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Just How Important Is Investment Time Horizon?

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In my previous two articles, I mentioned time horizon in passing. Many investors make decisions without giving due regard to the time horizon, yet it is such a fundamental consideration.

In theory, it sounds simple enough to determine one's investment time horizon – it is the time from the point of investment to when you will need to use the money. In practice, this could be a dynamic timeframe punctuated by unexpected or unplanned events that require capital. So, what should you do when your investment time horizon changes? What are the implications on your portfolio?

We typically advise clients to construct a portfolio with their main long-term accumulation objective in mind, but cater for a certain access to liquidity if there are identified near-term needs. This allows the overarching time horizon to be determined by the longest time horizon available. The longer the investment time horizon, the smaller the risk of loss becomes, and the portfolio can then be constructed to withstand greater volatility.

To illustrate this, take the example of the Standard and Poor's 500 index (S&P500), one of the most widely followed indicators of US large cap stock performance. In any given year, there is a 20% chance that the S&P500 will lose money. However, the S&P500 has never declined over a 10-year period since 1940.

Want an example closer to home? Since 1980, the Straits Times Index (STI) has always closed higher at the end of every 10-year period. In contrast, the STI has closed lower in 13 out of 26 one-year periods. In other words, if you were trading the STI with a time horizon of 1 year, you would have a fairly even chance of losing rather than making money. This shows that short term price fluctuations are unpredictable.

Investors are people, after all, and our decision-making cannot always be devoid of emotion. That is why no one can predict future market performance: its participants are all human, and it merely reflects the sum of all transactions, whether these are rational or not. I would not envy the job of a day trader, especially if the capital he is risking is his own.

Without the clear direction that an investment time horizon gives you, it might be easy to fall prey to distractions. How many times have you followed a hunch or a hot stock tip, only to end up at the losing end of a trade? Or chased a stock as it was going up, only to have it turn a cropper? Or perhaps sold off believing it has peaked, only to miss out on new highs? More often than many people care to admit.

Since markets over the long term do go up, for the strategic investor, market timing should not be a major concern. In fact, many studies have shown that market timing does not work, period. [If someone you know says they can time the market successfully, challenge them to do so consistently and repeatably, making sure to document the results.] Some of the best market days have come soon after some of the worst. On 20 Oct 1987, the STI fell 25.3%, making it the worst one-day performance, yet on the very next day it rose 16.7%, its best single day return. If one were to stay out in the name of loss aversion, one would miss out on the subsequent strong rebounds. Missing just the 10 best days of STI performance out of the last 15 years would have meant an underperformance of 30%. This shows that staying invested, diversifying and accepting a certain level of volatility would reward the strategic investor much more.

Day-to-day swings in the market, even during choppy times, should not unduly faze the investor if he is positioned for growth over a longer duration of time. Put in another way, short-term market timing does not work, but long-term timing does. This is because macro- and micro-economic factors drive asset prices. Stock prices reflect the earnings and growth prospects of the underlying companies. Over a short duration, economics has little influence over stock price, which is determined more by the cumulative behaviour of human participants. This explains why there are times when you find a stock ridiculously expensive (having a price-earnings ratio much higher than the general market, for instance), or a stock that is incredibly cheap. Given time, economics will prevail and prices should approximate the fair value of the underlying asset.

If you are in an accumulation or saving phase, your asset allocation or investment mix should be determined primarily by when you will need to start drawing down on the money for income. The more time you have, the greater your exposure to stocks should be. There might be occasions when you need money midway. You can either liquidate the least volatile holdings in your portfolio first, or make a proportional withdrawal so that your asset allocation remains unchanged. Either way, you should have concrete plans to replenish your portfolio so that your objectives do not get derailed.

The best portfolios are constructed to be robust and do not require constant tinkering, so don't panic if you see the valuation dip in response to a broad market decline. It will resume its upward trend as long as your investment time horizon is set right. Remember that time heals all wounds, including those inflicted by unkind or difficult markets.

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