Can this be Serious?

By Robert Huebscher
December 13, 2011

Of the hundreds of investment books that we are asked to review, a recent one stood out for its utter audacity: *401(k) Day Trading: The Art of Cashing in on a Shaky Market in Minutes a Day,* by Richard Schmitt. The premise of this book is as preposterous as its title. But it raised two important questions, meriting this review.

Schmitt, who is an adjunct professor at Golden Gate University, where he teaches retirement planning, argues that equity investors should not be content with the mediocre returns the US equity markets offered over the last decade. Investors should instead engage in day-trading, or what he calls "hyperactive rebalancing."

Following Schmitt's advice, a 401(k) investor should rebalance his or her portfolio daily. The portfolio should consist of an investment, such as an equity index fund, and a cash account. When the market goes up, you sell a little bit, moving more into cash, and when it goes down you buy a little bit, moving back a bit toward full investment. Schmitt provides a "calibration factor" for the investor to determine how much to buy and sell.

Such activity would quickly expose the investor to the penalties imposed (for good reason) by fund companies on short-term trading. Schmitt has a solution, though. The investor should establish two 401(k) accounts, each with a cash account. One would be used for buy transactions and the other for sell transactions.

To execute these trades, the investor would need access to a real-time feed of market prices. At 3:55pm ET, he or she would observe the price of the index, use the calibration factor to determine how much to buy or sell, and execute the trade at 3:59pm in the appropriate account.

According to Schmitt's book, this strategy would have returned 1.84% annually for the 10 years ending December 31, 2010, versus -0.48% for the S&P 500. He must not have included dividend reinvestment, since the correct return on the S&P 500 over that period was 1.31%. I'd also like to know whether Schmitt obtained his result using pricing at 3:55pm ET, as he advocated in his book, or whether he simply used closing 4pm prices, but I'll leave that question for someone else to answer.

I've now summarized Schmitt's entire thesis, which occupies about five of the book's 298 pages. Apparently his publisher, John Wiley & Sons, could not justify the $49.95 price stated on the book jacket if the book looked more like a $10-per-page pamphlet. So on the other 293 pages you will find a primer on how the global economy functions, how our capital markets operate and the ways in which one can save for retirement.

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The notion that an investor should employ such a strategy is absurd. Even if it provided the 53 basis point advantage for which Schmitt claims there is anecdotal evidence – and I don't trust his numbers – it is guaranteed to lose over the long run, which is relevant time horizon for retirement planning. Equity markets will appreciate over time, and this strategy will decrease exposure to the market and erode returns.

Two questions

By sidestepping the fund industry's rules against short-term trading, Schmitt says investors can effectively rebalance daily without incurring transaction costs. Before dismissing his strategy, I had to answer the question of whether there is any theoretical basis for such frequent rebalancing, assuming it is in fact cost-free.

Michael Edesess explored this topic in an article last year, and his analysis showed that no such basis exists.

First, it would be impossible for all investors to pursue this strategy. For every buyer, there must be a seller, so there is a limit to the degree to which this strategy can be implemented. But it's highly unlikely that this strategy will gain sufficient popularity for this to be a concern.

The concern raised in Edesess' article is even more problematic. He showed that rebalancing is not theoretically justified (and will not generate a profit for the investor) unless the return in one period is independent of the return in the prior period. Edesess argued that rebalancing has a theoretical basis only if the opposite is true: there are trends to pricing patterns that investors can exploit.

Schmitt, however, advocates his strategy on the basis of trendless markets.   He specifically used the decade from 2001-2010, which he called a "sideways" market for US equities, to justify his approach. He even based his strategy on the intra-day randomness of market movements. "At every opportunity," he said, "you need to buy stocks on a dip and sell them on a rise in the stock market."

The theoretical reason to rebalance is to align a portfolio's asset allocation with one's financial goals. Unless the actual asset allocation deviates significantly from its target, then the only reason to rebalance is if those goals change. The goals should change – for example, to have less risk of losing principal as one ages. Rebalancing once a year, or perhaps once a quarter, will be sufficient.

The greater question is why this book was published in the first place. Given the extreme and justifiable distrust of markets that many investors harbor, this is exactly the wrong kind of advice to offer. That is especially true of the 401(k) investors to whom this book is targeted.

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This book is being promoted to “do-it-yourself investors” and “the little guy,” according to Schmitt’s publicity agent. Does Schmitt truly believe that such investors should engage in day trading? Didn’t someone at Wiley stop and ask whether there is any basis for promoting these tactics to unsophisticated investors?

Unfortunately, the same short-sighted greed that led to Wall Street’s worst excesses and failures lives on in the book publishing business.

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