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Talking Point

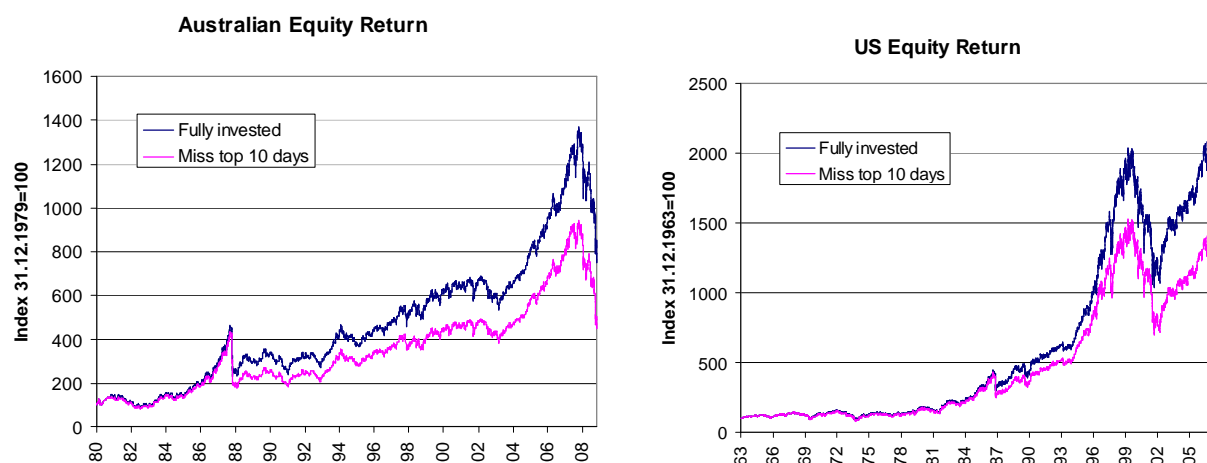
Deconstructing the 'Time in the market' mantra

By Greg Cooper, CEO, Schroder Investment Management Australia Limited

The catch-cry most commonly rolled out to investors in times of significant market (downward) volatility is 'It's time in the market, not market timing' that is important. While a nice marketing phrase, unfortunately it isn't always true.

What's wrong with the 'time in the market' adage?

Take the common presentation of this statement, which is usually along the lines of "if you had missed the top 10 days of market performance over the long term you'd be xx% worse off". That statement is indeed in itself correct. As the charts below show for Australia and the US, if you had missed the top 10 performing days in the last 28 years for Australia or 45 years for the US – you would be worse off, and substantially so.



Source: Schroders, Thompson Datastream, through to 31 October 2008.
Note for the sake of simplicity dividends have been ignored.

In the Australian example, an investor missing those top 10 trading days would have been 40% worse off over the accumulated period and our US investor over 48% worse off.

However, the logic of the above analysis is flawed. Firstly, it assumes that our hapless investor who misses the top 10 trading days would have been fully invested in the lead up to those days, able to completely sell out of their holdings for one day and then fully invested again the day after.

While there are some investors who may have managed this feat of market timing, I suspect that even for a "professional" this would be somewhat difficult to pull off (not to mention the transaction costs involved with such an exercise). Interestingly, if we look at when these top 10 days occurred, those with an eye for detail may notice a somewhat disturbing relationship.

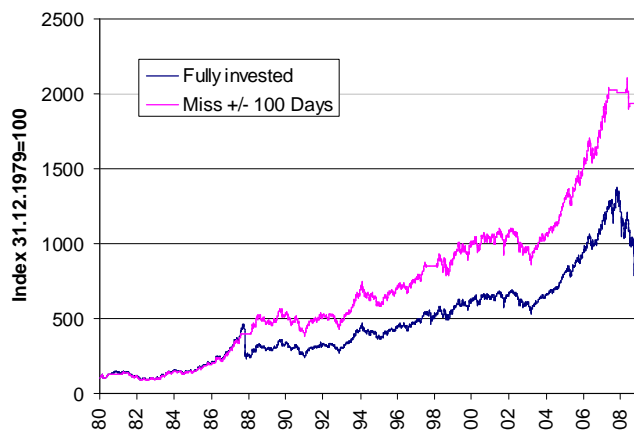
Top 10 performance days for the Australian and US equity markets

Australia – All Ordinaries		US – S&P 500	
20-October-1980	6.8%	13-October-2008	11.6%
29-October-1997	6.3%	28-October-2008	10.8%
13-November-1987	5.8%	21-October-1987	9.1%
28-October-1987	5.5%	24-July-2002	5.7%
13-October-2008	5.1%	30-September-2008	5.4%
02-November-1987	5.1%	29-July-2002	5.4%
25-January-2008	5.0%	20-October-1987	5.3%
12-November-1987	4.8%	28-October-1997	5.1%
20-August-2007	4.5%	08-September-1998	5.1%
22-September-2008	4.3%	27-May-1970	5.0%

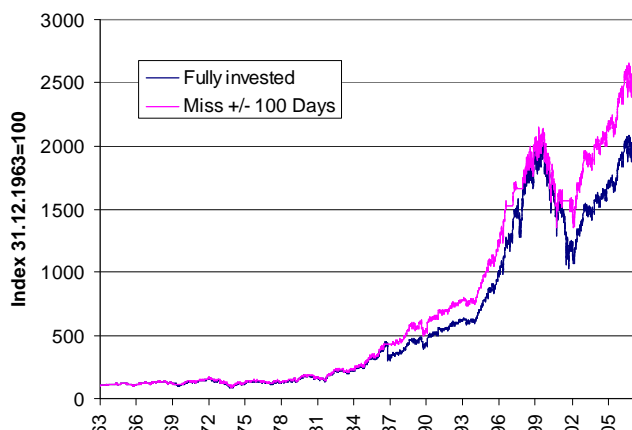
Source: Schroders, Thompson Datastream, through to 31 October 2008.

Most of the key dates above fell in periods when overall market returns were quite poor. We can see the significance of the above by reconstructing our “missed days” analysis above and assuming that not only did we miss the 10 days in the market over the period but lets assume we missed the 100 prior days and the 100 days thereafter (i.e. Got out early and didn’t invest until well after the event).

Australian Equity Return



US Equity Return



Source: Schroders, Thompson Datastream, through to 31 October 2008. Note for the sake of simplicity dividends have been ignored.

All of a sudden the notion that it’s “time in the market” starts to take on a different twist. Now, by missing the 7 or so months around each of these significant market “upticks” our returns have improved significantly. The hapless Australian investor who missed the top 100 days either side of the best day in the market is now 144% ahead of the index (and that is not even allowing for a cash return on their money while out of the market) and the US investor 73% ahead.

Is this just data-mining or is there something more to it? Looking at some other scenarios, if you just missed the whole year in which these “top performing” days occurred, you’d be 3% better off in Australia and 17% better off in the US. Even a shorter time such as missing the 5 days either side you’d be slightly better than 20% off in both markets over these time frames.

And all of that to say nothing of the volatility reduction (which is significant) from missing these spikes.

So, what’s an investor to do?

The ‘time in the market’ myth has encouraged many investors to remain fully invested in equity markets at all times regardless of asset price valuations for fear of missing out on those ‘great’ days. An investment in equities is a long term growth strategy so short term trading is not the solution. However,

when equities appear expensive it is sensible to reduce exposures as it's unlikely you'll get one of those 'great' days when markets are high.

Long-term successful investing is much more about managing risk than seeking returns. Remember, a 50% decline requires a 100% rise just to get back to square. As such, the focus should be on risk. Get risk right and let the returns look after themselves.

If the last 18 months has taught us anything it's that real risk management of portfolios is critical to achieving good long term performance outcomes. Whether its equities, hybrids or fixed income markets we at Schroders believe there are times when risk premia become sufficiently mispriced that it becomes almost impossible to ignore signals to 'market time'. When we don't believe investors are being adequately rewarded for the risks taken in our portfolios we act. Some examples of how Schroders have implemented this thinking include:

- Selling out of LPT's in 2007 across our equity and balanced funds
- Drastically reducing exposure to credit and raising cash in June 2007 in our fixed income funds when credit spreads were just too low to compensate for risk
- Reducing commodity exposure in early 2008 in our equity funds as the commodity bubble boomed and subsequently burst
- Reducing defensive sector exposure in late 2008 in our equity funds as the defensive bubble was getting overextended

Conclusion

'Time in the market' used to be the rationale why investors should hang on to equities come hell or high water. However this mantra rings hollow to many investors who have seen the value of their equity portfolios halved over the last year. While investing is still about taking a long term view what's more important is the identification of the risks and possible rewards associated with the investments at any one time.

At Schroders, we believe in the importance of ensuring that every investment we include in our funds provides adequate compensation to risk for our clients. This thinking permeates our stock selection and sector allocation within our equity and fixed interest products through to asset allocation in our balanced funds. Delivering appropriate reward for risk is of paramount importance to us in all the products we manage and a key focus in our investment process.

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