Should I stay or should I go?

At a time when volatility and risks continue to rise, we provide guidance

Wealth Management
Dominion Securities

Equity and Fixed Income markets have been exceptionally volatile this year, with increasing calls for a recession in the U.S. and Canada at some point in 2023. Investor resolve can be put to the test in such an environment as investors question the merits of staying invested or putting new money to work. We have spent some time thinking about how to best guide clients at such time, and the goal of this article is to reaffirm what we think are the benefits of staying invested instead of trying to time the market.

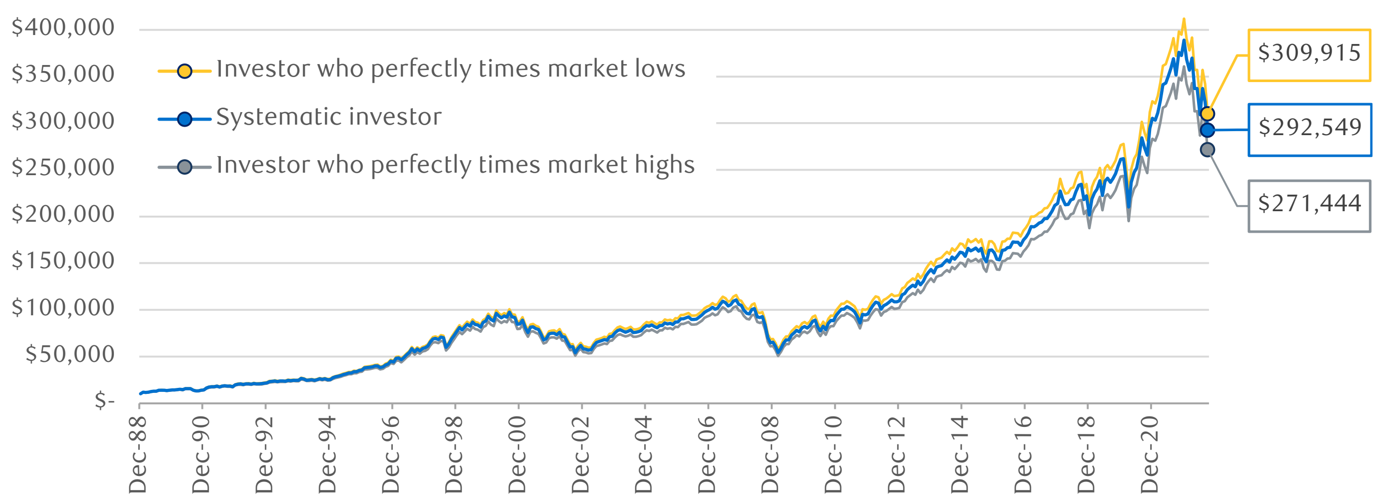
"Timing the market" vs "Time in the market"

The topic of timing is something that challenges most investors, and clients often get worried as volatility picks up and equity markets swoon 2% or 3% seemingly every day. These are the times when investors can become very concerned and are more likely to consider selling, rather than putting new money to work. There can also be a degree of fear in client minds around deploying cash, which can become paralyzing and cause them to remain on the sidelines in the hope of deploying capital when the market bottoms. **Our analysis shows that staying disciplined and "on-plan" at such times is important, and over the long term the benefit of perfectly timing market bottoms is not as great as it may seem.** As Sir John Templeton once said, "the best time to invest in the market is when you have the money".

In the first chart, we look at the returns of three hypothetical investors who started investing in 1989. Each investor began with a $10,000 investment in the S&P 500 on Dec. 31, 1989, and from there on each person contributed $1,200 annually to their investment, but in very different ways:

Hypothetical investor 1: This investor is a perfect market timer, has superhuman predictive abilities, and can time the $1,200 annual investment each and every year at the corresponding market low.

Time in the market is an important driver of returns



Source - RBC Wealth Management, Bloomberg

All values in U.S. dollars and priced as of Sept. 30, 2022, market close, unless otherwise noted.
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For important disclosures and author's contact information see page 5.

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Hypothetical investor 2: This investor is the opposite of the first. In an attempt to time the market, investor 2 has been wrong each year and invests the annual $1,200 contribution at the corresponding market high.

Hypothetical investor 3: This person is a systematic investor, and rather than try to time the market, investor 3 simply makes the $1,200 annual contribution at the end of January every year.

The first thing that stands out to us when we look at the chart is how relatively small the difference is between the three ending values. The difference between the investor that executed perfect market timing compared to the investor that had perfectly mistimed the market is about 14.2% over a 33-year period. This translates to a 0.4% difference in performance each year. Keep in mind that this illustrates a worst-case scenario. In practice, it is virtually impossible for an investor to perfectly time or mistime the market over 33 years. If we compare the difference in market value between perfect market timing and the systematic approach, the divergence in ending portfolio values is even smaller at 5.9%, or 0.18% annually.

The above results can be surprising (especially the small magnitude in divergence of returns), but they end up this way because of the power of compounding returns over a long period of time. Mathematically, the effect of compounding is a much more meaningful determinant of long-run returns compared to the impact that timing decisions have. In the short run, the market is going to do what it is going to do. **Over the long run, having a seat at the table and staying invested is what matters, in our view.**

Missing best days of the market yields sub-optimal results

Some investors often have the desire to beat the market by timing their buy and sell decisions. This could include selling stocks in anticipation of a market decline, or keeping cash on the sidelines with the hope of putting it to work when the market bottoms. But **seasoned investors would likely say that this approach is very difficult to execute**, and to pull it off one needs to: avoid selling as the market continues to move higher; time the top, and sell; and time the re-entry at the bottom, and buy.

It is hard enough to do one of the above, let alone all three, and generating consistent returns through market timing is seldom achieved. Moreover, it is also interesting to note that typically the best up days in a year come after very negative trading days, and missing the 10 best days (in pursuit of timing the markets) can result in sub-optimal performance. The only way to participate in the 10 best trading days is to remain invested, while the only way to guarantee missing the worst days is to not invest in equities at all. **The charts below highlight the benefit of staying disciplined and fully invested, which can help clients achieve their long-term objectives.**

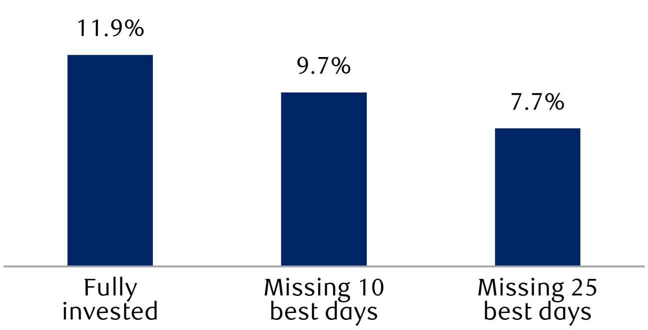
The cost of missing out

Invest for the good days, rather than trying to avoid the inevitable bad days

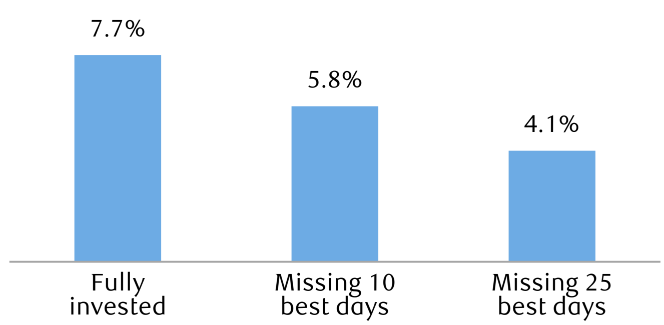
S&P 500: Growth of $100 invested Jan. 1, 1980

TSX Composite: Growth of $100 invested Jan. 1, 1980

S&P 500: Annualized returns since Jan. 1, 1980



TSX Composite: Annualized returns since Jan. 1, 1980



Source - RBC Wealth Management, Bloomberg; data through 4/30/22; calculations based on daily data from January 1980 to April 2022

Short-term noise versus long-term value

One of the main challenges equity investors face when assessing the merits of an investment is separating short-term noise from the long-term value drivers of a company. As the well-known investor Benjamin Graham once noted, "in the short run, the market is like a voting machine, but in the long run it is like a weighing machine". Indeed, over the short term the share price of a company can swing based on how popular or unpopular it appears at that time. When markets behave like a voting machine, they can ignore long-term business fundamentals and can be driven by fear, greed, speculation, and other factors.

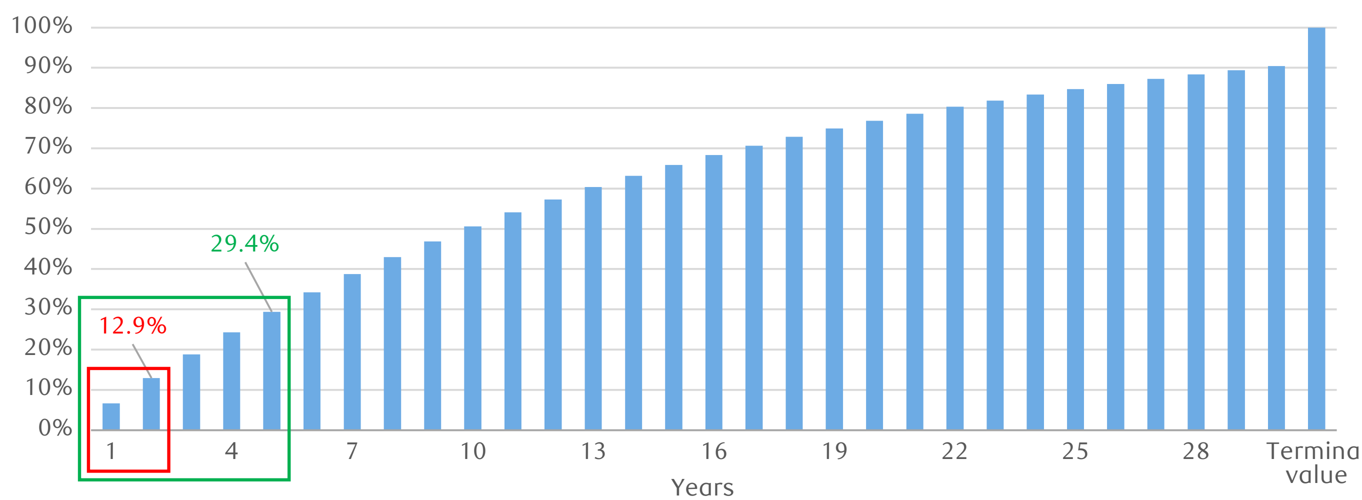
So, how does one assess the long-term value of a company? Some investors rely on discounted cash flow (DCF) analysis, which projects a company's cash flows well into the future, to determine the value of these cash flows in today's dollars. While forecasting a company's profits 5 or 10 years from now is a difficult endeavor (let alone forecast for next 1 or 2 years), it does provide a good framework to determine what a company might be worth today. Without getting into too many technical details, as the chart below shows, under this approach about 6.5% of a firm's value is driven by cash flows in year 1. This rises to 12.9% of the firm's value after year 2.

A couple of bad years where profits may be impacted doesn't materially affect long-term value of the company. It is far more important to assess the quality and longevity of these cash flows as about 70% of the company's value is determined by cash flows that will come after year 5. Consequently, the question to pose to clients is why would anybody sell a good business, in view of short-term risks, if the majority of its value will accrue many years into the future? This is where the quality of the business (i.e., its business model, competitive advantages, strength of the balance sheet, etc.) becomes an important consideration.

Investing in companies that can stand the test of time

Great compounders are extremely hard to find, and it is usually a mistake to sell them. This is especially true if the intention is to buy back the stock at a cheaper price further down the line. An investor may never get the opportunity to buy it back at a better price! For clients that are business owners, if they are asked whether they would sell their business due to one or two bad years, the answer would most likely be a resounding no. A similar approach can be applied when discussing quality companies in client portfolios, with the underlying message being "own a piece of the business, don't trade it".

Cumulative contribution of annual cash flows to the value of a business



Source - RBC Wealth Management

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