THE DIFFERENCE BETWEEN MARKET TIMING AND RISK MANAGEMENT

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A WEALTH OF COMMON SENSE
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A reader asks:

I'm a little behind and just listened to ATC [Ask the Compound] from 2/15 over the weekend. This is really a question for Josh but he made a few comments that left me confused. He scoffed at the idea of Ritholtz "market timing" in investment portfolios but then went on to explain the trade to add duration in fixed income. But that that trade wasn't market timing and was just "risk reward analysis" of the different possible economic outcomes. I am having some trouble in my own portfolio defining for myself when to make any tilts. I don't want to market time individual stocks or anything in a short-term window as I agree those are extremely difficult. But making bigger picture asset allocation tilts based on the economy/business cycle do [sic] seem prudent—how do you define market timing and when any tilts to a long-term asset allocation are prudent/can be made without it being considered "market timing?"

Fair question.

There is a distinction between market timing and risk management.

Market timing is about predicting.

Risk management is about preparing.

Market timing assumes you know what's going to happen in the future.

Risk management assumes you don't know what's going to happen in the future.

Market timing is for people who think they're smarter than the market.

Risk management is for people who know they're not.

I'm on my firm's investment committee. Our decision-making process looks at the past, but also considers the risk-reward trade-off in the present.

For instance, we don't try to predict the direction of interest rates. No one can do this—not the Fed, not bond fund managers, not pundits on financial television—no one. There are far too many variables at play—inflation, economic growth, investor preference for yield, central bank intervention, etc.

But, we can assess the current level of yield in relation to the risk and reward inherent in the various bond instruments.

When bond yields across the Treasury yield curve fell below 1% during the pandemic panic, taking duration risk in bonds made no sense. The downside far outweighed the upside. So we moved to ultra-short duration bonds.

That wasn't an implicit prediction that rates were going to rise. We had no idea rates would go from 0% to 5% in such a short period of time, wreaking havoc on bonds. That was a risk-reward trade-off decision where you weren't being compensated in yields commensurate with the level of potential downside if rates were to rise.

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And that was before T-bills were yielding 5%. We were comfortable investing in T-bills and short-duration bonds because the interest rate risk was much lower. Now that intermediate-term bond yields are higher, that risk-reward equation looks a lot different.

That was an allocation change based on market dynamics, not our ability to forecast the future.

Market timing requires you to be right twice—when you get out and when you get back in again. We never had any illusions we could pick the bottom or top in rates. It was more about understanding the different bond instruments and their potential upside and downside based on duration, yield, and credit quality.

Call it market timing if you want, but that's not the way I see it.

Rebalancing isn't market timing. It's a way to keep your portfolio in alignment with your stated risk profile.

Changing your asset allocation as you age isn't market timing. It's prudent risk management that considers the changing nature of risk as your time horizon changes.

Taking more or less risk as your financial circumstances change isn't market timing. It's understanding that your willingness, need, and ability to take risk can and will change depending on your situation.

Market timing is about outcomes.

Risk management is about process.

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