The Perils of Market Timing in a Golden Age of Earnings Growth

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SNAPSHOT

- Stock markets have had a good run since early 2020 amid mostly calm conditions, but we're not surprised by recent volatility.
- We don't equate higher volatility with a high likelihood that we're headed toward a bear market or a recession in the near future.
- Market timing requires two choices: when to sell, and when to buy back in. The costs associated with mistiming either of these decisions mount quickly.

It's quiet. Too quiet.

Film directors know that the best way to set the stage for the entrance of a howling T-Rex or a hungry great white shark is to let an eerie calm unsettle the audience.

Fortunately, real life doesn't work that way. Investors can be assured that there's no good evidence indicating that current conditions can reliably tell us anything about what will come next.

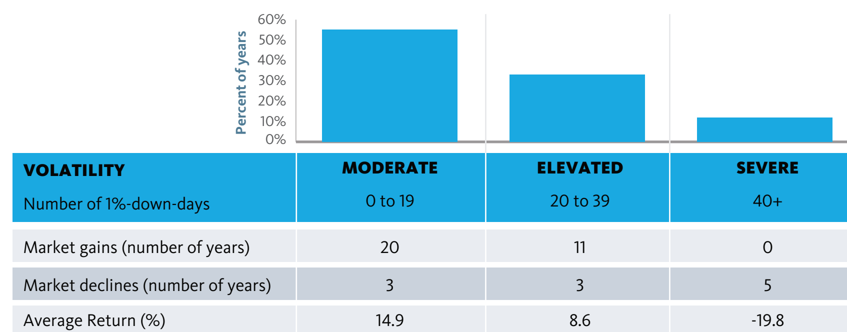
Why bring this up now? Some might say it had been too quiet in financial markets prior to the recent return of volatility. Stock markets have had a good run since early 2020 without experiencing much volatility. We wouldn't be surprised to see a bit more volatility going forward, given some of the risks facing the global economy. But we believe the positives outweigh the negatives.

Shaken, or just stirred? Volatility and declines often provide firmer footing

We don't believe that the possibility of higher volatility needs to be unsettling. The smooth, nearly straight-line portion of this recovery will eventually conclude; however, that doesn't necessarily mean we're headed toward a bear market or a recession in the near future.

Looking at the historical record for the MSCI World Index, we stratified periods of time by volatility, using the number of trading days with losses of 1% or more in a year to create groups (Exhibit 1).

EXHIBIT 1: FREQUENCY OF VARYING DEGREES OF MARKET VOLATILITY



VOLATILITY Number of 1%-down-days	MODERATE 0 to 19	ELEVATED 20 to 39	SEVERE 40+
Market gains (number of years)	20	11	0
Market declines (number of years)	3	3	5
Average Return (%)	14.9	8.6	-19.8

MSCI World Index price returns, in local currency terms, since 1980. Number of market gains (losses) refers to the number of calendar years in which the market had a positive (negative) price return. Average return is the average of the calendar year price returns. Data points for 2021 are year-to-date. Source: Bloomberg, SEI. As of September 30, 2021. Index returns are for illustrative purposes only, and do not represent actual performance of an SEI Fund. Index returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance is not a reliable indicator of future results.

There's a lot to feel positive about. The number of years that saw gains far exceeds those that suffered losses in both the moderate and elevated groups. Their average returns are also quite healthy relative to long-term average performance.

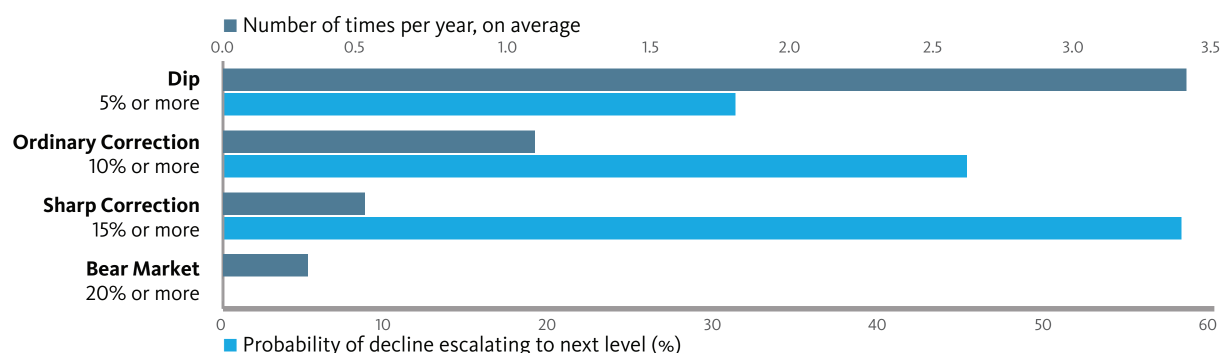
As for the severe-volatility group, there's no denying its steep average losses, but this type of environment is rare, occurring only about 12% of the time. In our view, it's much more likely that we move from a world of low or moderate volatility to one with elevated volatility, where markets continue to have a better chance of advancing, rather than declining.

Exhibit 2 examines peak-to-trough declines rather than volatility. We can see both the average annual frequency of different-sized selloffs, as well as the likelihood that each will progress to the next.

For example, a 5% dip has slightly less than a 1-in-3 chance of growing into an ordinary correction which, in turn, has historically occurred a little more than once per year. Sharp corrections occur about once every other year on average.

Like periods of severe volatility, bear markets are rarer occurrences. Smaller market declines can happen quite often without approaching serious bear-market territory. Corrections are normal and can be healthy, often providing firmer footing for further advances.

EXHIBIT 2: FREQUENCY OF VARYING DEGREES OF MARKET DECLINES



S&P 500 Index price returns, in US Dollar terms, since 1928. Source: Ned Davis Research, Standard & Poor's, SEI. As of August 31, 2021. Index returns are for illustrative purposes only, and do not represent actual performance of an SEI Fund. Index returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance is not a reliable indicator of future results. Performance prior to March 4, 1957 is back-tested. Back-tested performance, which is hypothetical and not actual performance, is subject to inherent limitations because it reflects application of an Index methodology in hindsight. No theoretical approach can take into account all of the factors in the markets in general and the impact of decisions that might have been made during the actual operation of an index. Actual returns may differ from, and be lower than, back-tested returns.

Peak growth: A compelling cliffhanger

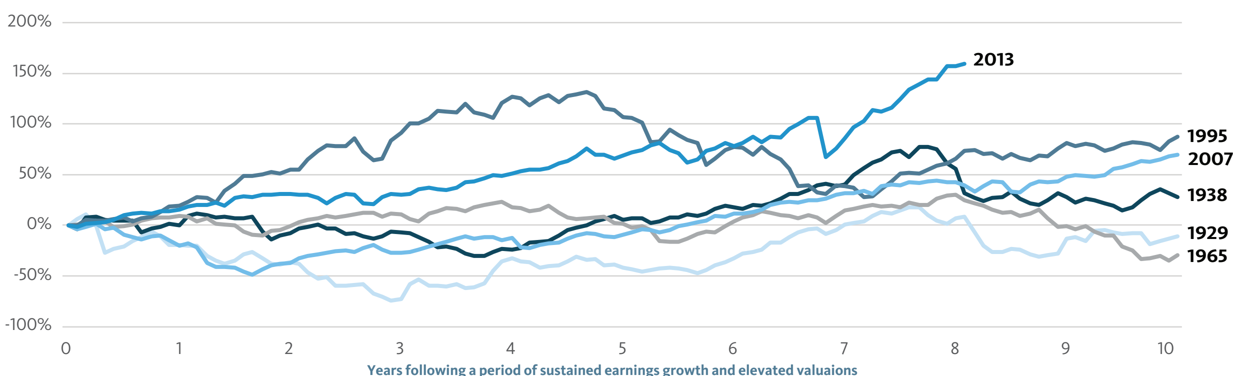
Moviemakers also love to rely on disorientation and the unfamiliar to keep the audience on the edge of their seats. Think about a scuba diver descending below the last reaches of sunlight or a climber scaling the face of a mountain in bad weather.

We may not be quite as captivated by evolving market dynamics, but plenty of investors may feel like they're staring out over the edge of a cliff today. Equity markets have benefited from a period of sustained above-average rates of earnings growth—propelling them to new heights—and elevated valuations.

Naturally, the question of whether we're witnessing peak growth conditions makes some investors nervous that we're at (or near) a market top. We know these characteristics will not last forever, but we have not found any convincing evidence that a peak in earnings growth or high valuations suggests that we should expect the bull market to conclude any time soon.

We studied a long period of history dating back to 1900 to see what we could learn from the past. There were six similar periods over this time frame that were characterized by sustained robust earnings growth that coincided with elevated valuations (Exhibit 3).

EXHIBIT 3: HISTORICAL PERIODS FOLLOWING ENVIRONMENTS SIMILAR TO TODAY'S



U.S. stock market data consisting of monthly stock prices, dividends and earnings data from Robert Shiller dataset from January 1900 to June 2021. Historical periods capture up to 10 years following the first occurrence of 2 characteristics: (1) earnings growth exceeding an annual pace of 8% over the previous 5 years and (2) a price-to-earnings ratio higher than 18. Both of these thresholds (8% earnings growth and PE ratio of 18) represent levels above which only about one-third of historical observations fall. Time periods shown are the years following July 1929, August 1938, January 1965, December 1995, July 2007, and May 2013. Source: Robert Shiller dataset, SEI. As of September 30, 2021. Past performance is not a reliable indicator of future results.

The market conditions we see today—elevated earnings growth and valuations—have not been clear indicators of a market top in the past, nor have they given any insight into the timing of the next major market decline. Only two of these six historical periods led to a market decline within the first year of the observation.

We looked at the 10-year period following each of these observations, so most of them contained a significant decline. But several didn't experience a major selloff until the second half of the 10-year period. An anxious investor compelled to exit the market due to the presence of peak growth characteristics would have watched a long market advance from the sidelines during these periods.

Timing investments around market declines can be risky business

The filmmaker's toolbox runs deep. One of the most unnerving devices that can be written into a screenplay is the "impossible choice." The hero can only save one person, so who will it be? Time is running out and the chance of a safe resolution appears to be slipping away, but our protagonist can't walk away now!

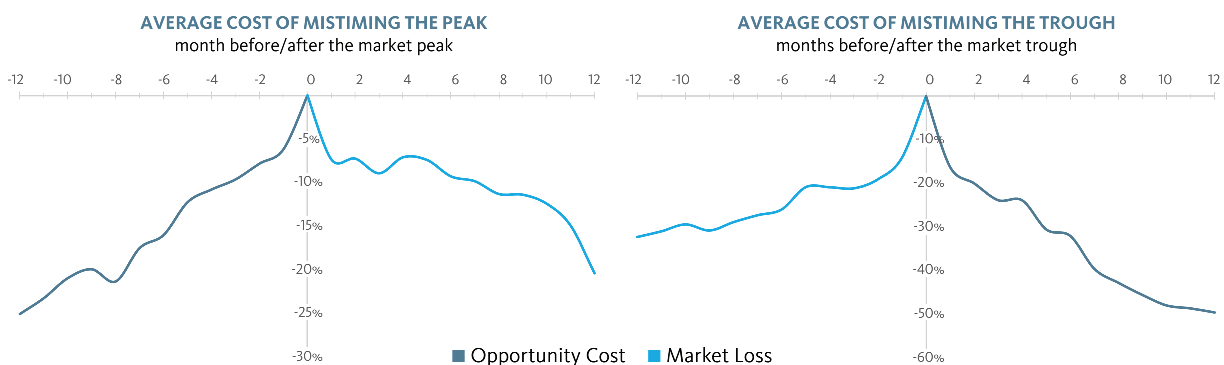
We should all be thankful that our options in the real world usually provoke less anxiety. But we sometimes still feel like we're facing an impossible choice.

Perhaps the best approach in these situations is to pull the camera lens back to get a wider perspective (last movie metaphor, I promise).

The urge to sell investments when it feels like we're near a market top is a self-imposed dilemma. Unless you have perfect foresight, our research suggests that attempting to time major portfolio changes around market peaks and troughs is a decision best skipped altogether.

Exhibit 4 provides a reminder that market timing requires two choices: when to sell, and when to buy back in. The costs associated with mistiming each of these decisions mount quickly.

EXHIBIT 4: TIMING INVESTMENTS AROUND MARKET DECLINES CAN BE RISKY BUSINESS



Average performance of the S&P 500 index surrounding six bear markets since 1972. Bear markets defined as price declines of 20% or more. Bear markets occurred from January 1973 to October 1974, November 1980 to August 1982, August 1987 to December 1987, March 2000 to October 2002, October 2007 to March 2009, and February 2020 to March 2020. Source: Bloomberg, Standard & Poor's, SEI. As of September 30, 2021.

We calculated the average returns surrounding major market peaks and troughs since 1972. The left-hand side—the peak—shows the implied costs of mistiming the decision to sell, while the right-hand side—the trough—shows the penalty for mistiming the decision to buy back in.

A mistimed sale of only two months on either side of the peak equates to roughly 10% in losses or missed upside. The opportunity cost of an early exit can set an investor back by up to about 25%.

This double bind appears to hurt most when it comes to re-entering the market. A mistimed buy of only two months has cost investors an average of 20%, and a late re-entry of 12 months means investors have missed out on a gain of about 50%, on average. Front-loaded recoveries mean that the costs of market timing can stack up quickly.

SEI's view

Perfect timing is elusive, if not impossible, in the real world. We expect investors to be well served by maximizing the amount of time that their assets are working in the market.

While we may be witnessing peak earnings growth, we've demonstrated why that's not sufficient cause to deviate from strategic positioning. We believe the fundamental picture remains quite solid as businesses and households remain in strong financial health and there's still upside for economic activity and labor markets.

We have high conviction that the recovery and its associated themes—stronger economic growth, gradually higher interest rates, firmer inflation, and changes in market leadership—will get back on track as the latest COVID-19 wave continues to moderate and global vaccination rates increase.

We expect the overall market trend to point upward, despite a potentially bumpier ride. Markets have a better chance of advancing, rather than declining, even when they enter periods of elevated volatility.

The best approach, in our view, is to maintain diversification across well-researched and established drivers of performance, like valuation and profitability. We believe this is a favorable environment for active management within equities—we're able to avoid the most expensive areas of the market and can lean toward cyclical sectors and stocks. This environment should also be favorable for diversified fixed income, including credit and inflation-linked bonds, and other inflation-sensitive assets, such as commodities.

Glossary of Financial Terms

Active management: Active management is an investment strategy that attempts to outperform an investment benchmark index or target level of return or risk.

Bear market: A bear market refers to a market environment in which prices are generally falling (or are expected to fall) and investor confidence is low.

Bull market: A bull market refers to a market environment in which prices are generally rising (or are expected to rise) and investor confidence is high.

Credit: Credit refers to debt securities issued by companies, governments, and packaged (or securitized) consumer debt. Credit investments can include bonds, notes, mortgage-backed securities, and others.

Cyclical sectors: Cyclical stocks or sectors are those whose performance is closely tied to the economic environment and business cycle. Managers with a pro-cyclical market view tend to favor stocks that are more sensitive to movements in the broad market and therefore tend to have more volatile performance.

Dividend: A dividend is the distribution of corporate profits to eligible shareholders.

Inflation-linked bonds/Treasury inflation protected securities (TIPS): These types of investment instruments are typically indexed to an inflationary gauge to protect investors from the decline in the purchasing power of their money. Their principal value typically rises as inflation rises, while the interest payment varies with the adjusted principal value of the bond. The principal amount is typically protected so that investors do not risk receiving less than the originally invested principal.

Price-to-earnings ratio (PE): The PE ratio is equal to the market capitalization of a stock or index divided by its earnings over either the next 12 months (for a forward PE) or prior 12 months (for a trailing PE). The higher the PE ratio, the more the market is willing to pay for each dollar of annual earnings.

Recession: A recession is a period of broadly declining economic performance that lasts for several months or more.

Robert Shiller dataset (Exhibit 3): Monthly dividend and earnings data are computed from S&P 500 Index four-quarter totals for the quarter, with linear interpolation to monthly figures. Stock price data are monthly averages of daily closing prices.

Index Descriptions

MSCI World Index: The MSCI World Index is a free float-adjusted market-capitalization-weighted index designed to measure the equity market performance of developed markets. The Index consists of the following 23 developed-market country indexes: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the U.K. and the U.S.

S&P 500 Index: The S&P 500 Index is a market-capitalization-weighted index that consists of 500 publicly-traded large U.S. companies that are considered representative of the broad U.S. stock market.

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