Why Is Market Timing So Difficult?

by F. Louis Floyd

Abstract

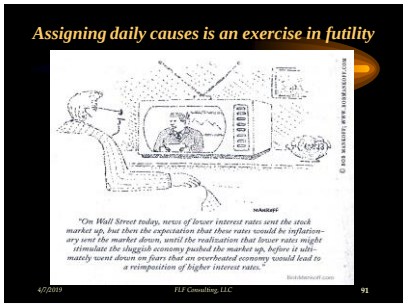
Market timing efforts involve attempts to *predict* both future price behavior and trend changes, using some form of modeling to create the forecast. Past efforts have had limited success for a number of reasons:

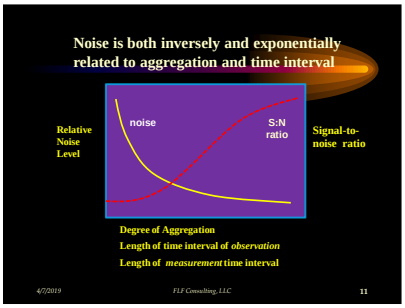
- At best, forecasts actually produce *lagging* results, because they cannot detect future *trend changes.* In effect, one ends up chasing rather than anticipating trend changes.
- The data employed in modeling efforts contain considerable noise which conceals the underlying signals of interest. Since noise never repeats itself, failure to first filter that noise results in predictions with little validity.
- Noise levels decline with increasing aggregation of components, and with increasing time intervals of both measurement and observation. Time intervals commonly employed are far too short to contain adequate replication of the *features* (trend changes) of interest.
- Modeling inevitably requires a number of simplifying steps, which are commonly linear in nature, while real world data mimic other geometric shapes. The implications of *bell-shapes*, *S-shapes*, *bathtubs*, and *exponential curves* will be discussed.
- Even validation efforts through back-testing have their own set of problems. For example, historical analysis is strongly susceptible to survivorship bias, which can materially distort the relative success of alternative strategies.

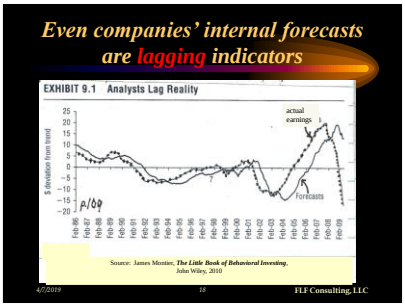
So what *can* one realistically expect from the wild and wooly world of market timing? In the speaker's view, the best alternative is to switch from trying to *predict* the future to *early detection* of what is actually happening, coupled with fast following decision strategies. Appropriate noise filtering is essential to this effort. As with conventional timing efforts, the goal is to *minimize* the impact of major bear markets, which have the single greatest adverse impact on one's financial health. Technical analysis can be a useful means of graphically illustrating both events and their context, which helps in implementing any timing strategy.

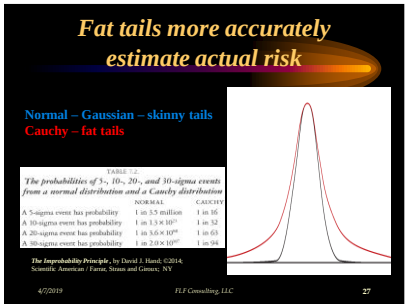
Illustrations

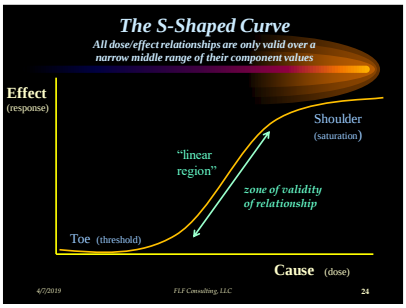
These are a few slides that illustrate some of the issues to be covered:

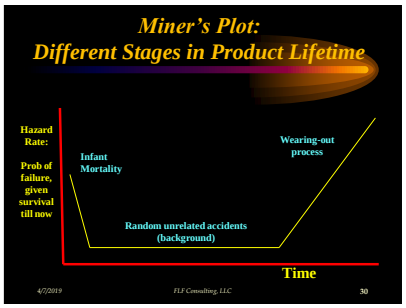


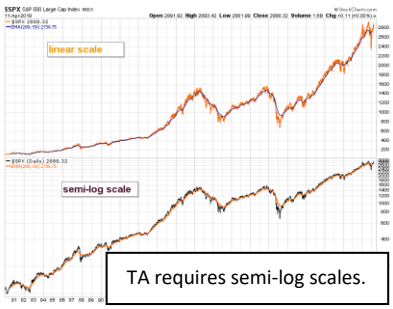


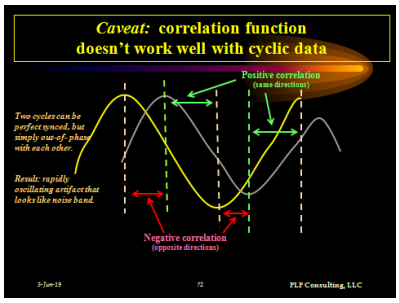












References

These are the most directly useful reference books for this talk: