FE Investments

INVESTMENT CONCEPTS | MAY 2022

The Importance of Remaining Invested

FOR PROFESSIONAL CLIENTS ONLY

Edward Margot,
Head of Client Investment Strategy

- **Financial planning requires time -** a well-designed plan is essential for success and covers many years ahead
- **Investing is emotional -** fluctuations in value can be unnerving but there are ways to manage emotions
- **Timing the market is difficult –** the cost for mistiming can be significant, selling out can derail your financial plan
- **Patience is a tool for investment -** it can increase the possibility of success of a financial plan
- **Perspective can provide comfort –** investment values fluctuate, some more than others, but this is normal
- **Expectations management –** our portfolio reports can help put performance into perspective

Financial planning requires time

Investing seems simple on the surface. Use your wealth to invest and over time the value of your investment should increase, hopefully commensurate with the risk you have taken. This high-level objective forgets that investment values gyrate, they are volatile - some assets are more volatile than others. Market volatility can be stressful for investors; the key is to take the appropriate amount of risk so you remain invested and have a chance of achieving your financial goals.

Investing requires that you invest for a defined period of time, or at least with a minimum threshold. Over the course of this time frame markets will inevitably deliver good years and weak years of performance. The risk you take is not one sided: investments don't keep going up in perpetuity. Investors will suffer weak years.

Since the global financial crisis, the economy and markets have enjoyed central bank support, with low interest rates and frequent monetary stimulus (quantitative easing), which has resulted in unusually depressed levels of price swings in financial markets. For investors, the last 14 years have been rewarding: relatively low levels of price fluctuation with good returns.

Markets have started to change and we could see a move back to pre-financial crisis investment conditions. Rising interest rates and elevated geopolitical risk means investors should expect more volatility.

Investing is emotional

After working hard and saving it is natural to have a strong connection with your wealth. Investing involves an element of emotion and as time passes - depending on your life, events, the economy and markets - you will feel differently about your investments.

Loss aversion is naturally wired into us; most people would prefer to avoid losing compared to gaining an equivalent value. So, when investors see the value of their portfolio drop they may feel the need to prevent further potential or expected losses; but this can work against an investor.

Emotions are in our nature, but how can we manage them in an effective manner, that ultimately results in a positive outcome to the financial plan?

The short answer is: perspective.

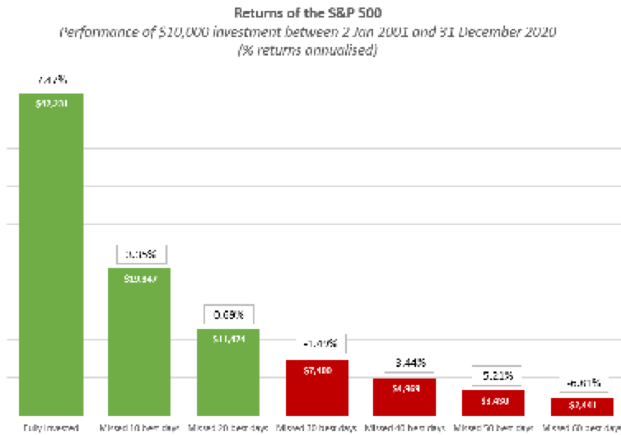
Timing the market is difficult

Investors have often tried to "time" the market – essentially selling to avoid falls in investment prices and investing to capture the upside. We have seen large institutions – for

example Goldman Sachs, JP Morgan, Prudential, and many more - try to time the market. They fail to do this consistently which is why it is part of our philosophy not to make conviction market calls, but to manage risk as effectively as possible.

Selling assets crystallises your investment position. You may have made a loss or a gain but de-risking or moving to cash eliminates the prospects for future investment returns. Market volatility can result in drops in value, but it can also see similar movements in the opposite direction over time. Usually, periods of sharp falls and sharp rises, the best and worst days in markets, occur in close proximity.

Here are the stats:



Source: JP Morgan Asset Management

Between 2001 and 2020, seven of the 10 best days of the S&P 500 index occurred within two weeks of the 10 worst days, and 6 of the 7 best days occurred the day after the worst of that year. The second worst day of 2020 - 12th March – was immediately followed by the 2nd best day of the year.

These data tell a story: remaining invested avoids decision making errors in the short term that can critically undermine the most robust of financial plans.

We have heard stories during the coronavirus crisis, where investors sold out for cash during the market fall. Sadly, they missed out on their returns over the coming months as markets rapidly recovered. We resisted calls from IFAs, and indirectly the underlying investors, to sell out for cash when prices were falling. Although investments fell sharply they recovered quickly throughout 2020 and most major equity markets were back to pre-pandemic levels within months.

Sometimes taking no action, is the action.

Patience is a tool for investment

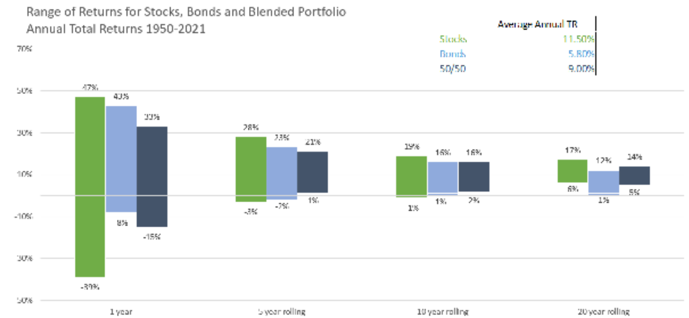
Our portfolios are designed to match up to a financial plan set out by an IFA for an investor's unique set of circumstances. Frequently an IFA will segregate money into "pots" for different goals or objectives. These pots of wealth will have a time scale assigned to them, they could be short or long term, but the time horizon for investment is important.

The longer you invest for, the more probable your investments will make a positive return; this relates to risk. Generally lower risk/volatility investments offer a higher probability of generating a positive return, for a lower, more certain return. Higher risk/volatility investments offer a lower probability return, for a higher, less certain return.

For goals or "pots" with shorter time horizons there is a tendency to use lower risk investments, and for longer time horizons there is a tendency for higher risk investments.

Over a very long period of time, say 20 years or longer, it becomes very likely that most investments deliver a positive return, regardless of market setbacks.

The chart below shows how patience, a core part of our investment philosophy, can serve investors interests well.



Source: FactSet, Federal Reserve, Robert Shiller, Strategas/Ibbotson, JP Morgan Asset Management

Risk, specifically volatility (or the short term rise or fall of investment prices), is defined as the uncertainty of return. The chart above shows that in any given year equities have delivered a possible 47% to -39% return. It is more risky than, say, cash delivering a 0.5% return. You could guess or gamble by investing in one year but the risk of outcomes is wide, or highly dispersed.

The chart also shows the rolling – or average - returns over various time periods: one, five, 10 and 20 years. Using a longer time period provides a better estimation of returns as it covers a range of market conditions over the 71-year data set and most people invest for longer than a single year.

In the very short term – one year - bonds tend to be less risky than equities and we can see the uncertainty of outcomes is narrower than stocks in most instances. It is still quite broad versus the comparisons over longer time horizons.

Over time we can see that returns become more certain and have a narrower "dispersion" of rolling returns. So, if returns become more certain over time, risk diminishes over time. For example, a range of returns over one year of 47% to -39% is less certain than 17% to 6% over 20 years rolling for equities. Risk, after all, is the uncertainty of return.

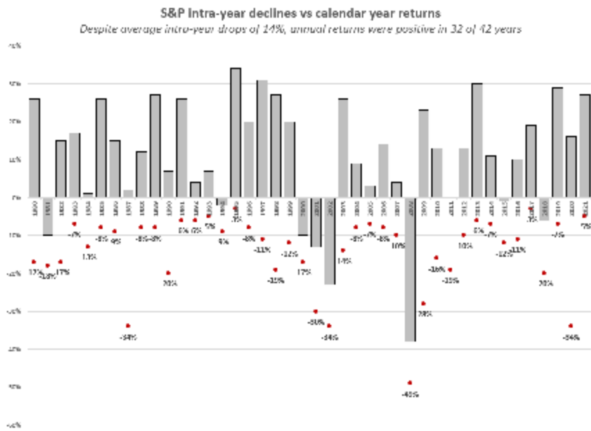
Note that the 50/50 portfolio has the narrowest return over five, 10 and 20 years. This is the diversification benefit of combining two asset classes together (albeit crudely in this example).

Perspective can provide comfort

We have established some perspective about investment, running the data to draw conclusions about the nature of investment including market timing and patience.

Most investors put money into a portfolio with a mix of investments normally bonds and equities. Let's consider the riskier investment: equities. In this case it is the US index,

the S&P 500, from 1980 to 2021. Equities are useful because we can use them to set our expectations in some of the more extreme circumstances for investment. Most investors will fall below this risk threshold.



Source: JP Morgan Asset Management

The chart above shows equity markets have delivered many positive years of returns. Out of the 42 years covered by the chart, 32 delivered a positive return, with an average return of 9.4%.

In all years the S&P 500 index went through a patch where the price fell. The minimum was -3%, the maximum was -49%, and the average was -14%.

The longest period was from 2000 to 2003 (approximately two years and five months long) during the dot-com bear market where the index fell by 46% using the information above.

Markets go through strong and weak periods and falls in value are quite frequent. Throughout the years we will see falls and these can add up over time. However, we see more positive years than negative ones and over time they add up to offset the weak periods of performance.

What should I expect from my portfolio?

We provide all our investors with a monthly portfolio report. This document provides you with important information about your portfolio and includes the underlying investments, performance and fees. It also helps you envisage the risks associated with investment.

To do this we have looked at investment performance of our portfolios going back to 2002. We launched as a discretionary investment manager in 2015 so to illustrate performance before this time we have used the asset class history of bonds and equities. This is provided by an actuarial consultant who were running asset allocations for investors prior to the launch of our portfolios. This allows you to form an impression of performance over a long period of time and a number of market and economic cycles.

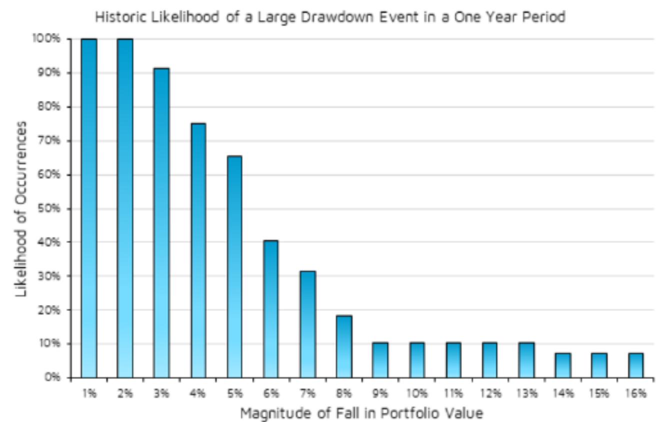
Simulated History for Hybrid Risk Grade 3 Medium Term

Source: FE Investments, May 2022

We can see a similar trend in the simulated history compared to the S&P 500 index in the prior section. At the time of writing the portfolio (Hybrid Risk Level 3 Medium Term) consists of 37% in bonds, or fixed income, and 63% in equities. Although the portfolio fell in value in the same years as the S&P 500, in 2002, 2008 and 2018, the falls were much less due to the effect of diversification.

The historical information is accompanied by further detail based on the volatility of the portfolio. This allows investors to understand what the potential magnitude of a loss could be in a given year.

Possibility of large losses



Source: Fefundinfo, May 2022

We can use the chart to see that there is approximately 20% chance of a fall of 8%. Looking back over the last 20 years, using the historic asset allocations, we can expect a fall of this magnitude every five years.

We can't look into the future and forecast if this will be the case. The information is for illustrative purposes only based on historical events. It will give you an insight about risk and you can gauge how comfortable you feel about the risk in and investment portfolio.

> *'Markets go through strong and weak periods and falls in value are quite frequent. However, we see more positive years than negative ones and over time they add up to offset weak periods of performance.'*

Conclusion

The information we provide on our portfolios allows you to form a view on absolute performance, risk for your portfolio, the risk of selling out and how patience can increase the probability of positive returns.

A financial plan typically looks years (sometimes decades) into the future. The purpose of this is to reason backwards to your current financial position. Decisions can be made about saving and lifestyle now and over coming years that will increase and hopefully maximise the probability of achieving your objectives. The value of working closely with a financial adviser cannot be understated.

When you run through your annual review you can work with your financial adviser to establish if you have saved enough, and if your investments are on track in the current market environment. Changes can be made; you may wish to save and invest more, or if you are well ahead, you may wish to save less or take a little wealth out of your savings.

Combining the right investment philosophy, patience, diversification and the appropriate amount of risk means you can increase the chances of reaching your goals. Effective risk management lies not just with us and your IFA, but with you, which is why it is important to remain invested where appropriate for your circumstances.

This document has been prepared for financial adviser use and contains general information only.

© FE fundinfo 2022

FE Investments and FE fundinfo are trading names of Financial Express Investments Ltd, which is authorised and regulated by the Financial Conduct Authority.

Although Financial Express Investments Ltd information providers, including without limitation, MSCI ESG Research LLC and its affiliates (the "ESG Parties"), obtain information (the "Information") from sources they consider reliable, none of the ESG Parties warrants or guarantees the originality, accuracy and/or completeness, of any data herein and expressly disclaim all express or implied warranties, including those of merchantability and fitness for a particular purpose. The Information may only be used for your internal use, may not be reproduced or redisseminated in any form and may not be used as a basis for, or a component of, any financial instruments or products or indices. Further, none of the Information can in and of itself be used to determine which securities to buy or sell or when to buy or sell them. None of the ESG Parties shall have any liability for any errors or omissions in connection with any data herein, or any liability for any direct, indirect, special, punitive, consequential or any other damages (including lost profits) even if notified of the possibility of such damages.