Vanguard

Vanguard's guide to staying the course

FOR INVESTORS

You've likely heard the phrase "time in the market, not timing the market". It's a useful truism, but one also backed by real research.

Introduction

Investing can be an emotional experience. When markets are tracking higher, we're usually content to follow our long-term investment strategy and plan. But when market volatility sets in, we may begin to question some things.

This short guide offers some important lessons to help you stay focused on what really matters: achieving your long-term investment goals. It also highlights the value of financial advice. As the role of advice evolves, advisers are becoming more than just practitioners. They're becoming financial coaches for their clients, guiding them to decisions that align with their long-term goals and interests.

Going it alone can be difficult. Your adviser can help you develop a plan that's tailored to your individual needs. Once your plan is in place, they can help you navigate the emotional side of markets by providing perspective, expertise, and insight into investor behaviour.

1. Make your financial plan your anchor

The financial plan you develop and agree on with your adviser should be central to every financial decision. Your plan should set out clear and achievable goals, clarify constraints and risk preferences, determine your asset allocation, and decide on the frequency of monitoring.

A collaborative plan can also serve as an important emotional anchor. By referring to your plan regularly, you can avoid falling into some common behavioural traps that may be detrimental to achieving your goals. Without a clear plan, you might be tempted to build a portfolio based on transitory factors such as news headlines, hype or fund ratings, or one that lacks appropriate diversification across markets and asset classes; all factors that can have a negative impact on long-term investment success.

There will always be setbacks along the way, but success should be measured against your long-term plan, rather than short-term market movements.

2. Acknowledge the emotional side of investing

As an investor, you should never discount the role of emotions when it comes to making investment decisions. A good financial adviser will listen to your concerns and help you make any sensible changes to your portfolio, while reinforcing your long-term plan.

The role of your adviser is to make recommendations, but that's not all. They also provide peace of mind and reassurance during challenging markets, helping you reach a level of comfort with your portfolio by understanding how it supports your goals. Advisers are also aware of the common behavioural biases that affect investment decision-making, such as herding behaviour and loss aversion that can lead to suboptimal outcomes. See **Figure 1** for an overview of common biases that can affect all investors.

Figure 1: Common behavioural biases

Behavioural bias	What is it?	Can lead to
Herding	We tend to follow the group to avoid danger or missing out.	• Switching away from our long-term investment plan. • Attempting to time the market. • Selling low and buying high.
Overconfidence	We tend to overestimate our knowledge, skill and judgement.	• Over-trading and incurring costs that impact long-term performance. • Concentrating too heavily on certain sectors or securities. • Overlooking holistic issues like tax, superannuation, estate planning, etc.
Status quo bias	We tend to preference the familiar and dislike change.	• Home bias—being overweight the Australian market and forgoing benefits of global diversification. • Failing to consider different asset classes or investment styles.
Loss aversion	Psychologically, losses tend to hurt us more than equivalent gains benefit us.	• Reacting to short-term market volatility. • Failing to remain invested and benefit from market recoveries.
Confirmation bias	We tend to overweight information that confirms our pre-existing beliefs.	• Relying on narrow sources of information for investment research. • Falling prey to dubious investment ideas that promise high returns. • Allocating too much of our portfolio to certain assets.

3. Diversify across asset classes and markets

When constructing a high-quality investment portfolio, one of the most important decisions you make is how you allocate your investments across different asset classes—whether equities, fixed income, real estate or cash.

Research conducted by Vanguard found that, on average, a portfolio's underlying asset class allocation explained the majority of its return variability over time.*

A carefully considered asset allocation ensures you are well diversified with a portfolio that suits your long-term risk and return needs.

* **Source:** Vanguard research: Donaldson et. al., *Vanguard's framework for constructing globally diversified portfolios*, June 2021.

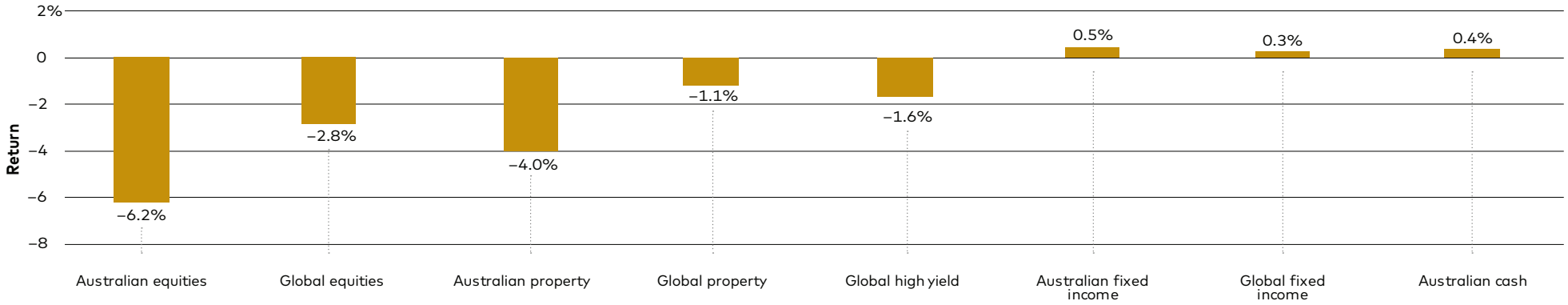
Diversification across equities and fixed income also offers ballast to your portfolio, with fixed income typically outperforming equities during periods of market stress, as **Figure 2** illustrates.

Along with diversification across asset classes, there are advantages to diversification across different markets and geographic regions.

Investors tend to be more comfortable investing in their local market (a behaviour known as home country bias). Ease of access to the Australian market and the avoidance of currency risk make domestic shares an attractive option to Australian investors. And let's not forget franking credits, which may offer tax advantages.

But while investing in familiar names may bring a sense of comfort, by focusing too heavily on the Australian market, investors limit their opportunity set and forgo the benefits of greater diversification.

Figure 2. Diversification is particularly critical during periods of market stress



Notes: Median asset returns during the worst decile of Australian equity monthly returns for the period 29 February 1992 to 30 June 2022. Australian Equities – S&P/ASX 300 Accumulation Index, Global Equities – MSCI World ex Australia Index, Australian Property - S&P/ASX 300 A-REIT Index, Global Property - FTSE/NAREIT Developed Index in AUD, Global High Yield Debt – 1992 to 1998 US Corporate High Yield Index and 1999 to 2022 Global High yield USD Hedged, Australian Fixed Income – Bloomberg Ausbond Composite Index, Global Fixed Income – Barclays Global Aggregate Index hedged into AUD, Australian Cash – Bloomberg AusBond Bankbill Index.
Sources: Bloomberg, Barclays Live, FactSet and Refinitiv.

4. Stay the course

For investors who have grown accustomed to a bull market, it could be easy to forget that volatility includes stock prices going down as well as up—and that such movement is quite normal.

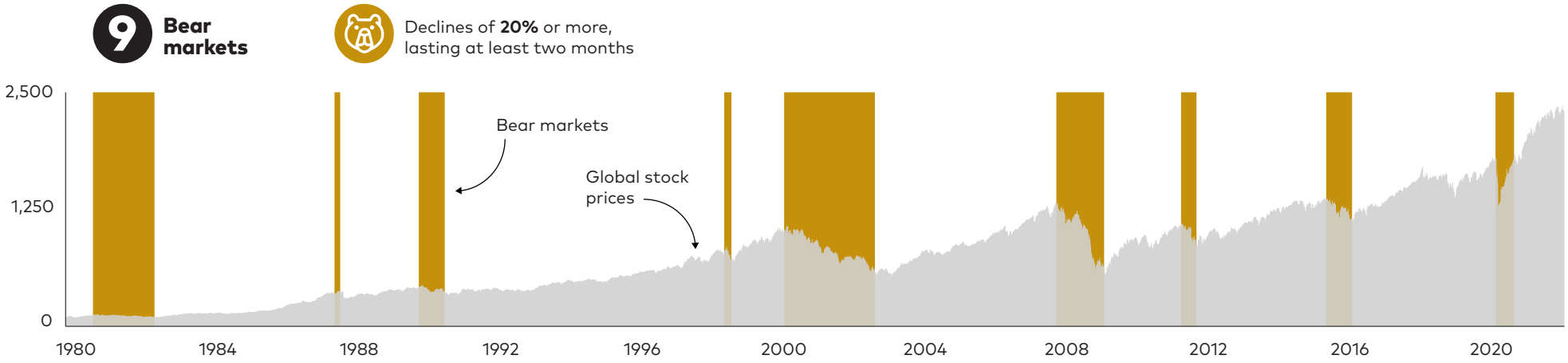
As **Figure 3** shows, since 1980 the United States has experienced nine bear markets (market declines of 20% or more lasting at least two months). However, despite these declines, markets exhibit a clear upward trend over long periods of time.

While investing in the stock market may be a prudent choice for investors seeking long-term growth, sharp drops can still be hard to stomach. When markets take a tumble, you may feel a strong desire to 'do something'.

However, an overreaction to short-term market movements may result in being shut out of the recovery that historically follows market downturns. Some bear markets since 1980 have been sharp, but many bull market surges have been even more dramatic, and often longer, leaving investors well compensated over the long term for the risk they take on.

It helps to zoom out from any particular period and focus on the long-term trend. Depending on your goals, it may be worth riding out a market downturn. You should also assess performance based on the whole of your portfolio, rather than focusing on a particular asset that may be underperforming.

Figure 3. Since 1980 there have been:



Notes: Although the downturn that began in March 2020 doesn't meet our definition of a bear market because it lasted less than two months, we have included it in our analysis because of the magnitude of the decline. Past performance information is given for illustrative purposes only and should not be relied upon as, and is not, an indication of future performance.
Sources: MSCI World Index from January 1, 1980, through December 31, 1987, and the MSCI AC World Index thereafter.

5. Don't try to time the market

You've likely heard the phrase "time in the market, not timing the market". It's a useful truism, but one also backed by real research.

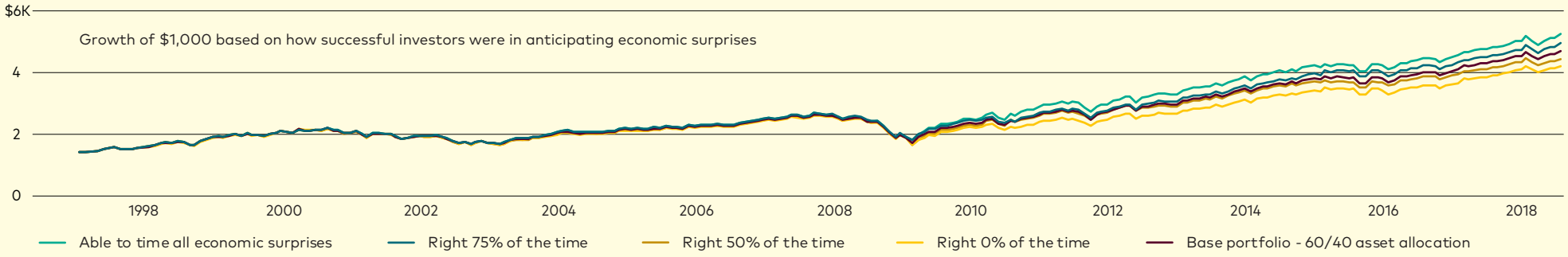
Timing the market is hard, and here's why. To successfully time the market, you need to be right not just once but at least five times. Here's what you need to get right:

1. Identify a reliable indicator of short-term future market returns.
2. Time the exit from an asset class or the market.
3. Time re-entry to an asset class or the market.
4. Decide on the size of the allocation and how to fund the trade.
5. Execute the trade at a cost (reflecting transaction costs, spreads, and taxes) less than the expected benefit.

Even if you can get it right most of the time, the value-add from successfully timing the market is likely to be marginal. Vanguard has conducted research on the incremental benefits of market timing, based on how frequently an investor was successful in anticipating economic surprises.

In the hypothetical scenario presented below, an investor would have to be correct 75% of the time or better to get a return only slightly higher than that of a fixed portfolio of 60% U.S. equities and 40% U.S. fixed income.

Figure 4. The difference in long-term return from market-timing is marginal



Notes: The MSCI USA Index and the Bloomberg U.S. Aggregate Bond Index were used as proxies for U.S. equities and U.S. fixed income. The lines show the growth of hypothetical portfolios with initial balances of $1,000 as of the start of 1992 growing through August 2018. Final balances ranged from $4,196 to $5,237. Significant changes in nonfarm payrolls were used as economic surprises. The hypothetical investors would change the asset allocation to either 80% equities and 20% fixed income in anticipation of a positive economic surprise, or to 40% equities and 60% fixed income in anticipation of a negative surprise. An investor who was correct half the time (the equivalent of a coin toss) would underperform the static 60/40 portfolio. The 75% correct investor would have had a balance only $252 greater than the base portfolio. Trading costs were not factored into the scenarios. Methodology originally published in the Vanguard paper Here Today, Gone Tomorrow: The Impact of Economic Surprises on Asset Returns, November 2018. Past performance information is given for illustrative purposes only and should not be relied upon as, and is not, an indication of future performance.
Sources: Vanguard calculations, using data from the U.S. Bureau of Economic Analysis, the U.S. Bureau of Labor Statistics, Bloomberg, and Refinitiv.

Talk with your adviser

Fears about the future and what markets may bring is natural. It helps to have someone to talk to who not only understands the emotional side of investing but who has the expertise to help guide you in the right direction.

Vanguard research has found that investors derive significant peace of mind from knowing their investments are on track. According to Vanguard's research, 80% of advised clients report having peace of mind, while only 24% believe they would enjoy peace of mind without an adviser.*

Often, it's this simple reassurance that provides the greatest value.

Connect with Vanguard™

vanguard.com.au

1300 655 101

Vanguard®

* Costa and Henshaw, *Quantifying the investor's view on the value of human and robo-advice*. Vanguard, February 2022.

ADVRSVGTSTC_022023