Top 6 Reasons People Bail Out In A Bear Market

It has been a long time since our last bear market. There is now a decent percentage of investors, particularly young physicians, who did not experience it personally. There is really no better gauge for your risk tolerance than what you actually did during the last bear market. If you weren't investing then, I suggest you err on the conservative side when setting your asset allocation. Far better to be a little less aggressive (especially early on when savings rate matters so much more than investment return) and ramp it up later, than to be a little too aggressive and bail out in a bear market. A financial catastrophe would be going to cash in the depths of a bear market, locking in returns, and missing out on the subsequent rebound. This is especially true late in your career or early in retirement. Doing this is far more common than many people realize. Nobody likes to talk about it, but the data doesn't lie.

This post is going to examine WHY people bail out, in hopes that once you understand the "why," you will be able to avoid that terrible occurrence. After the six reasons, I will give some quick advice to someone who has found that they have exceeded their risk tolerance.

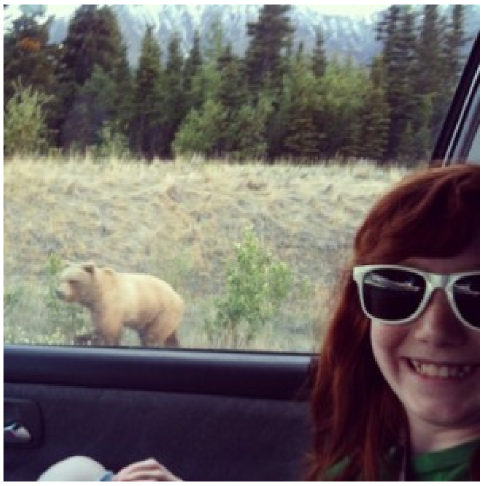
6 Reasons Why People Sell in a Bear Market

1. Scared By Short-Term Volatility

This is the number one reason people buy high and sell low, over and over and over again. They're afraid. They're afraid of losing money. And with good reason. They probably just lost a whole bunch of it. If you've got a million bucks in stocks, and the stock market drops 20% (the academic definition of a bear market), you've lost $200,000. That's real money. Even if your portfolio is buffered with bonds, you've probably still lost $100-150K. And yes, the money really is gone, no matter what anybody says about "You haven't lost money until you sell." If you made the mistake of investing money in long-term investments that you need in the short-term, you are probably really feeling the pressure. But even if you didn't, it hurts to realize that you could have gotten that kitchen upgrade, bought that new car, or even gone to Europe with the money you put in the 401(k) last year. That $200,000 loss may represent 5 years (or more) worth of contributions to retirement accounts. It becomes very visceral. Psychology shows repeatedly that it hurts more to lose money than it feels good to make money.

Personally, I think folks scared by short term volatility are simply paying too much attention to something they shouldn't be paying attention to. If you are investing money you don't need for 20 or 30 years, why look at it every month, much less every day, especially when you know you are in a bear market? Every year or two ought to be plenty. But people are people, and when the Dow is in the non-financial news and your co-workers are talking about how their 401(k) became a 201(k), it can be hard to ignore.

2. Lack of Understanding of Market History



Many of the people who bail out of stocks simply don't understand market history. They assume this time it really is different. They believe the talking heads on TV saying the world is going to hell in a handbasket. Truman said, "The only thing new in the world is the history you don't know." The stock market may not always come back, but it always has so far. I certainly wouldn't bet against it by selling low. Wikipedia lists 49 different crashes, recessions, and bear markets. I suggest you learn about each one of them. It's not different this time. Remembering that will encourage you to not sell, rebalance, and perhaps even throw a little extra in during the depths of the next bear market.

3. Lack of Diversification

Market history teaches us that the overall market always comes back eventually (at least so far.) However, that is not even close to being true for individual companies or even countries (yes entire national stock markets have disappeared.) If you're invested in a handful of stocks and they're tanking for good reason, those people have a legitimate fear of losing their money. So they bail out. You can obviously avoid this by simply buying the market via [low-cost index mutual funds] instead of pretending you're Warren Buffett. Problem solved.

4. Fear of Real Market Risk

There are two types of market risk. We discussed the first, short-term volatility, under reason number one. That's the less significant of the two to overcome. If you simply don't invest money you need in the next 5-10 years into stocks, you can pretty much eliminate that concern. However, the second type of market risk is very much real and is the type that "investing adults" worry about. That's the worry that the stock market won't come back….ever. The big risks here include hyperinflation (think Zimbabwe), deflation (think Japanese market in the 1990-2000s), confiscation (think about the Russian stock market just prior to the implementation of communism) and devastation (think German stock market at the end of WWII or a hypothetical handful of nuclear bombs going off in various US cities.) Many wise investors, who know market history, who weathered the initial volatility scare, occasionally get worried that this time it really is different. Obviously, just telling people to suck it up, quit watching TV, and be patient isn't going to work here. What does work is implementing a plan, a priori, that should survive as many of these terrible scenarios as is reasonable. The interested reader is referred to Dr. Bernstein's excellent book Deep Risk.

5. Herd Mentality

Some people who sell out in bear markets are simply following the herd. Sounds stupid, I know, until you realize who the herd is. The herd is the guy you always talk investments with at the cocktail parties. The herd is your brother-in-law. The herd might even be your spouse. What you must realize is that when you are deep in a bear market, many people will have already sold their stocks, and at a much higher price than they are currently at. A lucky few will somehow manage to get out early, but most have simply already bought high and sold low. Humans are social creatures and there is an undeniable draw to do what others are doing. You must avoid that and invest with your brain instead of your emotions. However, don't deny the effect of the herd on you and those you love. I know several doctors who sold out at 2008 lows at the insistence of their spouse.

6. Sense of Missing Out

In a bear market, you will experience a sense of missing out. It will be vague and you won't quite be able to put your finger on it. But it is a sense that if you had been investing in a different way you would not have suffered these losses. That "way" may be trend-following, valuation based market timing, stock picking or some other method. It can gnaw at you until you're no longer sleeping no matter how many TUMS you take. At that point, you'll be willing to lock in your losses just to get some sleep. Perhaps the best antidote is to teach yourself that neither you, nor anyone else, can accurately predict the future. If you haven't yet learned this, start now. Get a little 79 cent notebook from the grocery store. Write down what you think interest rates, the Fed, real estate, the stock market, the bond market, your favorite stocks etc are going to do in the next day, week, month, quarter, year, and 5 years. Every time you get a flash of insight, write it down. If you're like most (including me) it won't take you very long to convince yourself that your crystal ball shouldn't be trusted.

What To Do When You Can't Sleep

Now, as previously mentioned, is some advice for the person who is trying to weather a bear market, perhaps their first, and realized they can't do it. They're thinking about their investments every day, perhaps multiple times a day. They're waking up in the early morning hours worrying about the market. Here's what you should do.

1. Drag your feet

Don't do anything quickly. The median length of a bear market is 8 months (range 2-21). There is a very good chance by the time you get around to actually doing something, the bear market will be over and the next bull market will have begun.

If you're already a few months into it, it may be almost over. It's a good time to let yourself be lazy.

2. Stop looking at, reading, and discussing financial news

The truth is that most of us can go for months or even years without looking at our 401(k) balances. Studies show that those who do so actually have higher returns. If you're in a bear market and struggling to hold on, make it easier on yourself by distracting yourself from it. It's a great time to let yourself be uninformed. Chances are you'll be glad you did in a year or two.

3. Sell a little

While selling ALL your stocks in a bear market is a major catastrophe, selling a little bit of them isn't going to hurt you nearly as much. If you think that selling off 5-20% of your stocks will allow you to psychologically weather the storm so you don't sell them all, then go ahead and do it. Just remember not to load back up on stocks in the next bull market. You've found your risk tolerance.

4. Hire a GOOD advisor

One big benefit of an advisor is to "hold your hand" during market downturns. An advisor can earn 30 years worth of advisory fees by preventing you from selling out in a big bear. Of course, sometimes advisors have just as much trouble staying the course as investors, but in general, it's easier to stick to a sensible and reasonable plan when it isn't your own money being lost each day.

5. Stop by the WCI Facebook Group, Forum, Reddit, Pinterest, and Instagram Pages

It can be very helpful for you to realize that many investors will stay the course just fine and you can too. The various WCI social media groups are a great resource for finding these like-minded investing peers. It's kind of like using the herd mentality to your advantage. Just realize that many posting on social media today were not investing in 2008 and have never been through a bear market. But, the vast majority will do the right thing, and reading some advice from them won't give you hypercalcemia as those TUMS will.

6. Remember that stocks are on sale

When big screen TVs go on sale the day after Thanksgiving, we all run out and buy them. When stocks go on sale, we all try to sell them. It makes no sense, of course. The companies that seemed so valuable a few months ago really aren't making much less than money now than they were then. Remember what you're buying when you invest in the market. As Baron Rothschild said, "The time to buy is when there's blood in the streets." Some of the best returns I've ever had was the money I invested in late 2008 and early 2009. Remembering that fact will encourage me to avoid selling, to rebalance, and perhaps even to throw in a little extra money when the next bear market comes.

Plan now to survive the next bear market. Just because you don't know when it's coming doesn't mean it isn't.

How did you survive your first bear market? Did you use any of these techniques? Comment below!