Be patient, be brave

With a long-term view — and a little courage — your portfolio can recover from even historic volatility

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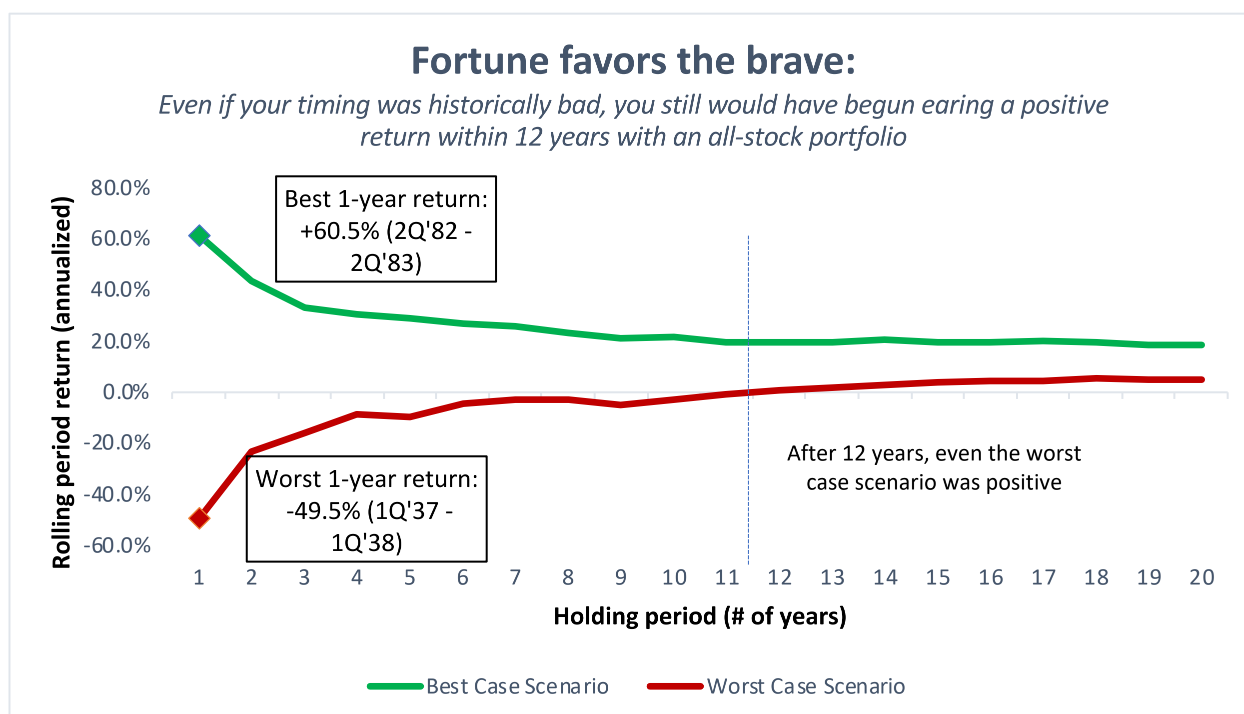
- Markets are suddenly volatile again, but making rash decisions in response is often a mistake.
- Instead of asking yourself, "Is this a good time to be invested in the market?" a better question might be, "Is my investment time horizon long enough to recover from any setbacks?"
- Since 1936, investors who were able to wait out market volatility were rewarded with positive returns within 12 years during even the worst of all possible market environments.
- For those who diversify across asset classes like bonds and international stocks, this "recovery time" has been even shorter.

After a powerful post-pandemic recovery and a long period of relative calm, markets are suddenly volatile again. Skyrocketing inflation, a sharp rise in interest rates and a handful of geopolitical stresses are creating a climate of fear that investors haven't faced for a decade or more. Add to that, worries that the U.S. economy may find itself tipping into recession at some point in the future, and you might be tempted to run for the exit.

But before you do, consider this: Making snap decisions in response to market volatility is often a mistake, because timing the market exactly right is nearly impossible for novices and professionals alike and even attempting it can lead to subpar performance. So instead of asking yourself, "Is this a good time to be invested in the market?", try asking yourself, "Is my investment horizon long enough to overcome any potentially bad market outcomes?"



Source for data: Morningstar®

Toward that end, we analyzed quarterly returns from the S&P 500® Index from 1936 to today and charted the hypothetical best and worst outcomes at each horizon from one to 20 years in the chart above. Notice how the lines connecting these extremes converge over time. Simply put, the longer your horizon, the more predictable the outcome has been — and the less likely you were to experience extreme results. For example:

- The worst one-year rolling return observed over the last 86 years was -49.5%, covering the period between April 1937 and March 1938.[1] How might an investor who had the bad luck to step into the market at exactly that point have reacted?
    - If they had kept a stiff upper lip and held on to their investment in stocks for the next 20 years, they would have eventually earned 10.6% on an annualized basis (or 649.4% on a cumulative basis).[2]
    - On the other hand, if they were frightened by the loss and moved into the safety of government bonds for the next 19 years, they would have locked in that awful loss and lost -1.5% per year during the 20-year period.[3]

But even those who enter the market at the right time will have their bravery tested. Someone who entered the market in June 1980 and held onto stocks for the next 20 years would have earned more than 18% per year, the best in our sample.[4]

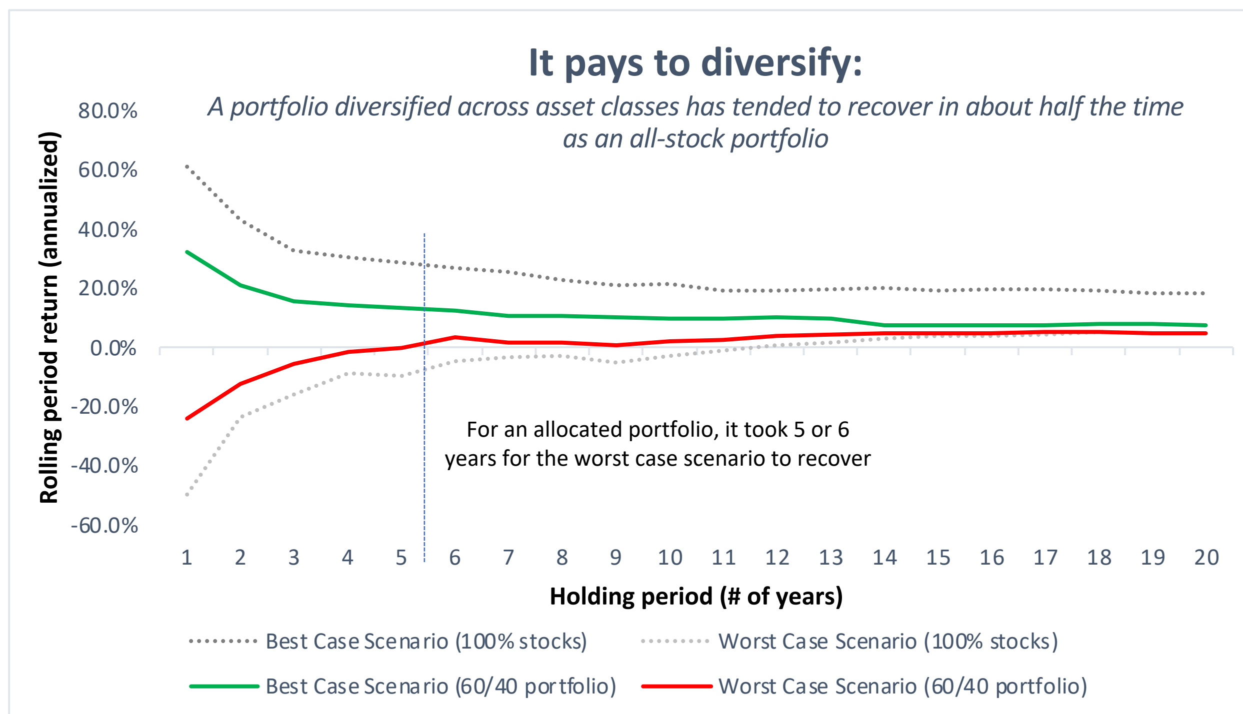
- But, during the 80 quarterly periods during that span, 18 of them (or 22.5%) posted negative returns. Across our entire 86-year sample, stocks dropped almost one out of every three calendar quarters.

The volatility — Reducing benefits of diversification

But for the vast majority of people saving for retirement, an asset allocation strategy that relies on 100% stocks is unlikely to be appropriate except perhaps during the very early years of one's savings career. Instead, most investors allocate their investment portfolios across different asset classes, such as domestic stocks, bonds and international stocks, to take advantage of the tendency for asset classes to underperform and outperform one another at different times — a concept known as cross-asset class diversification. To reflect that dynamic, we repeated the above analysis using a hypothetical portfolio comprised of 40% domestic large-cap stocks, 40% bonds, 15% developed-market international stocks and 5% emerging market stocks. (While this may or may not represent a wise allocation given your individual situation, it nonetheless gives a reasonable point-in-time estimate of what a typical diversified allocation might represent for some investors.) *

Given limitations on the availability of historical data, our analysis here extends back only to the late 1990s, but the message is still clear: a properly allocated portfolio has done an even better job rewarding patience and bravery during volatile times than a portfolio consisting entirely of stocks, because even under the worst conditions imaginable, it took between five and six years for our asset allocation portfolio to recover from steep losses and begin recording positive gains. That compares to a "recovery time" of approximately 12 years for the worst-case scenario in our all-stock portfolio, discussed above.

* Diversification doesn't protect against a loss or ensure a profit.



Source for data: Morningstar®

So if history is any guide, a long investment horizon may give you at least some freedom to ignore the ominous headlines and invest with confidence. The charts above make it clear that two things have occurred over time: 1) The dispersion between the worst and best outcomes for both an all-stock portfolio as well as one that is diversified across different asset classes narrows considerably over time and 2) historically, investors who remained patient and stayed invested recovered from market setbacks and were ultimately rewarded with at least modestly positive gains.

Of course, each investor has unique circumstances that they should consider when determining their own investment horizon as well as their asset allocation. But if you have the luxury of a long horizon — and the courage to stare market volatility in the face without flinching — history suggests that you're unlikely to suffer significant losses, even if you're unlucky enough to have invested at what might feel like the worst possible time.

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1 Total return for a hypothetical investor who remained invested in stocks during the period 04/01/1937-03/31/1938 (S&P 500 TR USD).

2 Annualized return for a hypothetical investor who remained invested in stocks during the period 04/01/1937-03/31/1957 (S&P 500 TR USD).

3 Annualized return for a hypothetical investor who invested in stocks between 04/01/1937-03/31/1938 (S&P 500 TR USD), then switched to bonds between 04/01/1938-03/31/1957(IA SBBI US IT Government TR USD).

4 Annualized return for a hypothetical investor who remained invested in stocks between 6/30/1980 and 3/31/2000 (S&P 500 TR USD).

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