Underweighting Equities is Usually a Bad Idea

Executive Summary

- Investors considering timing equities should proceed with caution
- Forecasting returns, particularly over short-time horizons, is very difficult
- Underweighting equities often results in unattractive opportunity costs
- Successfully timing the decision to return to a normal long-term allocation requires extreme fortitude

The past few months have been a period of very high volatility in equities due to several factors. Items weighing on investors likely include a combination of President Trump's decision to increase tariffs on imports, continued tensions between the US and China, unclear resolutions to the armed conflicts in Gaza and Ukraine, and uncertainty from the DOGE initiative, which could either help balance the budget resulting in a more efficient US government or weaken a variety of strategically important social services and government programs. We have started to receive some questions from clients about the merits of underweighting equities relative to their long-term strategic targets. In general, we do not recommend that course of action for several reasons:

1. Forecasting Challenges

It would add material value if we could avoid the very worst months or quarters in equities. Unfortunately, forecasting in investments is unlike forecasting in most other fields. Predicting outcomes over the next month or year is not that difficult in most industries. Most owners and operators of businesses have a good idea of how their company will perform over the next month or quarter. However, forecasting business outcomes over the next ten years is much more difficult, if not impossible, for most sectors. For example, many publicly traded companies provide guidance for the next year but very few provide detailed guidance beyond that. Forecasting in investments is exactly the opposite. The range of annualized returns for monthly or quarterly data points is very wide. If we instead looked at rolling five-year outcomes and annualized those results, the range of IRRs would be considerably tighter. In investments, the longer the time horizon becomes, the easier it is to accurately predict the

rate of return. The table below illustrates that shorter periods show a wider range of outcomes, with a 72% spread between the best and worst months. In contrast, longer periods, like five years, have a much narrower range, with approximately a 10% spread.

Range of Annualized Returns at Different Measurement Intervals, 1945-2024[1]

	Annualized Returns by Measurement Interval				
	Months	Quarters	1-yr	3-yr	5-yr
Top quartile	54.7%	33.0%	22.3%	15.4%	15.1%
Median	15.4%	13.3%	12.9%	11.2%	11.3%
Bottom quartile	-17.3%	-5.3%	1.2%	6.0%	5.6%

We observe the challenges in short-term forecasting when evaluating managers. One of the methods we use to evaluate equity long/short hedge funds is to decompose the sources of excess returns into three categories: longs, shorts, and value-added from variance in net exposure. Across a growing library of several hundred different managers, we have seen very little evidence of statistically significant value-added from short-term variance in the net by equity-oriented hedge fund managers. We utilize a similar strategy for long-only managers who prefer to hold cash. It is very rare for the managers' actual realized results to outperform a pro forma portfolio that grosses up their holdings such that they would have been at least 95% fully invested at all times. Even among trend-following managers, who are much more focused on market timing, we have seen mixed results. Short-term forecasting is very difficult.

2. Opportunity Costs

If we instead rely on longer-term forecasts, which are typically more accurate, we encounter a different problem. For an institutional portfolio, the meter is always running. We do not get to call capital when interesting opportunities arise and give it back when there are less attractive options. When we reduce equities, the capital must go somewhere else. The most obvious alternative to stocks when people are concerned about the risk of losing money is bonds or cash. The problem we face as investors is there are not many periods when bonds or cash outperform stocks over reasonable forecast horizons. We have used the S&P 500 and the benchmark 10-year Treasury bond for our analysis below.

Average Relative Results: Stocks vs. Bonds[2]

	Forward Horizon	
% of Total Periods 1950 – 2024	5-yr	10-yr
Stocks Generated Higher Return	71%	81%
Bonds Generated Higher Return	29%	19%

Even if the next five or ten years will in fact turn out to be one of these unusual periods when the return on equity is disappointing, it is important to evaluate the alternative use of capital. Revisiting the first chart and assuming the next five years will generally be a bottom-quartile return period for stocks, we can roughly estimate a 5% annualized return. The problem is that the yield to maturity on the 10-year Treasury bond is only 4.2%[3]. Selling something with an estimated return of roughly 5% to buy something that we should reasonably expect to return 4% is still a long-term expected performance concession. As outlined in Jay Willoughby's Q4 2024 CIO Commentary and given some of the fiscal challenges the US faces, we think a much higher starting yield to maturity on bonds would be required for investors to consider materially underweighting equities in favor of bonds.

3. Psychology and the Pattern of Returns

For an equity market timing strategy to be successful, investors need to get two calls correct, not one. Those who underweight their long-term strategic targets will eventually need to decide when to return the equity allocation to its normal level. This second decision is key because, in equities, the big days are very important. Since 1945, the annualized return on the S&P 500 is roughly 7.9%[4]. If we exclude the top 1% return days, the annualized return would be a loss of -1.8%. Market prices tend to overshoot the changes to long-term fundamentals. As a result, equities are often undervalued at the bottoms of drawdowns. Also, markets discount anticipated economic conditions. When sentiment finally improves at the bottom of a drawdown, prices can move back up very quickly. The tables below show the best single day returns for the S&P 500 since 1945. All of them occurred during points in the cycle when uncertainty and volatility were very high. Because the absolute best days and worst days tend to cluster together, mistiming one of the two decisions, even by a day, can be very damaging. The best time to add to equities will often be at the point in the cycle in which doing so feels the most uncomfortable. The average investor who tries to time the market is highly likely to miss at least the first part of the recovery. Missing these big days often locks in long-term underperformance.

Highest Single Day Returns for the S&P 500, 1945 – 2024[5]

Date	Return	VIX Level
10/13/08	11.6%	55.0
10/28/08	10.8%	67.0
3/24/20	9.4%	61.7
3/13/20	9.3%	57.8
10/21/87	9.1%	n.a.
3/23/09	7.1%	43.2
4/6/20	7.0%	45.2
11/13/08	6.9%	59.8
11/24/08	6.5%	64.7
3/10/09	6.4%	49.7
Long-Term Average		19.6

Key
Black Friday Period
GFC
COVID

Conclusion

While equity market volatility can be unsettling, maintaining a long-term perspective on equities is crucial for achieving optimal investment outcomes. Predicting short-term market movements is highly challenging, and the costs of missing key recovery days can be significant. By sticking to a long-term strategy around equities, investors can avoid market-timing pitfalls and benefit from the growth potential of owning stocks. Our tactical adjustments to equity exposure tend to be small because we understand how difficult it is to do this well. We tend to be biased to overweights because that improves our odds of generating good returns.

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Footnotes

1. Source: Bloomberg.
2. Source: Bloomberg and Federal Reserve.
3. Bloomberg as of 4/30/25.
4. Equity price data sourced from Bloomberg.
5. Source: Bloomberg.

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