The Importance of Staying Invested

Stock markets around the world have just enjoyed one of the best twelve-month periods of appreciation ever. The S&P 500 rose more than 75% from its intra-day low on March 23, 2020 through the close of trading one year later, and most other broad benchmarks posted similarly breathtaking gains. One could hardly be blamed for being tempted to cash in one's allocation to equities now, especially since the world is starting to re-open post-COVID, offering more ways to spend one's recent gains. After all, "Buy low, sell high" is one of the oldest mantras on Wall Street, and quite likely among the pieces of advice most people hear when they make their very first investment.

We are not against trimming into strength. Indeed, depending on one's long-term financial goals and tolerance for short-term volatility and risk, *slightly* reducing one's allocation to stocks when valuations are relatively high and interest rates are rising may be exactly the right thing to do. But note the emphasis on the word *slightly.* Such an outcome should only be the result of selling or reducing individual equity positions that appear to offer less favorable ratios of potential gains to potential declines, based on analysis specific to those companies. As we'll explore in more detail below, shifting one's asset allocation because one is trying to time the market as a whole is rarely a winning strategy.

Our advice when times are flush is much the same as when the storm clouds are darkest: **stay invested**.

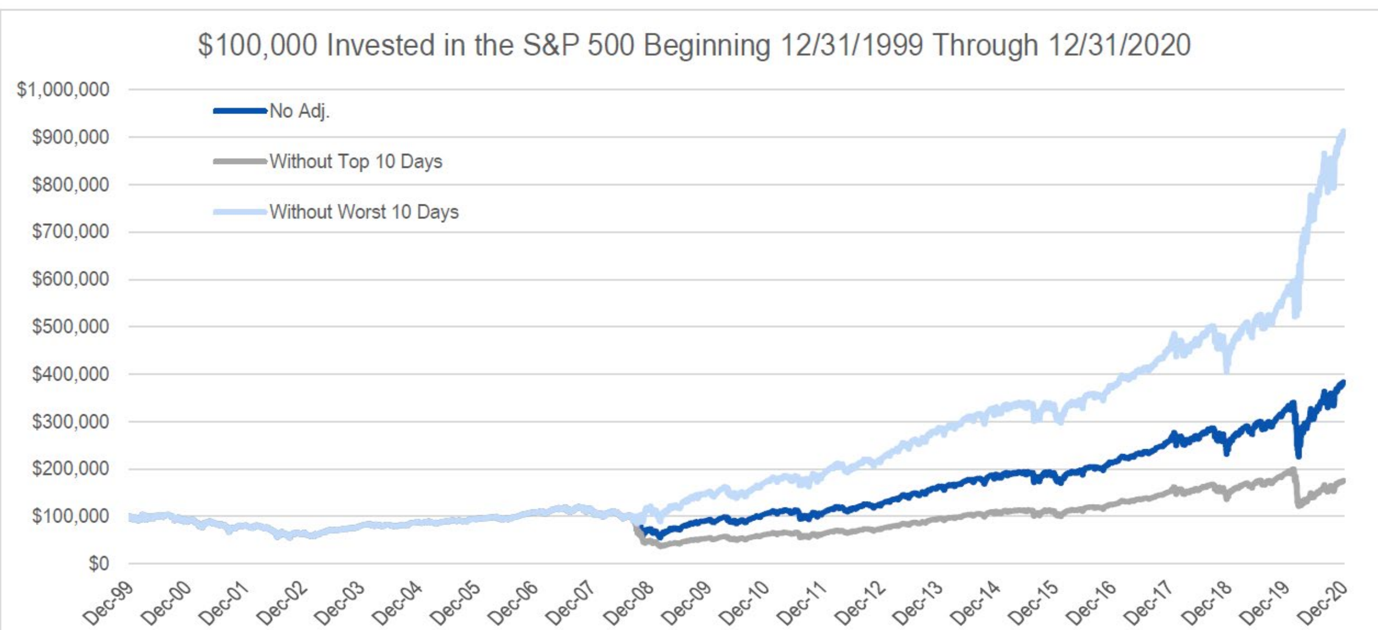
It's not a timing issue. It's an issue of time.

Although past performance is never a guarantee of future results, it is virtually certain that over any period measured in months (as opposed to days or weeks), the stock market will go up *and* down. Advances will be followed by declines, and declines by advances. Some of these changes in direction will be explainable as they unfold: the stock market's steep fall when the world went into COVID-19 lockdown in March, 2020 is a prime example. But many market reversals come out of nowhere, and are only obvious with the benefit of hindsight (and sometimes even then they seem inexplicable). Here again, the pandemic experience provides a great example: on March 23, 2020, just a few days after the lockdown went into effect, the S&P 500 ended the day down more than 30% from its December 31, 2019 close. The news of the day was horrible and getting worse by the hour, yet on March 24 that benchmark started rising and never looked back. By December 31, 2020, the S&P 500 was more than 67% higher than its March 23 close. We now know that some of the unprecedented global stimuli made their way into stocks instead of the economy, but that was hardly apparent at the time. It's pretty unlikely that anyone who reduced his or her exposure to stocks when the pandemic hit was prescient and unemotional enough to get back in at or close to that bottom, and those who did not return until later (if at all) missed a good portion of the market's historic rally.

The phrase "You've got to be in it to win it" is often quoted in sports to motivate teams hoping to reach the championship game. Those words could also apply to investing in the equities. Traders who dodge in and out of stocks trying to outsmart the market may miss the best days and end up with sub-par returns that inadequately compensate them for the risks they've taken (not to mention a fatter tax bill for any capital gains realized along the way). Let's look at the period from December 31, 1999 through December 31, 2020. These twenty-one years spanned three bear markets (defined herein as declines in the S&P 500 index of 25% or more from peak to trough), but the value of the index still grew at a compound annual rate of 6.6% (excluding dividends). In dollars and cents, $100,000 invested in the S&P at the end of 1999 would have grown to $383,860 by the end of 2020, illustrated by the dark blue line in the graph below. If one removed just the ten best daily gains from the more than 5,200 days covered, the compound annual gain drops to 2.7%, and the ending dollar value of one's portfolio drops to $175,860 (before taxes), illustrated in the grey line in the graph. If one removes the twenty-one best days, the return plummets to zero, and one's initial stake is worth a few dollars less at the end of the period than at the start. Stated another way, an average of just one day per year through the first twenty-one years of the twenty-first century accounted for 100% of the increase in the value of the S&P 500 over that time. Similar studies for other benchmarks reveal similar results. Being on the sidelines for one or several of those days would have put a serious dent in one's portfolio returns.

One might be tempted to counter, "OK, but what if one removes the ten *worst* trading days from the series? How much greater would the gains have been?" This is a fair question, in our opinion, and one that rarely gets addressed in studies such as this. Returning to the same twenty-one-year period, eliminating the ten worst daily declines increases the S&P's compound annual return to 11.1%. An initial investment of $100,000 would be worth $913,221 at the end, almost three times as much as the pile produced by staying invested the whole time (again, all figures are before taxes and exclude dividends). This is depicted in the light blue line in the graph.

That might seem like a big enough payoff to justify the gamble, even if one concedes that it would be virtually impossible to get out of the market on the precise day before a big drop and then back in the day after…even once, let alone multiple times. Imagine one said instead, "Well, I might not be smart enough to get the worst days exactly right, but I bet I could identify the months when the market is going to tank." We have yet to come across such a consistently prescient prognosticator. And even if such a seer exists, here's the rub: historically, in any given stretch many of the market's best days are within a couple of weeks of its worst. Sometimes the gems precede the bombs, and sometimes they come after. So one has to stick the landing perfectly, again and again and again, to enhance one's returns sufficiently to justify the effort.



Note: All ten of the S&P's worst days and best days between 12/31/1999 and 12/31/2020 were recorded after 9/30/2008, so the three lines coincided until then.

When researching this paper, we came across several articles that took a somewhat different tack to examining the merits of staying invested. A report published by Capital Group in early 2019[1] caught our eye, and we have taken the liberty of updating the analysis to include calendar years 2019 and 2020. In this study, we follow two investors from the beginning of 1999 through the end of 2020, a period of twenty-two years. Both investors put $10,000 into the market each year, for a total of $220,000. Investor A is incredibly lucky, choosing the single best day in each calendar year to put that year's deposit to work: the day the S&P 500 hits its low. Investor B is incredibly unlucky, choosing the single worst day each calendar year to put that year's deposit to work: the day the S&P hits its high. Lucky Investor A exited 2020 with a balance of $851,404, almost four times the original investment...pretty good, considering that the period included three bone-crushing market retreats. And despite being all thumbs when it came to timing, unlucky Investor B entered 2021 with a balance of $644,235, nearly three times the original investment. This illustration actually has two morals: one, it pays to stay invested, and two, a regular plan of investing over time can provide satisfactory returns even if one never catches the bottom of a given period's market move.

It is important to note that these examples are illustrations based on historical index data. Even if one employed exchange traded funds based on the benchmarks, one's returns would differ because of the costs of managing those funds. Moreover, past performance does not guarantee future results. Please see additional disclosures below.

Try as we might, we cannot invest with 20-20 hindsight. Some things in the coming year (or five, or ten) will go predictably right, and others will go unpredictably wrong. The key to successful investing is to allocate one's assets to suit one's long-term goals, to build a portfolio that suits one's tolerance for risk, and to maintain laser-like focus on these long-term guides while staying invested throughout the markets' ups and downs. We welcome your questions and comments.

Note: All market data is from Bloomberg.

1 https://www.capitalgroup.com/individual/planning/investing-fundamentals/time-not-timing-is-what-matters.html