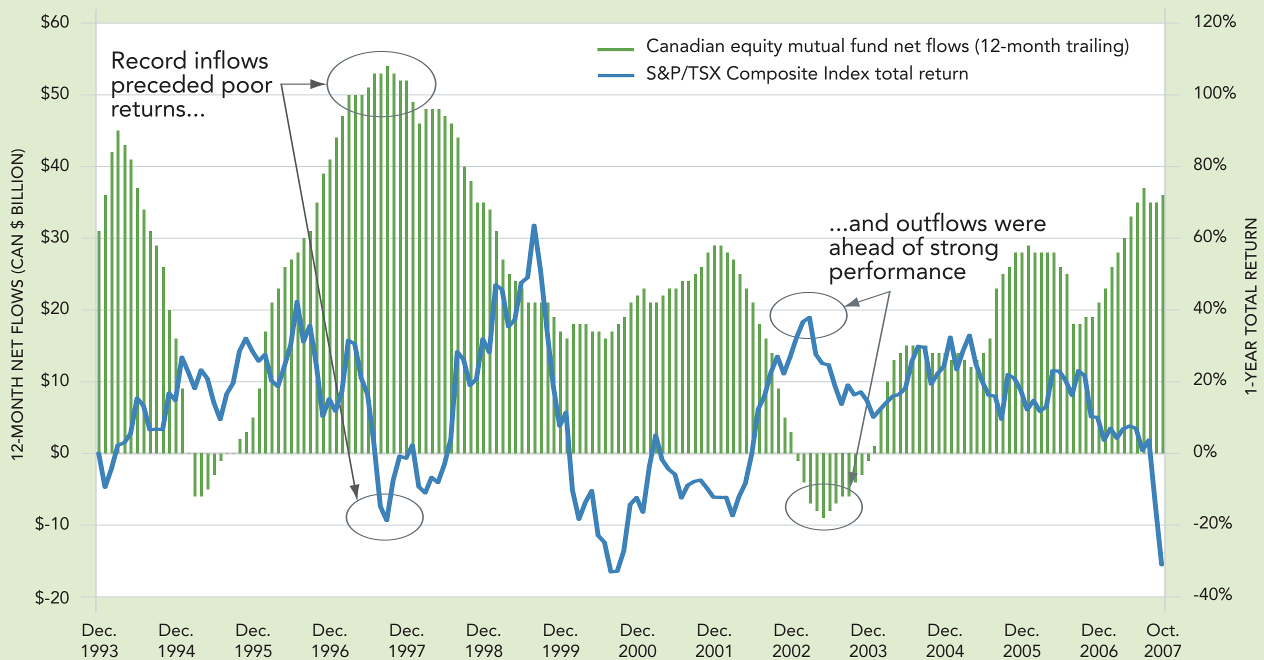
The stock market: exit at your own risk

Nothing ignites financial fear like a violent, short-term stock market correction. For many investors, the natural reaction is to reduce or liquidate exposure. But history shows that this is exactly the wrong reaction.

As painful as they are, stock market declines are reminders of the risk inherent in the market. It is precisely because stocks are a more volatile asset class that they have historically provided a higher rate of return than other major asset classes, such as bonds and cash. Investors expect higher returns to compensate them for taking on additional risk. So market fluctuations are the norm and not the exception, and short-term gyrations are inevitable in the long-term upward trajectory of the market.

Exhibit 1

Canadian equity mutual fund flows vs. market performance (1993 – 2008)

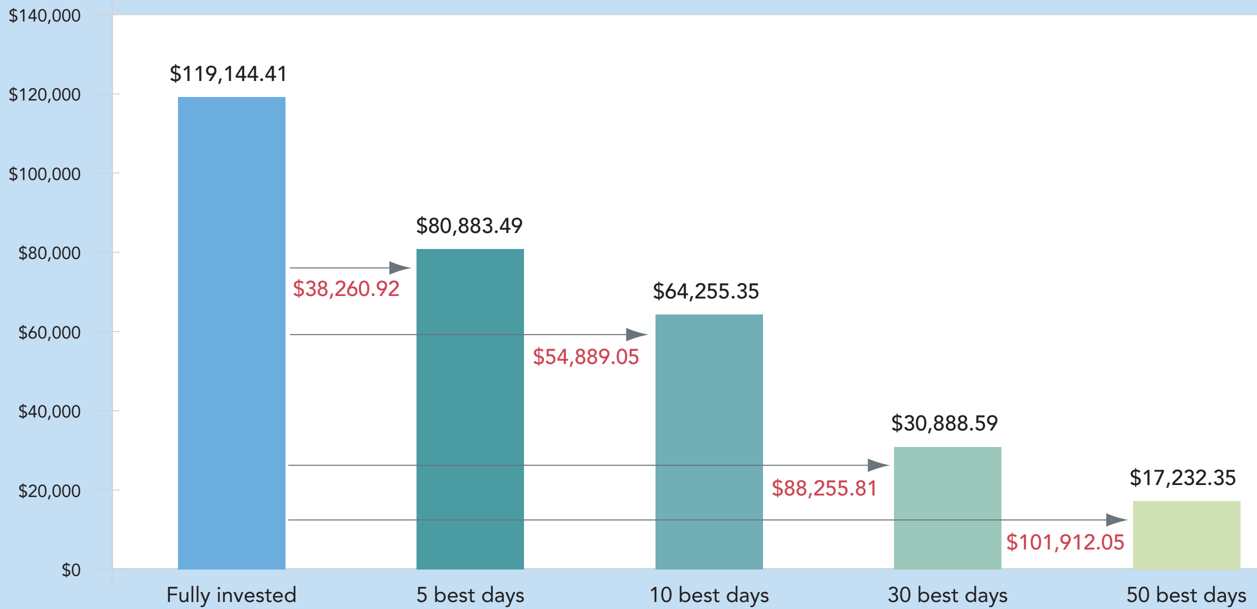


Source: Ibbotson EnCorr and IFIC, as at October 31, 2008. Green bars show 12-month trailing net flows from date listed; blue line shows subsequent 12-month period returns for the S&P/TSX Composite Total Return Index from date listed. At any given date, the chart shows the amount investors recently committed to Canadian equity mutual funds and the return they achieved over a 12 month period.

Fidelity INVESTMENTS

Exhibit 2

Hypothetical growth of $10,000 invested in the S&P/TSX Composite Index from January 1, 1980 to October 30, 2008



Source: Ibbotson EnCorr.

Market timing – More common in failure than success

An examination of historical flows into Canadian equity mutual funds and the performance of the Canadian stock market reveals that, on average, individual investors have done a poor job of market timing. In general, they tended to increase their exposure to stocks just prior to a sell-off and reduce their holdings just before a period of appreciation (see Exhibit 1). For example, investors allocated a record $53 billion in net new money to stock mutual funds during the 12-month period ending July 31, 1997, which preceded a steep decline in the S&P/TSX Composite Index. Another example of poor timing took place in 2003, when flows turned negative. Meanwhile, as investors were redeeming record amounts, the S&P/TSX Composite Index rallied 27%; it continued to post double-digit returns until the end of 2007, when it still posted a respectable 9.8%.[1]

In other words, many investors were selling out of Canadian equity funds before a significant rebound, exactly the time when they would have benefited the most by owning a higher percentage of stocks.

The cost of missing out

Attempting to move in and out of the market can be a costly affair, because a significant portion of the market's gains over time have tended to come in concentrated periods. Looking back at the performance of the S&P/TSX Composite Index since 1980, an investor who missed out on only the five best-performing days in the market would have ended up with a portfolio worth roughly 32% less than one who had been fully invested throughout the period (see Exhibit 2). Missing just 30 of the best-performing days for the market since 1980 – roughly 0.5% of the total trading days during this 28-year period – would have reduced the value of a portfolio by approximately 74%, compared with one that remained fully invested.

Successfully selling equity fund holdings before periods of sudden market turmoil may help stem further short-term losses if the market continues to decline. However, given the market's long-term upward trend, the odds of accurately avoiding the worst-performing periods are long, compared with the higher probability of missing out on positive returns.

When were the best times to enter the Canadian equity market?

Since 1956, investors could have done exceptionally well by investing money in just one of these three five-year periods.

START DATE	EVENT	SUBSEQUENT FIVE-YEAR RETURN
November 1975	OPEC oil crisis – Canada inflation climbed to over 10% – unemployment at 7%	210%
July 1982	U.S. experiences worst recession in past 25 years	240%
October 2002	Tech bubble burst and U.S. recession	159%

Source: Ibbotson EnCorr, as at October 31, 2008. Three dates determined by best five-year market return for the S&P/TSX Composite Index subsequent to the month shown.

For more reasons to stay invested, visit *fidelity.ca/volatility* to use any one of our easy-to-navigate online tools.

The best time is usually the worst time

Some of the best moments to enter the stock market have occurred during periods of particularly gloomy sentiment and market turbulence. Since 1956, the best five-year return in the Canadian stock market began in July 1982 – following one of the worst recessions of the post-war period – when stocks rallied 240%. The next best five-year period, during which the stock market rose 210%, began in November 1975 amid rampant inflation, high unemployment and the OPEC oil embargo. Investors might use these lessons from history to remember that staying fully invested can give them an opportunity to fully participate in the market's long-term upward trend. Waiting until it feels "safe" to make an investment in stocks has historically not been a good way to achieve strong returns. Many of the best periods to invest in stocks have also been the most unnerving.

Reason over instinct

Fleeing from any danger – including a falling market – is a natural human response. So is the belief that one can overcome the danger, and even profit, by doing the right thing at the right time. But analysis of historical stock market movements demonstrates just how difficult that is – and how costly the failed attempt can be. Over time, staying invested gives the best odds.

Note: This article is based on a research report written by the Market Analysis, Research & Education (MARE) group, a unit of Fidelity Management & Research Company. The data have been modified to reflect Canadian figures, unless otherwise stated.

1 Source: Fidelity Management & Research Company.

Read a fund's prospectus and consult your investment professional before investing. Mutual funds are not guaranteed; their values change frequently and past performance may not be repeated. Investors will pay management fees and expenses, may pay commissions or trailing commissions and may experience a gain or loss. Views expressed regarding a particular company, security, industry or market sector are the views of that individual at the time expressed and do not necessarily represent the views of Fidelity or any other person in the Fidelity organization. These views may not be relied upon as investment advice, nor are they an indication of trading intent on any Fidelity Fund. These views are subject to change at any time based upon markets and other conditions, and Fidelity disclaims any responsibility to update such views.

© 2008 FMR LLC. All rights reserved. Reproduction in whole or in part by any means without the prior written permission of Fidelity Investments is forbidden. Third-party trademarks are the property of their respective owners. All other trademarks are the property of FMR LLC.

Reprinted from the December 2008 issue of Market*Pulse*.

Proud to sponsor

510883.1.0 12/08 SAL-9560E 61.108388E