Market Timing

February 2022

PART OF INVESCO'S

Education Series

invesco

Niall Murphy, Investment Consultant

Introduction

We have all heard the old mantra of 'Time in the market beats timing the market'. However, most investors have been guilty at some point to try and time a rising market or a declining market. When markets are rising and setting new all-time highs as they did in 2021 several times, many investors waited for a pullback to allocate more of their capital. In this paper we analyse five different strategies to see which was the best in achieving the highest return. All returns quoted throughout the paper are before any management charges.

For this analysis we have reviewed five different scenarios over the last two decades up to 31st December 2021. These five scenarios look at different investors as follows:

Investor A

This investor had perfect market timing. They had great skill or luck and were able to invest at the lowest point of each month for our analysis period over the last 20 years.

Investor B

This investor was extremely unlucky and somehow managed to invest at the highest point each month over our 20-year analysis period. This investor followed the complete opposite path to Investor A.

Investor C

This investor is your most realistic type of investor who invests a portion of their income at the end of month. For simplicity, this investor allocated their capital on the last trading day of each month for the 20-year period.

Investor D

Investors A, B and C invested the same amount each month for our 20-year period. The total contributions were €24,000 over the 20 years. Investor D used a lump sum equivalent to the others total contributions over the period and invested it at the very start of our analysis period. They essentially invested their money and left it to grow over the full period and did not withdraw even when markets sold off strongly.

Introduction

Investor E

This is our risk averse investor who did not want to take any market risk for our entire analysis period and invested €100 into a cash fund each month. Cash performance is measured by the return of the FTSE 6-Month Euro Deposit rate.

Our first four investors did not pick individual stocks and simply invested in the MSCI World Index each month. The MSCI World Index is a commonly used benchmark for global stock market performance and used extensively in low-cost passive investing. The index is a market capitalization weighted index meaning that bigger companies have a higher weighting. The top holdings in the index as of 31st December 2021 are detailed in Figure 1 below. This index is highly diversified in nature covering 23 developed market countries with c1,545 constituents. Investors A, B and C started by investing €100 and invested a further €100 in each subsequent month. Investor D invested a lump sum of €24,000 which is equivalent to the others cumulative investment over the period.

Figure 1 – MSCI World Index Top Ten Holdings at 31st December 2021

Company	Weighting
Apple	4.7%
Microsoft	3.9%
Amazon	2.4%
Tesla	1.4%
Alphabet A	1.4%
Alphabet C	1.3%
Meta Platforms A	1.3%
Nvidia	1.2%
UnitedHealth Group	0.8%
JP Morgan Chase & Co	0.8%

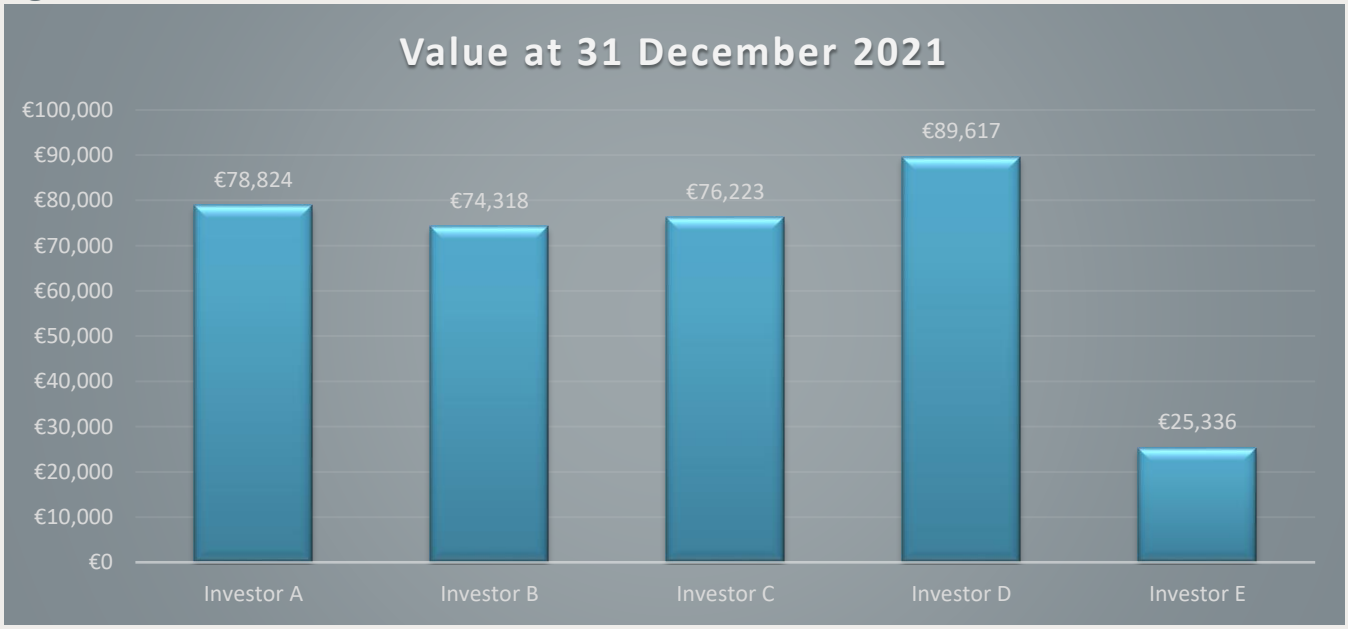
Source: MSCI

Analysis

The cumulative invested capital for each investor is outlined in Figure 2 below. The analysis did throw up some interesting results into timing. The most important of the results is that for any investor who stays invested for the long-term, they typically generate a positive return. Each investor has a total contribution of €24,000 over the 20-year period and each has generated at least €50,000 in market returns apart from our Investor E who was fully invested in cash. Even if you were Investor B who was our unluckiest investor you still generated a return of €50,318 while our lucky Investor A who invested at the bottom point of each month generated a total return of €54,824. This was a surprising finding from the analysis as our expectation would have been for a wider differential given the points of investment. However, it is worth noting that if we had looked at this on an annual basis as opposed to monthly the differential would be higher.

If you did not care about timing and just invested like Investor C at the last trading day of each month you are in between our lucky Investor A and our unlucky Investor B which was as expected. The clear winner here was our Investor D who was lucky enough to be able to invest €24,000 at the very start of the 20-year period. This showed that the longer time you have in the market, the more of a chance your funds have to grow over time. Our cash Investor E also helped in explaining this point as the risk averse investor only returned €5,336 which significantly underperformed their peers.

Figure 2 – Total Value



Is Timing Markets the Correct Strategy?

Of all the scenarios with regular investments (Investors A, B & C) throughout the 20 years our winner was Investor A who managed to perfectly time the bottom point of each month. While this looks to be a good strategy in theory, it is extremely difficult to execute in practice as no one knows with certainty the bottom point of a market each month. While markets are falling an investor can invest at a point which appears to be the bottom whereas if markets continue to fall, the investor could lose a significant chunk of their investment straight away. For example, in Q1 2020 the world and global markets were rocked by the widespread lockdowns due to Covid-19. The market was down c15% by March 6th, another c10% by March 13th, and another c10% by March 20th so if you did not get the absolute bottom point here you would lose a considerable amount of your investment. Getting your timing incorrect and not investing at the absolute bottom of each market sell-off would considerably shrink the gains Investor A achieved over their counterparts.

Additionally, this strategy runs the risk of waiting too long and missing a rebound in markets. Typically, the best days in markets occur very soon after the worst days and if you miss the best days, you can significantly hurt your investment over the longer-term. Our research leads to the point that investors are best off in taking a long-term approach investing regularly over your investment time horizon.

Benefits and Key Aspects of Investing for the Long-Term

1. Compound Returns

A key advantage of staying invested for the longer-term is to do with compounded returns. Compounded returns refer to when your investments produce positive returns these gains get reinvested and can continue to earn more. As demonstrated through our five investors the longer your money stays invested the greater opportunity it has to compound and grow. While compounded returns can have a significant long-term impact, there may be periods where your investments fall in value, so it is important to try and hold tough through these periods of drawdowns. The value of these compounded gains can turn out to far outweigh your investment over the longer-term as we saw in Figure 2 where each of our investors contributed €24,000 and each returned more than €50,000 over the 20-year period.

The earlier you can start investing the more of a chance you have of increasing your compounded returns as was the case with our Investor D who invested their lump sum in January 2002 and outperformed even our Investor A who had perfect timing each month for 20 years.

2. Timing Risk is Eliminated

The guesswork in trying to time markets is removed by investing a certain amount each month. This is referred to as dollar cost averaging. For investors contributing to a retirement plan this is the strategy they already have in place as the funds they invest in fluctuate in price so they can buy more units when prices are lower, but they buy fewer units when prices are higher all with the same monetary amount. This was the strategy of our Investor C who ended the analysis period only €2,601 shy of Investor A who timed markets perfectly.

Benefits and Key Aspects of Investing for the Long-Term

3. Beating Inflation

In our most recent paper 'Investing for Inflation' we noted investing in global equities/stocks as a strategy to provide investors with protection against the erosion of their pot due to inflation over time. As inflation increases, most companies have a certain ability to pass these cost increases on to their consumers which protects the investor's capital. This becomes especially important when a long-term time horizon is taken as the purchasing power of capital can be greatly eroded over these longer periods if the correct investments aren't made to protect your accumulated pot. For example, if you take €100 at the ECB target inflation rate of 2%. The real purchasing power value of this €100 is reduced to €66.76 over a 20-year period. Therefore, if you are prepared to take on risk with your investments you will give yourself the best chance to beat inflation over the longer-term.

4. Less Time Consuming

If your strategy is to invest a certain amount each month you will take up less time in trying to analyse financial markets to find attractive entry points. Investors can spend all day every day trying to research where the next bottom point of markets is going to come from but our research in Figure 2 shows that this doesn't yield the type of returns you would hope for compared to a simple buy and hold strategy over the longer-term.

5. Know Your Time Horizon

Everyone has different goals when investing whether that be for retirement, children's education costs or purchasing that holiday home in West Cork. Typically, long-term investing means allocating capital for a minimum of 5 years. While we have focused on global equities through the MSCI World Index in this paper different strategies require different asset classes at different points such as bonds and alternative assets. If investors want certainty with the value of their investment pot they should aim to allocate more to less risky investments such as bonds and cash.

Benefits and Key Aspects of Investing for the Long-Term

6. Be Fee Conscious

The costs of investing are represented by the Total Expense Ratio (all in cost for investment in a fund) and can have a large effect on your net returns over the long-term. Additionally, in years where your funds experience a loss these losses are further exacerbated by fees. Actively managed funds typically are much more expensive than the passive alternatives which we have focused on in this paper. While some active managers generate positive returns above passive funds it is worth speaking with your Investment Consultant before deciding on an actively managed strategy.

7. Stay the Course

Going to cash at first sign of volatility or sell offs and any reactionary investments can hurt your investment value over time. While it is important to review your investment strategy on a regular basis perhaps annually, you are best off to stick with a strategy for a prolonged period even if your returns are hurt for a period.

Summary

This paper provided the outcomes of five different types of investors based on real market returns as measured by the MSCI World Index and the FTSE 6-Month Euro Deposit rate over the last 20 years. Overall, timing markets has shown to be very difficult to execute in practice, so investors are better placed to develop a simple long-term investing strategy where time spent in the market is your biggest ally. A strategy of this nature takes out risks such as timing and consumes far less of your time in researching markets. This allows the investor to set their investments, hold for the long haul and ignore any noise in markets while letting their pot grow over time. Procrastination can also negatively impact returns over the longer-term as waiting for a pullback you may miss some of the best days in markets and as evidenced the best strategy was to invest a large lump sum early on. An investor's individual time horizon is key to deciding on when and what asset classes to invest in. A shorter horizon may lead to an investment in less risky assets such as bonds and cash whereas a longer horizon allows for a higher weighting to stocks/equities.

Holding your investments for the long-term and choosing the correct funds to invest in a cost-effective manner is an area Invesco has researched extensively for over 25 years. If you would like any further information about the options available via Invesco, please contact your client representative and we would be happy to discuss your options in further detail.

IF YOU HAVE ANY QUESTIONS ABOUT THE INFORMATION IN THIS DOCUMENT, PLEASE CONTACT YOUR CLIENT SERVICE REPRESENTATIVE.

contact us

INVESCO DUBLIN

2 Sandyford Business Centre,
Burtonhall Road, Sandyford, Dublin 18.

PHONE:
+353 1 294 7600

EMAIL:
info@invesco.ie

INVESCO CORK

Invesco Cork,
No. 6 Lapp's Quay, Cork.

PHONE:
+353 21 480 8041

EMAIL:
info@invesco.ie

www.invesco.ie