Down Markets and the Classic Mistake

While waiting in line at the deli counter, one of our advisors overheard a young broker talking more loudly than we'd consider polite on his cell phone. He looked frazzled and blurted out that he had finally capitulated. He had called all his clients and told them he was selling their investments and going to cash to wait out the bad market. Our advisor's first inclination was to feel sorry for those clients (hopefully there are not many) and then shake their head in disdain for his gross conceptual error. This broker was engaging in the most well-documented investor mistake in the history of recorded investment behavior – and he was supposed to be a professional.

He succumbed to emotion, sold securities whose prices had fallen, and is consciously waiting for them to rise until he buys them back. Selling and going to cash means you are waiting to *feel* better until you reinvest your assets. When will you *feel* better? You *feel* better after security prices have already gone back up. By moving to cash in a down market you would be making a conscious decision to sell low and buy high. Yes, we recognize that it sounds like blatantly unintelligent behavior – but, that's precisely why the overwhelming majority of investors fail to earn market rates of return. They flee to cash, CDs, or bonds when stock prices are low and repurchase stocks to join the recovery well after it has begun.

As an investor you share the fundamental belief that companies earn profits and that markets have long-term upward trajectories. Common sense, market history, and our second-grade math classes tell us that we'd much rather purchase a stock when its price is $5 than when its price is $10. At the risk of oversimplification, the best time to invest is when share prices are temporarily low. It follows logically then that the best time to *remain* invested is when share prices are temporarily low.

We have also repeatedly heard of late that investors are worried about "losing" all their money in the stock market. Hopefully there is one significant difference between you and those fearful investors. The difference we're hoping exists is that you are diversified appropriately across the global equity markets and that you'll be able to participate in the market recovery.

We say this because some investors will inevitably not be able participate in the eventual market recovery. That group includes investors sitting around in cash, and those who held concentrated positions of Fannie Mae, Freddie Mac, Bear Stearns, Lehman Brothers, or similar companies. Those single stock investors took on uncompensated risk and paid dearly for it. Uncompensated risk refers to the premise that you don't earn more risk-adjusted return by investing in individual stocks than by investing in the market at large. Single stocks do; however, subject you to the risk of permanent and total loss.

Prudent investors take only compensated risk, seeking to earn the long-term returns to which they are entitled to for the amount market risk which they bear. They hold baskets of thousands of securities and diversify away any uncompensated (single stock) risk.

The fastest way to make a bad market worse for you and your family is to panic and suddenly act as if markets don't periodically go down. Have confidence. You and we know the truth, which is that markets fluctuate. You cannot build wealth via a well-researched, disciplined investment plan when you abandon it as soon as it comes under stress. Recoveries are certainly not planned events. The timing and magnitude are not known to you, us, pundits, economists, or other so-called experts. To get compensated for the risk you take and to earn those long-term market returns you need to fully participate in all market recoveries – and that means no emotional flight to cash allowed.