The Perils of Trying to Time Volatile Markets

Key takeaways

• Missing a handful of the best days in the market over long time periods can drastically reduce the average annual return an investor could gain just by holding on to their equity investments during sell-offs.

• While missing the worst days can potentially offer higher returns than a “buy and hold” strategy, disentangling the best and worst days can be difficult, since they often occur in a very tight time frame—sometimes even on consecutive trading days.

What it may mean for investors

• There appears to be some benefit to missing both the best and the worst days, so an investor may wish to use tactical asset allocation adjustments in an effort to reduce equity exposure when the risk of a recession or bear market rises.

Chart 1. Market timing is difficult. Investors who allow their emotions to get the best of them may suffer lower returns.

Source: DALBAR, Inc., 20 years from 2000–2019; “Quantitative Analysis of Investor Behavior,” 2020, DALBAR, Inc., www.dalbar.com. For illustrative purposes only. DALBAR computed the average stock fund investor return by using industry cash flow reports from the Investment Company Institute. The average stock fund return figure represents the average return for all funds listed in Lipper’s U.S. Diversified Equity fund classification model. All DALBAR returns were computed using the S&P 500 Index. Returns assume reinvestment of dividends and capital gain distributions. The performance shown is hypothetical and not indicative of any particular investment. An index is unmanaged and not available for direct investment. Past performance is not a guarantee of future results. Inflation is represented by the Consumer Price Index. The Consumer Price Index measures the average price of a basket of goods and services. Lipper’s classification model is described at the end of the report.
Our findings

Our research suggests that missing a handful of the best days over longer time periods drastically reduces the average annual return an investor could gain by simply holding on to their equity investments during market sell-offs. Over the past 30 years, missing the best 30 days (based on S&P 500 Index returns from 3/20/1990 through 3/19/2020) took the annual average return from 6.8% per year down to less than the average inflation rate. Our research also showed that over the same time period, missing the best 40 days left the S&P 500 Index with a near-zero return, and missing the best 50 days resulted in a -1.6% annual return, on average.

Chart 2. Missing the market’s best days

Based on this study, equities accumulated most of their gains over just a few trading days.

What if an investor could somehow remain invested in the markets during the best days, but avoid the worst days? That would be the best of circumstances—and would result in far higher returns over the course of the holding period. But is that possible? Our work shows that the best days occurred in the S&P 500 in the midst of a bear market or recession, and some of the worst days occurred during bull markets. Of the 10 best trading days in terms of percentage gains, eight took place during a recession and the remaining two took place during a bear market. Disentangling the best and worst days can be quite difficult, history suggests, since they often occur in a very tight time frame, sometimes even on consecutive trading days. In our view, these findings argue strongly for most investors to remain invested in the equity markets even in the most volatile markets.
Chart 3. Market performance—The best days and worst days have often occurred close together

Not only have the best and worst days typically clustered together, they often occurred during bear markets or recessions, when markets were at their most volatile. Another historical study we conducted shows that missing both the best and the worst trading days during various time periods can result in somewhat higher equity returns than those of a traditional buy-and-hold strategy (see Chart 4). Although the difference may not be enough to account for trading and tax costs, it is interesting to note that, based on the historical returns in Chart 4, reducing equity exposure during periods with significant market volatility improved returns.

Chart 4. Missing the best and worst days—Reduced exposure during market volatility
Market volatility is elevated and equity markets recently entered a bear market due to the uncertainty surrounding the impact of coronavirus on the global economy and markets. We expect the global economy to enter a short—but possibly deep—recession this year due to coronavirus fallout. As risks continue to rise, we recommend focusing on quality at the asset class level. We currently prefer U.S. Large Cap Equities over international or small cap equities at this point in the market cycle. In Fixed Income, we favor higher credit quality securities over high yield debt. During times of heightened volatility, we encourage investors to review portfolio allocations and strategies. When opportunities arise, we typically use our tactical asset allocation strategy (increasing or decreasing exposure to asset classes over shorter time periods) in an effort to improve potential returns while decreasing volatility risk.

**DALBAR Study and Market Timing**

- In 2019, the **Average Equity Fund Investor** underperformed the S&P 500 by 535 basis points\(^1\) (31.49% for S&P 500 vs. 26.14% for Average Equity Fund Investor).\(^2\)

- The **Average Asset Allocation Fund Investor** gained 15.36 in 2019.\(^3\)

Since 1994, DALBAR’s Quantitative Analysis of Investor Behavior (QAIB) has measured the effects of investor decisions to buy, sell, and switch into and out of mutual funds over short and long-term time frames. These effects are measured from the perspective of the investor and do not represent the performance of the investments themselves. The results consistently showed that the Average Investor earned less—in many cases, much less—than mutual fund performance reports would suggest.\(^4\)

For 25 years, DALBAR has analyzed investors’ market timing successes and failures through net purchases and sales of funds. This form of analysis, known as the “Guess Right Ratio,” examines fund inflows and outflows as a potential mean to determine how often investors correctly anticipate the direction of the market the following month. Investors tend to “guess right” when a net inflow is followed by a market gain or when a net outflow is followed by a decline.

Based on DALBAR findings, investors have guessed right at least half the time in 13 out of the last 20 years, and guessed correctly exactly half the months of 2018. Unfortunately for the Average Investor, guessing right has not produced superior gains because the dollar volume of bad guesses exceeded the dollar volume of right guesses. Even one month of wrong guesses can potentially wipe out what’s gained from several months of right ones.

Over the last 20 years, when taking a deeper look into the cash flows of the Average Equity Fund Investor, we see the gap between net inflows/outflows and the direction in the market. The fund flows were often on the opposite side of the horizontal axis than the S&P 500 Index. For example, in 2018 the Average Equity Fund Investor withdrew funds every month in which the S&P 500 had a material gain and the only month the Average Investor made a significant contribution was in March 2018, when the S&P lost approximately 2.5%.

**Conclusion**

We believe that staying fully invested in equity markets over a full market cycle is more beneficial than attempting to avoid the worst-performing days. Historically, there appears to be some benefit to missing both the best and the

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1. One hundred basis points equal 1%.
2. Average Equity Fund Investor: The Average Equity Fund Investor is comprised of a universe of both domestic and world equity mutual funds. It includes growth, sector, alternative strategy, value, blend, emerging markets, global equity, international equity, and regional equity funds.
3. Average Asset Allocation Investor: The Average Asset Allocation Fund Investor is comprised of a universe of funds that invest in a mix of equity and debt securities.
worst days, so an investor may wish to use tactical asset allocation to reduce equity exposure when the risk of a recession and bear market rises. We also suggest rebalancing—buying asset classes that have fallen below a portfolio’s long-term allocations and selling those that are higher than long-term allocations—during periods of market volatility.
Risk Considerations

All investing involves risks including the possible loss of principal. Equity securities are subject to market risk which means their value may fluctuate in response to general economic and market conditions and the perception of individual issuers. Investments in equity securities are generally more volatile than other types of securities.

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. Stock markets, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. Foreign investing has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. Small- and mid-cap stocks are generally more volatile, subject to greater risks and are less liquid than large company stocks.

Definitions

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market.

Lipper's U.S. Diversified Equity Fund classification applies a "70%" rule to the Russell 3000 Index to determine the large-cap floor. All the stocks of the Russell 3000 are ranked by descending order of market cap; the total market capitalization of the index is computed by summing each constituent stock's capitalization; and then the large-cap/mid-cap breakpoint is calculated by adding each stock's capitalization weight until the 70th percentile of the total capitalization is reached.

An index is unmanaged and not available for direct investment.

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