the twenty worst days, your return improved to 26.4%. This is a 6.5% annual improvement in return over a buy and hold strategy.

- If you were able to identify the thirty worst days, your return improved to 27.9%. This is a 8.0% annual improvement in return over a buy and hold strategy.

- If you were able to identify the forty worst days, your return improved to 29.1%. This is a 9.2% annual improvement in return over a buy and hold strategy!

Given those potential rewards it sure is tempting to give market timing a try...

"**Only liars manage to always be out during bad times and in during good times**." Bernard Baruch



"**Tonight's weather forecast is dark, followed by widely scattered light in the morning**." George Carlin

Now, let's examine reality...

The results on the previous page assume that an investor can identify all of the ten or even all of the forty worst days in the stock market over an eight-year period. What happens if in the course of timing the market an investor happens to miss the ten, twenty, thirty or forty best trading days (often, when many of the best days follow some of the worst days)? The results of Stowe's study shed some light on this question (also pictured in the chart above):

- If you missed the ten best days, your annual return was 13.6%. This is a 6.3% annual loss in returns over a buy and hold strategy. You would have missed out on 32% of the available returns.

- If you missed the twenty best days, your return was 9.2% per year. This is a 10.7% annual loss in returns over a buy and hold strategy. You would have missed out on 54% of the available returns.

- If you missed the thirty best days, your return was 5.4%. This is a 14.5% annual loss in returns over a buy and hold strategy. You would have missed out on 73% of the available returns.

- If you missed the forty best days, your return was only 1.9%. This is a 18.0% annual loss in returns over a buy and hold strategy. You would have missed out on 90% of the available returns! Amazingly, only 2% of the trading days produced 90% of the return. Thus the lesson of market timing is perhaps best captured by the following quote...

"**Investors would do well to learn from deer hunters and fishermen who know the importance of 'being there' and using patient persistence - so they are there when opportunity knocks.**"
Charles Ellis

Not only is market timing risky in the sense that if you are wrong you can miss some of the best trading days that deliver almost all the return, but the odds of successfully timing the market are extremely low. Stowe calculates that the odds of being able to avoid the ten worst days are one in 309,400,000,000,000,000,000,000,000. The odds of avoiding the forty worst trading days are even more daunting (about the same as above, but add another 58 zeros to the end). At this rate, if you wish to do some gambling, Las Vegas clearly offers better odds (just don't gamble your retirement savings!).

"**It must be apparent to intelligent investors who if anyone possessed the ability to do so [forecast the immediate trend of stock prices] consistently and accurately he would become a billionaire so quickly he would not find it necessary to sell his stock market guesses to the general public**."
David L. Babson & Company, 1951