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Equity can be a risky asset class even when you don't invest in the stock market. Here's how.

Synopsis
Moving in and out of the market could lead you to miss out on days when the market is in a good mood. As per available data, if you had missed out on only 10 days out of 40 years of the BSE Sensex, you would have lost two-third of your returns. So what's the right strategy?

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Equity is understood to be a risky asset class. The assumption is, that while on the average, over the long term, we make higher returns in the stock market, these returns come with higher volatility and risk.

A figure often tossed around is that in the Indian equity markets, you should expect a compounded annual return of 14%-15%. This number is derived from the actual annualised return of just over 15% that the BSE Sensex has given in the 40-plus years since its launch in 1979.

It is commonplace to evaluate the risk of being in or investing in the stock market. The question I asked is whether there's a risk in not being in the market? A risk in being out of the market?

The question arose because after a euphoric 2021 when the Indian market was zooming and the Nasdaq looked even better, 2022 has been a flop show, to put it mildly.

Equity markets around the world have done very poorly. So much so that there are only a handful of countries which are in the green year-to-date. And these are primarily commodity plays.

Suddenly all of those who wanted to be in the midst of action want to head for the exits and sit on the sidelines of the stock market(s).

But is there a risk to this wait-and-watch strategy? Does it impact your long-term returns?

Let's step back from the short-term noise and have a look at the historical data.

Opportunity cost, opportunity lost

In the 40-plus years of the Sensex's existence, your INR100 would have compounded to INR44,000.

But suppose you missed out on just 10 good days, which is about one day in four years, that shouldn't matter much, should it?

Data shows it matters a great deal — the INR44,000 goes down to INR15,000. So two-thirds of the return is gone by just missing out on 10 days.

If you miss out on 30 such days, which is an average of less than one day a year, you are down to less than INR4,000. As much as 90% of the gains are gone!

And this isn't something exclusive to the Indian market. For the S&P500, the numbers are even starker.

If you miss out on investing in just 25 good days in the 100 years of S&P 500, then instead of compounding from USD100 to USD21,000, you give up 90% of your returns and end up with USD2100 (this data excludes dividends, but the pattern is the same with the total return index).

If you miss out on 100 days in 100 years, your USD100 actually goes down to USD38.

Thus, it is clear if you miss out on these rather infrequent up days you lose big time. There is a huge risk in NOT being in the markets for the long term.

Timing the good days

The other incredible fact that we found was that while the timing of these up days was unpredictable, the only discernible pattern was that most of these up days come in the middle of a crisis or after a crash.

The big up move days are rarely part of a bull-run and in India, the only time we have found them as being part of a bull-run was during the Harshad Mehta scam period in the early 1990s which was a rigged market.

Otherwise, you never get one of these 8% or 10% up days in a bull-run. They always come after a crash or in the middle of a crisis, when pessimism is high.

Therefore, given where we are in the markets, my assessment, based on history, is that the risk is more in sitting out rather than being in the market.

If you step back and not talk about one day, one week or even one month but are looking at

equity as a long-term investment in your asset allocation pie, this is the time to be back in.

Else, recency bias always misleads. We extrapolate what has happened in the recent past and expect it to continue but that isn't how markets, or life, works.

The bottom line

Around this time last year, everybody thought Nasdaq was a no-brainer and one could not go wrong buying Nasdaq. Which is why we had all these Nasdaq ETFs and funds coming in, people opening Robinhood accounts or accounts with other brokers. I had warned at the time that just because the Nasdaq had done well for two-three years didn't mean that it would continue to do well.

Nasdaq this year has been an absolute bottom performer. For the year-to-date, out of 40 indices, it ranks number 38 or something. It looks like suddenly the risks are very high there.

Also, if the risks appear very high in India, then they are so everywhere else. But all of this is, once again, only an extrapolation of the recent past.

Of course, in equity markets, only a long-term perspective works. If you have a six-month perspective, you do not know whether the market will be up or down. That is always the case.

None of the above means that the markets can't go down further. None of these big up days are predictable. One cannot say whether one or more of them will come next week or next month. So you should probably look at investing your equity allocation not just in one go, maybe split over two-three months - but stay invested.

You should have a long-term perspective, at least three to five years for whatever you think is your equity allocation.

Your investment strategy should depend on what your time frame is, what your objectives are, when you need the money and as I always say, always look at your portfolio on an asset allocation basis.

Not all your money should be in one asset or the other and it should be spread out geographically, and outside India as well.

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