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WEALTH
Partners

Strategic asset allocation: Why time in the market is better than timing the market

Given the turbulence in recent months across asset classes, the idea of the traditional balanced portfolio, or one based on “strategic asset allocation,” may seem antiquated. It’s tempting to turn to “tactical asset allocation,” striving to take advantage of market trends or economic conditions by actively shifting a portfolio’s allocations. But, if history bears out, investors may be making things worse for themselves by doing so.

You can’t be right just once with tactical asset allocation

There’s a reason why market-timing is difficult. For each tactical move to succeed, investors can’t be right just once. They must be right at least ***five*** times:

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

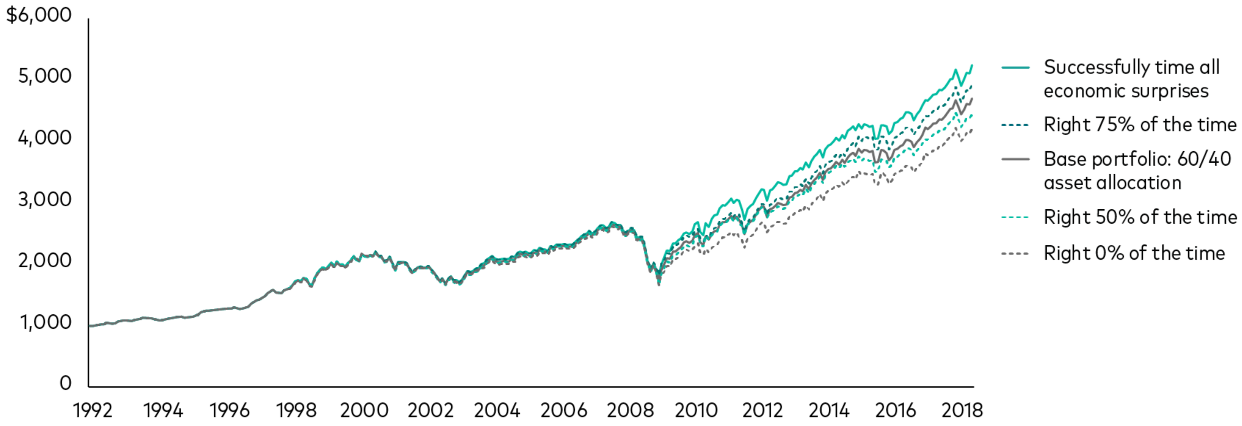
Even if you’re right most of the time, the gain will likely be marginal

Not only would investors have to be right on all five points above, but they would also have to repeat this success for most of their trades to make an impact. And the impact would likely be marginal.

The chart below shows that if investors successfully anticipated economic surprises

- 100% percent of the time, their annualized return over more than 25 years would only be 0.2% percentage point higher than a traditional balanced portfolio of 60% U.S. stocks and 40% U.S. bonds.
- An investor who was correct 50% of the time—the equivalent of a coin toss or random chance—would have underperformed the base portfolio.
- An investor who was correct 75% of the time would have a final balance only $252 greater than the base portfolio.

Growth of $1,000 based on how successful investors were in anticipating economic surprises



Past performance is no guarantee of future returns.

Notes on the above analysis:

- The MSCI USA Index and the Bloomberg U.S. Aggregate Bond Index were used as proxies for U.S. stocks and U.S. bonds.
- The chart represents the growth of hypothetical portfolios with initial balances of $1,000 as of the start of 1992, growing through August 2018.
- Significant changes in nonfarm payrolls were used as economic surprises.
- The hypothetical investors would change the asset allocation to either 80% stocks and 20% bonds in anticipation of a positive economic surprise, or to 40% stocks and 60% bonds in anticipation of a negative surprise.
- Trading costs were not factored into the scenarios; if they had been, the returns of the tactical portfolios would have been lower.

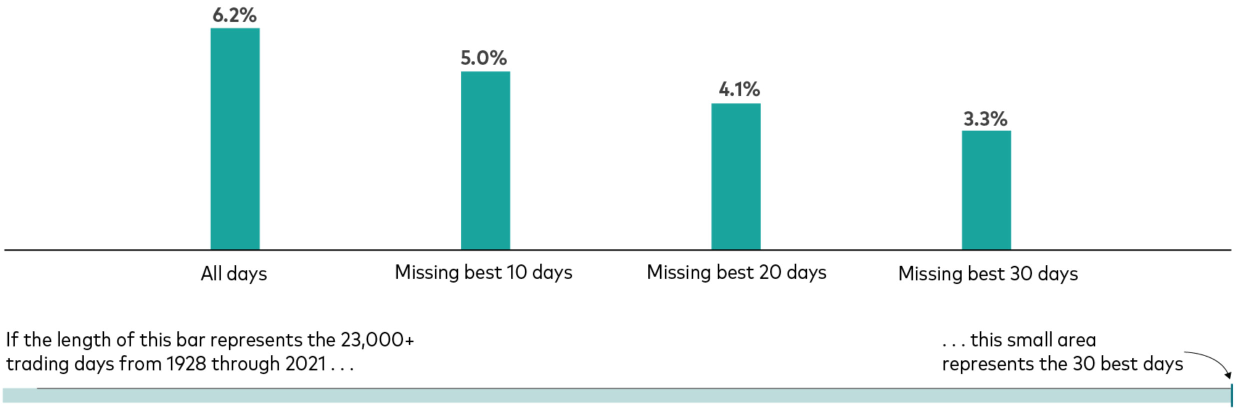
Source: Vanguard paper *Here Today, Gone Tomorrow: The Impact of Economic Surprises on Asset Returns,* November 2018. Vanguard calculations using data from the U.S. Bureau of Economic Analysis, the U.S. Bureau of Labor Statistics, Bloomberg, and Refinitiv.

A few days out of the market is costly!

Importantly, a few days out of the market will be costly

From 1928 through 2021, there were more than 23,300 trading days in the U.S. stock market. Out of those, the 30 best trading days accounted for almost half of the market’s return. Being out of the market at the wrong time is costly. And many of those **best trading days were clustered closely with the worst days** in the market, making precise timing nearly impossible.

Annualized returns of U.S. stock market from 1928 through 2021



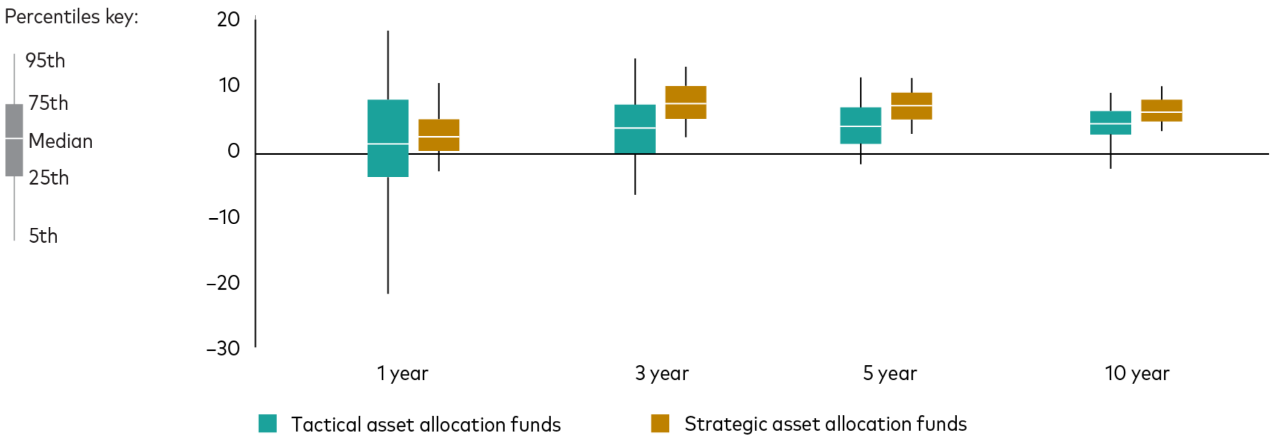
Notes: Returns are based on the daily price return of the S&P 90 Index from January 1928 through March 1957 and the S&P 500 Index thereafter through 2021 as a proxy for the U.S. stock market.
Sources: Vanguard calculations, using data from Macrobond, Inc, as of December 31, 2022.

Past performance is no guarantee of future returns.

Even professional asset managers have challenges timing the market

Need further proof on how difficult tactical asset allocation is? The chart below shows the distribution of returns over various periods for tactical asset allocation funds versus strategic asset allocation funds (those in the Morningstar categories of Flexible Allocation Funds and Target Risk Funds, respectively).

Distribution of annualized returns



Source: Vanguard calculations using data from Morningstar, Inc., as of December 31, 2021.

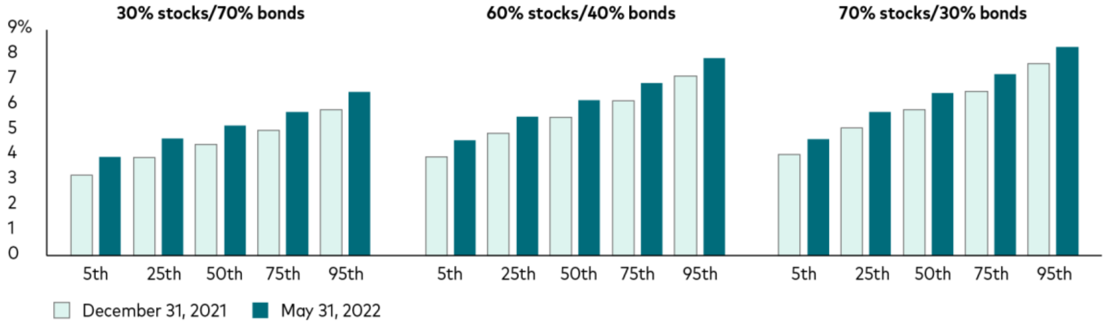
Despite all the advantages of their professional asset managers—armies of analysts, sophisticated computer models, and other resources beyond those of the average investor—tactical allocation funds had a lower median return and a greater distribution of outcomes (in essence, more risk) than their counterparts with strategic allocations.

The positive in a market downturn: Higher expected future returns

While the downturn in both stocks and bonds this year has been painful for investors, there is an upside. Lower market valuations mean that future expected returns are higher.

For those who are still in the accumulation phase of their investing life, this is a bonus, as they are buying securities at a lower price.

Annualized 30-year expected returns as of May 31, 2022, relative to year-end 2021



IMPORTANT: The projections and other information generated by the Vanguard Capital Markets Model (VCMM) regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. Distribution of return outcomes from VCMM are derived from 10,000 simulations for each modeled asset class. Simulations as of December 31, 2021, and May 31, 2022. Results from the model may vary with each use and over time. For more information, please see the Notes section.

Notes: Returns are based on Monte Carlo simulations using the VCMM as of May 31, 2022, versus the prior year-end. The chart shows the expected 30-year annualized return near the low end of the simulations (5%), near the high end of simulations (95%), and at select percentiles in between. The results were for balanced portfolios with different overall allocations to stocks and bonds. Both asset classes had a mix of U.S. and international securities. The stock allocation was a mix of 60% U.S. and 40% international; the bond allocation was a mix of 70% U.S. and 30% currency-hedged international.

Strategic asset allocation has endured for a reason

The concept and practice of the balanced portfolio goes back to the 1920s. It's even older when you read ancient scripts, for example, the Talmudic instruction to divide assets equally into three buckets (land, business, and reserves). Strategic asset allocation has been bolstered by academic research and has outlasted numerous bear markets.

Assuming investors already have a diversified balanced portfolio appropriate for their goals, time horizon, and risk tolerance, the best action may be inaction.
Of course, there is no one-size-fits-all solution.

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