



Market Analysis, Research & Education

A unit of Fidelity Management & Research Company

Stock Market: Exit at Your Own Risk

The Case for Staying Invested

Nothing ignites the fear of losing one's hard-earned money like a violent, short-term stock market correction. For many investors—even those with a long-term perspective—the natural human reaction to a sudden plunge in the stock market is to reduce or liquidate one's exposure, with the goal of trying to stem further loss of capital and soothe a rattled mind.ⁱ

As painful as they are, stock market declines can serve as 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 relative to other major asset classes, such as bonds and cash. Investors expect higher returns to compensate them for taking on additional risk. As a result, market fluctuations are the norm and not the exception, and short-term gyrations are inevitable in the long-term upward trajectory of the market.

KEY TAKEAWAYS

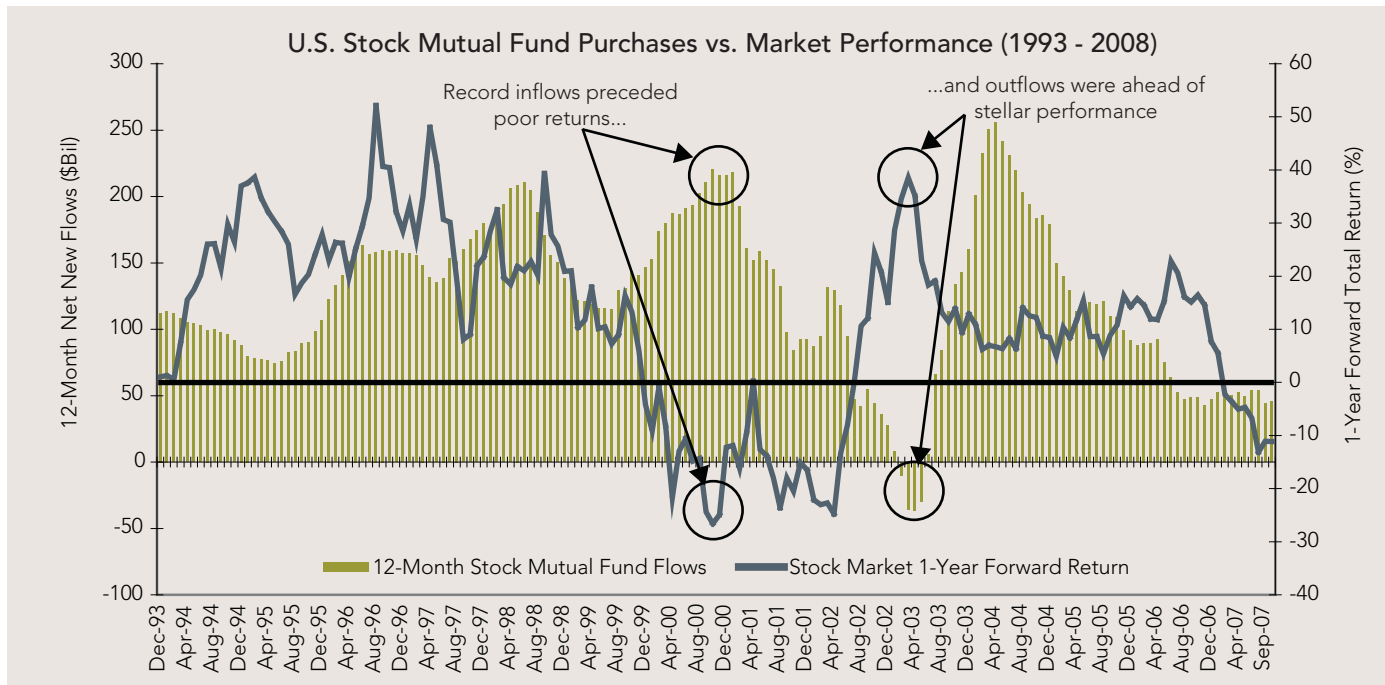
- Stocks typically have been more volatile than other asset classes, but historically long-term investors have been rewarded with higher returns to compensate for assuming this added risk.
- Investors face long odds in trying to time the ups and downs of the market, and data show they tend to increase their allocations to stocks ahead of downturns and decrease their exposure just prior to market rallies.
- Mistiming stock market rallies can be costly: Investors who miss out on only a handful of the best-performing days in the market can find their portfolios at a significant disadvantage to those who remain fully invested for the long term.
- Although unnerving at the time, some of the most challenging backdrops in history ended up being among the best periods to remain invested in stocks.

The Risk of Market Timing

Since 1926, the stock market had a positive return in 59 out of 82 calendar years—or nearly three out of every four years.ⁱⁱ Because the long-term trend of the stock market has been upward, one must also recognize that there are significant opportunity risks accorded with trying to accurately time the market's peaks and valleys in search of outsized gains. The odds are stacked against successfully timing short-term market fluctuations, particularly because long-term investors must also effectively time their re-entry.

An examination of historical flows to U.S. stock mutual funds and the performance of the U.S. 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 ahead of a period of stellar appreciation [See Exhibit 1, next page]. For example, investors allocated a record \$219 billion in net new money to stock mutual funds during

EXHIBIT 1: Investors have a poor track record of timing their stock mutual fund investments

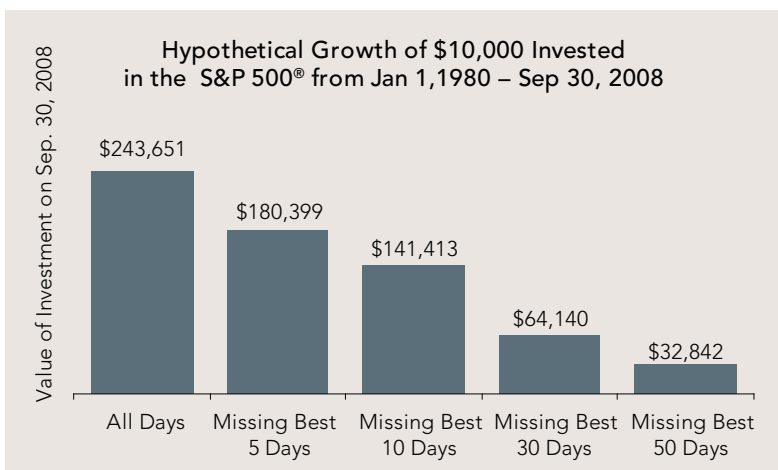


Stock mutual fund flows represent net new U.S. domestic mutual fund flows. Source: Strategic Insight, FMRCo (MARE) as of 9/30/2008
 Note: Green bars show 12-month trailing flows from date listed, blue line shows 12-month forward returns from date listed (at any given date, charts shows the amount investors recently committed to stocks and the return they achieved over the next 12 months).

the 12-month period ending October 31, 2000, which preceded a decline of 27% for the S&P 500® Index throughout the following year. Another example of

poor timing took place soon thereafter. After three straight years of stock market declines, flows turned negative (redemptions exceeded sales) during the 12-month period to February 28, 2003. However, from that point on throughout the next year, the S&P 500 rallied 35%. In other words, most investors were selling out of equity funds prior to a significant rebound and at exactly the time when they would have benefited the most by owning a higher percentage of stocks.

EXHIBIT 2: Missing only a handful of the market's best-performing days can be costly



*The hypothetical example assumes an investment that tracks the returns of the S&P 500® Index and includes dividend reinvestment and no taxes on earnings. There is volatility in the market and a sale at any time could result in a gain or loss. Your own investment experience will differ, including the possibility of losing money. You cannot invest directly in an index. Source: FactSet, FMRCo (MARE) as of 9/30/2008.

The Cost of Missing Out

Attempting to move in and out of the market can be a costly affair, particularly 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 500 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 26% less than one that had been fully invested throughout the period [See Exhibit 2]. Further, missing just 30 of the best-performing days for the market since 1980 would have reduced the value of a portfolio by about 73%, compared to one that remained fully invested.

Of course, successfully selling stock fund holdings prior to 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 precisely avoiding the worst-performing periods are long compared to the higher probability of missing out on positive returns.

Having the Fortitude to Stay Invested

Some of the best periods to have entered the stock market have been during periods of particularly gloomy sentiment and market turbulence. Since 1926, the best five-year return in the U.S. stock market began in May 1932—in the midst of the Great Depression—when stocks rallied 367% [See Exhibit 3]. The next best five-year period (when the

Waiting until the backdrop feels “safe” to make an investment in stocks has historically not been a good method of achieving future returns. Many of the best periods to invest in stocks have been those environments that were among the most unnerving.

stock market rose 267%) began in July 1982 amid an economy in the midst of one of the worst recessions in the post-war period, featuring double-digit levels of unemployment and interest rates. 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 the backdrop feels “safe” to make an investment in stocks has historically not been a good method of achieving future returns. Many of the best periods to invest in stocks have been those environments that were among the most unnerving.

EXHIBIT 3: Since 1926, it has paid off to stay invested in U.S. stocks during troubled times**

| Date | Subsequent 5-Year Return | Coincident Event |
|----------|--------------------------|---|
| May-1932 | 367% | Great Depression |
| Jul-1982 | 267% | Worst Recession in Past 25 Years |
| Dec-1994 | 251% | Most Dramatic Fed Tightening in Past 20 Years |

**Three dates determined by best five-year market return subsequent to the month shown. Source: FMRCo (MARE) as of 9/30/2008.

Investment Implications

Historically, stock price declines are not uncommon. In fact, such periods of sudden turmoil have been normal occurrences in the market's long-term upward trend. Investors face long odds in trying to time the ups and downs of the stock market, and data show they have historically mistimed their allocations to stocks by increasing their exposure ahead of market downturns and decreasing it just prior to rallies. This mistiming can be costly: Missing out on just a handful of the best-performing days in the market may leave investors at a significant performance disadvantage compared to investors who remain fully invested for the long term. Furthermore, hindsight suggests that during some of the most challenging economic backdrops in history, investing in stocks—not fleeing them—has been a prudent decision. ■

Editors Note: Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk.

The Market Analysis, Research and Education (MARE) group, a unit of Fidelity Management & Research Co. (FMRCo.), provides timely analysis on developments in the financial markets.

Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk. Past performance is no guarantee of future results.

[i] All references to stock market returns in this article refer to the total return of the S&P® 500 Index unless otherwise noted. The S&P 500® Index is a registered service mark of The McGraw-Hill Companies, Inc., and has been licensed for use by Fidelity Distributors Corporation and its affiliates. It is an unmanaged index of the common stock prices of 500 widely held U.S. stocks that includes the reinvestment of dividends. It is not possible to invest in an index.

[ii] Source: Ibbotson, FMRCo (MARE) as of 12/31/2007