momentum investments

The potential loss of gains by 'guessing'

Introduction

This paper focuses on the effect on returns caused by trying to time markets. The theory behind this is that we tend to 'think' we have the skill to time markets, although the decision is often driven by fear or greed to be invested or not. Research suggests that we do not have this skill of foresight, and nobody, not even Mr Warren Buffet, could convincingly attest to this. The problem lies in 'guessing' exactly when to start investing in a rising market and when to disinvest when the market turns negative. We are all guilty of this. This research focuses on proving how decisions at precisely the wrong time can affect gains over time. Investors tend to be oblivious to the effects of their choices and this research graphically shows the magnitude of the effects of their choices over longer investment horizons.

The findings

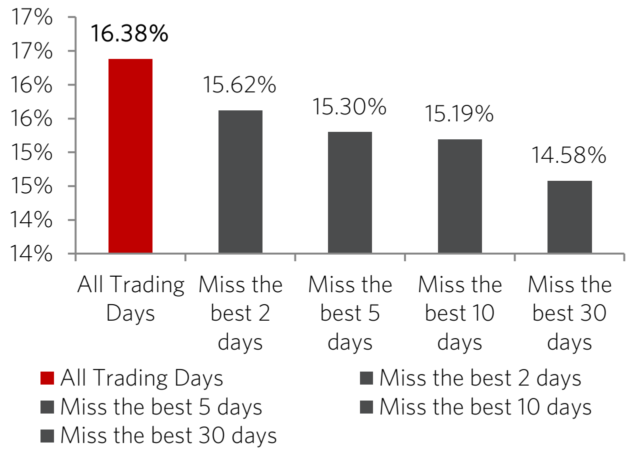
We base this research on calibrating the effects of missing the best trading days of the market. This is usually the case when investors try to time markets by deciding when to invest and when to disinvest.

We looked at the South African (SA) equity market and the United States (US) equity markets by analysing daily returns during the last 20 years. The findings are below.

The adjacent graph demonstrates what the returns would have been if an investor missed the best days during the past 20 years. The returns reduce as more days are missed.

The differences in returns may seem marginal, but when compounded over multiple years, they quickly add up. So, if an investor missed the best 30 days, he/she would have given up almost 2% of returns per year. When compounded, this rapidly expands to a 50% reduction of returns over the 20 years.

Graph 1: Returns missed in the past 20 years invested in SA equities

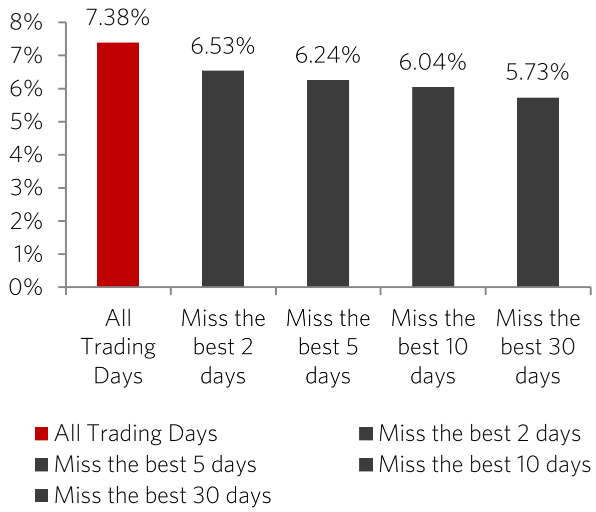


Source: Momentum Investments

To put it in another way, an investment of R100 on the first day, earning 16.38% per year for 20 years would have grown to R2 077.62, equivalent to 20.7 times the initial capital invested. At 14.58% (missing the best 30 days) per year, the investment value would have been R1 521.17, which is only 15.21 times the initial capital.

Quite a significant difference in value if you think what the resultant difference could be by only missing 30 consecutive days out of the market during 20 years. Looking at the US market, a similar trend appears. The more days missed, the more gains an investor is likely to miss.

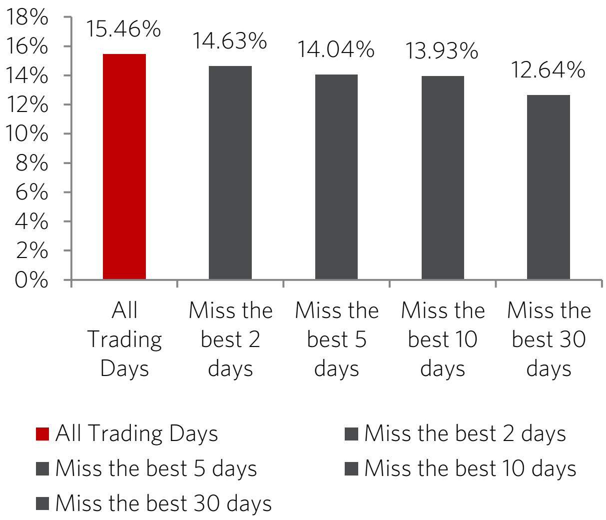
Graph 2: Returns missed in the past 20 years invested in the S&P500 in dollar terms



Source: Momentum Investments

Compounding the differences between the missed days would result in a significant opportunity loss of gains had the investor not been invested.

Graph 1: Returns missed in the past 20 years invested in the S&P500 in rand terms



Source: Momentum Investments

Using the S&P 500 in rand terms, the difference between all trading days and missing the best 30 days is an annualised return of 2.82%. When translating that cumulatively over 20 years, the investor loses out on another 74.36% of gains!

From the above examples, we can see the importance of long-term investing, staying invested through all market cycles and avoiding timing markets. With a focus on remaining true to a disciplined investment process, you can mitigate the adverse effects behavioural biases can have on investor outcomes. We focus on client outcomes by using every possible means to reduce risks and increase the chances of delivering on the predefined objectives of our clients through various market cycles.

Hamza Moosa
Senior Quantitative Analyst