Tatton
Investment Management

Time in the market

Sell investments in haste, repent at leisure?

For professional advisers only

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Introduction

Investing in the stock market carries risk as the value of investment can fall as well as rise. Over the long term investing into stocks and shares (equities) has been shown to generate strong investment returns. However, during any investment period stock markets will rise and fall as part of their day to day behaviour and sometimes these falls can be dramatic and unnerving.

Investors are often tempted to try to time market peaks and troughs, especially when the outlook appears bleak. For advisers, the challenge lies in convincing them not to act rashly.

Retail investors' finances have become increasingly stretched in recent months, with soaring energy prices and high inflation squeezing disposable incomes. However, their long-term financial goals are likely to be unchanged so achieving their target investment return has become more important than ever.

The outlook for many investment markets appears stark. The conflict in Ukraine, continuing Covid-19 induced lockdowns in China, the global semiconductor shortage, and tightening of monetary policy are all likely to continue playing havoc with supply chains for many months, possibly even years. But it is at the moments of greatest stress and uncertainty that markets reach their nadir. While a return to stellar returns is unlikely to be on the horizon, much of this bad news is already likely to be priced in.

UK Equities during Covid sell-off – 34% including the bounce 5%

Source: Morningstar, Tatton.

In the years following the Global Financial Crisis of 2008, central bank intervention led to markets experiencing a prolonged period of up-trending capital markets, regardless of whether they were invested in stock or bonds. This has come to an abrupt end, with inflation preventing central banks from smoothing out volatility with the balm of quantitative easing. Younger investors especially may not have experienced significant instability until recently.

Volatility can affect investors' judgement. Short-term movements can be shocking and extrapolating them into the future creates understandable fear. But the fact is these events have already happened and yesterday's valuations can no longer be achieved. Fear may tempt investors into selling investments after they have lost value, but often the best advice is simply to do nothing. The only available alternative is to sell out and crystallise a loss.

While this message may not be universally welcomed by concerned investors, history offers us a reassuring guide. Most recently, in March 2020, when governments around the world struggled to come to terms with the impact of Covid-19, markets slumped and many investors rushed to liquidate their holdings. In the UK, retail fund investors withdrew £9.7bn in March 2020, according to The Investment Association. The FTSE 100 fell from above 7,500 in February to barely above 5,000 by mid-March, before then very swiftly rebounding in a strong recovery rally that started in the last week of March, when the general outlook will have looked the darkest from a retail investor's lock down perspective.

However, selling was not a smart move. Extraordinary levels of government support and looser monetary policy bolstered the prospects that the economy would not suffer lasting damage which fuelled greater optimism. By the end of 2020, net fund sales in the UK reached £30.8bn and the FTSE 100 was back above 6,500 (Source: Investment Association). Those that panicked in March were left nursing heavy losses and entirely missed out on the market uplift. The episode shows how sudden sell-offs can lead retail investors into making knee-jerk reactions they can come to bitterly regret.

Market sell-offs can also be incredibly short term. Following the Brexit referendum, when trading opened on 23 June 2016, the FTSE 100 was down by around 10% (Source: Bloomberg). By the end of the day, however, the index was almost flat (helped by devalued pound sterling) and it climbed further in the following days and weeks. If short-term investors did not get back in immediately, they would have missed this upside. Again, simply remaining in a broad market strategy would have fared even better, calmly riding out the storm.

When each new market shock appears, investors need to bear in mind that while they could miss the biggest down days, they could equally miss the best-performing days.

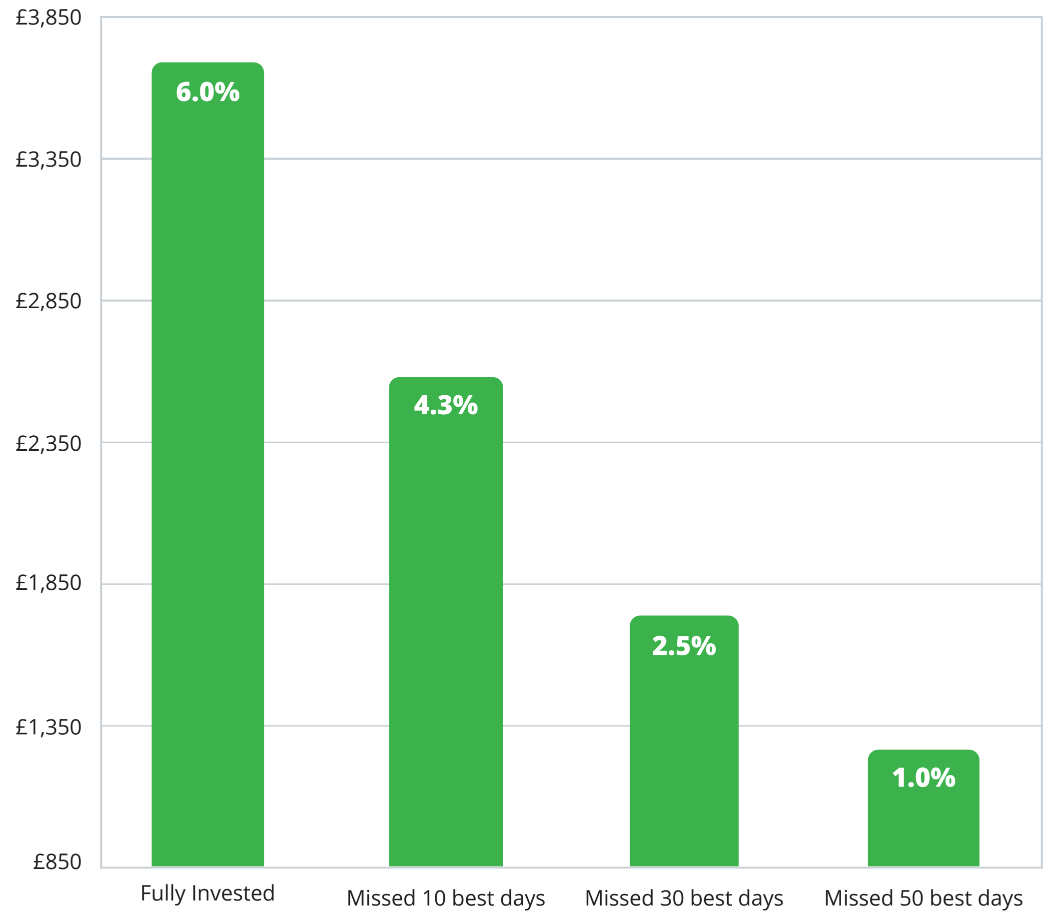
Evaluating options

Retail investors are increasingly finding they are unable to fund their long-term goals through cash savings alone. While interest rates on savings are increasing, inflation is far outpacing them so in real terms their nest eggs are shrinking. A diversified investment plan developed with the help of a financial adviser is far more likely to help clients meet their long-term financial objectives.

There is a world of difference between spending time in the market as part of a long-term strategy and seeking to time the market, moving in and out with each short-term event. Investors that try to time markets, making lots of small bets on its direction, will experience a high frequency of winners but also inevitably losers. Investors targeting a longer time horizon make infrequent changes, which means fewer possible mistakes.

Further, increased trading also incurs greater costs. As investors enter and exit positions more frequently, trading fees and spreads erode any returns they make, even if their short-term strategy is successful.

60/40 Portfolio. Value of a £1,000 investment over 22 years between 2001 and 2023 with annualised return (%)



Source: Morningstar Direct as at 31/12/23.

While very few investors want to run their portfolio like a day-trading strategy, they often cannot resist being carried away by market noise telling them to sell. The digitalisation of investment processes in recent years has made it easier for investors to quickly sell down their portfolios when noise is at its greatest and markets have already plunged. They often tell themselves they will put the money back in when the crisis is over and markets have hit rock bottom – not realising that there is an asymmetry in individuals' emotional thresholds between pulling out into cash and persuading oneself to get back in. Investors act quickly to sell, but wait to reinvest, concerned about further market falls. This is particularly important because we know that the turning point in markets tends to occur around the darkest moments of an economic downturn. The decision to buy is just as difficult to time as the decision sell.

Investors need to accept that volatility is a fundamental part of investing. Indeed, returns should be viewed as their payment for accepting risk. This is the reason bank accounts and gilts provide negligible returns; avoiding volatility necessarily means avoiding returns. It follows that the more risk investors are willing to accept, the greater the potential expected return.

In any case, volatility only matters when the investor is forced, or chooses, to sell their position at an unfavourable time. It is not sound investment planning to invest in equities if the invested money is needed back within the next five years.

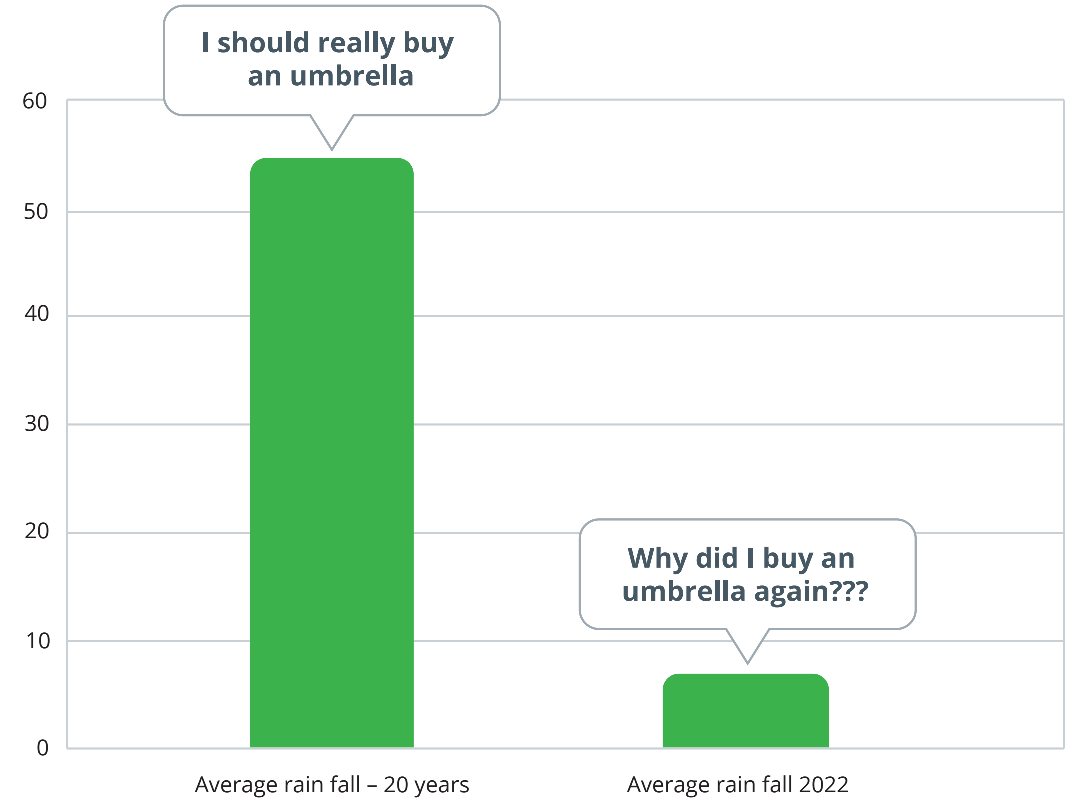
What do you really know about a market fall?

The lowest point of a market coincides with real-world events being at their scariest point, when many investors find it hard to believe the events that caused the fall will end, creating serious worries. But, while the bottom of a market is obvious to identify in history books, in the real-world it can take weeks or months before even investment professionals can pinpoint the actual low point.

Market prices factor in all available information to all the participants in that market. Before making knee-jerk reactions, retail investors need to ask themselves whether they truly have better information than everyone else. What makes them confident they can separate the beginning of a slide from a blip? Or whether or not a market crash will later rebound?

Investors must bear in mind that one of the leading reasons for making poor investment decisions is human psychology. It is in our nature to be tempted to intervene when things are not going in the right direction. But this can cause investors to become emotionally involved in short-term fluctuations and increases the chance of making wrong decisions.

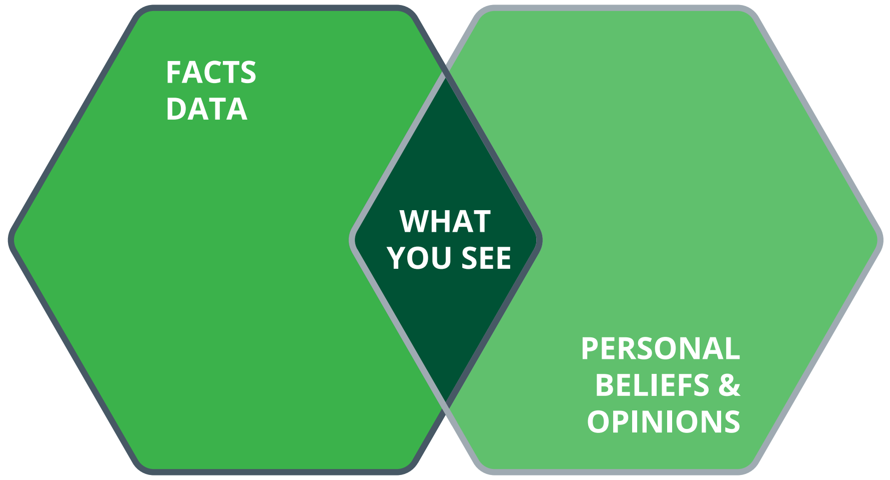
Academic behavioural studies also reveal humans are prone to 'recency bias'. This means recent events can falsely alter opinions about the future; a stock that has recently increased in value can provide a falsely positive impression, while one that has recently fallen can provide a falsely negative impression.



Source: Tatton. Illustrative example not based on real rainfall data.

Doing something, or just even anything, by trying to time the markets in the face frightening market volatility may feel like the “right thing to do” but it can equally be damaging to long-term investment returns if you get it wrong.

Confirmation bias



Source: Tatton – for illustration purposes only.

Another important behavioural phenomenon is ‘confirmation bias’. This refers to the tendency of people to favour information that confirms their beliefs and actions, making them more confident they have made the right call and unwilling to change tack in the face of mounting evidence.

When markets rise after a fall, there will always be some commentators arguing it is just a ‘bear market rally’ or a ‘dead cat bounce’, suggesting better entry points lie ahead. But waiting for a clear signal may well mean missing out on much of the rebound rally and re-entering at a far higher point. Crystallising a loss and hesitating before re-entering would likely leave an investor far worse off than if they had not acted at all.

Investors must also battle their own internal predilections for greed and fear. For risk-averse investors, getting out of an investment can be very easy, while deciding to go back in can be psychologically extremely hard. Conversely, overly risk-tolerant investors would likely enter too quickly and hang on to failing assets for too long. Either way, the outcome is likely to be worse than staying invested for the long haul.

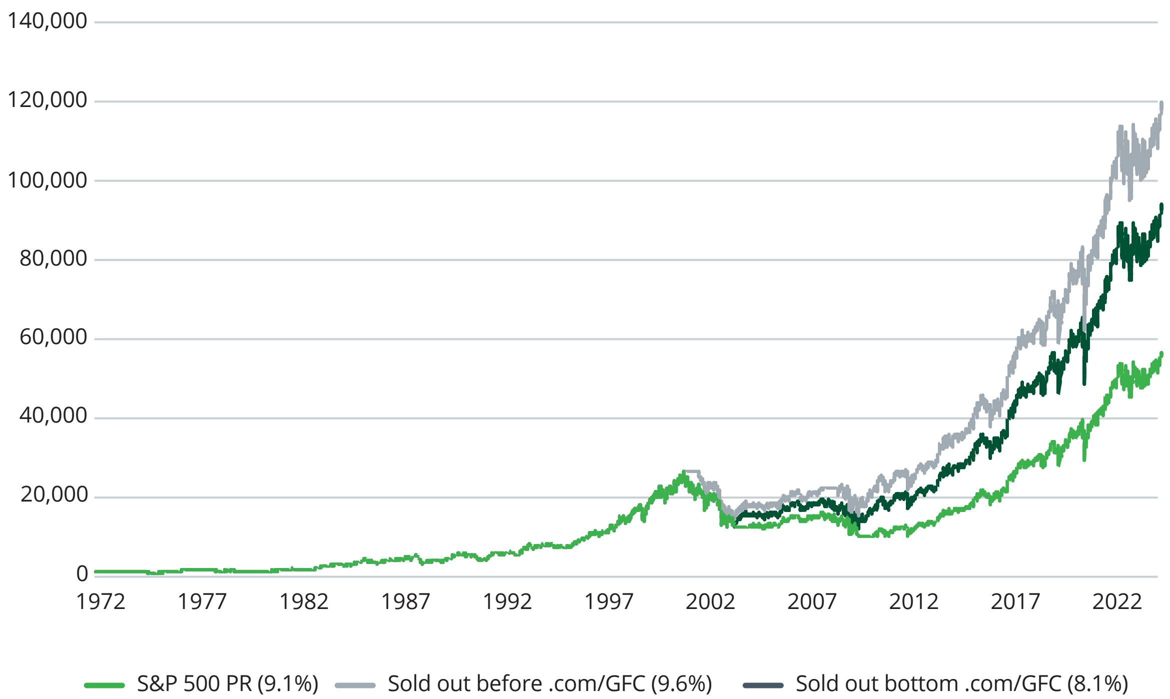
Dedicated day traders are unlikely to be enticed by the long-term investment approach favoured by many of our investors. But perhaps they should heed the risk warnings that many financial spread betting companies carry on their websites, such as “76% of retail investor accounts lose money when trading spread bets and CFDs with this provider”.

Consider that. Even a random coin flip to determine the long or short decision provides a 50-50 chance of being right and wrong. That day-traders lose so heavily suggests psychological factors play an outsize role.

We have repeatedly observed during every market crisis over the last few decades – from the Dotcom Bubble to the Global Financial Crisis and recent pandemic – that making the wrong decision at the wrong time damages returns much more than doing nothing at all. Those fortunate enough to sell at the top and re-buy at the bottom would have obviously made huge returns, and would have luck on their side. It is not impossible to get short-term trading right, but the odds of doing so are terrible.

Another hypothetical scenario looking at illustrative returns from trying to time the market based on two big events in financial history: the Global Financial Crisis and the dot com bubble. Doing something can potentially increase returns but doing the wrong thing at the wrong time can damage your long-term returns more than if you did nothing at all. We have not even looked at the additional trading costs you can incur as you enter/exit more frequently.

S&P 500 PR in GBP at 31/12/23



Source: Morningstar Direct over 52 years between January 1972 and December2023. Assumed 0% return for 252 days with annualised return for each scenario. Series rebased to £1,000

Selling out at the top of the market in both events increases your per year return by just 0.5% versus a time in the market strategy. But selling out at the bottom of both events drags down your annualised return by over 1% per year versus a time in the market strategy. Doing something in this scenario is worse than doing absolutely nothing.

Slow and steady wins the race

Long-term investors should not be too concerned by short-term volatility, as a diversified investment plan should smooth out periods of losses. Volatility only results in a real-world loss when a hasty sale crystallises it.

Investors need to understand that they are very likely to make a better return from a diversified long-term investment portfolio. This approach allows them to earn a risk premium, which is unavailable when depositing their money in a bank account, without exposing themselves to undue risk.

A broadly diversified portfolio is representative of a stake in the global economy, which means risk is spread out across risk factors. It is an entirely different proposition from making bets on a few selected companies.

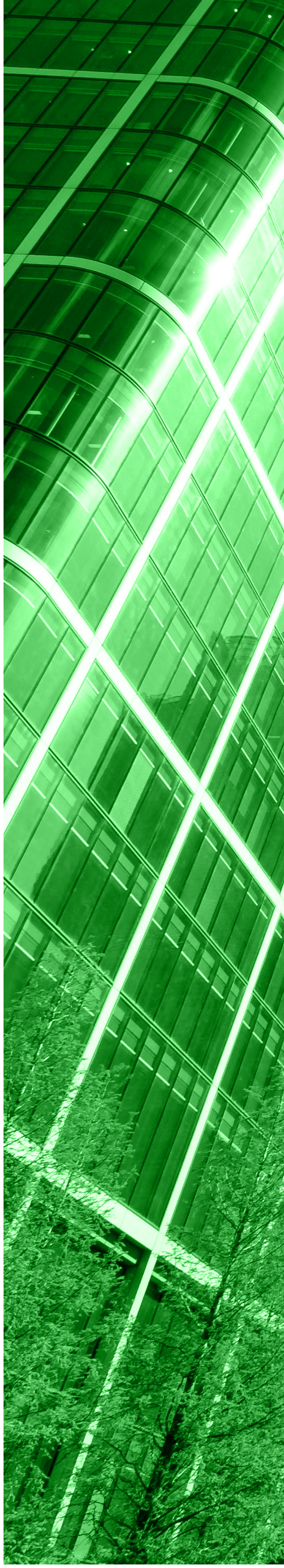
Any portfolio will inevitably experience ups and downs over a long period, but this is no reason to make hasty decisions. A commitment of around five to 10 years, with an exit at the time of the investor’s choosing, is likely enough to capture the risk premium while smoothing out loses.

Investors can also smooth out returns by making incremental monthly additions to their portfolio, rather than making a lump sum commitment that they may unwittingly make at the top or bottom of a market.

A long-term investment plan does not have to be static or unchanging. It makes sense for investors to review their plan regularly to ensure it continues to meet their objectives. Investors can meet their desired financial outcomes by changing allocations within a portfolio of investments or adding new asset classes and investment strategies, however, doing so at the height of capital market volatility risks behavioural factors skewing otherwise sound decision taking parameters into the emotional investment traps described.

Sound investment advice helps investors take on an appropriate level of risk while allowing them to achieve their investment objectives. It also means limiting the potential damage that can be inflicted on a portfolio by trying to time the market.

Market shocks should not lead investors to completely throw their long-term strategy out of the window. When an adverse event happens, as they always will, they should take a deep breath and take a cold, hard analytical look at whether any small and sensible changes may benefit their portfolio. It is highly likely that spending prolonged, uninterrupted time in markets is the best option.



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