EMPYRION™

WEALTH MANAGEMENT

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Monthly Insight

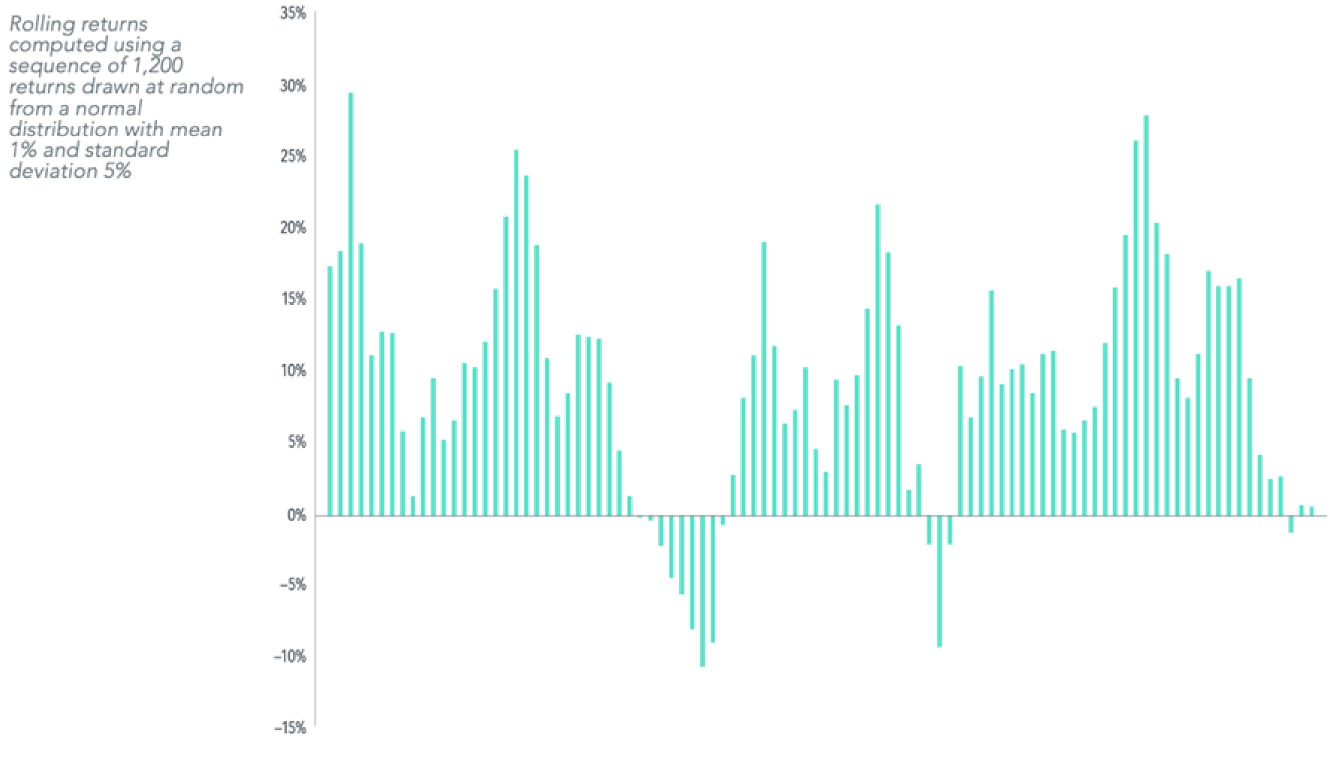
Why You Shouldn't Try to Ride the Market Cycle

Correctly anticipating the Next Big Market Move is the Holy Grail of investing. But like the Holy Grail of legend, it typically proves highly elusive, and those who pursue it often find themselves battered and bruised. For proof of this, you need look no farther than the percentage of professional fund managers—whose job, after all, is to position their funds for maximum growth—who are actually able to beat their fund's benchmark on a consistent basis. Consider, for example, the S&P Indices vs. Active (SPIVA) scorecard, which tracks the number of active fund managers who outperform the S&P 500 in a given year. In 2021, 79% of active managers underperformed the broad market index. In fact, for 12 consecutive years now, the average large-capitalization fund has lagged the S&P 500.

But despite such statistics, investors persist in trying to outguess the market's next move. The main reason it's so hard for us to accept the randomness of the markets is that we are genetically and evolutionarily wired to seek patterns. As we have often mentioned here and elsewhere, our ancient hunter-gatherer forebears used seasonal, visual, and other types of patterns to anticipate when the rains would come, where the game animals would be found, and what dangerous predators looked and sounded like. This important ability enabled them to survive in an often-hostile environment.

The problem is, today's financial markets are not equivalent to the prehistoric landscape in any significant way. The threats and opportunities are of a completely different type. Not only that, but in our deeply interconnected, digital world, information moves at a pace our hunter-gatherer ancestors could not even conceive. Because "the markets" consist of every buyer and every seller everywhere in the world making independent decisions all at once, the collective effect is so massive that it is impossible for any single individual to make a correct judgment about future price movements with any more than a random chance of success.

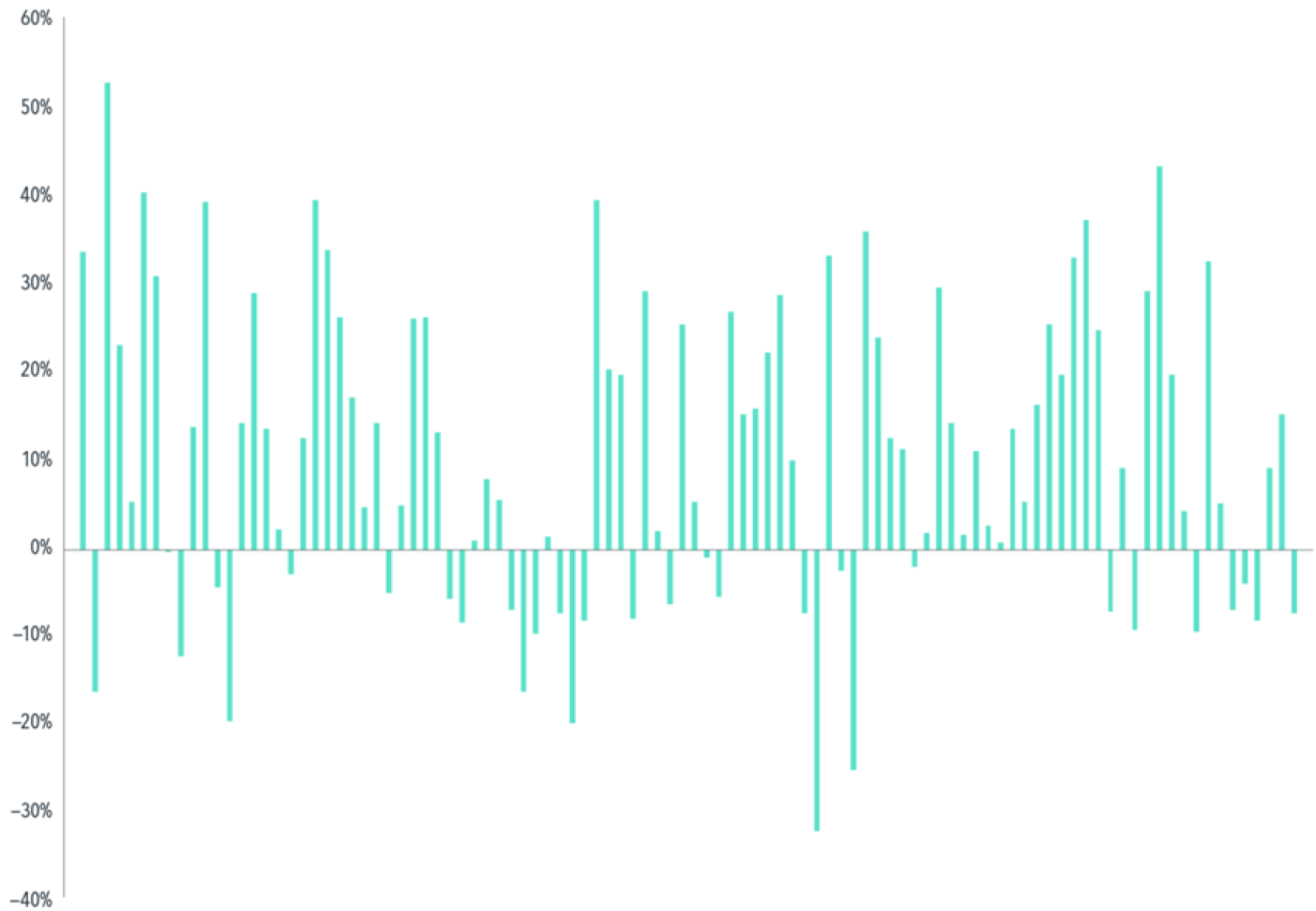
All this is not to say that the markets don't sometimes generate observable trends, however. These trends, which are completely apparent only in hindsight, can provide useful indications of what markets have done. Statisticians and analysts often use a technique called a "rolling average" to smooth out the fluctuations that is always present in the markets in order to perceive a long-term trend. For example, a multi-year rolling average of stock returns based on overlapping periods might generate a pattern that would look like this:



SOURCE: Dimensional Fund Investors. Past performance is no guarantee of future results.

Notice that there is a discernible pattern in the returns illustrated above. These market returns graph the results from a series of multiperiod returns expressed at specific intervals of time. Because they are "overlapping," the results of the previous period are collated into the results of the following period, which means that each period measured is highly correlated with the period that preceded it. The result of viewing returns from overlapping periods in this way is that market fluctuation is "smoothed out," permitting the analyst to look at longer-term trends, rather than the actual day-to-day changes in prices.

But what happens when returns in a particular period are not correlated with the preceding period? When each period's return rate stands on its own, with no reference to preceding or following periods, the resulting chart looks like this:



SOURCE: Dimensional Fund Advisors. Past performance is no guarantee of future results.

Using the same randomly selected set of 1,200 monthly returns, but viewing them as stand-alone occurrences (i.e., the way an investor would experience them in real time) provides a much different picture than the relatively smooth undulation shown in the first chart. Returns may go from extreme highs to deep lows; they may stay at the same relative level for two or three periods; they may proceed in stair-steps—up or down—for several periods and then either fall off the table or soar to the stratosphere. There is no discernable pattern.

What all this means for investors is that there is little evidence for the existence of a statistically reliable method that uses past market performance to anticipate what will happen in the next period. The key thing to remember is that market movement is only perfectly comprehensible in the rear-view mirror. We can study the market's past patterns in an attempt to understand what moves it and why, but we cannot apply that knowledge with absolute certainty to what the markets will do tomorrow. Or next month. Or next year.

Notice the disclaimer under both of the charts above: "Past performance is no guarantee of future results." If that sounds familiar, it should! This phrase is required on most communications from advisors, fund managers, or anyone who is providing financial advice to the public. And it is absolutely true. By looking backwards at the markets, we can begin to understand why they do what they do. But that does not give us the ability to predict what they will do, or when, or by how much. Yes, the markets can be viewed cyclically and in a long-term perspective. But that does not help us with knowing what they will do in any particular period.

Rather than trying to decipher the next phase of a supposed market cycle, most investors will be better served by:

- developing a long-term strategy that aligns with their goals, needs, and risk tolerance;

- creating a well-diversified portfolio of holdings that support their strategy;
- rebalancing periodically to stay within their asset allocation guidelines;
- and remaining disciplined, patient, and confident of the long-term outcome.

At Empyrion Wealth Management, each client is unique in their needs and priorities. That is why our most important time with clients is spent in getting to know them as thoroughly as possible. That's the only way we can help them construct a portfolio that will withstand the market's inherent unpredictability and provide the foundation for their most important financial objectives. If you would like to learn how you can gain greater clarity around your financial strategies, please click here.

Stay Diversified, Stay YOUR Course!

SOCIAL MEDIA DIGEST

In case you missed them, here is a roundup of my latest posts on social media:

One benefit of the falling market is that taxpayers holding traditional 401k and IRA accounts now have an opportunity to convert to Roth accounts. We take a closer look.

While we often advise clients to avoid making major financial decisions in the early days of bereavement, there are some actions and decisions that can't be put off, especially for newly single parents. Schedule a call to learn how we help.

A career in finance can be personally and financially rewarding. It can also require long hours and high stress. In this article for The Forage, I share my thoughts on the pros and cons.

KIMBERLY FOSS

President, CFP®, CPWA®,
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"We understand that every person we serve has distinct values and ambitions, and they each need their own plan for wealth management."