KEATING
WEALTH MANAGEMENT

NEWSLETTER

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Time in the Market vs. Timing the Market

The story of personal finance can be summarized in four words: **Most wounds are self-inflicted.**

"We do not have, never have had, and never will have an opinion about where the stock market, interest rates or business activity will be a year from now."

— Warren E. Buffett, the world's most admired, least imitated investor, in his annual letter to shareholders, February 28, 1989

One of the worst sins is trying to time the market. If there were no major and lasting consequences, we could simply categorize this behavior as folly. But since the penalties are permanent and can ruin a person's financial well-being in retirement, we must label the behavior what it really is: deadly. Still, this behavior is pervasive and always will be—because we're human.

On March 8, 2019, the bull market turned 10 years old, with the S&P 500 climbing more than 305% since hitting its financial crisis low on March 9, 2009. The index's 500 total return over this period was 400.1%, or an astonishing 17.5% per year. However, if you missed the 20 best percentage gain days over the 10-year bull run (i.e., 20 days in total, ***not*** 20 days per year), the annual gain was cut in half to 8.6%. Timing the market successfully is impossible because returns are often concentrated in very short time frames. If you aren't invested in the market on its top days, you miss out, and your returns are decimated.

Much has been written about this subject, yet it remains an abstraction even for experienced investors. We'll explore it from several angles in an attempt to simplify and enlighten.

Conceptual

Let's start with the basics: Since 1926, after adjusting for an annual inflation rate of about 3%, large-cap equities have delivered a 7% real return compared to 3% for bonds—more than double.

Why are stocks returns so much higher than bond returns? Because there is a perception that stocks are likely to incur infrequent but catastrophic "losses," the market prices them to include a premium for that risk.

But volatility and risk are two totally different concepts. Think about volatility as short-term fluctuations, whereas risk is properly defined as the permanent loss of capital and/or purchasing power over time.

The catastrophic event in equities is a bear market, defined as a 20% decline from a peak stock index closing price. There have been 10 such events for the S&P 500 index since the end of World War II, or an average of about one every seven years, with an average, and temporary, decline of about 35%. But equities are a good investment because they go down temporarily and up permanently.

Numerical

The current bull run became the longest in U.S. history in the fall of 2018 (though, as of the 10-year bull market March 2019 milestone date, it still ranks third in terms of market returns). The record is the 417% growth from October 1990 to March 2000.

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The Wisdom of "St." Jack Bogle

John Clifton Bogle, Jr., the Vanguard founder who brought low-cost index funds to the masses, died last month at the age of 89. His critics snidely referred to him as "St. Jack," because they felt his critiques of the mutual fund industry specifically, and Wall Street generally, were often sanctimonious.

If the label of sanctimony is the cross that Bogle had to bear for his conversion to the gospel of low costs, count us among his disciples. One *Wall Street Journal* columnist elegantly summed up Bogle's lifetime achievement as "lowering the costs of investing almost to the vanishing point."

By now, the Vanguard story is well-known. Believing it was foolish to pay high fees to fund managers trying to outperform the market—since so few actually do—Bogle created the first equity index mutual fund in 1976. The rest is history. At about $5 trillion in assets under management, the Vanguard Group is now the world's second largest asset manager, and index funds now represent almost 50% of all mutual fund assets.

Bogle wrote 13 books devoted to elucidating some basic principles he felt investors should follow: saving regularly, buying and holding investments rather than trying to time the market, diversifying those investments, and staying the course. He also gave us more than a few priceless quotes reflecting fundamental truths, including this gem: "In the fund business, you get what you don't pay for." In other words, every dollar not paid to a fund manager or for administrative expenses means an extra dollar of return for investors.

The Wall Street Journal editorial board elevated Bogle to the same pantheon of business titans as Henry Ford, Sam Walton and Michael Dell for his role in driving down prices for the benefit of the masses. And in Berkshire Hathaway's 2016 annual report, Warren Buffet opined, "If a statue is ever erected to honor the person who has done the most for American investors, the hands-down choice should be Jack Bogle."

For the first few decades of Bogle's crusade, the principal argument against indexing was that it amounted to a guarantee of "average"—and therefore *mediocre*—results. But as the years passed and the data rolled in, it became clear that active managers were systematically, over every time period, underperforming index returns.

Nobel laureate William Sharpe revealed the reason: "Because active and passive returns are equal before cost, and because active managers bear greater costs, it follows that the after-cost return from active management must be lower than that from passive management."

In fact, based on the now indisputable evidence, index funds actually give the investor top-decile returns. Better than average is a mathematical certainty, but the best performance is surprising.

We have recognized Bogle's enormous influence in past articles, in particular, with respect to a simple, reliable model he developed for forecasting 10-year stock and bond returns "Bogle Model" and on the index fund's 40th anniversary in 2016 "Investors Have Crossed the Indexing Rubicon."

To be sure, we profoundly disagree with two of Bogle's long-held positions—on asset allocation and the benefits of international equities. But although Bogle believed in a 60% stocks/40% bonds asset allocation model and that American investors need not hold any foreign equities, these differences amount to mere quibbles over policy.

Even more important than the gift of lower costs, and arguably the greatest part of Bogle's legacy, are some of the fundamental truths and timeless principles that shaped his worldview and formed the foundational pillars of the overall investment wisdom he imparted. Here, we share three.

1. Long-Term Thinking

There are only so many ways to explain the pitfalls of short-term thinking and the benefits of a long-term perspective. Here's one you aren't likely to forget:

> *If you never peek from the age of 20 to the age of 70, you'll rip that first 401(k) statement open at age 70, and I recommend you have a doctor on hand because you'll go into a dead faint. Your heart might even stop. You're going to have an amount of money you can't even imagine.*

Takeaway: Think in decades, not days.

2. Behavior

Benjamin Graham famously said, "The investor's chief problem—and even his worst enemy—is likely to be himself." Similarly, Nobel Prize-winning behavioral economist Daniel Kahneman advised, "All of us would be better investors if we just made fewer decisions." Here is Bogle's more memorable spin on the same subject:

> *While the interests of Wall Street's businesses are well served by an aphorism "Don't just stand there—do something!," the interests of Main Street's investors are well served by an approach that is its diametrical opposite: "Don't do something—just stand there!"*

Takeaway: Investor behavior—not investment performance—drives the financial outcomes experienced by most investors.

3. Simplicity

Sir William of Ockham was a 14th century English Franciscan friar and scholastic philosopher whose "razor," or law of parsimony, postulated that the simplest solution to a problem is the solution most likely to be correct, and that problems should not be more complicated than necessary. Bogle loved Occam's razor and referenced it often:

> *Avoid complexity and rely on simplicity and parsimony, and your investments should flourish.*

Takeaway: Amen. Thank you, St. Jack Bogle, for helping to crush the crisis of complexity and making the investment world a simpler place for those choosing to abide by this everlasting wisdom.

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Of course, one could have only enjoyed those returns by being fully invested at all times. The rub is that it requires exceptional intestinal fortitude to ride out bear markets. In just the last two decades, there were two episodes when stock prices were cut in half: 2000-02 (-49%) and 2008-08 (-57%). And there were also plenty of reasons to panic in the 10 years since the March 9, 2009 S&P 500 low price of 677—a level that was 75% below the 10-year anniversary closing price of 2,749.

Timing the market successfully is impossible because returns are often concentrated in very short time frames. If you aren't invested in the market on its top days, your long-term return returns will suffer enormously.

As noted earlier, during the 2,517 trading days over the entire 10-year bull period, the S&P 500 total return was 17.5% per year. Had you missed just the 10 best percentage gain days in this period (i.e., 10 days in total, ***not*** 10 days per year), your annual total return would have dropped to 12.1%. Missing just the top 20 days in the entire period would have ***cut the total annual return in half to 8.6%***. And missing the top 50 days would have decreased the annual total return to a mere 0.7%. The chart on the next page illustrates the incremental damage.

But the numbers in the chart are hypothetical, so let's examine the real-world experience of actual mutual fund investors. Since 1994, DALBAR, Inc. has published an annual report that measures the effects of investor decisions to buy, sell and switch into and out of mutual funds over short- and long-term time frames.

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Over the 10 years through the end of 2017, the average equity mutual fund investor experienced an average return of 4.9% compared to the S&P 500's 8.5%, while the average fixed-income investor experienced an average return of 0.5% compared to the Bloomberg Barclays Aggregate Bond Index annual return of 3.3%. So the average Joe invested in equities earned a return that was only slightly better than the bond index return.

Behavioral

In an ideal world, investors buy low and sell high. In the real world, investors do the exact opposite—buy high and sell low—especially during the most volatile times.

When stocks get pummeled, our reptilian brain, the oldest of the three human brain parts, triggers a primal "flee" instinct. We succumb to psychological traps, act irrationally, buy and sell at exactly the wrong times, and then experience underperformance—or worse.

The evidence: Based on DALBAR data, the three months with the most acute investor underperformance since 1989 correspond precisely with the three periods of maximum pessimism and panic in the financial markets: the Great Financial Crisis of 2008 (-7.4%), the Dot-Com Bust of 2000 (-6.1%) and Black Monday in 1987 (-5.3%).

Antidote

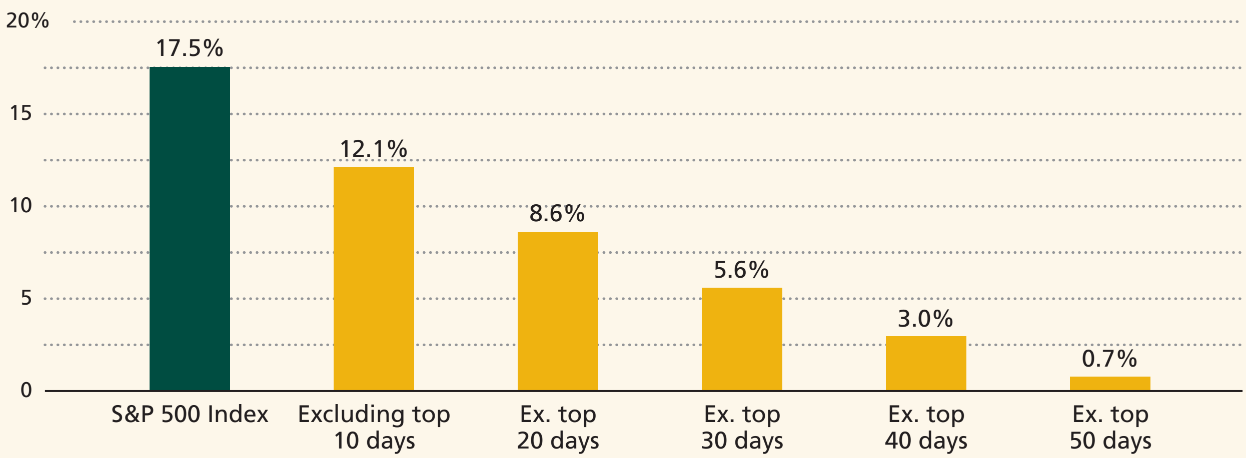
Countless experts have tried—and failed—to predict or time the markets. To capture 100% of the long-term return of equities, investors must be in the market at all times. This means experiencing 100% of the short-term volatility. In short, you must train your brain to think in terms of decades—not days. Time is the only effective antidote to volatility.

Despite the fact that most investors are planning for multidecade retirement periods, or even for multi-generational goals, they still check stock prices and their portfolios too frequently—even daily. How can this ever make any sense?

In short: It's never about timing the market. It is always about time in the market.

Annualized Total Returns

Excluding Total Number of Top % Gain Days in Period
March 9, 2009 – March 8, 2019



Source: By The Numbers

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