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If time's on your side, don't time the market

Market volatility has little effect on returns of long-term investments, which are more than 10 years

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Last year, inflows into equity markets continued despite a correction, due to optimistic expectations and sentiment. This tapered off only after January 2016 as one- and two-year returns turned negative. Earlier as well, inflows into equity markets were high closer to market peaks. According to data from the Association of Mutual Funds of India (Amfi), the highest ever monthly inflows into equity mutual funds was in January 2008, a period when the equity market touched an all time high till then.

Even though trying to time an entry or exit in a market is common investor behaviour, historical data shows this doesn't yield much for a long-term investor.

How do we know this? We took a look at rolling returns for two indices: Nifty 50, a domestic large-cap index, and Nifty 500, a broader index. Rolling returns are a return series for any specified frequency taken regularly for overlapping cycles to account for the fact that investors enter and exit at all times. Nifty50 is a relatively focused index as it has 50 stocks, while the latter has 500 stocks. However, data shows that both have something in common—the longer you invest for, the less volatile your return will be, and hence, the less valuable a market timing strategy.

What is market timing?

Domestic equity markets haven't done well after the peak of January-March 2015. Until before the Budget session in 2016, experts were talking about more downside, but the mood has changed now with monsoons expected to be on track, industrial production numbers being good and global sentiment positive. If you were waiting for markets to fall further before starting to invest, you were timing the market. Alternatively, it could be that you are new to equity, and as the market picks up, say, a year into the rally, you speak to friends and acquaintances and realise that they are making a good return. You too want a piece of the pie and jump in. Again, you would be timing the market.

"Trying to time the market is usually futile. Individual stock investor behaviour in this space is a function of time spent in the market. First-time investors predictably try to enter the market when they think others around them are making money; most of these stories do not end well," said Lalit Nambiar, senior fund manager, UTI Asset Management Co. Ltd. "Someone more experienced might search for bargains in a falling market, having learnt the hard way that when everyone is buying is not a great time; they prefer exiting when markets are back to euphoric levels," he said.

So, trying to time the market is a function of how an investor perceives not only the price (cheap or expensive) but also the market mood.

"Investor behaviour, including that of sophisticated institutional investors, veers towards investing larger amounts when markets have consistently gone upwards. Hence, largest allocations come closest to a market peak. Most don't consider valuations and that is the only way one should think about timing—looking at absolute market valuations and comparing historically. Also, comparing equity valuations with fixed income is important," said Vikas Gupta, executive vice-president—traded markets and investment research, ArthVeda Fund Management Pvt. Ltd.

Does timing market work?

It can work in the very short term. But volatility by definition means ups and downs. So, it's difficult to time your return precisely. Say, you started your equity investment in January 2015, when euphoric markets sent benchmark indices close to all-time peaks. One-year returns for 2014 (calendar year) looked good at 31%. This, combined with the heightened expectations of India's economic growth, made it enticing to invest in equity markets.

However, a year later, returns on your investment on, say, 1 January 2015 would have been -4%. Had you invested six months earlier, on 1 July 2014, your one-year return would have been 10.7% and your return on 31 December 2015 would have been 4%. Markets can turn fast, and timing the market isn't just about when you start but also when you exit. Even equity mutual funds have not been able to generate consistently positive one-year returns.

"In the short run, volatility matters and sometimes you can time the market to an extent, but you can't do it extremely well all the time. There is no formula," said Ambareesh Baliga, an independent Mumbai-based market analyst. "Recently, when the markets were headed down, it was hard to know that 6,800 (Nifty 50 value) would be the bottom. I believed 7,500-7,300 are the lows the market could see. But markets went down further," he added.

That's why, for the average direct equity investor, it's important to know the quality of stocks one holds and have the confidence to hold on through market cycles, he added.

In the long run, the picture changes—consistent returns can be generated simply by remaining invested. For long-term investors who want to remain invested for at least 10 years, timing the market won't add much to returns; the return impact evens out.

We took rolling month-end returns for Nifty 50 and the Nifty 500 for 3, 5 and 10 years, from April 2006 till March 2016. For the Nifty 50, the average 10-year annualised rolling return was 15.2%. If we remove the top 20% readings from this data series (the best 24 returns), the average 10-year rolling return doesn't change much—14.4%. This is done to demonstrate what happens if you don't catch the best time of the market cycle.

Repeat the exercise for three-year annualised rolling returns from 2006 to 2016 and you will find that on removing top 20% readings, the average drops to 9.5% annualised returns as compared to the original 15.3%. This again shows that in the short term, volatility has to be managed, but in the long run, it has less of a bearing. The result for Nifty 500 was similar (see graph).

Gupta, a fundamental value-oriented fund manager, said, "Timing the market price is a mere illusion. Ups and downs don't last an entire cycle. Hence, it really can't be done. A better approach is to assess the intrinsic value of individual stocks."

What should you do?

"Equity fund managers can't sit out of the market as they usually have a mandate to stay invested. Some may take a tactical position for a particular eventuality. But it is difficult to time the market right consistently. In most cases, especially in mid-cap portfolios, building a position when a good stock is out of favour is a more repeatable skill set than trying to time entry and exit," said Nambiar. For an investor, assessing these various parameters can get complicated.

Financial planners advise goal-based investing, which removes the need to time markets. You must keep in mind that a long-term equity investment is not for three years but at least 10 years. "Investing for the short term in equity should only be done if the funds are surplus and not needed for any other purpose," said Baliga.

Portfolio managers prefer to focus on stock selection and intrinsic value rather than reading where the markets are headed in the next few months.

Long-term equity investing, shows data, can provide consistency—linking this to a goal will help. But keep in mind that as you reach closer to your target, the remaining investment period is short term. You should treat your entire accumulated investment as the principal corpus, which you need for your goal. At this point, shifting out of volatile assets like equity into fixed return products will help in capital preservation.