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Time in the market, not timing the market

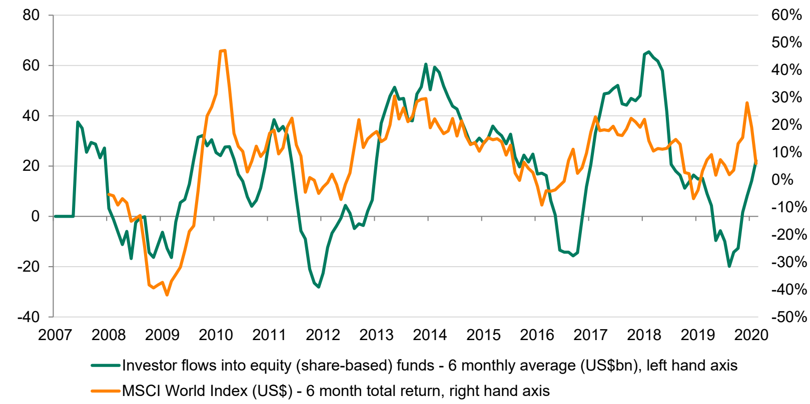
We've all been there – in the queue that's moving forward at snail's pace while the one next to you moves along smartly. Losing patience, you switch, only to find that your new queue has ground to a halt as your former queue speeds up!

This is a great analogy for investing. When the market is volatile and prices are falling, it's tempting to jump to a more promising investment – 'the grass is always greener' scenario kicks in. But performance chasing can be a costly mistake – not only due to the narrow investment choices it encourages, but also due to the higher costs and taxes incurred. Overall, investors can end up selling low, buying high and, importantly, missing out on creating long-term value.

This is demonstrated in the following chart, which shows net new cash flow into equity funds (which invest primarily in shares) from 2007 to 2020. Take a look at the period around the global financial crisis in 2008: investors reacted to market falls by pulling out of share-based funds in 2009, but it would have been better to stay put, as the market performed strongly from that point. A similar reaction occurred after the 'dot-com bubble' burst in 2002; the market panic, begun in technology stocks, led to a mass exit from share-based funds just as markets began an upward surge in 2003. Only time will tell what decisions investors will make following March 2020's market falls, and if – with hindsight – these will be deemed too hasty.

New investor flows into equity (share-based) funds is typically linked to global stock market returns

Investor flows into equity funds and MSCI World Index returns



Source: Morningstar, MSCI. Data from 31.01.07 to 28.02.2020

Past performance is not a reliable indicator of future results.

Taken together, what this indicates is that most investors are not strictly rational and can be subject to behavioural biases, such as past experiences, personal beliefs and preferences, which can influence judgment and skew decisions. These biases can steer them away from logical, long-term thinking, and deter them from reaching their long-term investment goals. It is therefore important to be aware of these biases and their effects. Let's look at three examples.

Reacting to noise: investors can get caught up in media noise and short-term geopolitical and macroeconomic events. A litany of stories (often negative) from round-the-clock news channels, the internet and social media tends to exacerbate investors' emotions. They can then put too much emphasis on these short-term events and extrapolate them into long-term themes.

Overconfidence: overconfident investors may overestimate their ability to identify winning investments, whilst at the same time blaming failures on 'bad luck' or

> “Investors who give into, or are unable to control their behavioural biases will generally find their investments lag those of investors who adopt a long-term buy-and-hold strategy.”

unexpected events. Chasing winners and selling losers can result in a high degree of short-term trading and potentially a loss-making spiral.

Following the herd: people often exhibit herding behaviour or a ‘group think’ mentality when investing. They mimic the behaviour of others, especially in times of uncertainty. However, the majority is not always right, and basing one’s investment decisions on the actions of others makes little sense given everyone’s different investment goals and financial circumstances.

Buy-and-hold requires patience and discipline

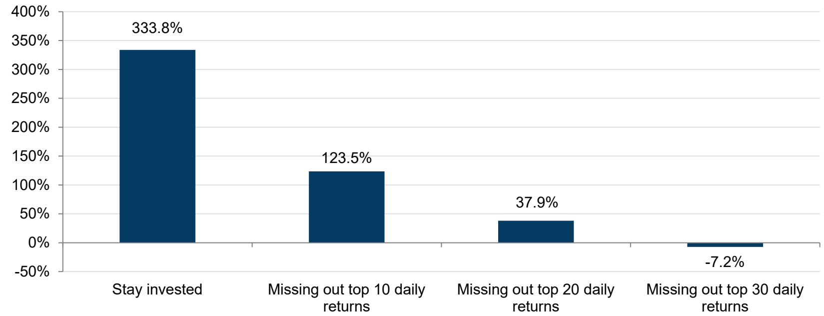
Unfortunately, investors who give into (or are unable to control) their behavioural biases will generally find their investments lag those of investors who adopt a long-term ‘buy-and-hold’ strategy. This is despite the fact that most investors are naturally averse to taking losses. Research shows that losses hurt about 2-2.5 times more than gains satisfy.

A buy-and-hold strategy, though, is not easy; it requires patience and discipline. There may be prolonged periods when the strategy does not appear to be working, but it will ultimately emerge stronger as investments capture the upside throughout market cycles. Having a long-term horizon can therefore help investors to avoid making poor short-term investment decisions. Time in the market, not timing the market is what’s important.

Trying to time the market can reduce portfolio value

Missing the top 10 days in the market could reduce portfolio value by over 200% between 1997 and 2020

Impact on portfolio value if the top performing 10, 20 and 30 best performing days are excluded



Source: FactSet. Data from 31.12.97 to 27.03.20

Past performance is not a reliable indicator of future results.

A detailed study published by Vanguard[1] in 2014 compared the returns and risk-adjusted performance of nine different shares-based investment strategies. The study aimed to determine if taking action based on past performance is typically worthwhile. Looking at the three-year rolling return performance between 2004 and 2014, the study also tracked the ‘Sharpe ratio’ (a measure of risk-adjusted return) of the average fund in the category. The study found that a buy-and-hold approach was superior to performance chasing across all nine strategies. Additionally, the study did not include costs and charges, which would have detracted even more from the performance chasing strategy returns.

How to keep focused on long-term goals

Successful long-term investors create diversified portfolios that are tailored to their goals, risk tolerance and time horizon. This is where skilled active managers can help. Active funds will aim to achieve a specific objective by investing in certain assets, with an approach to risk and return that could resonate with an investor’s goals. Using a skilled active manager can add value in both rising and falling markets and can calm investor nerves when markets turn turbulent.

Making money from investments whatever the conditions can be a tall order, but it is the overarching goal of funds that aim to achieve an ‘absolute’ or ‘target’ return, for example, to outperform the inflation rate by a certain amount over a ►

1 Quantifying the impact of chasing fund performance - Vanguard Research, July 2014

given timeframe. By using a range of investment tools – including alternative asset types, such as hedge funds, commodities and private equity – to profit from market downs, as well as ups, managers can look to target steady positive returns while limiting potential losses when markets are falling. Positive returns can never be guaranteed, and should not be relied upon, but using this mix of different types of assets can help funds to perform well under different circumstances.

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