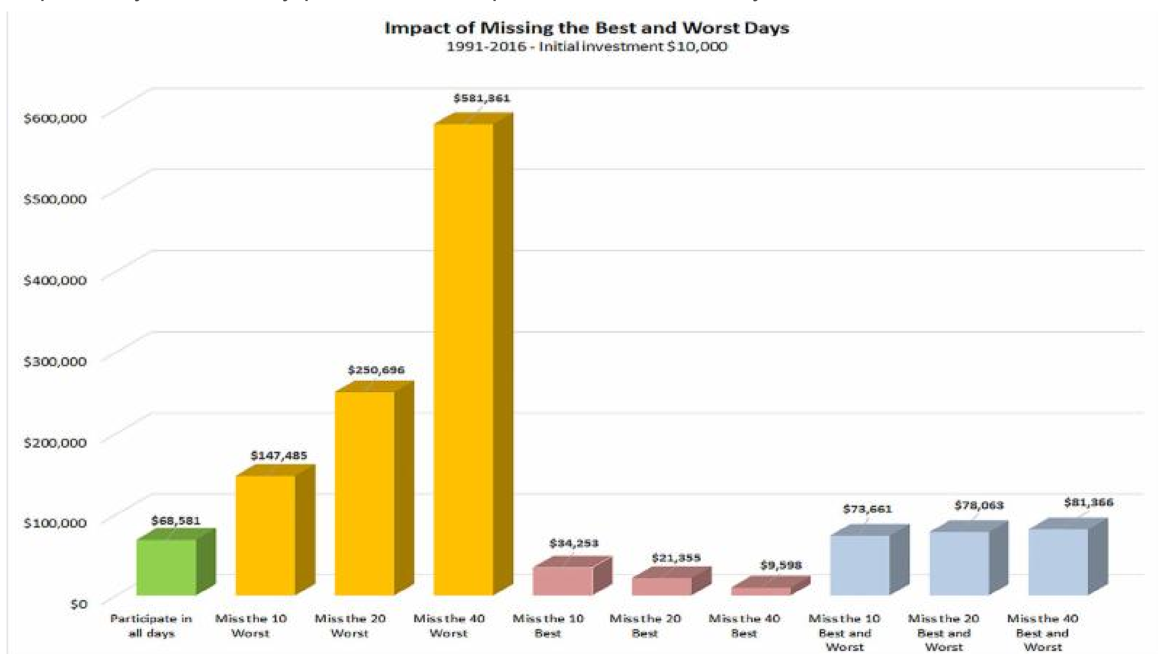
AN UPDATED LOOK AT AN OLD FALLACY

One of the most common arguments against trying to actively position assets to take advantage of market trend is "Missing the Best." In this approach, the supporter of passive management points out that no one is able to perfectly forecast the market and if you miss just the best 10, 20 or 40 days of the market your returns decrease dramatically.

Which makes it interesting to take an updated look at the data behind the argument. In the 25 years of S&P 500 daily returns ending 2016, missing the best does indeed dramatically affect performance. But there's more to the story. What if you miss the worst days? And therein is all the rationale and reason for active management. Losing money hurts performance far more than missing the best up days. But, what is also interesting is that missing both the best and worst days of the S&P 500 over the past 25 years actually produces better performance than a buy-and-hold investment.



How easy would it have been to miss the worst days? If you were out of the market during 2008, you would have missed 17 out of 40 of the worst days of the last 25 years. The worst day for the market was October 15, 2008 when the S&P 500 fell -9.0%. Miss the first four months of 2009 when the market was still struggling and you would have missed 23 of the worst 40 days or 58% of the worst days for the market in 25 years. For trend followers, these would have most likely been the times one would naturally be out of the market. And as the graphic above shows, missing the worst has a dramatic impact on performance.

But, if you were out of the market 2008 through the end of April 2009, you would also have missed 20 of the best 40 days for the S&P 500, with the best day on October 13, 2008 topping 11.5%. Which brings us to the reality of financial markets. The best and worst days often occur in close proximity when market volatility spikes. The odds that one would miss just the best or just the worst days out of 6,552 trading days are next to impossible. But it is much more likely that one could miss both the very best and very worst and outperform a buy-and-hold investment in the process.

Another interesting fact from the study: If you look at the average for the 40 best and worst days, the average good day was +5.2%, the average worst day was -5.0%. Out of the 6,552 days in the study, 3,059 had negative returns, while 3,489 were positive and four days had no change in value from the prior day. What conclusions might one draw from that information? The one that jumps to mind is that buy-and-hold investing is a very inefficient way to make money, with the S&P 500 up just 11% more days than it was down.

Active management is an attempt to make the financial market more efficient by participating in up moves and avoiding the down trends.

Behind the potential for active management to outperform the market is the mathematics of gains and losses. If your investment is down 20%, it doesn't take a 20% increase to return to breakeven, it takes 25% because you are starting from a smaller portfolio value. As long as the active manager avoids the majority of the down trend, there's room to miss part of the uptrend and still outperform a buy-and hold-investment, typically with a lot less volatility, or risk.

Naturally, there can be no guarantee that an active investment management strategy will achieve its objectives.