QS Investors
A LEGG MASON COMPANY

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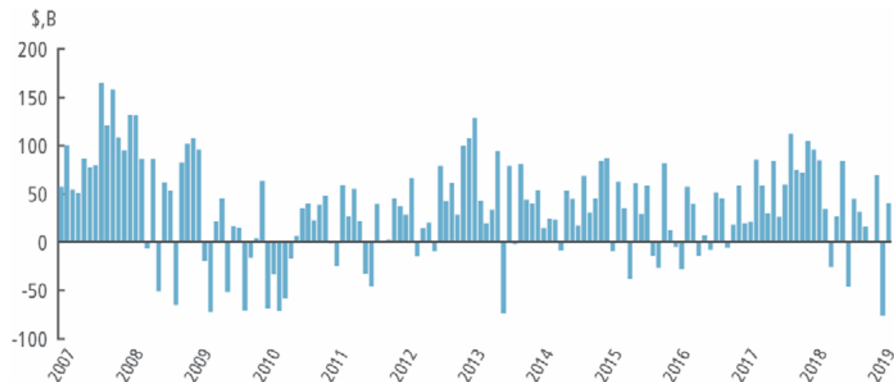
Time in Rather than Timing the Market

2018 tested investors' resolve. After peaking in September, US equities markets came near bear market territory drawing down 19.8%. During the last quarter of the year, investors fled equity markets amidst the heightened volatility pulling over $75 billion from US Equity Mutual Funds and ETFs in December alone.

Investors that left or reduced their equity exposure during the fourth quarter of 2018 missed out on one of the biggest Januaries on record, as the S&P 500 returned nearly 8%, realizing its biggest January rise since 1987!

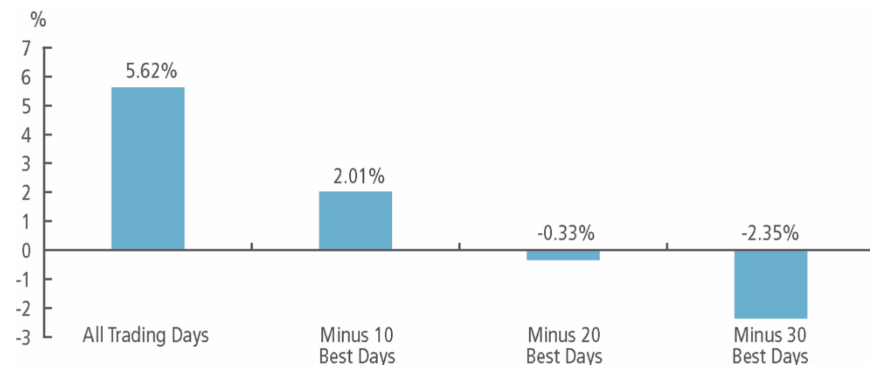
NET FUND FLOWS, MONTHLY



Source: Lipper. Includes ETFs, Mutual Funds, Commingled Funds and Fund of Funds.

Investors that left or reduced their equity exposure during the fourth quarter of 2018 missed out of one of the best Januaries on record, as the S&P 500 returned nearly 8%, realizing its biggest January rise since 1987! In fact, the S&P 500 Index, up nearly 12% as of the end of February 2019, has realized the best start to the year since 1991. This swift rebound in returns underscores the difficulty and danger of timing the markets. It is human behavior to react to bouts of volatility with fear; however, history shows this can greatly impact overall total returns. Missing just ten of the best trading days over the last 20 years, would have reduced returns over this period by 64%. Missing 20 of the best trading days over this 20 year holding period would have actually resulted in a negative overall return.

ANNUALIZED RATE OF RETURN S&P 500 INDEX (JAN 1998 – DEC 2018)



Source: Bloomberg, S&P 500 Index.

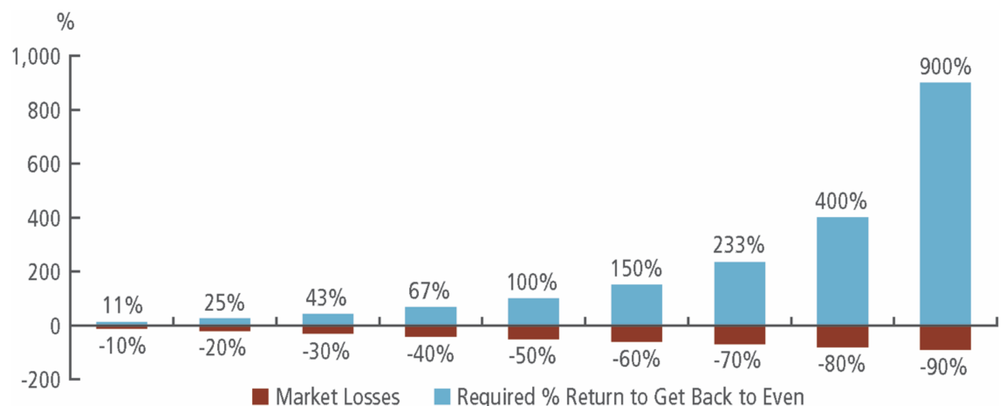
How does understanding the importance of time in the market impact investors today?

It is important for investors to consider diversifying equity allocations to high quality and attractively priced defensive large cap equities.

As we enter into the latter stages of the economic cycle with anticipated slower economic growth combined with likely increases in volatility, investors need to be mindful of portfolio positioning. Equities continue to be an integral growth component of portfolios, providing the ability to continue to capture supportive economic fundamentals and profits. However, the true benefit of the asset class is only realized when investors are able to stay the course. As such, it is important for investors to consider diversifying equity allocations to high quality and attractively priced defensive large cap equities. Exposure to relatively cheap, non-cyclical dividend paying securities can provide access to equity risk premia and increase diversification while mitigating volatility and downside risk which can leave investors susceptible to selling at the wrong time. Considering the historical upside/downside capture of a fund relative to the market cap weighted index allows investors to set expectations for the overall risk profile and what drawdowns may look like in the midst of volatility.

Investors often fail to appreciate the impact that large drawdowns may have on their investment outcomes. Downside risk is asymmetric and therefore offsetting a large loss requires an even bigger gain. It is important to consider allocating to a fund which allows investors to weather equity market volatility enabling them to maintain market exposure over the long-term. Through reducing volatility and drawdowns, defensively oriented equities may offer a more palatable risk/return profile.

RECOVERING FROM DRAWDOWNS



This is meant to be an educational illustrative example and not intended to represent investment returns generated by an actual portfolio. These returns do not represent trading or an actual account, but were achieve by means of using the following formula: 1/(1-"market losses")-1.

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