Stay the Course!

It's been a rough couple of weeks in the stock market. It has reminded many of the downturn in 2008. In fact, 9 of the last 10 trading days have been negative. I think it is an appropriate time to put things in perspective. The ETF VT (Vanguard All-World Index) is a good approximation of global stock markets. On July 22nd it peaked at $69.71 a share. Right now (Friday afternoon) it is trading at $61.57, a drop of 11.7%, most of which came in one day (Thursday.) As comparison, VT dropped from $77.54 to $34.11 in the last bear market, a 56% loss. Technically, you don't call a stock market drop a bear market until there is a 20% loss. We've still got a ways to go before we get there. If it does occur, I suppose one could call this the feared "double-dip" since we never did get back to the market high.

There are a few things to remember at moments like these:

#1 Investing for the Long-Term

You're not investing for a day, a week, a month, a year, or even a decade. Your retirement portfolio likely won't be used for decades, and even after you start spending it, you'll do so over 20-40 years. A two week period has almost nothing to do with the eventual value of your portfolio either at the time of retirement or the amount you withdraw throughout retirement.

#2 Stocks are Risky

No matter what their yield, or how unattractive other asset classes may be, stocks have a nasty habit of losing a lot of money in a short period of time. Those who invest in stocks need to realize that this type of behavior is NORMAL for stocks. This is what they do. There is a reward for this behavior, called the risk premium. This is the reason that in the long run stocks are expected to return more than bonds and other less risky assets. John Maynard Keynes said, “I should say that it is from time to time the duty of a serious investor to accept the depreciation of his holdings with equanimity and without reproaching himself… An investor should be aiming primarily at long-period results.” Things are never as good as they seem, nor as bad as they seem. John Bogle likes to say, “If you have trouble imagining a 20% loss in the stock market, you shouldn’t be in stocks.”

#3 It is Important to Diversify Your Portfolio

A 100% stock portfolio invested in VT would have lost 11.7% over the last couple of weeks. If that portfolio were 50% VT, and 50% bonds (say Vanguard Total Bond Market Fund), your loss would be only 5.3%. Few investors can tolerate a 100% stock portfolio. Many people have felt bonds were overvalued recently and that we were in a bond bubble. But recent events show us that bonds still serve an important function in a portfolio.

#4 Don’t Catch a Falling Knife

Many investors, particularly young investors with small portfolios who have some knowledge of market history, get excited when the stock market drops. They see it as buying "on sale." Some of these bought early last week only to watch their investment take a bigger drop on Thursday. Just because the market has gone down recently doesn't mean it can't continue going down, or that it must come up sometime soon. While it is true that you are better off paying less for an asset, buying something just because it has gone down recently doesn't necessarily work out well. I caught a lot of falling knifes in Fall 2008. It all worked out okay in the end (and I had lots of tax losses I harvested), but in retrospect, I was definitely too eager to jump in. Emotional investing is rarely a good thing, even if you are being a contrarian.

#5 Make Things Automatic

Invest when you have the money. Have a written investment plan. Rebalance your portfolio as dictated by your plan (either on a time basis, such as annually or on a percentage basis, such as using the 5/25 rule).

#6 You Can't Predict the Future

I can't predict the future, and neither can anyone else, including you. A little humility will help you be a better long-term investor. If you are still of the misunderstanding that you can predict the future and time the market, I suggest you start writing down your specific predictions. Go back and look at them in a few months or a few years. You may be surprised at how wrong you were.

#7 Don’t Forget to Tax-Loss Harvest

I’ll address this in my next post, but just remember that in a taxable account you might as well take Uncle Sam up on his offer to share in your losses.

#8 Stay the Course

John Bogle wrote, “Stay the course. No matter what happens, stick to your program. I’ve said “Stay the course” a thousand times, and I meant it every time. It is the most important single piece of investment wisdom I can give to you.” Bailing out of stocks at market lows is the easiest way to torpedo your investment program. Yes, it feels hopeless when you read the newspapers or watch CNBC, but this too shall pass, and those who stuck with a solid investment plan will be rewarded when it does.