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Market time, not market timing, has led to better results

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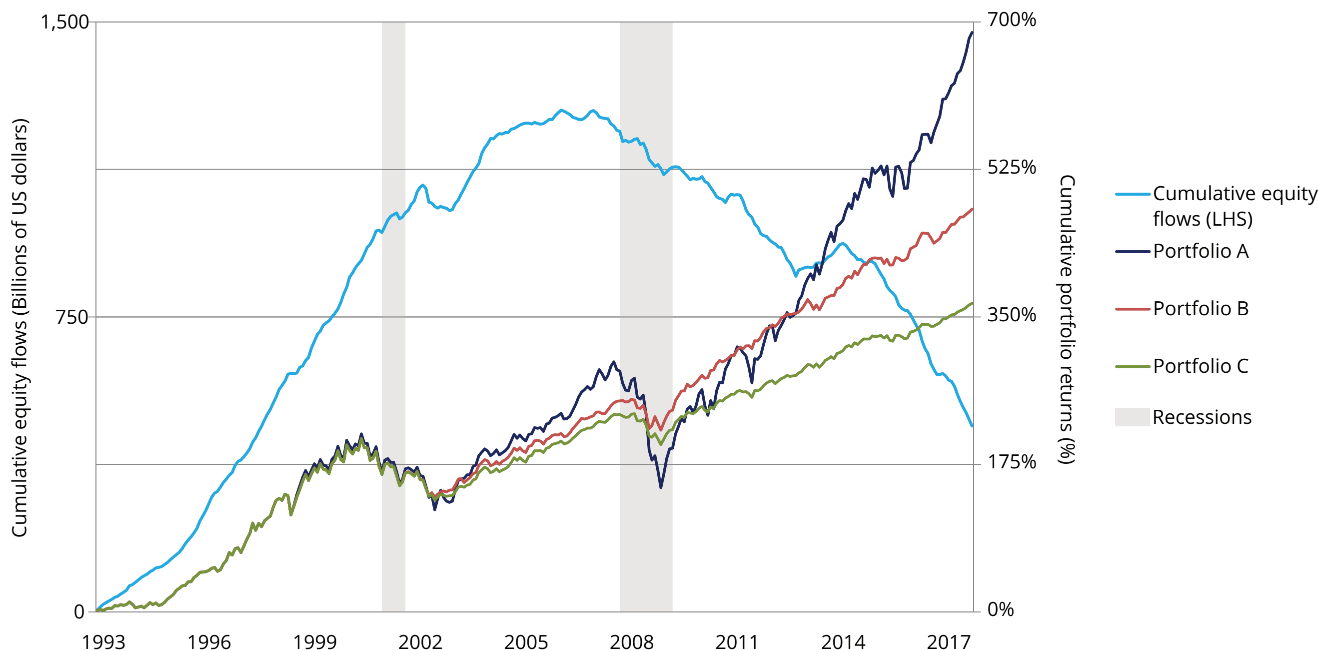
The bouts of high market volatility we've already experienced this year beg the question, "How should I behave in this environment?" Many investors I've spoken to are wondering if they should take a more defensive stance by reducing their equity allocation and moving to either fixed income or cash. While the temptation to reduce risk during the heat of a market correction can be potent, these temporary gyrations are a good reminder of the historical benefits of long-termism: establish a strategic allocation, stick to it, and avoid the urge to jump in and out of the market.

To illustrate this point, I use mutual fund flows from 1993 to 2017 as a proxy for investor behavior in **FIGURE 1**.

FIGURE 1

Staying in the market resulted in higher cumulative returns in these scenarios

Hypothetical portfolio returns (gross), February 1, 1993 – December 31, 2017



As of December 31, 2017 | For illustrative purposes only and not representative of any Hartford Funds mutual fund. **Past performance is not a guarantee of future results.** Equities are represented by the S&P 500 Index. Fixed income is represented by the Bloomberg Barclays US Aggregate Bond Index (see back page for index definitions). Investors cannot directly invest in an index. Assumes reinvestment of capital gains and dividends and no taxes. Cash is represented by the effective federal funds rate. Equity flow data is from Morningstar: US open-ended (ex-money market funds and ex-funds of funds and including obsolete funds). Recession data is from the Nation Bureau of Economic Research, which defines a recession as a "significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales."| Sources: As noted, and Wellington Management

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FIGURE 1 shows the results of three different approaches:

- **Portfolio A:** Holding a portfolio of 70% equities and 30% fixed income steady over the entire period;
- **Portfolio B:** Reducing the equity allocation in favor of fixed income during periods of equity outflows, and reversing those allocations again during periods of equity inflows;
- **Portfolio C:** Following the same tactical rebalancing strategy described above for Portfolio B, but adding or subtracting cash instead of fixed income.

During the period, reducing equity allocations sometimes improved performance over the short term, but over the long term, if investors tried to time the market by selling equities and going into either fixed income or cash, performance lagged far behind the steady 70%/30% portfolio. For the purposes of this illustration, over the full 24-year period, **Portfolio A** outperformed **Portfolios B** and **C** by 210 and 321 percentage points, respectively.

It is worth noting that prior to the financial crisis in 2008, equity flows turned negative, resulting in lower equity allocations in **Portfolios B** and **C**. This helped these hypothetical portfolios outperform for a short time. **Portfolio B** outperformed **Portfolio C** because fixed income was generating a higher yield than cash, and because fixed income benefited from consistent capital gains as interest rates fell over this period.

Methodology for the Approaches Shown in FIGURE 1

Portfolio A: 70% equities/30% fixed income

Portfolio B: Begin with a 70% equities/30% fixed-income portfolio, and:

- After one month of equity outflows, decrease the equity allocation by a 10 percentage-point increment and increase the fixed-income allocation by a 10 percentage-point increment to a minimum 20% equity allocation and maximum 80% fixed-income allocation
- After three consecutive months of equity inflows, increase the equity allocation by a 10 percentage-point increment and decrease the fixed-income allocation by a 10 percentage-point increment to a maximum 70% equity allocation and minimum 30% fixed-income allocation

Portfolio C: Begin with a 70% equities/30% fixed-income portfolio and make the same adjustments as with Portfolio B, but reallocating in and out of cash

Important Note: We waited longer to increase the equity allocation during inflows than to decrease the equity allocation during outflows because we believe that investors tend to be more reactive to outflows than inflows.

Investment Implications

In my view, a prudent course of action for investors should potentially include:

Finding your strategic asset allocation and sticking with it. Trying to time the market is incredibly difficult. Investors who reduce their equity allocation during periods of temporary market stress could risk missing both near-term rallies and sustained recoveries.

Choosing wisely within fixed income. Fixed income, an important component of a diversified portfolio, is unlikely to benefit from declining interest rates as it has since the 1990s. Within their allocations, investors may want to consider seek flexible or shorter-duration fixed-income strategies in an effort to minimize their interest-rate exposure.

Consider revisiting equity allocations if needed. Negative equity flows since the financial crisis indicate that many investors have kept their equity allocations low. If equity allocations have fallen below their strategic weight, I believe it is prudent to use further stock market corrections as opportunities to increase that exposure, as I see a low probability of recession over the coming year.

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