FE Investments

Timing the Market
The Strategist's View

26th March 2020

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As the UK adjusts to life under the new restrictions, the initial shock from social distancing seems to have sunk in for most, but sadly not all, people. Nonetheless, in times of adversity we see elements of human nature at its very best. Engineers, distillers, supermarkets, manufacturing companies and many more have reoriented their businesses and focussed on the greater good, supporting each other and the country in a time of need.

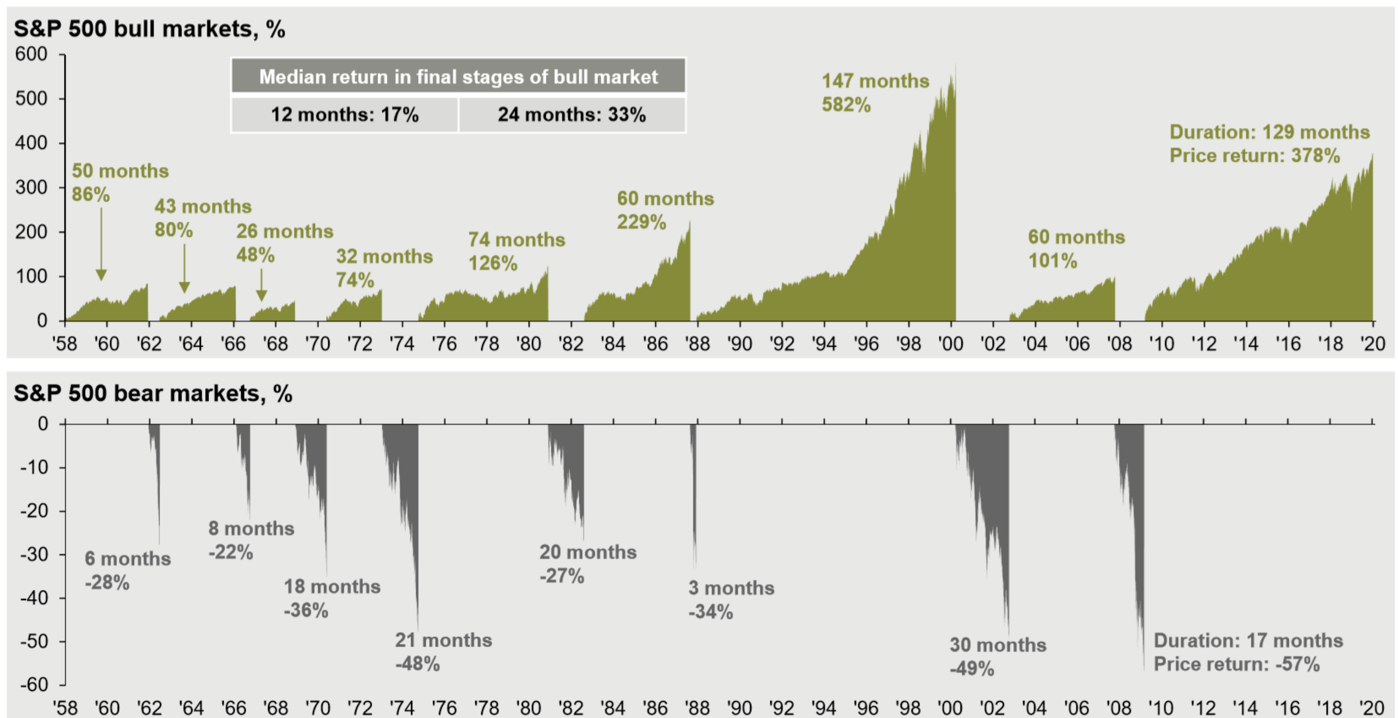
Financial markets are not excluded from the influence of human nature and our animal instincts have been helping drive the swings we have seen across the globe.

Markets have moved through various psychological stages: denial, fear and panic seem to be making way for hope, relief and optimism. This week has seen a strong recovery in equities, driven by solid and unified economic action plans from governments. This combined support from authorities around the world has been viewed positively by investors. The responses both fiscal and monetary, should filter through to the global economy in stages.

While the pandemic progresses and economic stimulus gradually filters through, what should investors do during times of market stress?

What has happened in the past?

Every time markets fall the circumstances are different but there are some common features that are repeated and we can separate positive and negative periods to make sense of market gyrations.



Source: JP Morgan Asset Management

We are currently in a bear market. This is the term we use to describe markets that fall 20% or more from their peak and we can see there have been eight since 1958. They have also been noticeably shorter than the periods when markets have increased. In the last 50 years there have been only eight occurrences where markets have fallen peak to trough by 20%. There have been 621 positive months and 123 negative months.

In the intervening periods markets undergo a "bull run" where they increase in value from the bottom of a bear market trough. These periods produce the best returns from investors. The returns outweigh the falls and on average they last longer than bear markets. Weighing out the peaks and troughs, since 29th January 1988, the S&P 500 has returned 2,763%.

How does this look over a long period of time?
When these bull and bear markets are looked at in total the picture looks very different over time. The dot-com bear markets saw the S&P 500 fall 49% and at the time this seemed significant. Fear was prevalent in markets and this fed through to everyday life. But looking back over time, the falls we saw were relatively small in the long-term context of markets.

Many of the bear markets of the past are relatively small fluctuations. Some don't register at all.

How long will this fall last?
There is only one period where investors experienced a negative 5-year return and this was during the dot-com recession. This would suggest that the duration of negative returns for investors relatively short. Even at the close of business last week the fall in markets of 30% hasn't pushed 5-year returns into negative territory. In fact, over the last five years investors are still up 80% and investors are much better off than in other market sell offs.

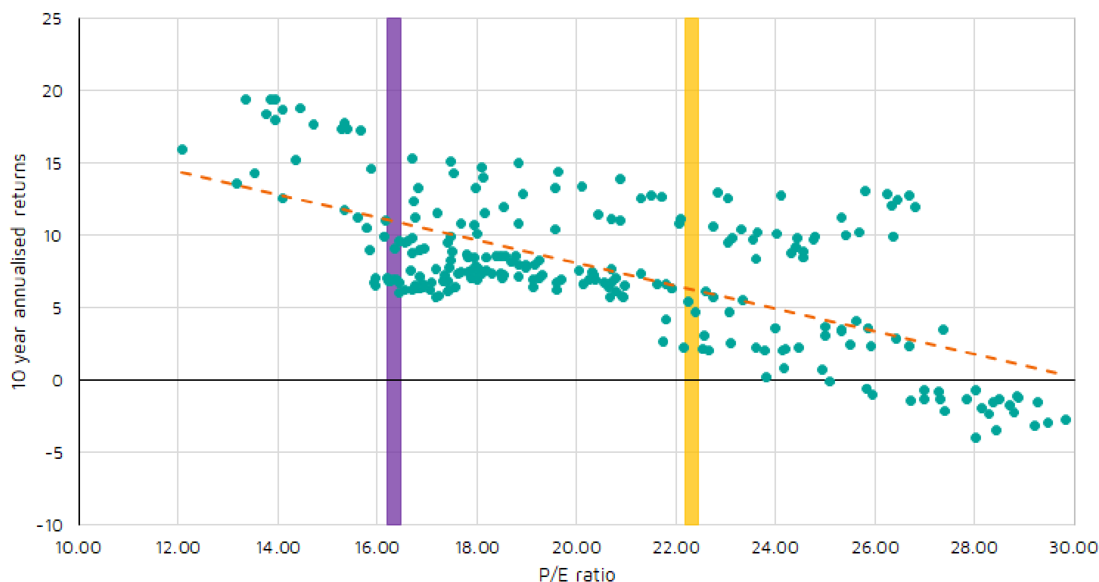
Should we have been expecting the fall?
To put this in perspective, until last month markets have enjoyed one of the longest upward runs in history. No one should expect financial markets to experience unbroken growth. The longer a bull run continues the more likely it is that we will suffer a fall.

Over the past few decades, investors have suffered a number of "shocks" where the prices of investments have fallen and the risk, as measured

by the amount that prices move up and down, or so-called volatility, has increased. It had become more likely that one of these shocks would be significant.

Before the recent correction, investments were expensive. Looking at equities, the price to earnings ratio, which measures a company's share value compared to its profits, stood at 18.4 times, around 16% over the long-term average. It was therefore more likely that equities would fall back to their long-term average.

Valuations are important as they are an indicator of investment returns over the long term. When price to earnings ratios are high, the returns from equities are lower over the following 10 years; when valuations are low the returns are usually higher. In the table below, the green bar is the level of valuations prior to the COVID-19 crisis and the red circle where we are today (which is variable due to shifts in market prices).



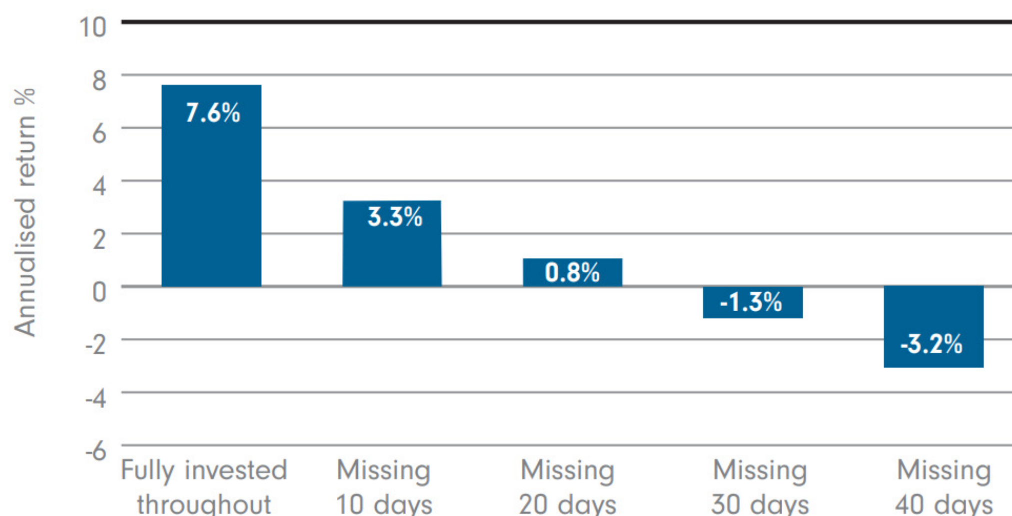
Source: Bloomberg 31/01/1990-26/02/2010

Prior to the crisis equities were expensive and now they are cheap compared to historical valuations. This suggests that the returns in the coming years may be higher. Logically you would sell when valuations are high and invest or stay put, while valuations are low.

Before this recent correction there were many indicators that suggested equities may fall in value. However, timing and predicting markets is very difficult to do consistently and those who do occasionally call markets are lucky.

Should I sell my investments?

Our review of historic bull and bear markets indicates strong returns are often seen after a fall in markets. Cheap valuations suggest returns over the next 10 years will be higher than before the fall. But if you sell and are out of the market on the best days in markets, it can significantly reduce the returns on your investment portfolio. For example, missing just 10 of the best trading days in equities can reduce your annualised returns from 7.6% to 3.3%. Missing additional gains over 20, 30 or 40 days, is even more detrimental to your returns and your financial plan. Do you want to risk missing the best days or remain invested? We don't, so we chose to stay invested.



Source: Fidelity International Period: 31/12/04 – 31/12/19

In summary
There are some key lessons to be observed from history because certain factors remain constant for investors.

Markets are difficult to predict, and we cannot foresee the future. We therefore do not try to foresee market changes in direction. Instead, we focus on the risk in your portfolio and taking the appropriate amount to deliver the returns for your financial plan.

As professional investors we have remained calm as markets have adjusted; we expected it and could not time it correctly. Knowing our limitations is an important part of our philosophy. We have been considering the risks in your portfolio and made some slight changes, to avoid unwarranted risk, but we have not sold out as we are aware of the risks with market timing.

Time and patience will overcome the unpredictability of markets. We know that over time the gyrations and noise that we hear in the press will pass. Valuations of equities indicate that returns will be higher than before the crisis but to realise these we should remain invested.

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