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FOCUSED ON WHAT MATTERS MOST.

The Cost of Panic

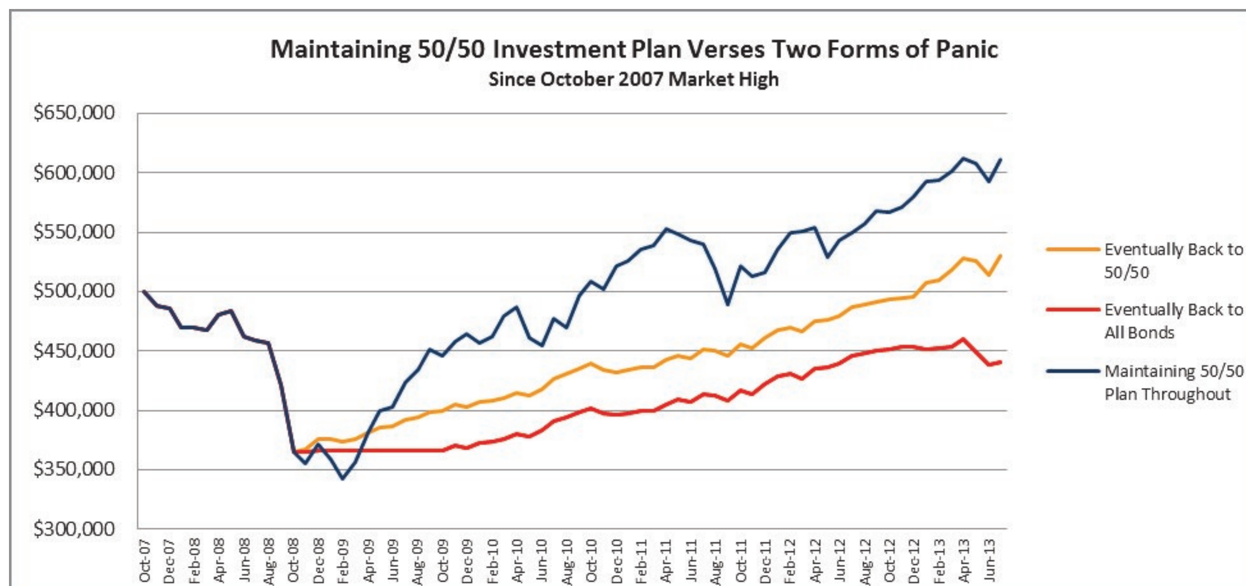
Five years ago this September was when the market correction that started in October of 2007 turned into an official bear market. The next month the bear market turned into a credit crisis, which eventually found its bottom on March 9th, 2009. Just how bad was that period in historical perspectives? 9 of the 20 worst stock market days between January 1, 1950 and December 31, 2012 occurred within just a four month span – 45% of the pain crammed into 0.5% of the days. A majority of bond sectors were also getting beaten up, and it certainly felt like there was nowhere to hide except cash for people who were inclined to panic.

That downward move is now almost 6 years behind us, and we were curious to know how investors who stuck with their game plan would have done verses investors who panicked and went to cash during those dark days. We did not pull the following scenarios out of thin air. Checking the flow of money into and out of mutual funds since that October 2007 high point shows when investors got out of stocks and bonds, when they got back into bonds, and when they (finally) got back into stocks.

> ***9 of the 20 worst stock market days between January 1, 1950 and December 31, 2012 occurred within just a four month span – 45% of the pain crammed into 0.5% of the days.***

For our comparison, we're going to assume one investor stayed with his or her planned 50/50 stock/bond mix over the entire period. We're going to assume a second investor couldn't stomach stock market volatility and did what a lot of investors did: sold all equity positions at the end of October, held those proceeds as cash for 12 months, finally grew a little comforted by the fixed income rebound and invested that cash in the bond market, and held all investments in bonds until finally getting back into the stock market early in 2013. Despite panicking and getting away from the original plan, this investor eventually does get back to the original 50/50 mix. That does sound a bit circuitous, but industry information shows that scenario to be very common over the past six years.

Finally, we're going to assume another common scenario with our third investor. Like a lot of people, this investor panicked and liquidated everything, all stock and bond positions, but after about a year of watching things rebound decided to put everything back in bonds but never got back into stocks at all. Unlike the second investor, the third investor not only panicked, but allowed that emotional moment to completely alter his or her investment plan permanently.



Not only did the first investor get back to even within 3 years, but he or she also earned a higher net average annual return than the stock market, 3.6% versus 2.8% for the period, with less volatility. And even though this investor initially lost more value during the crash than the other two investors, -32% versus -27%, he or she still ended up with 15-39% more money at the end than those who abandoned their plans and panicked.

Going to all cash or just liquidating all stocks in late 2008 felt like the right thing to do for millions of people. The problem was that was never part of their initial plan, so they also did not have criteria for when to get back in other than when getting back in also felt right. A large percentage of those investors never got back into equities at all.

There is an equally corrosive flip side to this scenario which is also incredibly common among investors, and that is to load up on risky investments after they've gone on a long and meaningful upswing. The amount of money that went into technology stocks in late 1999 is staggering, after 95% of the tech bubble had already inflated and was near to bursting. Systematically abandoning investment plans due to fear and greed is what destroys investment returns over time.

What we illustrated was a simple buy and hold strategy and what happens when people deviate from that based purely on emotion. Using an unemotional, data-centered process to move in and out of the market over time is different than what the second and third investors did, and we believe that approach can add value by reducing volatility over time, provided that strategy is a sound strategy.

We do not mean to imply that sticking to a 50/50 allocation would have always worked better over all time periods, nor do we mean to imply that this strategy is the best moving forward for everybody. Whatever the correct approach is for investors going forward depends on their goals, risk tolerances, and how we feel the various investment sectors may perform over the next 1, 3, 5 and 10 years.

The Fall of 2008 was an incredibly difficult period to be an investor. Hopefully it is far enough in our rearview mirrors to forget how emotionally difficult it was, but also hopefully not so far behind that we forget that by not panicking and abandoning our plans, we stand the best chance to achieve our goals.

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Our Take

How the Federal Reserve is going to scale back its historic Quantitative Easing program is still front and center for the markets. The volatility in both stocks and bonds after 2:00 EST on Wednesday August 21 when the notes from the last Federal Reserve meeting were released for public review indicates to us that the market is largely dependent on the liquidity provided by the Fed. The Dow dropped 77 points initially, then rallied 139 points before proceeding to drop 129 points into the close 2 hours later. Now that's volatility! Even though the Fed's message has been that scaling back the level of accommodation (money-printing) will only take place if the economy's on solid footing, the markets haven't taken that as a positive and instead have focused almost exclusively on what the Fed's next move is.

As we wrote last month, this poses a real dilemma for the Fed. It knows it can't print money forever, but it also knows the markets have become somewhat addicted to easy money. In an effort to quell that addiction, the Fed's been very purposeful about trying to get investor focus back on the economy by stating that QE will only be reduced if the economy shows strength. Good plan, but as Tuesday, August 21 suggests, it's not working. Pulling back QE may be a bit painful unless economic figures improve so dramatically that investors can't help but feel incredibly positive about the future. Our feeling is that those odds are slim to none. Breaking addiction is never an easy process and quite often requires taking a couple steps back before moving decidedly forward.

Another interesting thought is what happens if the economy refuses to pick up appreciably and the Fed decides to slow down its printing presses anyway under the realization that the risks of continuing are beginning to outweigh those of stopping. As Bernanke's hinted about more than once, Congress needs to do its part to address structural issues within the economy in order to get lasting results. What he may have been saying all along or at least believes more now that ever, is that it may be these structural changes that are needed to get any results. As uncomfortable as it may feel to depend on Congress to keep us on the right track, we see this as a natural progression that really does need to take place in order to get back to a more normal environment – the Fed needs to back down and Congress needs to step up. The thought that a retiree can't earn money safely in a CD is disturbing enough, add to that that the Fed is deliberately trying to create inflation that takes more money out of that same retiree's pocket and it's borderline criminal. Given that rates have been held down for 5 years now, it's fair to refer to the Feds policy as financial repression, and it's becoming somewhat morally questionable. The irony is that a good deal of those who are now benefiting from low rates and easy money will ultimately experience similar financial difficulty as a result of overextending themselves and being caught in a downdraft of asset deflation when the Fed finally cuts the cord. Although nobody wants sluggish or negative growth, if that's the economy's natural state for a period of time given limited intervention, then it may be just what's needed to get back on track - especially if those lumps get us to a strong sustainable economy that much sooner.

So where does this leave us from an investment standpoint? Our position continues to be to play it very conservatively until we get a better buying opportunity in the stock market. The risk of a large market correction is simply too great to warrant being invested heavily in stocks right now. Although they could continue to rise for a bit, it doesn't change the fact that there's too much risk for most people in owning them and that fact alone needs to guide our decision-making. In addition to our big picture view of things being a bit less than rosy for stocks, a couple of our technical models are suggesting we may be close to experiencing some trouble.

First, our sentiment model is indicating that investor behavior has become overly optimistic toward stocks, which we take to be a contrarian signal. Historically, when investors get too excited about something, it can be a sign that the trend is about the reverse course. In addition, our divergence model is indicating some fairly abnormal behavior between small cap and large cap stocks as well as a couple of the Dow Jones indexes, which can also be a sign that a sea change may be afoot. As of August 27, the S&P is down 2.6% for the month, which puts it on track for the worst monthly performance since May 2012.

Could this be the start of something bigger? More times than not, these indicators have demonstrated considerable accuracy in helping us get a feel for turns in market direction. Now that they're both saying the same thing gives us a little more reason for concern.

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