Market Insights

YOU'VE GOT TO KNOW WHEN TO HOLD'EM

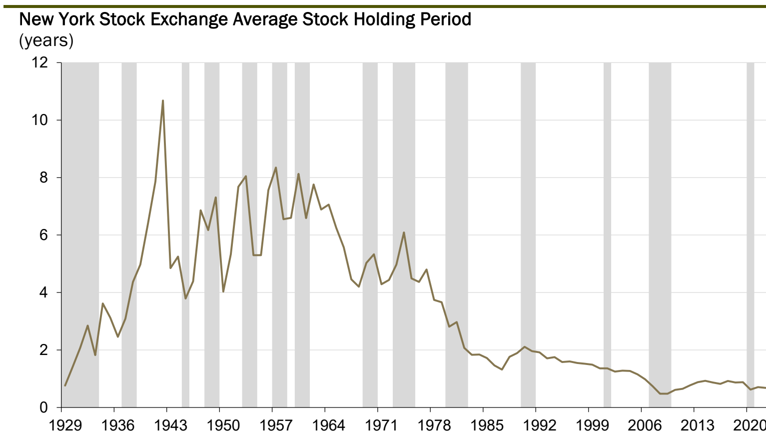
> *"When we own portions of outstanding businesses with outstanding managements, our favorite holding period is forever. We are just the opposite of those who hurry to sell and book profits when companies perform well but who tenaciously hang on to businesses that disappoint. Peter Lynch aptly likens such behavior to cutting the flowers and watering the weeds."*
>
> *-Warren Buffett*

The speed with which news flows into the marketplace these days is astounding, with a wide array of sources providing investors with unprecedented access to information to be used in decision making. The unfortunate reality, however, is that the vast majority of the material entering the fray is nothing more than noise. In the short-run, market movements can be dominated by that noise rather than any true signals, which can cause financial asset values to become detached from their underlying fundamentals — the actual fundamentals of a given company change nowhere near as frequently as its equity price.

Investors, however, have increasingly adopted a short-term focus that can result in missing seeing the forest because the view is obstructed by the trees. This is evident by the fact that the average holding period of a stock listed on the New York Stock Exchange has been steadily declining over the last 70 years, with equity holdings now being turned over roughly every eight **months**, compared to over eight **years** in the 1950s and early 1960s.

A big reason for this shift is that many investors are less focused on long-term investing and more on short-term trading, seeking to exploit these short-term dislocations by timing the market for a quick profit. Since equities tend to move together over short periods such as a day or week, these types of trading decisions are "low conviction" with respect to specific stocks involved instead seeking to either capture, or avoid, market beta.

CHART 1: SHORTENING INVESTING TIME HORIZONS



Average holding period is calculated as the inverse of the NYSE group turnover ratio
Shaded regions represent periods of US recession
Source: Guardian Capital based on data from the New York Stock Exchange and Ned Davis Research to December 2022

These types of company-agnostic strategies can be profitable since catching the stock market's upswings generates positive returns while avoiding the downdrafts would result in improved performance beyond the broad market benchmarks — indeed, high-turnover algorithmic trading strategies have found success with this tactic.

In general, these short-term trading strategies are fairly low risk and with that, the magnitude of the upside of an individual trade is small — high-turnover strategies are typically focused on a high volume of low return trades. Research[1] has argued that there are necessarily larger profits to be made by pursuing longer-term opportunities since such investment strategies are being chased by less capital. Of course, longer time horizon strategies are inherently riskier since, as John Maynard Keynes once said, "the market can stay irrational longer than you can stay solvent" — mispricing's can become more aggravated in the short-run, forcing investors out of positions before the investment pays off.

Calling a peak or trough in the market is exceedingly difficult and doing it consistently is near impossible. The unfortunate truth is that the public's investing decisions are typically driven by emotion which leads to chasing momentum, a strategy that often results in buying the most at the top and the least at the bottom. Further to that, one of the most common mistakes investors make is selling at the bottom and turning paper losses into realized ones that permanently impair portfolio capital.

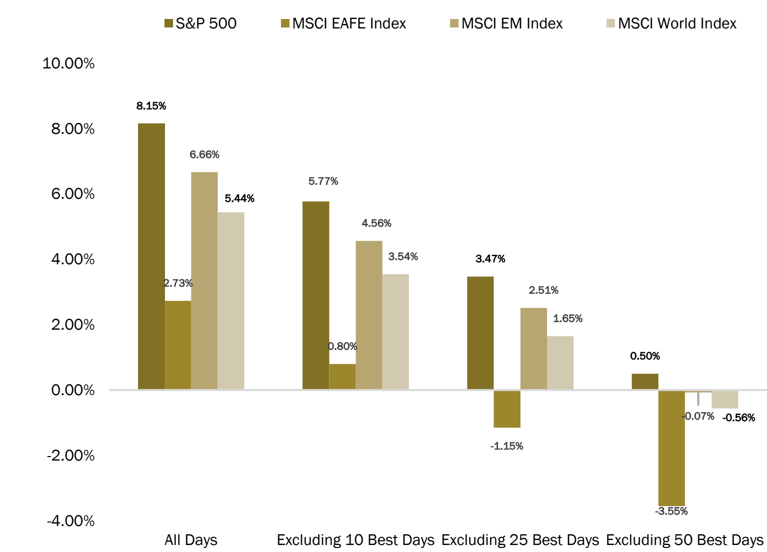
Timing the market is a double-edged sword since it not only requires determining when to sell, but also when to buy. Even being a day late with respect to rejoining the party can have significant negative performance implications. Sitting on cash means that investors find themselves on the sidelines when markets recover, failing to participate in the bulk of a market rebound that historically occurs early (and quickly) following a correction.

Research[2] has shown that as much as 96% of absolute return in the market is accounted for by just 1% of trading days, roughly equivalent to an entire year's performance being driven by just three days. As an example, missing out on just the 10 best of the more than 8,000 trading days spanning the last three decades reduces annualized returns by more than two percentage points. That means that $100,000 invested at the beginning of 1988 would be worth nearly 50% less now strictly if those top 10 days were missed thanks to the power of compounding.

This serves to emphasize the importance of "time in" rather than "timing" the market for investors with longer horizons — markets have shown that they ultimately rise over time and thus it is more important to ensure there is market exposure for the many good days than trying to avoid the few bad days.

CHART 2: TIME IN, NOT TIMING, THE MARKET IS THE KEY

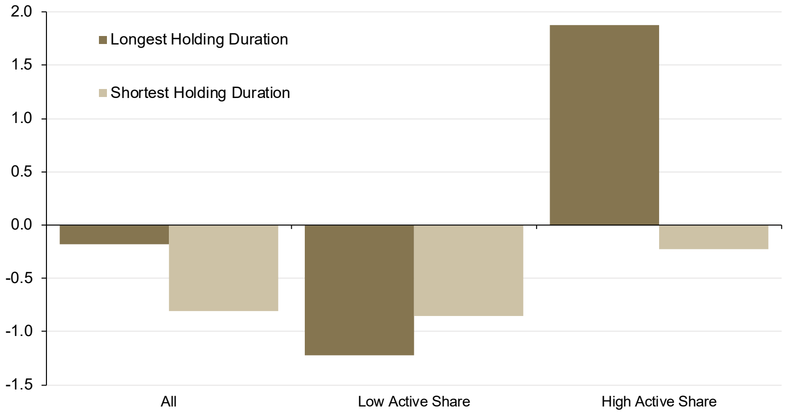
Equity Market Total Return
(annualized percent change in US dollars)



Based on daily data from January 4, 1988 to December 31, 2022
Source: Bloomberg, Guardian Capital
The MSCI World Index captures mid- and large-cap representation across 23 developed market countries.
The MSCI EAFE Index is a stock market index that is designed to measure the equity market performance of developed markets outside of the U.S. & Canada.
The MSCI Emerging Markets Index (MSCI EM Index) captures mid- and large-cap representation across 27 Emerging Markets countries.
The S&P 500 is an index of approximately 500 stocks designed to reflect the risk/return characteristics of the large-cap US equity universe.

CHART 3: SKILL & CONVICTION YIELD BEST RESULTS

Excess Net Returns of US Mutual Funds, 1990 to 2015
(annualized percent)



Source: Cremers[3] Table 2, Guardian Capital

Further to this point, research[3] indicates that portfolios had the longest holding duration for stocks (lowest turnover) outperformed those with the shortest holding periods — and when these longer holding periods were paired with high active share, they historically have generated excess returns of nearly 200 basis points.

In other words, it pays to have a skilled investment manager that maintains a disciplined, long-term approach to investing and is focused not on “active trading” but “active management”.

This finding should not be a surprise. True active portfolio management is about focusing on best idea stocks that have the greatest prospects while eschewing those that offer less upside in an effort to generate returns in excess of the broad market. Such a focus on a concentrated number of high quality stocks allows skilled portfolio managers to have a deeper understanding of each company they own and the underlying drivers of the businesses, meaning that they are better able to differentiate the noise from the signal.

These managers approach their holdings from the perspective of long-term buyers of a business, not as short-term traders, and have high conviction that the companies they own can thrive no matter the market environment. As such they do not panic and sell in times of broad-based market turbulence like a correction or even bear markets, instead, viewing these periods as opportunities to build positions at even better prices, thus setting themselves up well for the time when markets recover.

This “private equity” approach to public market investing means that portfolio managers look through short-run fluctuations in their holdings’ market prices with the conviction that their investments will ultimately fully reflect their intrinsic values resulting in long-term rewards — again, something evident in the historical outperformance of those mutual funds that have been actively and patiently managed.

On top of the positive performance, another benefit of having an investment horizon measured in years or decades rather than days or weeks is that it means transaction costs are kept low, limiting the erosion of portfolio capital and the drag of portfolio performance. Mutual fund pioneer Jack Bogle referred to excessive turnover as a “bogey that investors ought to avoid” because of its propensity to limit returns — research[4] has shown a strong negative relationship between aggregate trading costs and fund performance, with the difference in average annual returns for the decade ended 2006 between the highest and lowest quintile of trading costs being nearly 200 basis points.

Similarly, for portfolios that are taxable, longer holding periods for stocks are typically more tax efficient as well since it means that taxes paid on capital gains are deferred — and note too that many jurisdictions tax capital gains on assets held for less than a year more punitively than those on assets held for longer.

The bottom line is that excess return opportunities exist when there is a mispricing in the market and these are best exploited by an active manager who has the skill and strong conviction to invest for the longer-run.

[1]Shleifer, A., & Vishny, R. W. (1990). Equilibrium Short Horizons of Investors and Firms. American Economic Review, 148-153.
[2]Seyhun, H. N. (2005). Stock Market Extremes and Portfolio Performance, 1926-2004. Towneley Capital Management.
[3]Cremers, M. (2017). Active Share and the Three Pillars of Actrive Management: Skill, Conviction, and Opportunity. Financial Analysts Journal, 61-79.
[4]Edelen, R., Evans, R., & Kadlec, G. (2013). Shedding Light on “Invisible” Costs: Trading Costs and Mutual Fund Performance. Financial Analysts Journal, 33-44.