INVESTMENT INSIGHTS

Analysis, Insights and a Different Perspective July 2020

KEY POINTS

- Often investors buy high and sell low in reaction to short-term price volatility.
- Many short-term returns can be best described as random and unpredictable.
- Markets tend to reward investors who maintain a long-term perspective, which makes patience one of the most important investment principles.

VIRTUE OF PATIENCE

With the recent volatility in the stock market, it may be tempting for many investors to react to short-term trends. Each headline on the economic development brings with it an opportunity to do something — or does it? In this issue of Investment Insights, we take a closer look at the importance of maintaining a long-term perspective in a short-term world.

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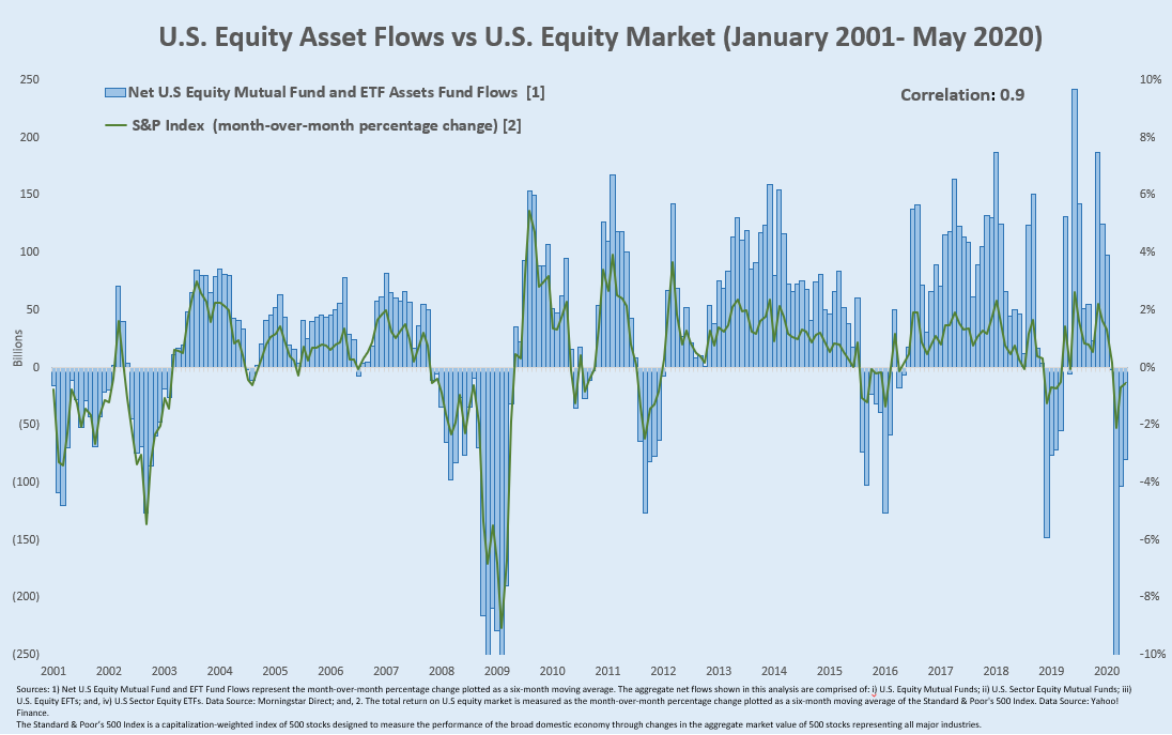
INVESTORS BUY HIGH AND SELL LOW

We do not have to look too far to find ample evidence of investors reacting to short-term price volatility. The following chart shows the relationship between the flow of money in and out of the stock market, along with the performance of the stock market. Historically, when the market has performed well, there is generally a significant inflow into stock funds. Conversely, when the market declines, investors sell their equity holdings. In short, many investors buy high and sell low. As you can see in the graph below, many investors poured into equities right before market peak in 2006-2007 and sold their equity funds near the market bottom in 2008. Many investors appear to have made this mistake yet again during the recent market decline.



Buying and selling broad asset classes, like stocks and bonds, based on short-term performance, is also often a mistake. The following chart (often called the quilt chart) shows the range of returns for various asset classes across a 10-year time period. It includes the performance of many major asset classes, including U.S. stocks, international stocks, bonds, real estate, and commodities. This chart shows that it would be impossible to historically to predict the relative performance of asset classes from one year to the next. On a yearly basis, the relative investment returns are random in nature. Relatively good performance once a year is often followed by a relatively weak performance the next year. Investors who base their decisions on recent one-year performance can often end up buying high and selling low.

Source: Morningstar.

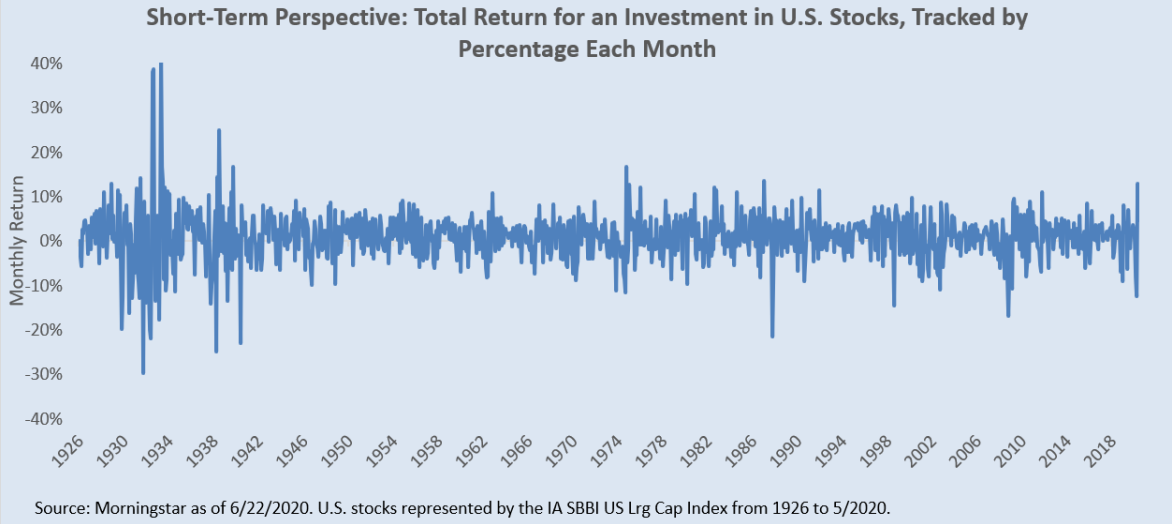
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	
Best	26.93	9.20	18.93	33.48	27.24	5.67	17.34	37.28	2.02	36.39	S&P 500
	18.88	7.84	18.22	32.53	13.69	2.14	11.96	30.21	0.01	31.49	Russell 1000 Growth
	16.71	6.05	18.04	32.39	13.45	1.82	11.37	25.03	-1.51	28.92	Russell 1000 Value
	15.51	2.64	17.51	22.78	13.05	1.38	11.19	21.83	-4.03	26.54	MSCI EAFE
	15.06	2.11	17.32	1.77	6.15	0.55	9.62	13.66	-4.38	22.01	MSCI EM
	11.83	0.39	16.00	0.06	5.97	0.05	7.56	9.84	-5.33	18.42	BBgBarc US Agg Bond
	9.03	0.06	15.26	-1.22	0.03	-0.81	7.08	8.29	-8.27	17.63	JPM EMBI Plus
	7.75	-1.18	4.21	-2.02	-2.19	-3.83	2.65	5.77	-13.79	12.60	S&P GSCI
	6.54	-12.14	0.09	-2.60	-4.90	-14.92	1.00	3.54	-13.82	8.72	DJ US Real Estate
Worst	0.14	-18.42	0.08	-8.31	-33.06	-32.86	0.34	0.97	-14.57	2.15	USTREAS T-Bill Auction Ave 3 Mon

Notes: Past performance is no guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index. Please see the last page for Index definitions.

RANDOM NATURE OF SHORT-TERM RETURNS

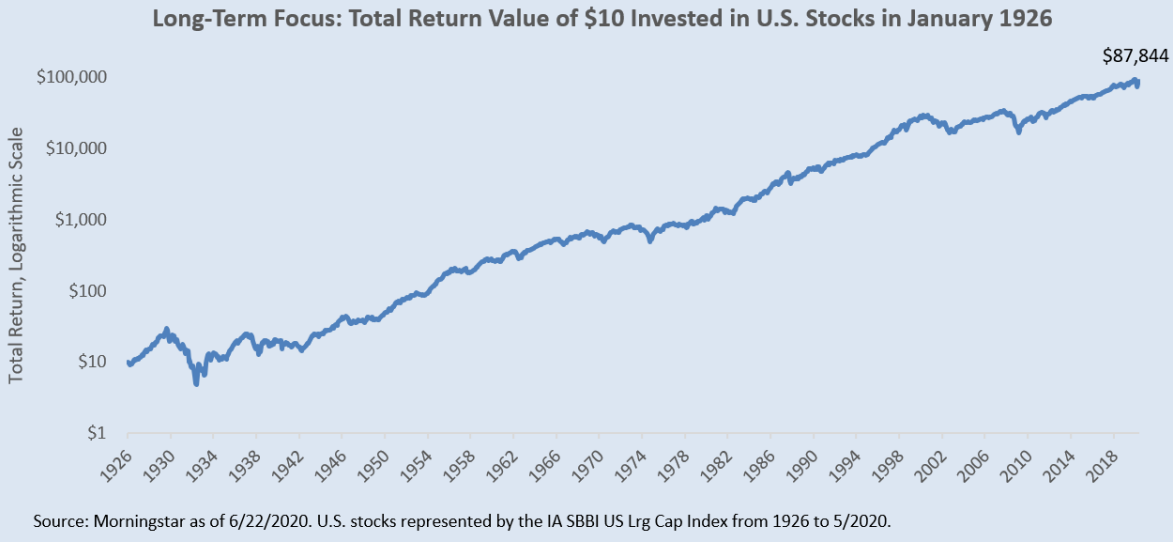
One reason why many investors buy high and sell low is that it is often extremely difficult to maintain a long-term perspective. Digitally wired investors are constantly inundated with a vast amount of information on markets from media, analysts, and experts. One of the surest ways to gain audience attention is using emotion, and one of the strongest emotions in finance is fear. According to research, fear-including headlines gain 30% more attention than happy headlines.[1] As we saw in the first chart, fear not only leads individuals to panic sell during market turmoil but also to buy near a market peak for fear of missing out.

With the inflow of a vast amount of information, the pressure to buy or sell has arguably never been higher. Indeed, according to one study, as of year-end 2018, the average holding period of stocks is now less than one year and lower than any time since 1929. While it is essential to stay informed, reacting to short-term volatility can often be futile, as many times short time periods can best be described as random in nature. The following chart shows the monthly stock returns since 1926.[2] As you can see, over the short-term, investors try to drive returns in reaction to market noise, which seems random and unpredictable.



MAINTAIN A LONG-TERM PERSPECTIVE

Rather than reacting to short-term market noise, many investors can benefit by making investment decisions by maintaining a long-term perspective. While it is difficult to stay focused on the distant future, maintaining a long-term view in a short-term world is often the key to investment success. The following chart shows the performance of U.S. stocks over the same time period as in the previous chart, this time displayed as a commutative return. Over long time periods, the stock market is driven by corporate earnings and growth in the economy. Historically, the stock market has rewarded investors who maintain a long-term perspective, which makes patience one of the most important qualities of many successful investors.



1 *Bad news: we can't get enough negative headlines* by Kinder as of 7/9/2018.

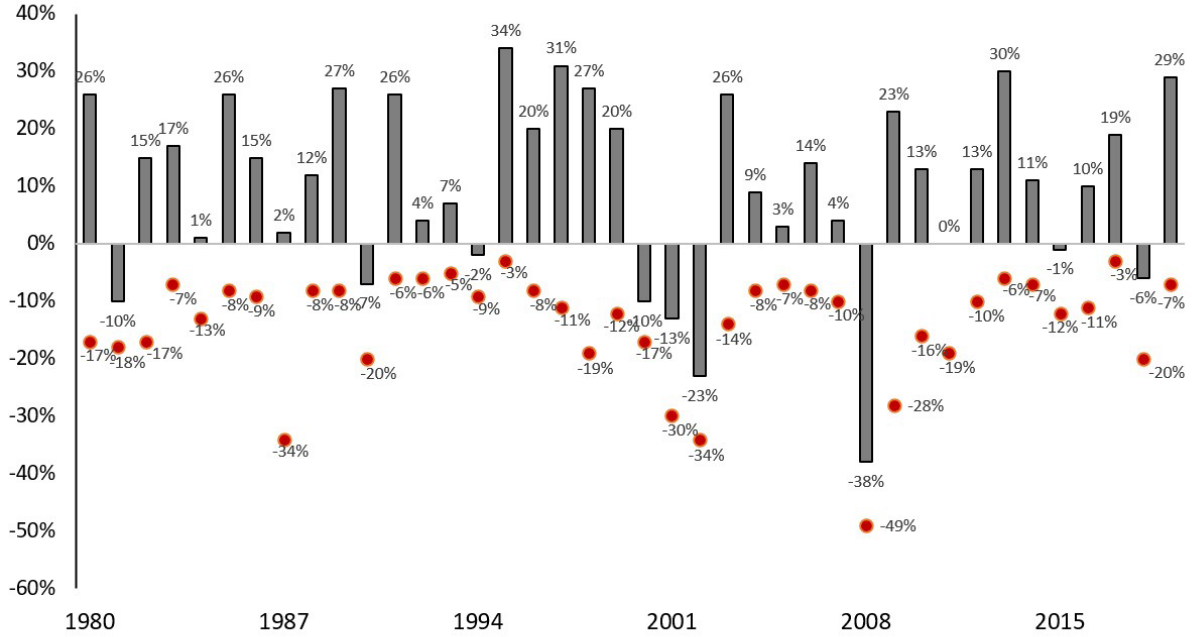
2 *Lengthening the Investment Time Horizon by MFS Investment Management*. Source: Ned Davis Research Group, from Barron's and IDC. The average holding period for a stock was 0.8 years as of 12/31/18.

UNDERSTAND VOLATILITY

Investors with a long investment horizon should not react to short-term volatility. In the graph below, bars show the annual returns in the stock market since 1980, and the red dots show the peak to trough decline for each year. While the average intra-year decline has been around 14%, 75% of the time, the market ended up positive for the year.

S&P 500 intra-year declines vs. calendar year returns

Despite average intra-year drops of 13.9%, annual returns positive in 30 of 40 years



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management. Returns are based on price index only and do not include dividends. Intra-year drops refers to the largest market drops from a peak to a trough during the year. For illustrative purposes only. Returns shown are calendar year returns from 1980 to 2019. *Guide to the Markets – U.S.* Data are as of December 31, 2019.

Many investors can be best served by thinking of short-term investment returns as random and unpredictable. Having this understanding can help investors ignore short-term market noise and maintain a long-term perspective for investment success.

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The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure the performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The Russell 1000® Growth Index measures the performance of the largecap growth segment of the U.S. equity universe. The Russell 1000® Value Index measures the performance of the largecap value segment of the U.S. equity universe. The MSCI EAFE Index is an equity index which captures large and mid cap representation across 21 Developed Markets countries around the world, excluding the U.S. and Canada. With 915 constituents, the index covers approximately 85% of the free floatadjusted market capitalization in each country. The MSCI Emerging Markets Index captures large and mid cap representation across 26 Emerging Markets (E.M.) countries. With 1,403 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. The Bloomberg Barclays U.S. Aggregate Bond Index is a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States. The S&P GSCI® is a composite index of commodity sector returns representing an unleveraged, long-only investment in commodity futures that is broadly diversified across the spectrum of commodities. The JP Morgan EMBI Plus measures the performance of US-dollar-denominated debt instruments issued by emerging-markets countries and traded in international markets. Issuers are limited to countries having a credit rating of or below Baa1/BBB+ by Moody's and S&P. The D.J. U.S. Real Estate Index is designed to track the performance of real estate investment trusts (REIT) and other companies that invest directly or indirectly in real estate through development, management, or ownership, including property agencies. The USTREAS T-Bill Auction Ave 3 Mon index measures the performance of the average investment rate of US T-Bills securities with the maturity of 3 months. IA SBBI US Lrg Cap Index is represented by the S&P 500 Composite Index (S&P 500) from 1957 to present, and the S&P 90 from 1926 to 1956.