Should I stay invested amid market volatility?

Volatility may tempt many investors to try to time the market, but history tells us that market timing is virtually impossible to do successfully.

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Performance of a $10,000 investment between January 2, 1998 and December 29, 2017
Source: PMFA, Standard & Poor's

When markets experience a significant pullback like we saw in October, investors may consider pulling their money out of the market to avoid further losses. However, history has shown that timing these moves is virtually impossible, since you have to be right twice (when to get out and when to get back in).

Historically, missing just a few of the best days in the market can have a significant negative impact on returns. An investment of $10,000 in the S&P 500 in 1998 would have seen an annualized return of 7.2% over the following 20 years, reaching a final value of over $40,000 at the end of 2017. However, an investor that missed the top 40 days over that period (approximately 1.6% of the total days) would have actually seen negative returns, with a final value of less than $6,000. Additionally, many of the 40 best days came within two weeks of one of the 40 worst days, making it very difficult to time. By going to the sidelines, investors are not only missing potential rebounds, but all of the compounding growth on that money going forward.

Sharp movements in equity markets can create angst for investors, but it's important not to let short-term emotions drive investment decisions. Investors should maintain a long-term, disciplined investment strategy and avoid the temptation to attempt to time the market.

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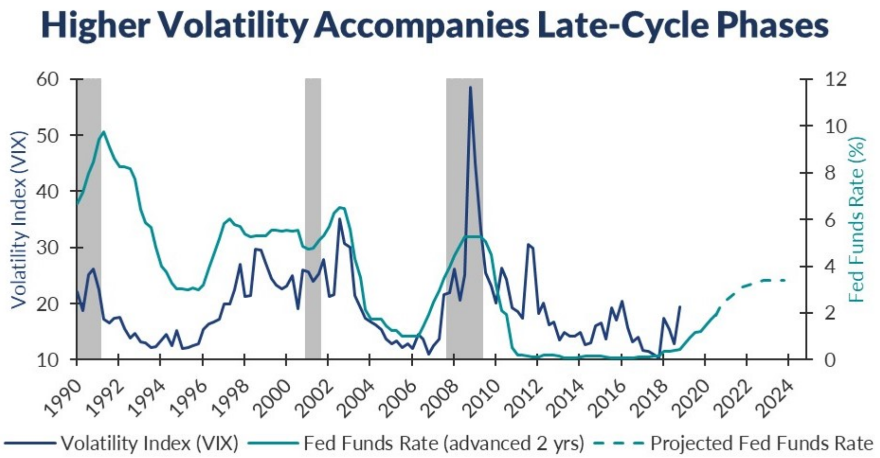
Should investors prepare for higher volatility ahead?

Heightened volatility has been a hallmark of late-cycle phases historically. This time may not be different.



Grey bars indicate recessionary periods
Source: PMFA, Federal Reserve Economic Data (FRED)

For the last several years, a combination of near zero interest rates and increased liquidity from quantitative easing has helped to suppress market volatility. Now, more than nine years into this economic expansion, the Fed is well along its path toward normalization. The fed funds rate has risen by 2.0%, and is not far away from the Fed's estimate of the long-term neutral level – around 3.0%. This suggests we may be approaching the latter stages of this economic cycle, as rate hikes beyond the neutral level contributes to tighter financial conditions, which is often viewed as the culprit of an ensuing recession. Historically, these upward moves in rates, as the Fed attempts to prevent late-cycle overheating, have been accompanied by heightened market volatility (as illustrated above). While interest rates may not have moved into restrictive territory yet, an uptick in volatility from exceptionally lower levels should not be unexpected as we look ahead – particularly given the Fed's telegraphed path for short-term rates.

Despite the fact that heightened volatility may be ahead, it may be 2020 before the fed funds rate truly moves into "restrictive" territory, and thereby the current economic expansion may have more room to run. Traditionally, equity markets have performed well in the latter stages of a business cycle, thus de-risking in anticipation of increased volatility or a potential recession has not typically been an effective strategy. As shown in our accompanying piece, pulling out of the market at the wrong time and missing just a few days of strong performance could drastically reduce portfolio returns. The bottom line is that volatility is a normal part of the market cycle, and while unnerving, it often presents opportunities for long-term investors with a disciplined investment plan.