FACTORS IN FOCUS

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The Scariest Part of Investing

by Eric Nelson, CFA

With Halloween fast approaching, now is a good time to discuss the part of investing that people are often most afraid of—losing money!

To get ahead with your investment portfolio, of course, you have to take risk. Unfortunately, many don't understand what the investing risks are or how to handle them at various stages of life. Let's examine this topic in more detail this month.

Keeping It Safe Will Cost You

We can't begin to discuss risk without first reviewing the potential rewards. If we look at the period from 1970-2018, the first year where data exists on both US and international stock indexes, we find that a well-diversified asset allocation—the Dimensional Equity Balanced Strategy Index—earned a return of +13.1% per year. One dollar over this period grew to $419.20, a substantial sum (the S&P 500 Index of large US stocks grew to $117 after a +10.2% gain). The "risk-free" return over this period—represented by One-Month Treasury Bills—was just +4.7%, so $1 grew to only $9.45.

But these are "nominal returns." Over the same 49-year period, the rate of inflation in the US was +4.0%. Net of inflation, accepting the risk of stocks rewarded you with over 9% per year in "real" (inflation-adjusted) gains; risk-free T-Bills earned just +0.7%, or about 13x less.

If we also consider the taxes owed on dividends and bond interest, stock returns would be lower than 9%, but T-Bill returns would be negative! The lesson for long-term investors is clear—if you need to grow your savings so that you can eventually retire and rely on your portfolio for ongoing income, you have to hold stocks. *Keeping it safe will cost you.*

Learning About Losses

What then, has been the "price" for the significantly higher long-term return on stocks? **Short-term losses**. Over the last 49 years, there have been eight occasions where the Dimensional Equity Balanced Strategy Index fell 20% or more (-5% to -10% losses are more common but not as traumatic), the classic definition of a "bear market." The table below lists each of these episodes.

Bear Markets & Subsequent Recoveries (Dimensional Equity Balanced Strategy Index: 1970-2018)

BEAR MARKET	% Return	$1 Growth	RECOVERY	% Return	$1 Growth	TOTAL PERIOD	% Return	$1 Growth
Apr to June 1970	-19.6%	$0.80	July 1970 to Jan 1971	31.2%	$1.31	Apr 1970 to Jan 1971	5.5%	$1.06
Jan 1973 to Sep 1974	**-37.3%**	**$0.62**	**Oct 1974 to Jan 1976**	**71.3%**	**$1.21**	**Jan 1973 to Jan 1976**	**7.5%**	**$1.08**
Sep to Nov 1987	-23.4%	$0.76	Dec 1987 to Oct 1987	32.3%	$1.32	Sep 1987 to Oct 1988	1.3%	$1.01
Aug to Oct 1990	-18.9%	$0.81	Nov 1990 to Mar 1991	25.5%	$1.26	Aug 1990 to Mar 1991	1.9%	$1.02
May to Aug 1998	-21.0%	$0.79	Sept 1998 to Apr 1999	29.6%	$1.30	May 1998 to Apr 1999	2.4%	$1.02
Apr to Sept 2002	-20.9%	$0.79	Oct 2002 to July 2003	31.4%	$1.31	Apr 2002 to July 2003	3.9%	$1.04
Nov 2007 to Feb 2009	**-58.6%**	**$0.41**	**Mar 2009 to Apr 2011**	**145.3%**	**$2.45**	**Nov 2007 to Apr 2011**	**1.4%**	**$1.01**
May to Sept 2011	-22.2%	$0.78	Oct 2011 to Dec 2012	30.7%	$1.31	May 2011 to Dec 2012	1.8%	$1.02

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Bear markets happen about once every five years. Sometimes they are clustered in a relatively short window—1970 and 1973/1974 or 1998 and 2002. Other times we've gone a decade without a big decline. Sizable losses are relatively infrequent, but to be expected.

Big declines don't last long. Many lasted only a few months, and only the 73-74 and 07-09 periods lasted longer than a year. Most bear markets are over before we knew they started. There doesn't appear to be any pattern in the duration of the declines; the two longest were followed by bear markets just three and five months long. Proximity also seems random—after 1974, the first subsequent decline (1987) was 12 years later; after 2009, the next bear market (2011) occurred just two years later.

In the throes of a bear market, you often hear that at "average" rates of return, it will take many years to recover losses, further frustrating investors already unhappy from their setback. But *stocks don't tend to experience "average" returns during recoveries*. Gains have been significantly higher early on and full recoveries happen far sooner than expected. In all but two bear markets since 1970, stocks have declined, rebounded, and reached new highs within two years! In the case of the 1973-1974 and 2007-2009 periods, the entire cycle took just over three years. Considering the significant potential rewards to owning stocks, the short duration of most setbacks seems almost too good to be true.

Surviving The Storm

What, if anything, should you do about stock market declines? The answer depends on your investment goals. People saving for retirement and those investing exclusively for their beneficiaries are different than those who need an ongoing paycheck from their portfolio.

If you're not withdrawing money, you can afford to ignore bear markets. The values you see on your statement might not be ideal, but you aren't forced to sell at those prices. You can wait until markets recover and your portfolio value is higher. Selling, in hopes of getting back in at lower prices, or avoiding further declines, sounds better. But "timing the market" is notoriously difficult. In reality, you will usually miss out on a surprising but significant recovery and the losses from liquidating your portfolio (and missing out on gains) will dwarf any additional declines.

If you're still saving for retirement, or adding to your portfolio consistently, then bear markets are not to be feared, but instead celebrated. Lower stock prices allow you to accumulate more shares that will eventually be more valuable. You can buy lower and improve your future retirement prospects if you're able to hold tight. You read that right—there's a benefit to bear markets!

If you need ongoing income from your portfolio, you may not want to sell stocks while they are down. This is one case where holding bonds can help. In all eight bear markets, the return on an index of short-term bonds—the Dimensional Fixed Balanced Strategy Index (One-Year Treasury Notes prior to 1973)—was positive, ranging from +1.3% to +9.0%. Bonds might not have big returns, but if you stick to high credit ratings and short-term maturities, you can be confident that they will hold up when stocks decline.

Instead of getting in and out of the stock market attempting to capture gains while avoiding losses, you should hold a few years of your spending in short-term bonds, selling bond fund shares during bear markets and stock fund shares in bull markets. Since 1970, a portfolio with just four years of withdrawals in bonds (15% to 20% allocation) would have prevented you from having to sell stocks before they had fully recovered their bear market losses! This approach also has the benefit of keeping most assets in higher expected returning stocks, making your long-term growth and legacy goals more likely.

Preparing, Not Predicting

This article isn't a suggestion that stocks will soon be heading lower. No one, least of all me, can predict that. But how you invest *in preparation* for bear markets, and *how you respond* to them, impacts whether you will be successful financially.

Too many investors are over allocated to bonds and "alternative" investments, or they panic and bail on stocks after a rough stretch. They're trying to avoid losses but they wind up missing out on the returns they could have, need, and deserve.

By periodically confronting the reality about the risks of investing I think you'll be better prepared, with my help, to handle them. You will also be more confident and successful in the process.

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Contact Eric Nelson, CFA at eric@servowealth.com with any questions, comments, thoughts, or to discuss your personal financial situation.