Investors would do well to learn from deer hunters and fishermen who know the importance of “being there” and using patient persistence, so they are there when opportunity knocks.

— Charles Ellis, on investment policy

One of my favorite sayings is, “If you think education is expensive, try ignorance.” This is certainly true about investing, which is why I believe that knowledge of investment history is an important, if not necessary, condition of achieving success. The following is offered as evidence.

Distribution of returns

Most investors know that the U.S. stock market has historically returned about 10%: Over the 92-year period from 1927 through 2018, the S&P 500 returned 10.1%. If we were to remove the returns of the best 92 months over that period (not the best month each year, but the highest-returning 92 months of 1,104 months), what would you guess was the return of the remaining 1,012 months? I believe most investors would be shocked to learn that the answer is virtually zero.

The remaining 1,012 months provided an average return of just 0.01%. The best 92 months (just 8.3% of the months) provided an average return of 10.4%, more than 100% of the annualized return over the full period!

In case you think the above is unique to the U.S., we can also look at the data from international markets. Over the 49-year period of 1970 through 2018, the MSCI EAFE Index (gross of dividends) returned 9.1%. The best 49 months provided an average return of 9.6%, while the other 539 months returned 0.0%. Again, we see that the return of the best 49 months was greater than the annualized return over the full period.

We see the same evidence when we look at emerging markets. From 1988 through 2018, the MSCI Emerging Markets Index (gross of dividends) returned 10.4%. The best 31 months of that 31-year period provided an average return of 12.5%, while the other 341 months returned 0.0%. Again, we find that the best 31 months (an average of just one month a year) provided more than 100% of the annualized returns.

Recent data

The following is a more recent example of how much returns happen in short and unpredictable bursts. 2018 was a miserable year for U.S. small value stocks – and the smaller and deeper the value, the worse the performance.

As a fund with large exposures to both the size and value factors, Bridgeway’s Omni Small-Cap Value Fund (BOSVX) (which my firm, Buckingham Strategic Wealth, recommends, and I own) had even worse returns than U.S. small value indexes. Morningstar reports that the fund lost 17.2% in 2018.

Now let’s look at what happened in the month (though in this case, not a calendar month) from the period following the stock market’s bottom on Dec. 24, 2018. On that day, BOSVX closed at 13.30. One month later, on Jan. 24, 2019, the fund’s net asset value (NAV) had risen to 15.24, a gain of 14.6%. As of Feb. 24, the NAV was 16.47, a one-month gain of 8.1% and a two-month return of 23.8%. As we saw in the three earlier examples, so much of the market’s returns come in short, and obviously unpredictable, bursts.

Perhaps it was evidence like the above that convinced Charles Ellis, legendary investment consultant and author of “Winning the Loser’s Game,” that: “The best way to achieve long-term success is not in stock picking and not in market timing and not even in changing portfolio strategy. Sure, these approaches all have their current heroes and war stories,
but few hero investors last for long and not all the war stories are entirely true. The great pathway to long-term success comes via sound, sustained investment policy, setting the right asset mix and holding onto it.” (Quoted in the Barrie Dunstan article, “Global Money Masters,” Australian Financial Review, November 2006.)

Such evidence likely also influenced the thinking of William Sherden, who, in his book “The Fortune Sellers,” advised: “Avoid market timers, for they promise something they cannot deliver. Cancel your subscription to market timing newsletters. Tell the investment advisers selling the latest market-timing scheme to buzz off. Ignore news media predictions, since they haven’t a clue … Stop asking yourself, and everyone you know, ‘What’s the market going to do?’ It is an irrelevant question, because it cannot be answered.”

**Important lessons**

There are two important lessons in the data for investors. Because so much of long-term returns occur over very brief periods, it’s critical that investors stay disciplined, adhering to their asset allocation plan and not paying attention to the noise of the market.

Second, when selling a fund for the purpose of harvesting losses, you should not wait the 31 days that are required to avoid the IRS’s “wash sale” rule before buying back the fund. This is a common error. Instead, when tax-loss harvesting, you should simultaneously buy the most similar fund you can find.

For example, to replace a U.S. small value fund, one could buy the iShares S&P Small-Cap 600 Value ETF (IJS) or the Vanguard Small Cap Value Index Fund (VISVX). You want the choice to be as similar as possible because, as you saw, even over a period as short as a month, you can have large gains, and you don’t want to have to take a short-term capital gain and pay the much higher tax rate.

If you have a significant gain, the preference should be to wait at least a year in order to obtain long-term capital gains. The gains could become so large that you might need to hold the fund for a very long time – which is why you want as similar a fund as you can find.

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