The news of markets reaching all-time highs makes investors nervous. When stocks trade below their previous highs, investors lament the fact that they used to have a larger portfolio balance, and can often recite exactly how far below their high-water mark they currently are (“but I used to have $X”).

Once that previous threshold is surpassed, the assumed elation never materializes. Instead, they often become concerned that stocks are “overpriced” or poised for a significant drop. While the latter is always a possibility and a reality, what all long-term investors should accept and come to grips with is that this point-of-view misses the mark completely.

For all the fear investors have around volatility, bear markets and significant portfolio losses, it is entirely possible if not probable today, as it has always been in the past, that those temporary and short-term phenomena had no bearing on the long-term investor. They didn’t actually “lose” money, as we’re so often told is the case when stocks decline and portfolio values are below previous levels. If share prices eventually recovered, as they always have, then temporary setbacks represent nothing more than “paper declines.”

The most important take-away from a new all-time high for the market is the reality that, once again, no investor in stocks has actually lost money at any point in their lifetime, unless they made the decision to sell shares before they returned to previous levels and eventually tracked higher.

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How should an investor ensure that they don’t turn paper declines into permanent losses, and what impact should this have on investment policies?

Paper or Permanent?

Stock portfolios, even those that are broadly diversified across large and small, growth and value stocks in US and non-US markets, occasionally fall—sometimes significantly.

Table 1: Significant Stock Market Declines (1995-2014)

<table>
<thead>
<tr>
<th>Time Period</th>
<th>All-Stock Asset Class Return</th>
<th>Short-Term Bond Return</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>5/1998 to 8/1998</td>
<td>-19.6%</td>
<td>+2.8%</td>
<td>22.4%</td>
</tr>
<tr>
<td>5/2002 to 9/2002</td>
<td>-22.2%</td>
<td>+7.6%</td>
<td>29.8%</td>
</tr>
<tr>
<td>11/2007 to 2/2009</td>
<td>-57.1%</td>
<td>+4.5%</td>
<td>61.6%</td>
</tr>
<tr>
<td>5/2010 to 8/2010</td>
<td>-13.7%</td>
<td>+4.1%</td>
<td>17.8%</td>
</tr>
<tr>
<td>5/2011 to 9/2011</td>
<td>-24.1%</td>
<td>+3.3%</td>
<td>27.4%</td>
</tr>
<tr>
<td>1/1995 to 12/2014</td>
<td>+10.5%</td>
<td>+5.6%</td>
<td>4.9%</td>
</tr>
</tbody>
</table>

Looking at just the last 20 years (ending in 2014), we’ve seen a decline of -19.6% from May to August of 1998, -22.2% from May to September of 2002, -57.1% from November 2007 to February 2009, -13.7% from May to August 2010, and -24.1% from May to September 2011. This can be viewed as the pain an all-stock investor had to endure to earn a +10.5% annual return from 1995-2014, turning every $1 into $7.38 before advisory fees.

If an investor during any of these temporary drawdowns was forced to sell stocks for unexpected cash-flow needs or regular retirement income goals, their actual long-term return would have been lower. Shares that were sold were never given the opportunity to fully recover. So how should you insulate yourself from the reality of regular stock declines?

First, if you don’t have any realistic plans for requiring withdrawals from your portfolio for many years, consider an all-stock allocation and just don’t sell, no matter how bad things may seem.
If instead, you are going to withdraw some of your investment portfolio at a point in the near future, along with stocks you should also include an allocation of high quality, short-term bonds.

Low-risk bonds do not come with the same expected returns as stocks, but they do have one very important attribute: they tend to appreciate, or at least hold their value, when stocks decline.

While their 20-year return over the period mentioned in Table 1 was only about half that of stocks—+5.6% annually—and will most certainly be lower going forward with interest rates at record-low levels, they had reliably positive returns in each of the five downturns listed above: +2.8%, +7.6%, +4.5%, +4.1% and +3.3% respectively.

**Be Careful With Bonds**

Now that we have a better understanding of the role that bonds play in helping you achieve your long-term goals, the question should be asked: why high quality and why short term?

Just as stocks are adversely impacted by economic downturns, political disruptions and environmental calamities (all of these events have the potential to negatively affect companies’ future abilities to generate profits), bonds also have their Achilles heel(s).

*The Quality Decision*

Some of the same factors that affect stock prices can also have a negative influence on lower quality, investment-grade and “junk” bonds. 2008 was a year where strategies with lower-tier (rated A and BBB) corporate bonds and junk (rated BB and below) bonds lost 5% to 20% and fell in unison with stocks. If you were looking for an alternative source of cash flow in 2008 other than sales of stock shares, these lower-credit-quality bonds would have failed the test.

Higher-quality corporate bonds, on the other hand, notched 4% gains; government bonds produced impressive double-digit returns. No other asset classes demonstrated such powerful counter-stock movements.

*The Maturity Decision*

Rising inflation and interest rates are also problematic for bonds. As rates rise, existing bond prices fall in value. If the bonds don’t default, the prices will eventually return to par. But for someone who is looking to bonds for immediate income during these periods, longer-term maturities (more than five years) represent a risk best avoided.

Some might assume simply holding cash or bills that mature in a few months would be better, but the evidence is clear that a significant return improvement (almost 2% from 1928-2014) is possible by extending bond maturities from a few months to a few years. Historically, higher returns plateaued around five years, so portfolios are best kept at these maturities or less.

**Prepared For Portfolio All-Time Highs**

If you have an ample (but not excessive) amount of your portfolio in bonds and you’ve chosen the right kinds—high quality and short term—you’re able to sell shares during periods of financial distress or upheaval without being forced to liquidate stocks at temporarily depressed prices.

Assuming you have enough in bonds to weather the next financial storm, you can patiently sell them to generate the needed cash flow knowing that your stock setbacks are not actually “losses,” but “paper declines” that you should recover from in the near future. As the recent headlines of fresh record highs for the market confirms, no one who avoided selling shares during difficult times has actually lost money in stocks.

This seemingly simple concept and encouraging fact is lost on most investors but it has an important and meaningful impact on investment portfolio policies and asset allocations, a topic we will cover next month.

*Source of data:* DFA Returns 2.0

All-Stock Asset Class Mix = 21% DFA US Large Co. (S&P 500) fund (DFUSX, DFLCX prior to 2010), 21% DFA US Large Value fund (DFLVX), 28% DFA US Small Value fund (DFSXV), 18% DFA Int’l Value fund (DFIVX), 12% DFA Int’l Small Value fund (DISVX), rebalanced annually.

Short-Term Bonds = 100% DFA Five-Year Global Bond fund (DFGBX)

Past performance is not a guarantee of future results. There are limitations inherent in model performance; it does not reflect trading in actual accounts and may not reflect the impact that economic and market factors may have had on an advisor’s decision-making if the advisor was managing actual client money. Model performance is hypothetical and is for illustrative purposes only. Model performance shown includes reinvestment of dividends and other earnings but does not reflect the deduction of investment advisory fees or other expenses except where noted. This content is provided for informational purposes and is not to be construed as an offer, solicitation, recommendation or endorsement of any particular security, products, or services.