The Stan Clark Financial Team's

PERSPECTIVES

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Asset Allocation

Time in the market vs. timing the market

By Michael Chu, Investment Advisor

Heading into 2020, many investors believed that valuations were stretched. Add record-high stock prices, inverted yield curves, international trade disputes and above-average returns in 2019 – it certainly appeared 2020 wasn't looking good for the stock market.

Who would have predicted what actually happened in 2020? A global pandemic, two impeachments of a sitting United States president, large-scale social movements and a U.S. presidential election with legal challenges to the results. If someone had correctly predicted these dire events, investors would likely have sold stocks. Yet – 2020 and 2021 so far have been very good for stocks!

So, even if we had foresight into geopolitical and macroeconomic events, predicting the resulting stock market movements would be extremely challenging. As legendary investor Peter Lynch said, "Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in the corrections themselves."

Granted, the idea of trying to time the market is tempting. We've all experienced bear markets, and in hindsight believe we could have avoided the impact of huge meltdowns. All we had to do was go to cash just in time, then bought back in at market bottom. Easy, right? But this is yet another example of our behavioral biases wreaking havoc on our decision-making. *Hindsight bias* causes us to think after the fact that events were much more predictable.

In his book *Thinking Fast and Slow*, Daniel Kahneman discusses an example of this bias: Heading into 2008, few investors expected the impending financial crisis. But now there are "far too many people who claim to have known well before it happened that the 2008 financial crisis was inevitable," despite the fact that the "crisis was unknowable." Such thinking may lead otherwise well-intentioned investors to be overconfident in their market-timing abilities.

Emotions are a natural part of investing. Many investors feel the strongest emotions when stocks either have a sudden plunge or are trading at record-high levels. But these intense reactions, while common, ignore two important facts. Firstly, the long-term trend of the stock market has always been up. Secondly, the above-average returns from stocks have more than compensated for their volatility.

The chart below shows the U.S. bear and bull markets since 1942. There have been many downturns (orange) in the last 80 years – including some pretty painful ones. Examples in recent memory: -33% due to the pandemic (2020); -52% in the financial crisis (2007); and -37% in the dot-com bust (2000). But each of these bear markets was followed by a bull market (blue) that eventually more than made up for the losses… as long as you were still invested. And that's the key. While we will always experience downturns, as long as we stay invested the markets eventually more than come back. That's why we often say *time in the market* is more important than *timing the market*.

Timing the market means trying to predict when the stock market will go up or down and then acting accordingly. It sounds easy enough. Predict this and be consistently correct – that is, buy before stocks go up and sell before they go down – and you will quickly become the greatest investor of all time. But we're not aware of anyone who can do this consistently. In fact, we don't think it's possible. For that reason, it's a practice we don't support.

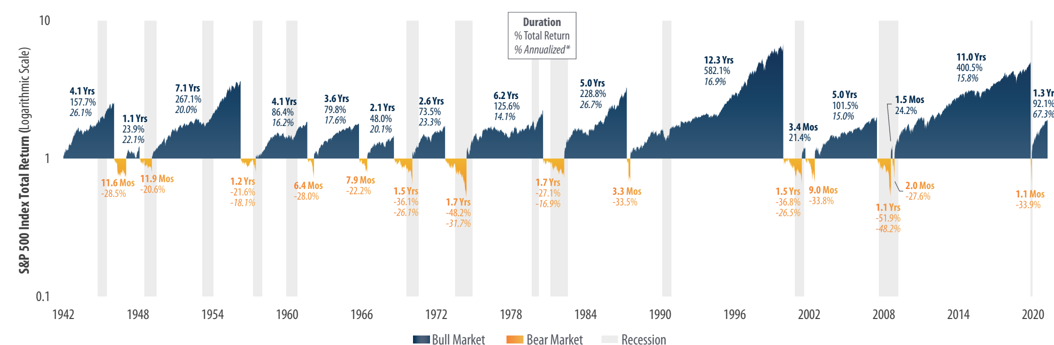
2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
CDN Bonds 9.7%	EM Equities 15.6%	US Equities 41.6%	US Equities 24.4%	US Equities 20.8%	CDN Equities 21.1%	EM Equities 28.3%	US Equities 3.8%	US Equities 25.1%	EM Equities 16.6%
Global Bonds 6.5%	US HY Bonds 15.4%	INTL Equities 31.0%	Balanced Portfolio 11.9%	INTL Equities 19.0%	US HY Bonds 14.3%	INTL Equities 16.8%	Global Bonds 1.9%	CDN Equities 22.9%	US Equities 16.1%
US HY Bonds 5.7%	INTL Equities 14.4%	Balanced Portfolio 16.8%	CDN Equities 10.6%	Balanced Portfolio 8.2%	US Equities 8.6%	US Equities 14.1%	CDN Bonds 1.4%	INTL Equities 16.5%	Balanced Portfolio 10.0%
US Equities 4.3%	US Equities 13.1%	CDN Equities 13.0%	Global Bonds 9.4%	CDN Bonds 3.5%	EM Equities 7.3%	CDN Equities 9.1%	Cash 1.3%	Balanced Portfolio 15.5%	CDN Bonds 8.7%
Balanced Portfolio 1.1%	Balanced Portfolio 8.7%	US HY Bonds 7.1%	CDN Bonds 8.8%	EM Equities 2.0%	Balanced Portfolio 6.0%	Balanced Portfolio 9.8%	Balanced Portfolio -1.1%	US HY Bonds 14.0%	INTL Equities 6.4%
Cash 0.9%	CDN Equities 7.2%	EM Equities 3.9%	EM Equities 6.6%	Global Bonds 1.9%	Global Bonds 3.5%	US HY Bonds 6.4%	US HY Bonds -2.9%	EM Equities 12.9%	Global Bonds 6.0%
CDN Equities -8.7%	Global Bonds 5.3%	Cash 1.0%	US HY Bonds 4.3%	Cash 0.6%	CDN Bonds 1.7%	CDN Bonds 2.5%	INTL Equities -6.0%	CDN Bonds 6.9%	CDN Equities 5.6%
INTL Equities -10.3%	CDN Bonds 3.6%	Global Bonds 1.0%	INTL Equities 3.7%	US HY Bonds -2.7%	Cash 0.5%	Global Bonds 1.8%	EM Equities -6.9%	Global Bonds 6.8%	US HY Bonds 5.1%
EM Equities -16.4%	Cash 0.9%	CDN Bonds -1.2%	Cash 0.9%	CDN Equities -8.3%	INTL Equities -2.5%	Cash 0.6%	CDN Equities -8.9%	Cash 1.7%	Cash 0.6%

Source: Bloomberg

Of course, on occasion, someone may correctly time the market. However, it's likely the analysis or thought process leading up to their action wasn't all that sound. When someone is right for the wrong reasons, it's a clear sign of luck rather than skill. And you do not want to depend on luck.

A recipe for losing money

Timing the market is usually a recipe for losing money. Historically, the market is up two-thirds of the time. So, right away, the odds are stacked against someone getting out of the market at a so-called "right" time. Actually, many investors typically increase their stock holdings just before downturns and decrease them just before rallies. This is because these investors focus excessively on recent performance. They also make long-term predictions based only on recent performance – and that's probably the last thing you should do. The chart above shows the top-performing markets each year,



Source: Bloomberg

sorted from best to worst. As you can see, it looks quite random. The best performers for one year don't usually repeat the year after. In fact, there's an argument for investing in the worst performer for a big comeback the year after.

Let's say you got out of the market successfully by selling at the top. Okay, but you still have to get back in at some point. Deciding when to do that is going to be just as hard. Warren Buffett advises that, if you're going to even attempt to time the market, at least do the opposite of current trends: "…if [investors] insist on trying to time their participation in equities, they should try to be fearful when others are greedy and greedy only when others are fearful."

Obviously, this is easier said than done. Perhaps Buffett is hinting to not even try! Waiting until you feel safe in the market is not a good way to invest. Valuations tend to be better during tough times and more expensive during good times. Sometimes the market can come roaring back quicker than expected. 2020 provides a great example: After the bottom in March, the S&P 500 rallied 18% in just three days. The market continued to recover, despite the ongoing recession and pandemic. The market regained its previous high by mid-August – just six months later.

If an investor insists on trying to time the market, they better be right, down to the exact day! Over the last 20 years, just missing the market's best five days would have reduced your portfolio by almost half compared to simply staying in the market. Missing the best 30 days would have reduced your portfolio by 80%. Of course, missing the worst days would help stem your losses. The truth is, however, that a market timer is much more likely miss an up day than a down day.

Stock market declines are not uncommon. They can be stressful. But remember that declines have always been followed by recoveries. This is what we mean when we say that stocks' returns compensate for their volatility. There's no denying that stocks are volatile. In fact, over shorter time periods, stock returns are highly variable. But over longer periods, especially 10 years or more, stocks have given much better returns with less chance of losing. Since 1927, 88% of 10-year rolling periods for the S&P 500 were positive. Even three-year periods were 77% positive. Attempting to avoid the declines by timing the market will most likely give you lower returns over time.

So, if we can't time the market, then what *can* we do? Here's what. We set a target equities mix based on your own personal circumstances. Then we rebalance your mix back to your target when it varies notably by a predetermined amount. This will help you benefit from the volatility with a systematic method of buying low and selling high. *It's about time in the market*, not timing the market. Time in the market allows investors to better position themselves for better long-term results. A long time horizon that benefits from the power of compounding is much more impactful and generally more successful than the mirage of market timing. ■

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