Wealth Management
PH&N Investment Counsel

Stu's View

August 2020

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Timing isn't everything

Part one: Time in the market, and there's always a reason to sell

In this two-part series dedicated to the topic of market timing, we take a look at the topic of market timing from different approaches. In part one, we discuss the difficulty with market timing, and why it is not necessary to achieving your financial goals and objectives. In part two, we discuss the behavioural biases that lead to emotional investment decisions, and we offer up a few nudges to help improve potential outcomes. We stress the importance of the Investment Policy Statement (IPS) in the process, and reiterate the preference for a goals-based approach to investing.

Have you ever wanted to know how to buy and sell stocks with impeccable timing? Have you ever owned a stock that appreciated two, three or even ten-fold, and grappled with the decision to sell or hold on for more? Did you sell some or all of your stocks this year, and wonder if you should get back in, or wait for further "all-clear" signal to invest in stocks again (if there is such a thing)?

Market predictions abound, and you certainly don't need someone else opining on the subject. You will find no predictions here on the future direction of the stock, bond or other financial markets. Instead, you will find some perspective on market timing, and why it's a proficiency that few, if any, possess (or even need to possess) when it comes to investing. Following a rules- and goals-based investment process is a sound investment approach that does not require market timing in order to be successful. And success in this case is you achieving your financial goals and objectives within the confines of your wealth plan, and doing so without taking undue risks.

Let's begin with a multiple-choice question. If you were asked to select the most important determinant to long-term investment returns, which one would you select?

A. Having enough exposure to countries/regions with economic growth

B. Selecting the top performing fund manager(s) to invest with

C. Making sure I have the right mix of stocks, bonds, cash and other investments

D. Timing buys and sells in the portfolio

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Most people would have selected their answer based on their own investment experience. But based on empirical research, "C" would be the most important determinant when it comes to portfolio performance. In the financial industry, this is referred to as the "strategic asset mix" (i.e. the mix in the portfolio between equities, fixed income, cash and alternative investments). Understandably, it may be difficult for most investors to come to terms with the view that successful investing, defined here as achieving stated goals/objectives over time, is less about picking stocks or funds, and more about the appropriate mix of stocks, bonds and other investments to achieve one's goals within the context of risk tolerance, risk capacity and time horizon.

One influential academic study around market-timing decisions, titled "Determinants of Portfolio Performance" (Brinson, Hood, Beebower), found that 93% of a portfolio's long-term variance from indexes, or benchmarks, was attributed to asset allocation. The selection of individual securities such as stocks, and the timing of security buys/sells and other variables, accounted for only 7% of the variance. This study sparked a wave of follow-up work by academics and practitioners who questioned its conclusions. Other studies found that about three-quarters of a typical portfolio's variation in time-series returns comes from general market movement, with the remaining portion split roughly evenly between the specific asset allocation and active management.

Regardless, there are two generally accepted principles today as it relates to the determinants of portfolio performance: (1) being in the market, and (2) doing a strategic asset allocation.

Why is timing the market such a difficult task?

Financial markets such as the stock market are very complex, adaptive systems that reflect the aggregate forecasts and expected outcomes of countless individuals and entities. In order to profit from market timing consistently over time, you would theoretically have to know the forecast of every individual and entity participating in the market, and then figure out if that aggregate forecast is too optimistic, or too pessimistic in order to place your bet as to the future direction of the market itself. It's the classic analogy that James Surowiecki discussed in his 2004 book titled The Wisdom of Crowds: Why the Many Are Smarter Than the Few and How Collective Wisdom Shapes Business, Economies, Societies and Nations.

Conveniently, I have come up with the three T's as to why marketing timing is difficult:

- **Transaction costs** – despite the lower cost to trade securities today, it is not free and there are still explicit and implicit costs (e.g. the drag on expected portfolio returns from holding more liquid instruments such as cash, which offers downside protection but little to no return).
- **Taxes** – portfolio turnover as a result of buying and selling securities in an attempt to profit from market timing can result in immediate tax consequences for individual investors, and that also needs to be taken into account. Even for unsuccessful market-timing, taxes could be added costs to account for.
- **Time and resources** – as mentioned above, the amount of time and resources you would need to dedicate in order to unravel the fabric of the stock market forecasts at a single point in time is daunting to say the least. Nobody will be able to tell you with any degree of certainty what the market is pricing in to future expectations today.

There are a number of risks in this approach to market. Specifically, the obscene number of variables and permutations of outcomes that increase the chance of forecasting error, and risk to future expected portfolio values. Marketing timing involves exposing your portfolio and wealth plan to a number of factors beyond your control. What is in your control? Adhering to your strategic asset allocation and overall wealth plan designed to achieve your goals/objectives within a prescribed level of risk based on your investment experience, time horizon and unique circumstances.

Time in the market, not timing the market

One of the more potentially damaging decisions that an investor could make is to materially move away their strategic asset allocation during a correction (a market that drops 10% from prior highs) or bear market (a market that has dropped 20% or more), with a view to "move to the sideline" until the situation "improves. Often times, such decisions are based on emotion and cognitive biases that can cost investors dearly. The belief that market timing can preserve wealth as the market corrects is a myth.

In the following chart, we show how the investment strategy of dollar cost averaging (DCA) compares to market timing. DCA is a gradual way of buying into the market, which aims to reduce the impact of volatility on large purchases.

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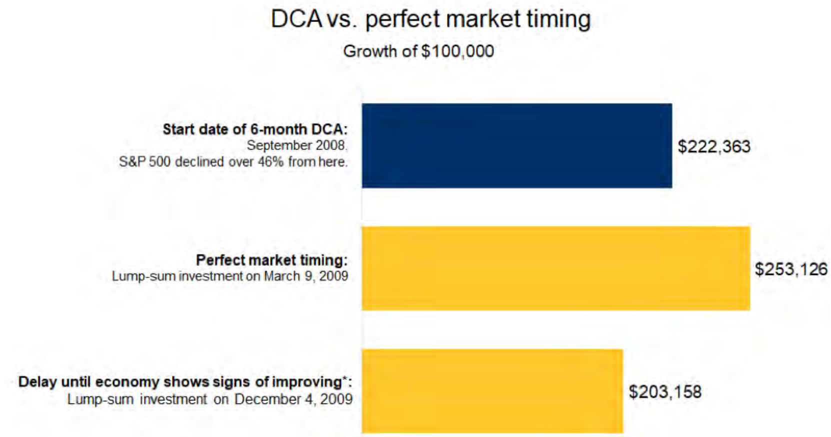
In the chart we look at how three different scenarios affected a (hypothetical) $100,000 investment portfolio during the 2008 financial crisis. In the first case, the investor started to invest after an initial 46% decline in the S&P 500 index starting in September 2008. The DCA strategy deployed cash across six equal monthly installments beginning September 1, 2008, and would have resulted in a portfolio value at May 31, 2020 of $222,363.

In contrast, if an investor had perfect foresight and chose to invest the entire $100,000 at the bottom of the S&P 500 index on March 9, 2009, that May 31, 2020 ending value would be $253,126. The difference of just over $30,000, or 13% over 11 years, is not very material, and the probability of such perfect timing is very low.

In the third and final scenario, the entire $100,000 portfolio is invested almost nine months following the bottom in the S&P 500 index, on December 4, 2009. This date may be considered a point when some investors considered the "all-clear" signal to get back in to the market. The hypothetical May 31, 2020 value of that portfolio is the lowest amongst the three scenarios, but more important it's lower than the portfolio that was invested a full seven months before the S&P 500 index bottomed in March 2009.

Again, timing isn't everything.

Chart 1. Dollar Cost Averaging (DCA) versus market-timing



Source: RBC GAM, Morningstar. RBC Select Balanced Portfolio Series F data as of May 31, 2020. Scenario involves an investor with $100,000 in cash. The DCA strategy deploys the cash across six equal monthly installments beginning September 1, 2008. The lump-sum investments involves deploying cash on specified dates. *December 4, 2009 is date the November U.S. non-farm payroll report was issued, showing first decline in unemployment rate during global financial crisis. All amounts are based in CAD.

Chart 2. S&P 500 price return March 2009 through July 2020, accompanied by major news headlines

Source: S&P 500 Index, total return March 2009 through December 2019, in USD. Bloomberg, RBC Phillips, Hager & North Investment Counsel Inc.

There is always a reason to sell

Looking back at the S&P 500 index from the lows of March 2009 to more recently in Chart 2, we can see there are always reasons to sell your stocks and move into cash, to "wait it out." Bad news, headwinds, impending danger, heightened volatility, etc. are forever present in financial markets. Despite the seemingly unending reasons to sell out of stocks over the last 11 years, and the material corrections in the market over that time period, a cumulative return (not including fees, transaction costs, commissions or dividends, in U.S. dollars) would have yielded 476%! That's approximately a 9.9% annualized return over the period.

Having reduced or eliminated exposure over this time period would have been detrimental to long-term investment objectives. Trying to manage a portfolio by reacting to the headlines could have proved costly over the last 11 years as shown in Chart 2.

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With the never-ending reasons to sell, when would you ever decide to "get back in" if you left? If you recently exited the market and are wondering if now is the right time to get back in, let Chart 2 be your guidepost to buying back into the stock market.

Again, timing isn't everything.

Please reach out to your Investment Counsellor if you have any questions about this article or your portfolio.

Be well,
Stu

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S&P 500 Index: The S&P 500 Index includes 500 companies across many sectors of the U.S. economy. The index is weighted by market capitalization so bigger companies make up a larger proportion of the index than smaller companies. The index is designed to measure performance of the broad US economy through changes in the aggregate market value of the largest US companies.