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The Nonprofit Minute

By Adam J. Smith

The Math and Mentalities of Market Timing

The concept of “market timing” continues to divide the investment industry: Some investors, particularly active traders, believe an investor can profit from changes in an asset class’s outlook by moving entirely into or out of that asset class at a certain moment, while academics tend to believe it impossible to consistently generate excess returns this way. Active traders build portfolios around market timing strategies, and even those who don’t engage in highly active investment strategies are still susceptible to emotional market timing – for example, eliminating or reducing exposure to the U.S. equity market after a significant decline.

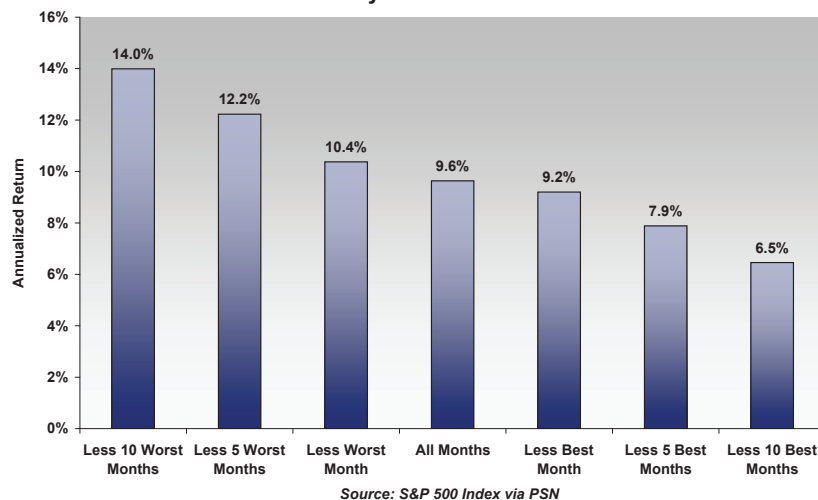
It’s always tempting to try to time the market; this is one of the core reasons that financial advisers are constantly instructing institutions not to. But what happens if they do try – and

they’re right? Or wrong? And can institutional investors consistently time the market?

Studying Hindsight

Numerous studies have shown the impact on long-term returns if investors miss the days with the highest returns in a given benchmark, such as the S&P 500 Index. Although this is an interesting analysis, it has a significant shortfall when applied to institutional investors: Institutional investors are not day traders. Before amending the portfolio, the recommended change typically must be presented to and reviewed by an investment committee. The likelihood of approval coming in a single day is very low; a month is a more reasonable time frame. So what is the impact on long-term returns from missing the best and worst performing months over time within an index?

S&P 500 Index: Return Impact January 1973 to March 2010



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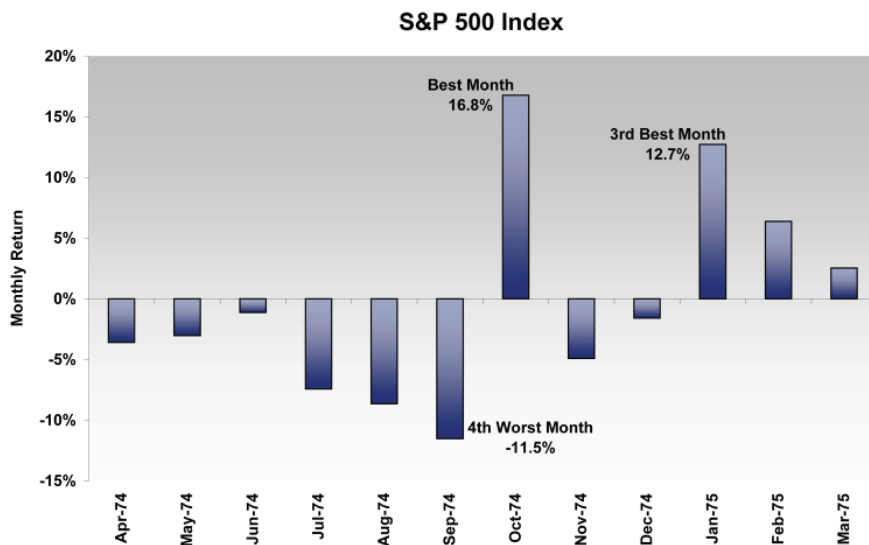
# The Capital Issue: The Nonprofit Minute

From Jan. 1, 1973, to March 31, 2010, the S&P 500 Index generated an annualized total return of 9.6% per year; however, if an institutional investor had a negative outlook for U.S. stocks and happened to be out of the market during the S&P 500's best month, the annualized total return declines to 9.2% per year. Said another way, missing just the single best month during that 444-month period would reduce return by 40 basis points per year (1 basis point equals 1/100th of 1%). Translated into dollars, \$10 million invested in the S&P 500 in January 1973 would be worth \$308 million in March 2010 if invested for the entire period. It would be worth \$42 million less in March 2010 if it missed the single-best performing month in that period. If an investor were more frequently unsuccessful at timing the U.S. equity market and missed the five or 10 best months, then the total annualized return would decline to 7.9% and 6.5%, respectively, or \$139 million and \$205 million less in March 2010. Unsuccessfully trying to time the U.S. equity market can significantly reduce long-term returns.

Alternatively, if an institutional investor were prescient enough to be out of the U.S. equity market when the S&P 500 experienced its worst month, the annualized total return would increase by 80 basis points to 10.4%. Translated into dollars, a \$10 million portfolio invested in 1973 would have had an additional \$88 million by March 2010. Missing the five and 10 worst months would produce annualized total returns of 12.2% and 14.0%. By March 2010, this would mean an additional \$427 million and \$1 billion, respectively, for the \$10 million portfolio invested in 1973. Clearly, avoiding the worst months can significantly increase long-term returns; but can institutional investors consistently avoid the worst months and be fully invested in the best?

## Can Investors Consistently Time the Market?

The key to successfully timing the market is doing so consistently. Any investor can get lucky and avoid one of the worst months; however, if in the process of moving in and out of the market they miss one of the best months, returns can decline by a significant amount, as well. Hitting all the high points and avoiding the low ones would require incredible conviction and strength of stomach.



Source: S&P 500 Index via PSN

In late 1974 and early 1975, the S&P 500 experienced extraordinary volatility that produced two of the best monthly returns and one of the worst in the 37 years of Lancaster Pollard Investment Advisory Group's study (see Figure 2 below). Returns in 1974 were negative month after month, culminating in an 11.5% decline in September, the Index's fourth-worst monthly return going back to January 1973. But the very next month, the S&P 500 Index gained 16.8% – its single best monthly return over the analysis period. Using this example raises two important questions: Would institutional investors have been able to correctly forecast the decline in September 1974 and get out of the U.S. equity market? Just as important, would institutional investors have then had the conviction and courage to reverse their decision and invest in the U.S. equity market the very next month? The volatility inherent with the U.S. equity market and the inability of institutional investors to accurately and consistently forecast monthly returns – and buy and sell quickly – makes this highly unlikely.

## Conclusion

Rather than trying to outperform market benchmarks or reacting to recent market performance by attempting to time the market, Lancaster Pollard Investment Advisory Group recommends institutional investors maintain a disciplined approach, aligning the portfolio's actual asset allocation with its strategic asset allocation policy. Doing so prevents institutional investors from the potential consequences of being wrong, which should ensure that long-term returns of the portfolio are similar to those of the market.