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No taking chances

Recently overheard: “You should invest in the S&P 500.”
“I should have invested in the S&P a year ago.”

With the benefit of hindsight, we can say that the stock market collapse in the spring of 2020 was an overre-action, and in fact it was a great time for bargain hunters. But given all the uncertainties we faced about vac-cine development and the economic consequences of the lockdowns, that was exactly the time when putting down a big bet on stocks may have seemed reckless and much too risky.

What’s an investor to do about financial market volatility? For many investors, the answer is, not much. Ideal-ly, one wants to be in the market on the up days and out on the down days. In reality, no one can call those days accurately in advance. Academic studies have shown that most of the gains in the stock market occur on just a few trading days. The risk of being out of the market on good days outweighs the reward of avoiding the losers and the transaction costs of managing the process.

The historical record

In one major study of market returns, business professor Javier Estrada of the IESE Business School in Barce-lona, Spain, quantified the effect that exceptional days can have on investment returns. He studied the Dow Jones Industrial Average for the period from 1900 through 2006. Looking at the best 100 trading days, the lowest return was 3.9 standard deviations above the mean. Statisticians will tell you that data suggest such a return should be seen once in 83 years—yet that return or better occurred 100 times in the course of the study.

To translate Estrada’s findings into dollars, $100 invested in the DJIA at the beginning of 1900 would have grown to $25,746 by the end of 2006. However, if the investor had missed just the ten best days of those 107 years, the investment would have grown to only $9,008, a reduction of 65%. Miss the 20 best days, and the portfolio would have grown to only $4,313. Finally, missing the 100 best days of the 29,190 in the period under study, one-third of one percent of the trading days, would have resulted in a loss of capital, as the ter-minal wealth would have been just $83.

Of course, there are exceptional days on the downside as well, as Estrada documented. If you had kept all the best days and avoided just the ten worst days, terminal wealth would have jumped to $78,781. If you had accurately predicted the 100 worst days and avoided them, your $100 would have grown to an astonishing $11,198,734!

And it’s not just the U.S. stock market that exhibits such behavior. Estrada went on to document similar re-sults in foreign markets as well. He concluded: “A negligible proportion of days determines a massive crea-tion or destruction of wealth. The odds against successful market timing are just staggering.”

Lessons for investors

What can investors take away from studies such as these?

- The costs and risks of trying to time the market probably are larger than the potential benefits. Academic studies of returns are inherently artificial and tend to overstate returns because they do not factor in trans-action costs or taxes. Thus, the case against market timing is likely even stronger than suggested by Profes-sor Estrada.
- Over the long term, the stock market has balanced the negative and positive abnormal days. Past perfor-mance does not guarantee future results, but, overall, stocks have outperformed all other investment clas-ses.
- Diversification may help moderate the impact of exceptional days. On a day when the stock market overall is down, some stocks are, nevertheless, up. Stock selection matters. The bond market doesn’t always move in lockstep with the stock market, so an allocation to this asset class also may reduce the impact of daily swings. Keeping some cash on hand may help the investor weather a rough patch, or even take ad-vantage of opportunities that arise.

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