ILLUSTRATION: ISTOCK

Leonardo Drago
Co-founder
AL Wealth Partners

May's the time to sell?

Outperforming the market simply by following a set of rules is a tough goal for investors to achieve

"SELL in May and Go Away" – investing is full of memorable one-liners which purport to give good investment advice that is also easy to remember.

At mid-May at press time, one of the most famous one-liners has been repeated unusually frequently this year, and the behavioural aspect of investing would show why. The long uptrend since 2009 in US equities seems to have stalled, with the S&P 500 showing no returns for the last two years. Investors also had to sit through two sharp volatile periods: the flash crash in August 2015 and the more recent sharp selloff in January of this year. Asian equities have performed much worse, with Hong Kong returns at -23 per cent and Singapore -16 per cent in the last year alone.

The fundamental picture is not looking much brighter, with problems ranging from earnings revisions in many large US companies, to the continued fears emanating from China's slowdown. It's little wonder that investment publications and blogs are having a field day with the "Sell in May" mantra. Rather than assuming that selling in May is good advice, as always it would be good to have all the facts straight before making such a decision in one's portfolio based on emotion and fears.

Historically, the majority of gains in the US S&P 500 equity index has been achieved in the November to April period. To further cement the "Sell in May" adage, many of the biggest losses during bear markets occurred in the seasonally weak months of September-October.

However, it is critical for investors to know that the weaker historical returns from May to October are not actually negative. The returns for these periods on the S&P 500 have averaged almost +2 per cent, so selling in May is actually a long-term money-losing strategy. In the good old days of normal interest rates of about 4 per cent per annum, an investor would have achieved a similar average return on cash for six months as what the S&P 500 gave, without having to suffer the volatility that is often seen in these periods. In the current era of zero interest rates however, investors would be giving up returns by doing so, before even counting transaction costs.

This average return for the six-month period is also not very useful, as it masks plenty of underlying facts and tendencies. Inclusive of dividends, in 2013, the performance from end April to end October was +11.14 per cent. In 2014, it was +8.21 per cent. In 2015, it was +0.78 per cent. In 2012, it was +2.16 per cent.

We have to go back to 2011 to find the last year that this strategy worked, where the S&P 500 fell -7.12 per cent, and was as much as -16 per cent by September, in the depths of the European crisis. In 2010, the S&P 500 was flat over the period (+0.75 per cent including dividends), but that masked a drop of -12 per cent up until June.

Investor fund flows already show that retail investors are selling out of equity assets in May. This is not a sound and profitable investment plan because it only addresses one part of the equation: the one that happens to be the least important to long-term returns.

After selling in May, when does the investor buy back? After October has passed? What if the market has actually gained in value from May to October, does the investor still buy back at the higher price? When an investor buys the position back is far more important to determining the efficacy of the strategy. How an investor buys the position back is the most important component.

Risks and rewards

Armed with facts, investors can craft an investment plan that actually takes advantage of the volatility often seen in the summer and increases returns while also reducing volatility. Here's a simple example of such an investment strategy that is more robust than the simple adage:

- Sell equities on April 30 near close or May 1 near open
- Buy back 67 per cent of the sold amount on a drop of -5 per cent
- Buy back 33 per cent of the sold amount on a drop of -10 per cent
- On Oct 30 near close or Nov 1 near open, if the full holding hasn't been bought back, bring it back to 100 per cent invested

The strategy above improves the risk-adjusted returns compared to holding the S&P 500, however the absolute level of profitability is much more mixed in the last few years, as post-2008 the market tendency has been to actually achieve gains from May to October. This strategy would have been profitable in 2010, 2011, 2012 and 2015, but would have lost money in 2013 and 2014 compared to being fully invested for the whole year.

Adjusting the parameters above will lead to different risk/reward outcomes, and investors should find the best combination that suits their temperament, as there are no absolute "best" parameters. Increasing the amount of stock market weakness before buying back from 5 per cent and 10 per cent to say, 10 per cent and 20 per cent, would have saved investors a significant sum in 2008. However, it is a money-losing strategy in the long term as big bear markets do not occur that often.

More critically, employing any kind of trading strategy such as the one above means that investors need the emotional fortitude to buy back equities if they did not fall during the period, or risk missing out on the long-term upside of the asset class. In 2009, the S&P 500 did not go below the April levels, and gained +20 per cent for the period. Investors who sold in May would have done so near the lows of the last two decades, and if they did not get back in October, they would have missed all of the subsequent stock market rally that followed in the next six years.

If an investor is certain that they can follow a set of rules to trade a market, they can indeed outperform and do so with reduced risk. Realistically, this is a difficult goal for people to achieve. The average investor would be much better served in ignoring all the recent talk about "Selling in May" (and many other similar trading strategies) by accepting the volatility of owning equities and sitting tight. W

AL Wealth Partners is an independent Singapore-based company providing fund management and advisory services to accredited investors