MAY 2020 CLIENT QUESTION OF THE MONTH

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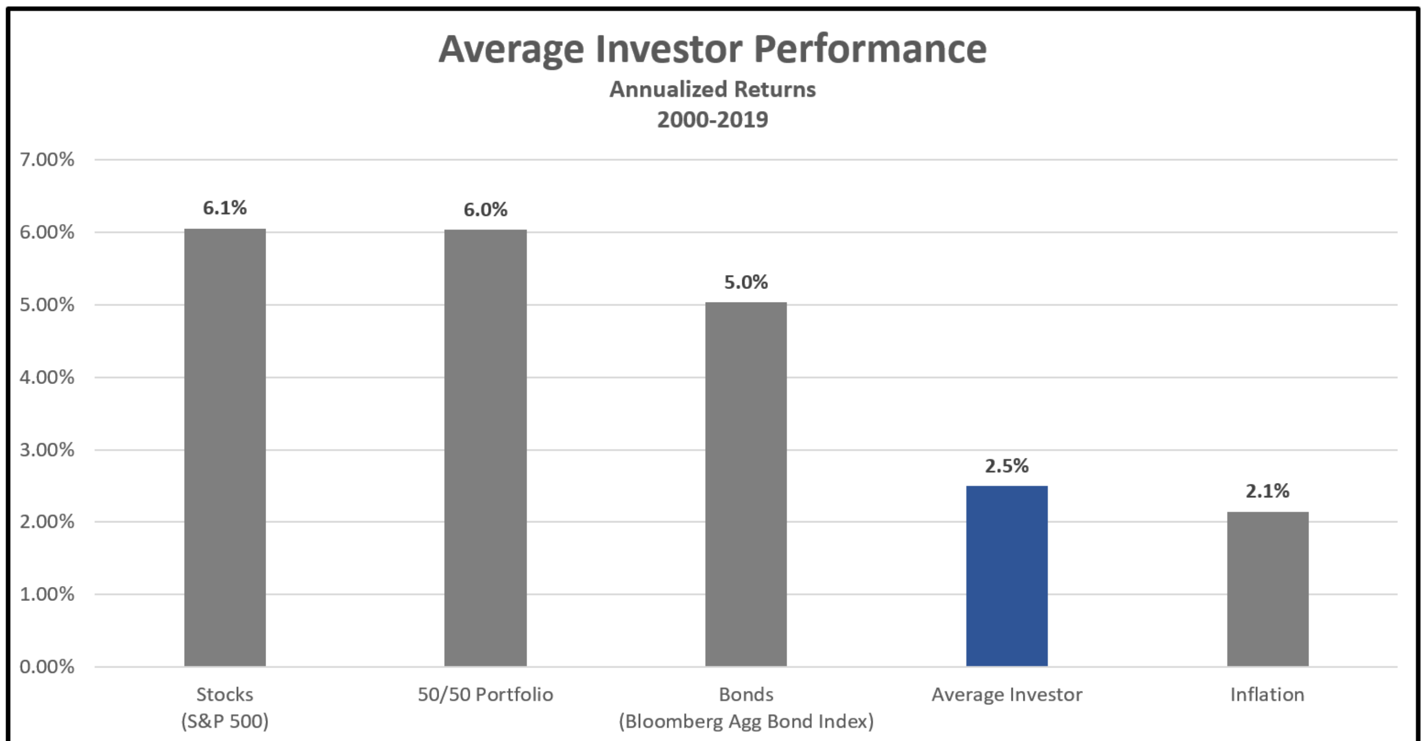
What are the costs of market timing and bad investment decisions?

At Winthrop Wealth, our investment philosophy is based on a long-term approach and consequently we do not believe in market timing (*see below for the definition of market timing). We often stress that emotionally driven market timing decisions are value destructive over time. In our May Client Question of the Month, we will quantify the impact that market timing and bad investment decisions have on investor portfolios. The following chart is from a Dalbar study titled "Quantitative Analysis of Investor Behavior" that displays the annualized returns of various asset classes and the average investor for the twenty-year period of 2000 through 2019. The average asset allocation investor's return is based on an analysis of the net aggregate mutual fund sales, redemptions and exchanges each month. The study shows that the average investor's return over this period was only slightly better than inflation and less than half of a balanced portfolio (50% stocks and 50% bonds). Dalbar cites market timing as a main factor for poor investor performance.



Source: Dalbar Inc.

What is our advice to the average investor?

Given the damaging impact that emotionally driven market timing decisions have on performance, the average investor should look for ways to mitigate this behavior. A trusted financial advisor can help make rational and data driven decisions rather than ones based on emotion. In our experience, the best course of action is to combine comprehensive financial planning with a globally diversified portfolio constructed by a thorough investment process, and to recognize several time-tested principles about investing in the stock market.

Combine Financial Planning and Investment Management

At Winthrop Wealth, we follow a total net worth approach to wealth management that combines both comprehensive financial planning and investment management. While financial planning and investment management can function successfully on their own, the combination produces a whole greater than the sum of its parts. The financial plan defines cash flow needs, optimizes account structures, considers tax minimization strategies, and determines the appropriate asset allocation based on the client's willingness and ability to take risk. Based on the output of the financial plan, our investment management process designs a well-diversified portfolio constructed with a methodology based on prudent risk management, asset allocation, and security selection. We ensure that our client's short-term cash flow needs are met while constantly stress testing both their financial plan and investment portfolio to help them ultimately reach their longer-term goals and objectives despite challenging markets. Without a comprehensive financial plan and investment process, it is very easy to shoot yourself in the foot by making an emotionally based market timing mistake.

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Remember Time-Tested Market Principles

The following market principles are valuable to remember as they can put the environment in perspective and help control emotional reactions during periods of market volatility. We will offer the latest statistics and provide links to old Client Question of the Month pieces that go into greater detail on each principle.

- **The stock market increases over time**: The S&P 500 has generated a total annualized return of +9.3% since 1928. A $1,000 investment in 1928 would be worth about $3.8 million today. Remember that this period included eleven bear markets, fifteen recessions, and dozens of corrections and pullbacks.
- **Returns are not linear (December 2019)**: The stock market increased in 67 (73%) calendar years and decreased in 25 (27%) calendar years. In other words, while annual market returns have been positive more often than negative, equities do not rise by an equal amount every week, month, quarter, or even year.
- **Declines are common (November 2018)**: Since 1928, the S&P 500 has averaged a peak-to-trough decline of -15.8% each year (including 2020's price decline of-33.8%). The market increases over time despite plenty of drops along the way.
- **Missing the best days in the market destroys long-term returns (January 2019)**: From 2000 through 2019, the S&P 500 delivered a total annualized return of +6.1%. This period included roughly 5,000 days when the stock market was open. If an investor missed only the 10 best days in the market, their return would have been +2.2%. An investor who missed the 20 best days would have lost money with an annualized return of -0.1%. To add to the difficulty, many of the best days in the market occur during periods of extreme stress and volatility.
- **The benefit of diversification and time (March 2020 Update)**: Diversification and time are an investor's two best friends. Diversified portfolios can lead to more consistent and less volatile results than a single asset class. We know that markets can be extremely volatile in the short-term but difficult periods do not last forever. The longer the investment time horizon the greater the odds of positive returns.

Over the past several weeks, we have enjoyed speaking with many of you to provide updates to financial plans, the markets, and investment portfolios. We are privileged to serve as your trusted advisor, and we are committed to helping you live life to the fullest. As always, please contact us if you have any questions or updates to your personal or financial circumstances.

** Market timing is an investment strategy that is implemented by selling a large portion of equity holdings when the market is high (keep in mind this could result in substantial capital gains for taxable investors), patiently waiting on the sideline as the market declines, reinvesting at the market low, and then riding the market back up to new highs. Rinse and repeat. Although this might sound easy, the reality is that successful market timing is nearly impossible to execute consistently. Market tops and bottoms are never obvious in real time, only in hindsight. To execute a market timing strategy an investor must get two decisions precisely correct: when to sell out of the market and when to buy back in. Most investors come up short with the second decision, buying back in. Investors who wait on the sideline and hope that the market declines further often miss significant rallies.*

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DISCLOSURES:

The economic forecasts set forth in this material may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Content in this material is for general information only and not intended to provide specific advice or recommendations for any individual.

All indexes mentioned are unmanaged indexes which cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is no guarantee of future results.

The Standard & Poor's 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Bloomberg Barclays U.S. Aggregate Bond Index is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

Financial planning is a tool intended to review your current financial situation, investment objectives and goals, and suggest potential planning ideas and concepts that may be of benefit. There is no guarantee that financial planning will help you reach your goals.

Likewise, it is important to remember that no investment strategy assures success or protects against loss. Asset allocation does not ensure a profit or protect against loss. There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not protect against market risk. Rebalancing a portfolio may cause you to incur tax liabilities and/or transaction costs and does not assure a profit or protect against a loss. All investing involves risk which you should be prepared to bear.

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