IG PRIVATE WEALTH MANAGEMENT

Time in the market, not timing the market, is what builds wealth.

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01 Stocks go up in the long run

02 Year-to-year returns are unpredictable

03 Fallacy of forecasts

04 Stay focused and stay invested

05 Trying to time the market can be costly

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With the odds so overwhelmingly in favour of gains, why do so many investors fight those odds trying to time the market? Market pullbacks are frequent and avoiding just a few of them could potentially add significantly to investment results.

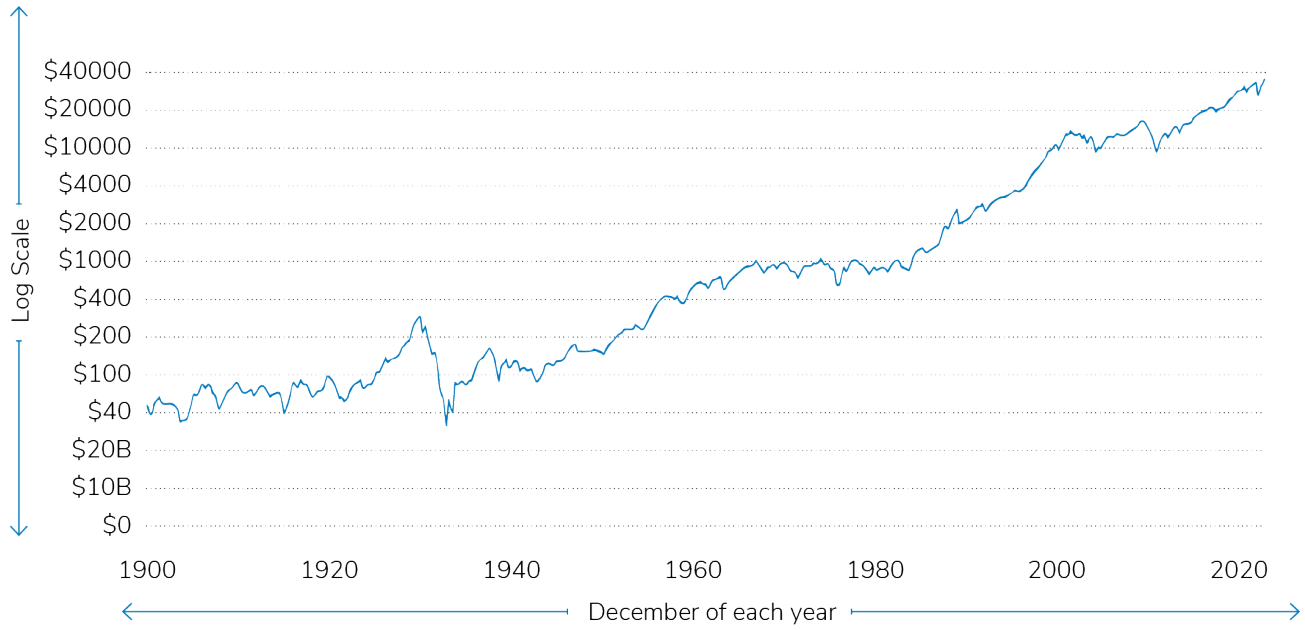
> *The average long-term experience in investing is never surprising, but the short term experience is always surprising.*
>
> Charles Ellis, author, Investment Policy – How to win the loser's game.

But attempts to avoid pullbacks more often lead to missing out on significant advances. And missing out on just a few of these can be devastating to investment results. In almost all circumstances the fundamental key to successful investing is having the discipline to stay invested. Time in the market is what creates wealth.

01 | Stocks tend to go up

Consider Figure 1, reflecting the return on U.S. equities over the course of the last 120 years. With a long enough perspective, most dramatic equity market selloffs (with the notable exception of the 1929 crash) including the 2008 “great recession”, the bursting of the dot-com bubble, the crash of 1987, and the COVID-19 correction of 2020, begin to look like mere noise in a seemingly relentless advance. Figure 1, depicted on a log scale to equate moves of similar percentage magnitudes, illustrates the consistency of positive long-term returns in equities. In fact, according to Merrill Lynch, $1 invested in U.S. large company stocks in 1824 with dividends reinvested would have been worth more than $10 million at the end of 2019. Granted, two hundred years is not a realistic time horizon, but many investors today did personally experience the great bull market of 1982 to 1999 where U.S. stocks returned 1654%. And more recently, U.S. large caps returned over 500% between the low of March 2009 and the high in February 2020.

FIGURE 1 | DOW JONES INDUSTRIAL AVERAGE (1900-2020)



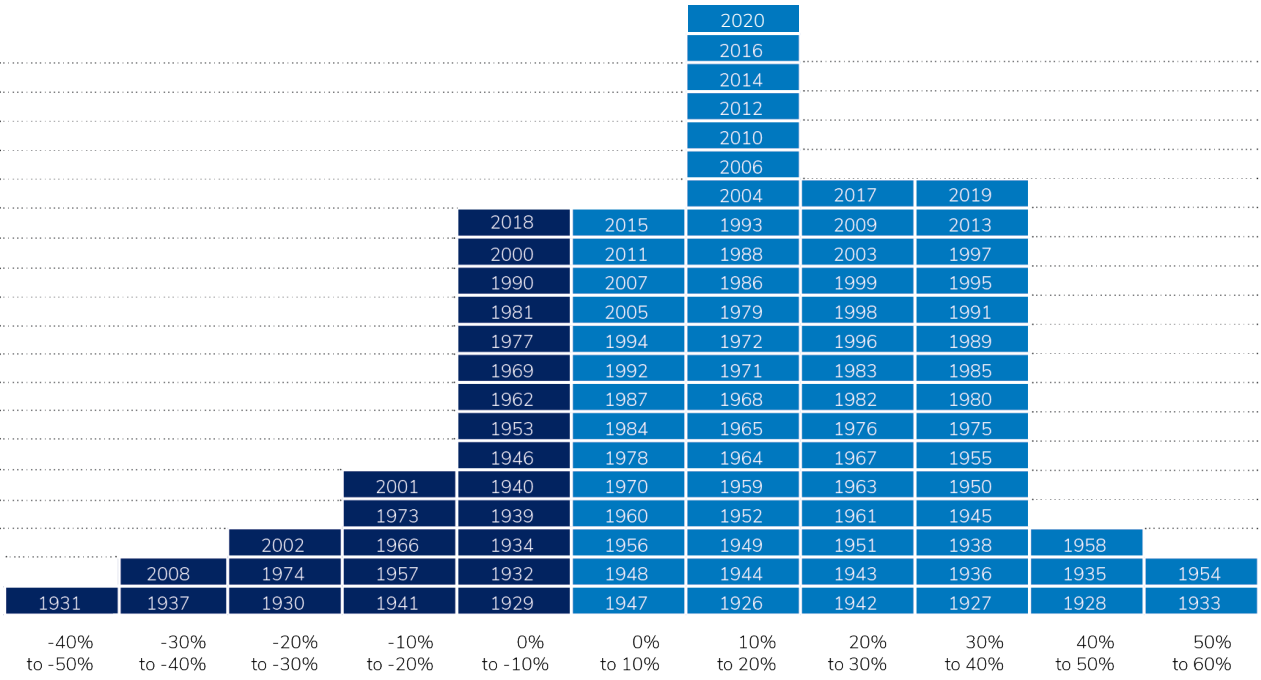
Source: Source: Mackenzie Portfolio Analytics, Bloomberg

02 | Year to year returns are unpredictable

If the upward trajectory of stocks long-term is, as Charles Ellis said, never surprising, why is it so difficult for investors to stick to a disciplined long-term investment plan? Because, as Ellis also says, the short-term is always surprising.

Figure 2A depicts in histogram format the distribution of S&P 500 calendar year returns since 1926.

FIGURE 2A | S&P 500 TOTAL RETURN RANGES BY YEAR FROM 1926 TO 2020



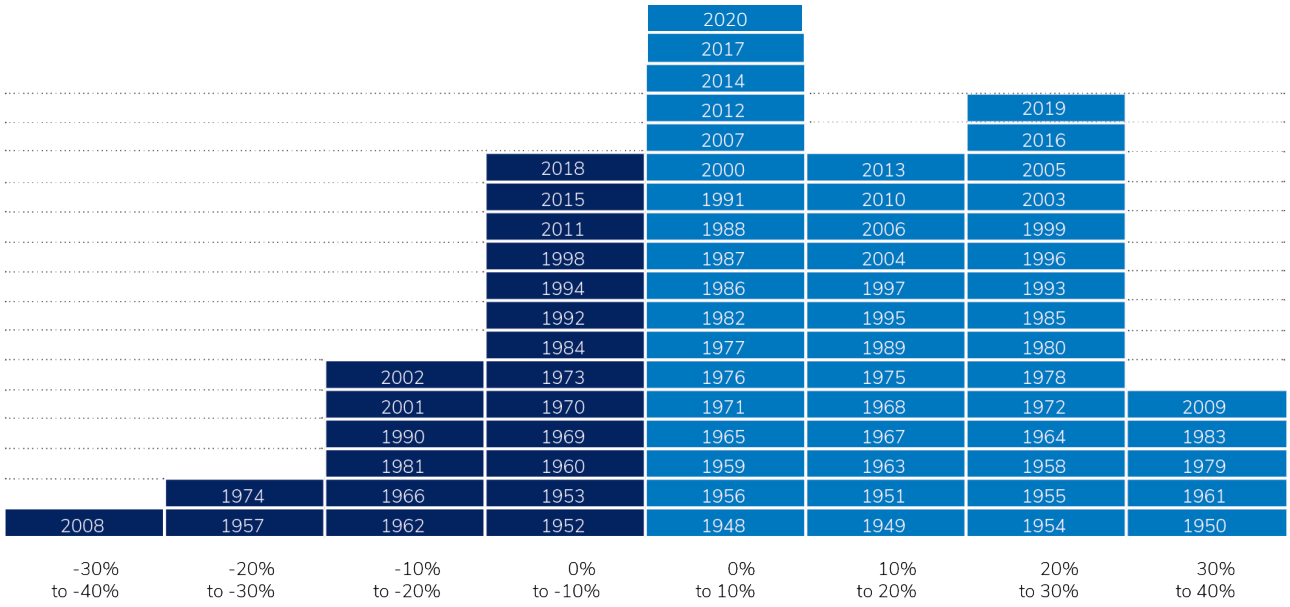
Source: Mackenzie Portfolio Analytics

Figure 2b presents similar data for Canada's S&P/TSX composite index since 1948. A few observations stand out:

- The returns are distributed in a classic 'normal distribution' pattern, or bell curve, where typically about 68% of values are found within one standard deviation from the mean. In this case, the mean appears to lie within the +10% to +20% column for the S&P 500, and within the 0% to 10% column for the S&P/TSX. For the U.S. benchmark the limits of one standard deviation on either side lie within the 0% to -10% and the +30% to +40% buckets, while in Canada they fall in the same range on the low side and between +20% to +30% on the high side.
- In roughly 74% of the instances in the U.S. returns are positive (70 of the 95 years), while in Canada positive results occurred almost as frequently at 70% of the time (51 of the 73 years).
- There is no obvious pattern in the returns based on their chronological sequence. That is, the location of any one year's data point provides no clue as to the likely position of the next year's location on the graph.

It is perhaps, in part, the apparently high incidence of negative calendar year returns (U.S. 26%, Canada 30%) that tempts many investors into mistakenly believing that value can be added through market timing, or tactically moving in and out of market exposure based on near-term forecasts of expected market returns.

FIGURE 2B | S&P/TSX TOTAL RETURN RANGES BY YEAR FROM 1948 TO 2020



Source: Mackenzie Portfolio Analytics

03 | The fallacy of forecasts

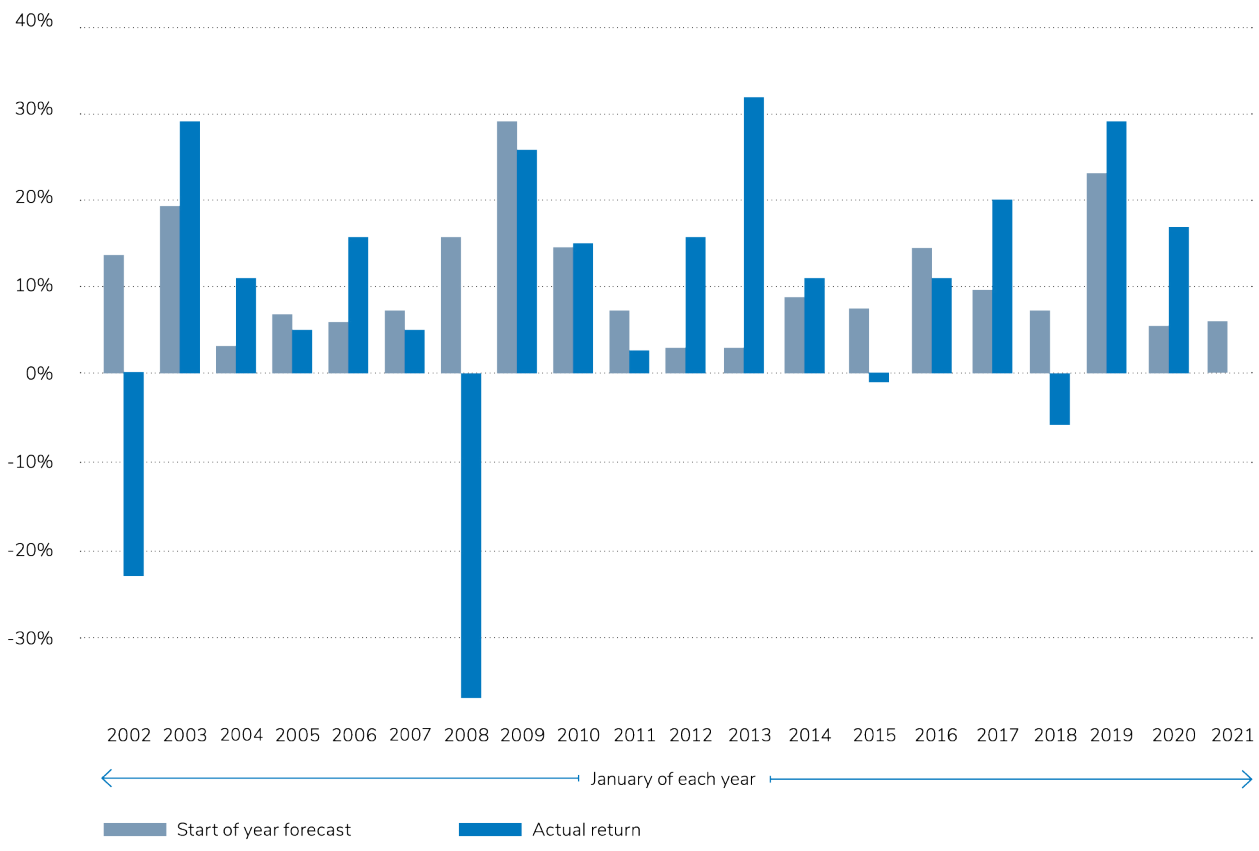
If one could simply predict in advance how the market would perform each year, market-timing would make so much sense. But not even the experts can pull this off. So how is the average investor likely to do any better?

Let's start with Figure 3. The grey bars depict the consensus of Wall Street analysts and strategists at the beginning of each year, using an expected return from the S&P 500 for the calendar year (note the consensus always starts the year a positive number, perhaps the safest guess considering how we've just seen the market deliver a positive return roughly 70% of the time!).

The blue bars indicate the actual return experienced by the market benchmark each year. The consensus is almost always wrong, and often dramatically so! Look for example at 2002 – analysts expected a return of +14% and the realized return was -22%. Or 2008, where expectations were for +16% and the actual return was -37%. In 2013 analysts expected only +2% and the market roared ahead +32%.

Clearly one should not put too much stake in what the experts predict for financial markets year to year. The bottom line is you can't predict the markets in the short term! What is predictable is that markets will advance over time, so let time be your friend.

FIGURE 3 | IMPLIED UPSIDE FROM CONSENSUS STRATEGIST S&P 500 TARGET



Source: BofA ML, Bloomberg,Mackenzie Portfolio Analytics
*Note: Although January 1, 2016 consensus 1 year target was +14.3%, by March 1 consensus had fallen to -3.5%

04 | Stay focused and stay invested

Investors without a long-term plan, or the focus and discipline to stick to it, too easily follow the crowd responding to short-term noise. One of the most common investing mistakes is to sell in response to a sudden or dramatic downturn and thus crystallize what had been until then just paper losses – only to be left on the sidelines, un-invested when markets recover.

It is instructive to consider just how common significant downdrafts are. According to research from Bank of America Merrill Lynch (illustrated below in Figures 4 and 5) the S&P 500 since 1930 has experienced a 10% pullback on average once per year, and a 5% pullback on average three times per year.

FIGURE 4 | S&P 500 FREQUENCY OF 10%+ PULLBACKS

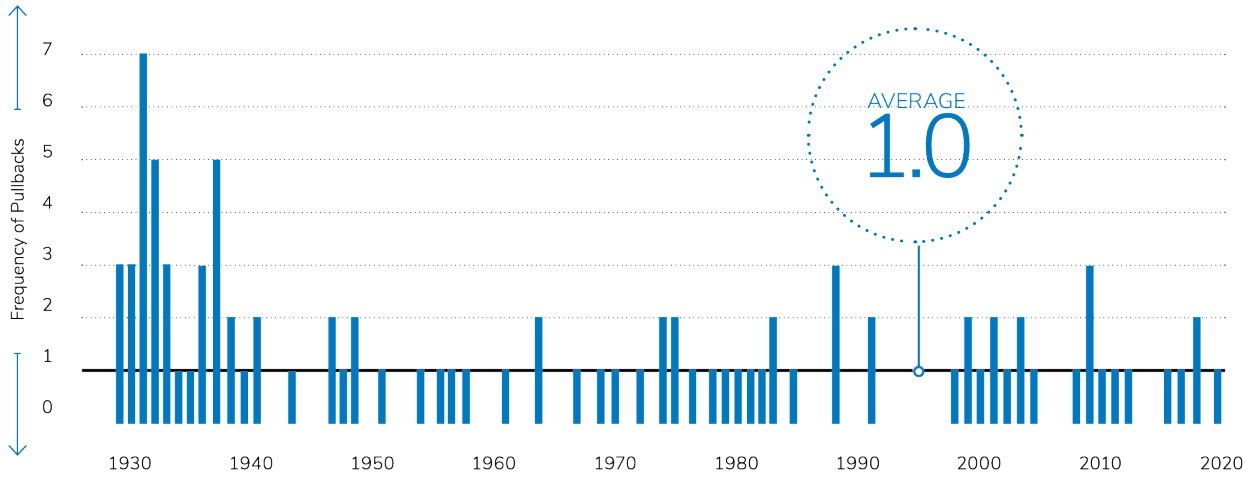
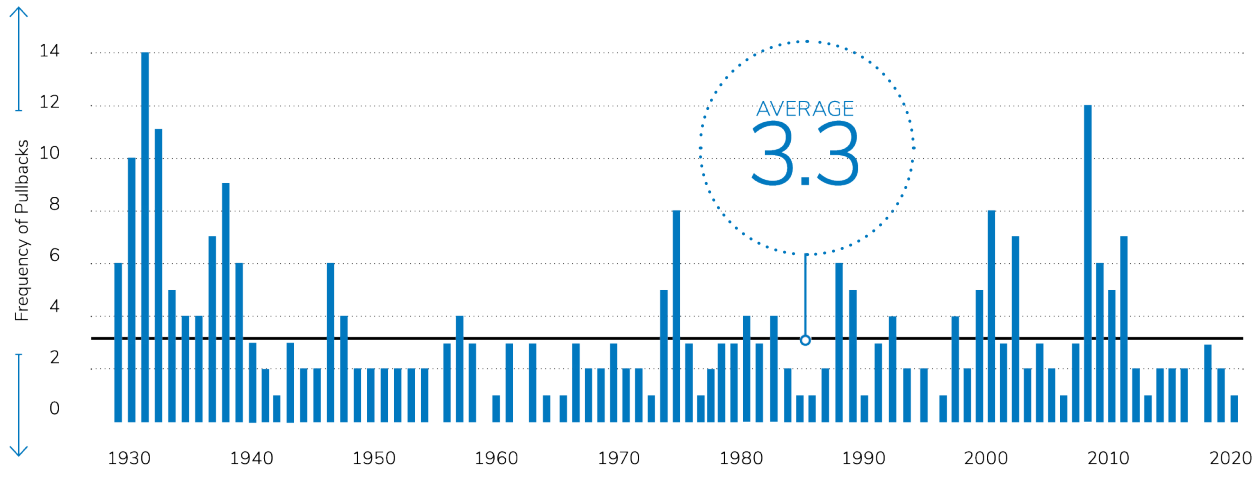


FIGURE 5 | S&P 500 FREQUENCY OF 5%+ PULLBACKS

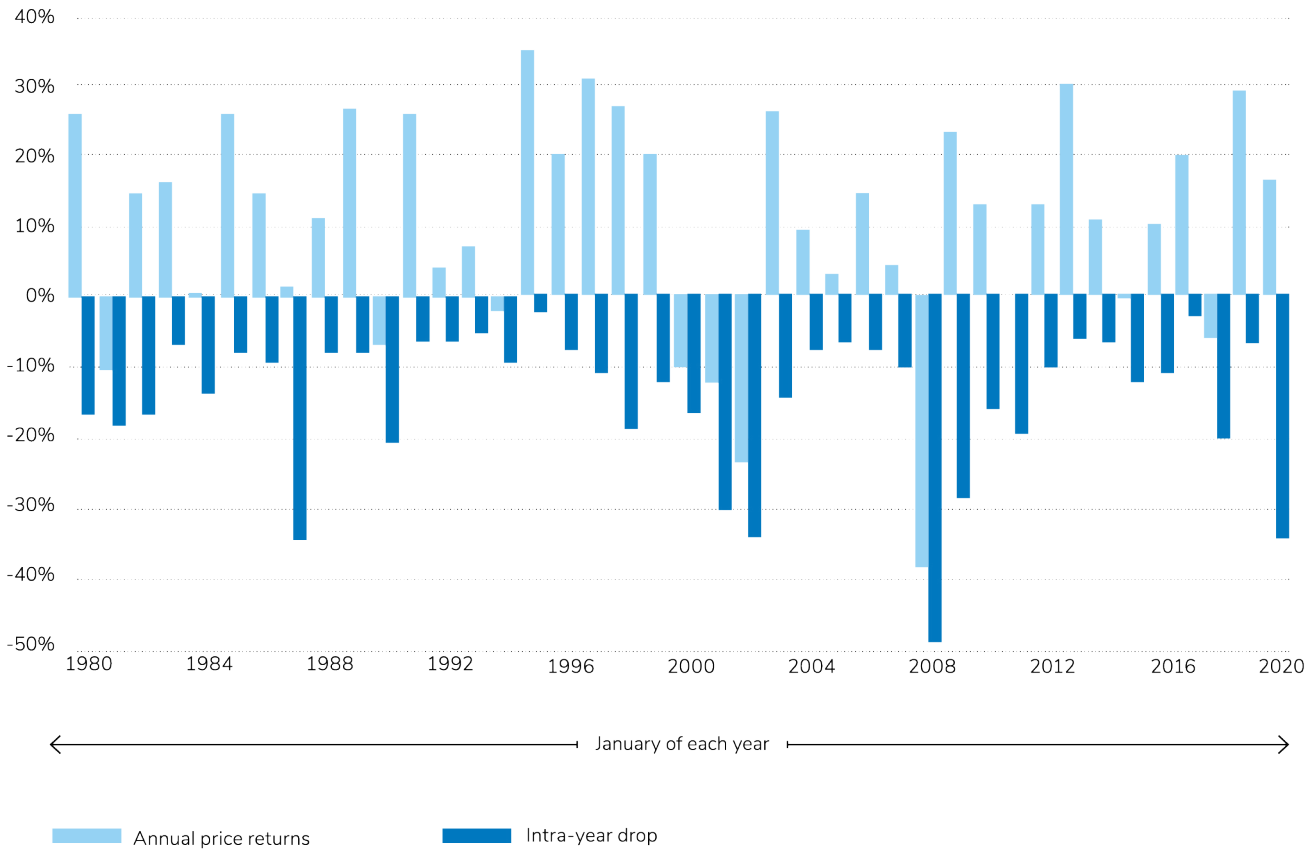


Source: Original data 1930-2015 BAML - Since 2015 Bloomberg, Mackenzie Portfolio Analytics

More importantly, as the Figure 6 shows, large intra-year declines in no way diminish the likelihood of annual returns finishing in positive territory. There is perhaps no better example of this than the experience of 2020, when the S&P 500 endured an intra-year plunge of 37% only to finish the year with a 16% gain. Despite the average year since 1980 experiencing an intra-year decline of -14%, the S&P 500 has delivered positive returns in 30 of 40 years, or 75% of calendar years.

We've seen how trying to successfully predict near-term market direction is difficult even for the pros. But each market-timing tactic is doubly difficult as it requires two successful decisions: when to sell and when to buy back in. Waiting to confirm that you have actually seen a "bottom" usually means missing out on a significant portion of potential returns, as returns tend to occur disproportionately early in a recovery.

FIGURE 6 | S&P 500 INTRA-YEAR DECLINES VS. CALENDAR YEAR RETURNS



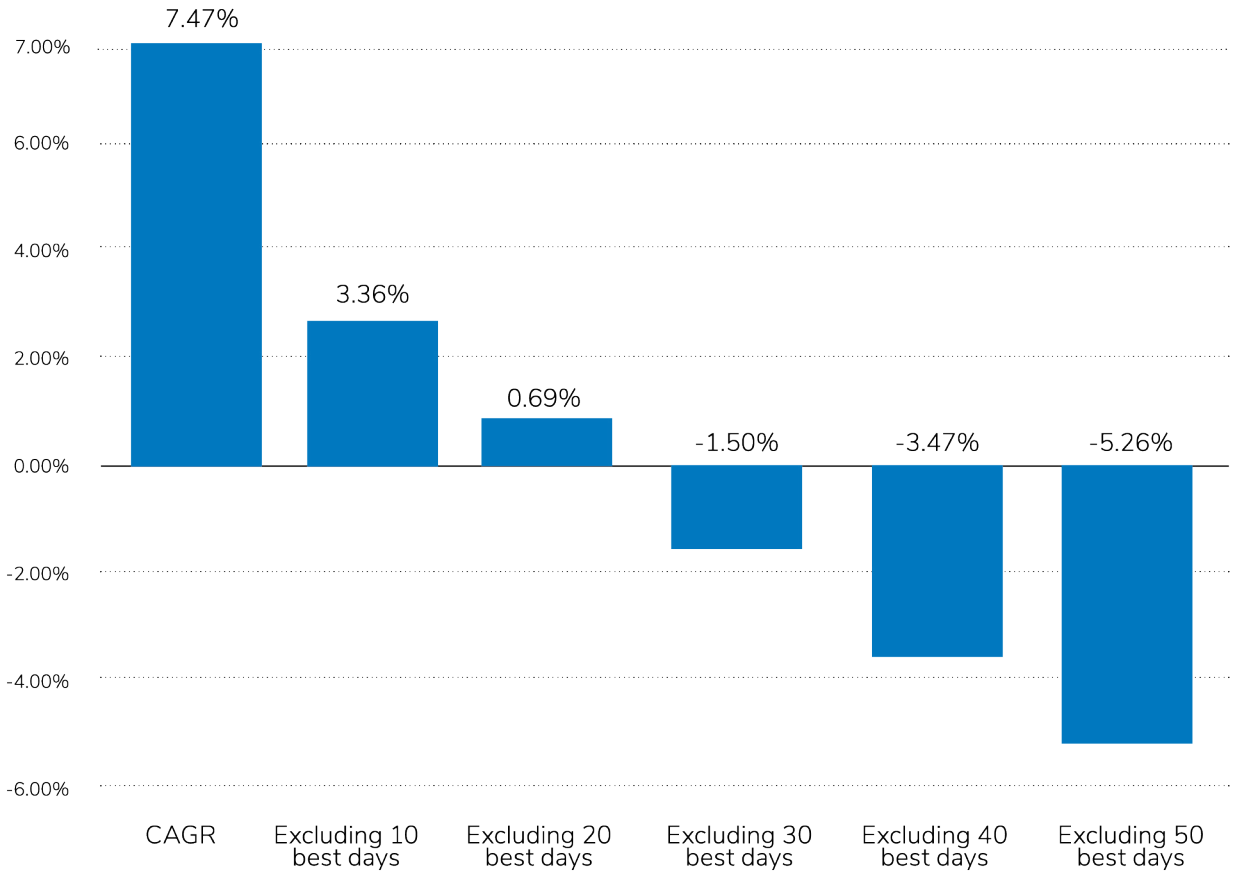
Source: JPMorgan, Bloomberg, Mackenzie Portfolio Analytics

05 | Trying to time the market can be costly

Most big moves in the market, both up and down, tend to be concentrated in short periods lasting just a few days at a time. A commonly cited rule of thumb suggests 90% of the market's absolute return is typically accounted for by the moves of only 10% of the trading days. A 1994 study by University of Michigan Professor H. Nejat Seyhun of all the trading days in the preceding 31 years concluded that 95% of all the market's gains were generated by just 1.2% of trading days, or an average of only three days per year! (H. Nejat Seyhun, University of Michigan, "Stock Market Extremes and Portfolio Performance").

To illustrate the importance of this concept, Figure 7 compares the compound annual price return of the S&P 500 over the 20 years ended December 31, 2020, to the theoretical results if participation in the market was excluded for just the 10, 20, 30, and 40 best days of this 5000+ trading day period. An investor who hypothetically remained invested in the S&P 500 throughout this period would have earned a total annualized return of 7.5%. A notional investment of $100,000 at the beginning of this period would have grown to more than $422,000. By excluding just the 10 best-performing days in that time period, the compound annualized return drops to 3.4% and the end value of the investment to less than $194,000. By excluding the 30 best-performing days (less than 0.6% of the trading days in the period) the total return becomes negative, eroding the initial investment to less than $74,000. Five of the top ten best days occurred within a six-week window in the fourth quarter of 2008. Another three of the top ten best days occurred in March and April 2020. Missing these days by trying to time the bottom almost guarantees a long-term loss.

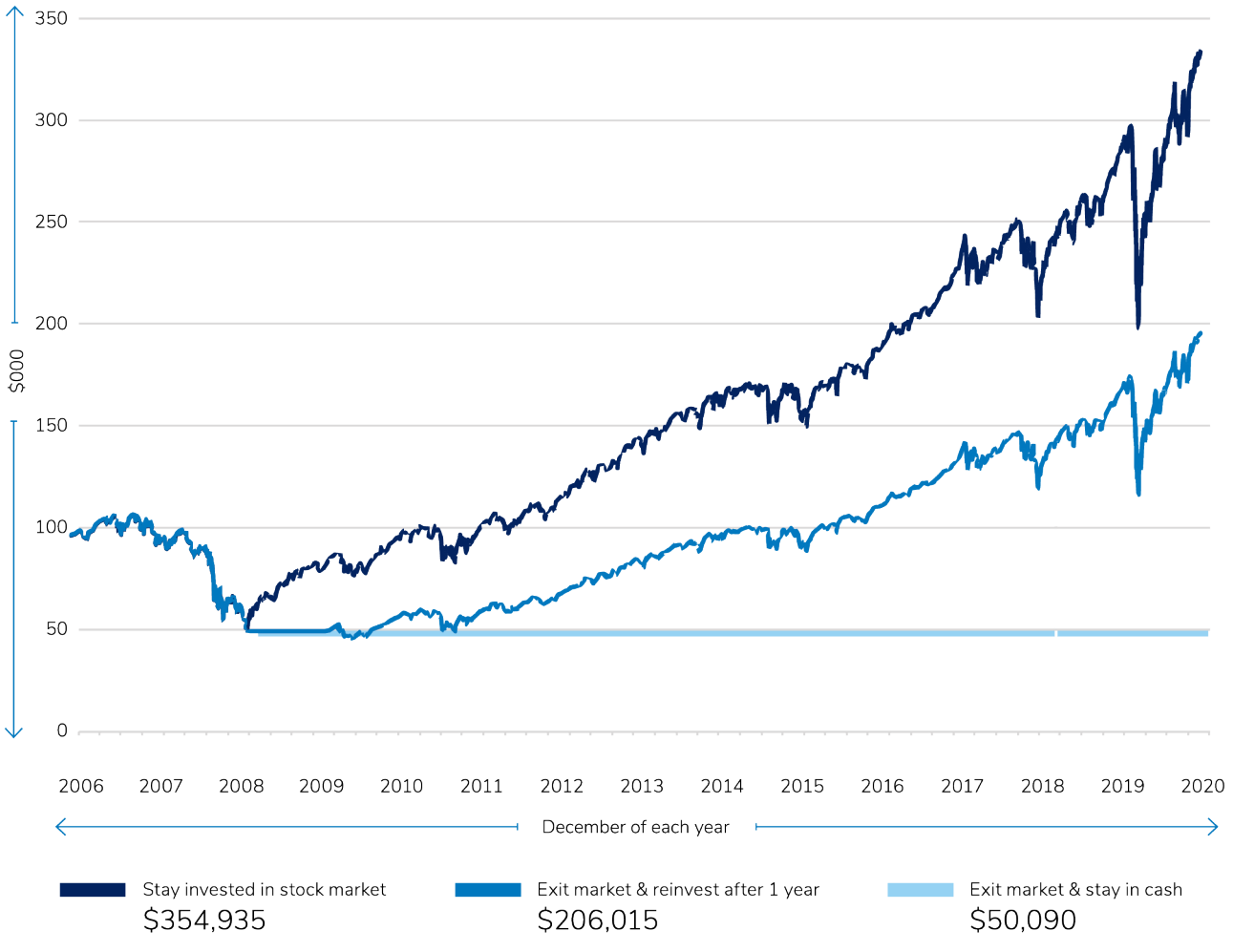
FIGURE 7 | ANNUALIZED PRICE RETURNS S&P 500 (MARCH 2000 TO DECEMBER 2020)



Source: Bloomberg, Mackenzie Portfolio Analytics

Figure 8 illustrates the importance of staying invested by looking at the value at the end of December 2020 of a notional $100,000 investment in U.S. equities – as represented by the S&P 500 Total Return – invested just before the 2008 financial crisis. Held throughout the two largest market declines of the last 15 years - the 2008 recession and the 2020 COVID-19 drawdown, it is compared to an investment sold at the bottom (or at the peak of market despair) of the 2008 Great Recession and reinvested one year later when recovery looked more assured. Ten years on, the "stay-invested" portfolio has grown to a level more than 70% higher than its fleet-footed counterpart (the data assumes reinvestment of income and does not account for taxes or transaction costs).

FIGURE 8 | THE POWER OF STAYING INVESTED



Source: Bloomberg,Mackenzie Portfolio Analytics

06 | Let time be your friend

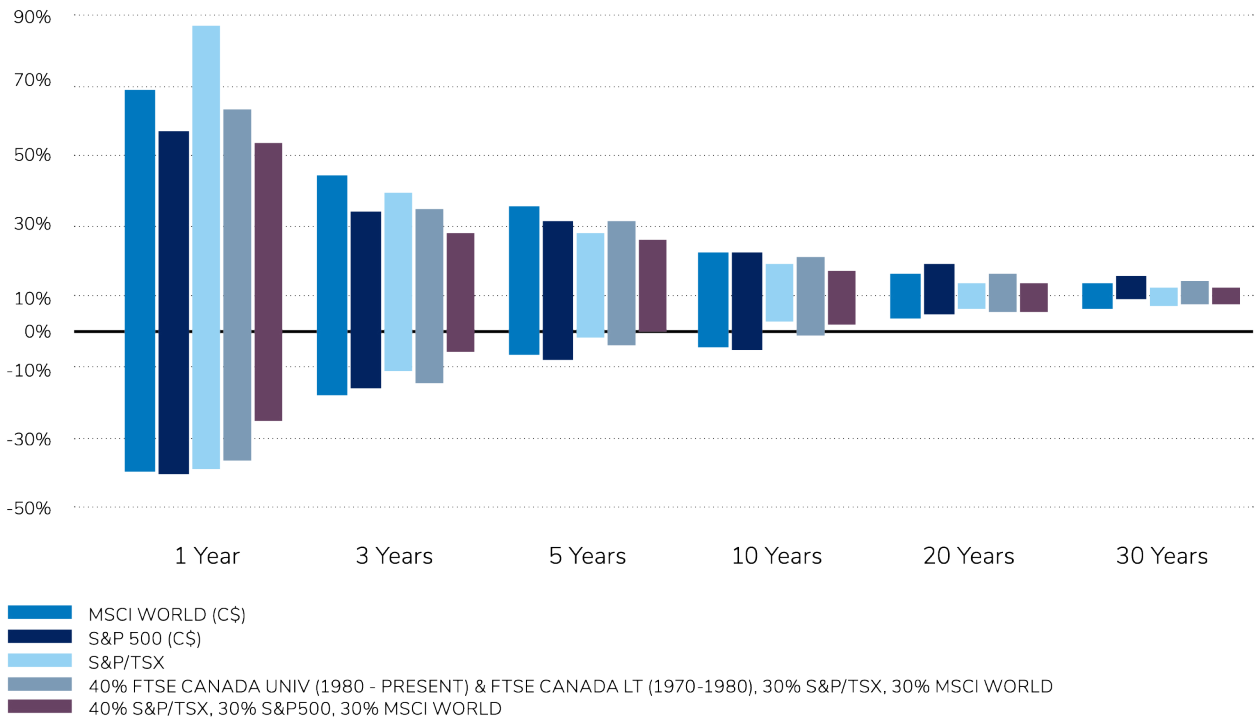
As we saw in Figure 2, the S&P 500 has had negative calendar year returns 26% of the time since 1926, which means the market is up virtually three of every four years. In Canada since 1948, the S&P/TSX has delivered negative returns on a calendar year basis 30% of the time. According to Bank of America Merrill Lynch, the likelihood of the S&P 500 returning a negative result over any one year period (i.e., not just calendar years) within this time is 27%. And the likelihood of experiencing an overall negative return diminishes as the investment term lengthens.

Also according to Bank of America Merrill Lynch, the likelihood of the S&P 500 experiencing a negative return over any five-year period is only 11%, and the likelihood over any 10-year period is only 6%. By extending the rolling study period to 15 years, the likelihood of a negative return drops to 0% – which is to say that from any starting point since 1926, U.S. stocks as represented by the S&P 500 have always generated a positive 15 year return.

A review of the range of rolling returns experienced by the S&P/TSX since 1956 (Figure 9) reveals a similar pattern of decreasing likelihood of negative returns as time passes. In the case of the S&P/TSX the empirical likelihood of experiencing a negative return is eliminated even earlier – within the ten-year horizon. In addition, the longer the time horizon considered, the tighter or more stable the range of investment returns potentially experienced.

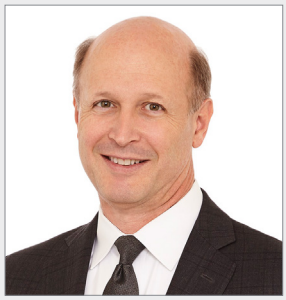
When downdrafts do occur, it is impossible to predict how long they will last. What is easier to predict is that staying on the sidelines looking for an optimal re-entry point usually results in missing out on what is likely the most powerful portion of the rally from the bear market lows. The most important decision leading to long-term investment success is the decision to be invested and to stay invested. Let time be your friend.

FIGURE 9 | RANGE OF RETURN (1970 TO 2020)



Source: Mackenzie Portfolio Analytics

ABOUT THE AUTHOR



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In his role as Investment Strategist at IG Investments, Steve brings over 30 years of experience in the investment management industry. His role is to support the education of IG Consultants, clients and prospective clients on markets, economies and investment strategies. Steve provides written market activity updates and commentaries for various communications channels. He also creates insightful commentary on specific funds and products and exploring capital markets subjects of relevance to advisors and clients.

Prior to joining IG Wealth, Steve was an award-winning portfolio manager responsible for U.S. equity mandates at several leading Canadian mutual fund and active-ETF providers. He won numerous accolades including “Best U.S. Equity Fund” at the 1998 Canadian Mutual Fund Awards, and was named “U.S. Equity Manager of the Decade” by Gordon Pape in his Year 2000 “Guide to Mutual Funds”.

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