Market Timing vs SIP By Devangshu Datta

It is certainly not impossible to outperform an SIP but there is no easy and systematic way to do it

The argument for passive index investing is simple. An easy no-brainer index investing strategy can produce excellent results. In any market-driven economy with real growth, a systematic investment plan will beat inflation over the long run.

In most cases, the returns from a SIP will comfortably exceed inflation. Over a sufficiently long period, given the basic condition of growth, an equity SIP is also low-risk. The inherent volatility of an equity-based return is smoothed out automatically by the passage of time.

A SIP also has several practical advantages. It does not require day-to-day monitoring, few basic decisions must be taken before a SIP is set up and the implementation is also a simple one-time process. The investor decides which index fund or ETF to invest in and how much to commit per month and that's it. Once a month, he review the SIP, and perhaps once a year, considers increasing or decreasing commitment.

A SIP is also very tax-efficient. Whatever the tax regime, long-term capital gains tend to carry the lowest impost. And there is no tax to pay until and unless you cash out and the point of a long-term SIP is that you don't intend to cash out for a long time. In many jurisdictions (including India), LTCG carries zero tax and that is a major factor in favour of SIPs.
Given almost-guaranteed decent long-term returns, low expense ratios, excellent tax efficiency, hassle-free implementation, etc., any alternative equity investment strategy must offer extraordinary excess returns for the investor to try and beat a SIP.

There are several possible ways to try and outperform SIPs:

One is via the pure stock-picking route. A great stock-picker who has the luck running with him could indeed beat an index hollow. There are inspiring examples like Rakesh Jhunjhunwala, Warren Buffett, etc. But very few investors have the requisite skills to find great stocks consistently. Apart from sheer skill (and luck), a successful stock-picker also needs patience, self-confidence and strong nerves.
Individual stocks are often much more volatile than the index, which represents an averaged market return. The stock-picker must be able to hold a stock through big downturns, and even to increase positions in situations where he is facing capital loss.

One problem with implementing a stock-picking strategy is that stock picking is an art rather than a science. There is no formula or algorithm to be systematically applied to turn an investor into a great stock picker. Great investors all develop their own stock picking skills, patience and nerves in their own individual fashions.

A variation on stock picking is to take SIPs and create a portfolio of diversified active funds, which have a record of consistently outperforming indices. This is possible and it may even be an attractive strategy in India where 80 per cent of active diversified funds outperform benchmarks.
India is very exceptional in this respect and as the disclaimer goes, past performance is not indicative of future returns. In most markets, the majority of active mutual funds don't beat benchmarks consistently. Indian investors holding a portfolio of diversified mutual funds must be prepared for the possibility that this exceptional situation of beating benchmarks won't last.

Another possible way to beat a SIP is timing-based. Suppose for example, that a 'timer' buys index funds only after there has been a serious correction. This method reduces the average cost of acquisition and it should boost returns. But it also means that the investor must wait for corrections.
The consequence of not being in the equity market all the time is that there are long periods of no investment. So a timing strategy leads to lumpy sums invested at uncertain intervals. In contrast, the SIP achieves a steady rise in corpus and compounding. In practice, quite a few retail investors are 'timers' in that they do buy on big corrections. Some are 'reverse timers' in that they only buy in rising markets! Obviously, the specific returns for a timing strategy depend on the numerical specifics. Should the investor enter on 10 per cent corrections, or 20 per cent, or 5 per cent? How much money should be committed at each entry? How often does the market see corrections of the requisite 'trigger' amount? These details are important.

A modified version of a timing strategy is possible and potentially powerful. The investor could run a normal SIP except after 'significant' corrections, (whatever is set as significant). If there has been a significant correction, the commitment is increased.
Again, the specific returns depend on the parameters of correction and the excess amount invested on each correction. But this strategy beats a standard equalised SIP on the long term because it does lower the average cost of acquisition. This strategy can also be turned into a mechanical process.
But we must also assume that an investor is using an asset-allocation strategy with some exposure to assorted assets like equity, debt, gold, etc. Both in a modified SIP and in a

lumpy timing strategy, the investor must keep account of where he keeps money when it is not deployed in equity markets.
Short-term money market funds for example, may be convenient for parking funds that need to be converted into cash at short notice to enter equity on a correction. But there's an opportunity cost. Such instruments usually give less interest than longer term debt. Optimising a timing-based system for the best results would also involve quite a bit of back-testing.

Another possibility for beating SIPs involves trading. A great trader may be able to keep getting in and out of the market and thereby earning more returns than a passive SIP. However, several things come into play here.
First, a successful trader needs a lot of self-control and any trading method carries much bigger risks than a SIP. So there needs to be a good understanding of key trading system details such as position-sizing, setting stop losses, using leverage, etc. There is also a need for continuous monitoring in any trading strategy.
It is also a fact that very few traders make serious pre-tax profits. A very small number of traders, say 10-15 per cent of all traders in a given market make profits. But they make 100 per cent of the profits. For argument's sake, let's say a trader is good enough to be successful.
This is where tax efficiency comes in to action in favour of a SIP. The trader will pay short-term capital gains, or trading profits will be added to business income and taxed at the applicable rates. The SIP investor pays zero tax.
In India, STCG is also the same rate as the highest income tax bracket and roughly a third of profits. This means that, if a SIP earns X per cent, a trader must earn 1.5 times X just to break-even. That is a big barrier. Don't forget brokerage which would again, be much more for a serious trader.

Now for a few indicative numbers.

A SIP on the Nifty returned around 23 per cent CAGR in the last 36 months (the point to point return for September 2011 versus Sept 2014 is about 17 per cent CAGR). Hence, a trader needs 35 per cent CAGR pre-tax just to match the SIP. Given brokerage, the returns must be 40 per cent or more to actually beat the SIP.
A stock-picker would not need that high a return because a stock picker can also be tax-efficient. But of course, a picker would need to find the right stocks.
For a timing strategy, let's assume that the trigger is a 10 per cent correction. That is, a lumpy timing strategy will take a new position every time there is a correction of 10 per

cent from the last peak. A SIP-based timing strategy will also increase position in such circumstances.

The last correction of 10 per cent or more came in August 2013. There have been only four corrections of 10 per cent or more since January 2012. The sustained rally of the last 12 months highlights the major problem with this approach: long periods when the timer is on the side-lines.

This discussion should give you a better understanding of exactly why it is difficult to beat a SIP. It is certainly not impossible to outperform a SIP but there is no easy systematic way to do it.