ROCHESTER BUSINESS JOURNAL
RBJ
VOLUME 30, NUMBER 26 WWW.RBJDAILY.COM SEPTEMBER 26, 2014

Downturns can be scary but also ripe with opportunity

VIEWPOINT
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Given the length of the current stock market rally and the level stock market valuations have reached, there is a large and growing consensus that the next downturn is right around the corner.

Many believe that rather than just a modest decline, the next downturn will be another sharp, painful correction, similar to what we experienced in 2008.

I'm not sure I agree with those sentiments. Nevertheless, it is instructive to think through what to do in the event that the next bear market arrives sooner rather than later. This is a particularly important exercise, as investors are apt to react emotionally when a financial crisis occurs.

Everyone is risk tolerant in a bull market, but bear markets test our mettle. It therefore makes sense to devise a plan before the next market panic to ensure you are making rational decisions, which may be difficult during stressful and emotional times.

First off, don't panic. Selling at the bottom may cause damage that your portfolio will never be able to recoup. It can be hard to watch your portfolio decline in value, particularly if you are relying on it to meet living expenses.

However, ask yourself what has changed as a result of the market's decline. Are people still going to work? Are companies still trying to earn profits? Is the economy still functioning? If so, there probably is no reason to expect Armageddon. During times of market extremes it may seem like stocks are never going to rebound, but in over 200 years of history, they always have.

Selling to stop the pain may feel good at the time, but in order to be successful at timing market peaks and troughs, you not only have to get out of the market at the right time, but you also have to get back in before it rebounds. There isn't much evidence that investors have used this strategy profitably over time. Rather, a better approach is to stick to your discipline, re-evaluate your portfolio and make changes that are in accordance with your long-term plan.

As part of this evaluation, you will likely need to rebalance your portfolio. If you have asset allocation targets, which you should, then severe market swings will likely skew your portfolio away from those targets. For example, a portfolio that targets 60 percent in stocks and 40 percent in bonds would be only about 45 percent in stocks and 55 percent in bonds, after a 40 percent decline in stocks and a 5 percent rise in bonds, similar to what happened in 2008. Clearly, this is a different and more conservative risk profile than you started with.

It may seem that being more conservative during periods of market extremes is a good thing, but really the opposite is true. When stocks trade at low valuations, it is the time to have a full allocation to stocks, as future returns often prove lucrative.

Indeed, Warren Buffett aggressively invested in financial company stocks back in 2008. He invested $5 billion in Goldman Sachs shortly after the collapse of Lehman Brothers, when the outlook for financial companies was at its worst. The Wall Street Journal estimated last year that Buffett likely earned profits of more than $10 billion from the investments he made during the depths of the stock market crash in 2008.

So, while it may seem counterintuitive to buy stocks when the world appears on the verge of collapse, that is exactly what you should do in order to maximize long-term earnings. In the asset allocation example above, your stock portfolio would sink from a 60 percent target to an allocation of 45 percent.

To get back to the target allocation, you would need to sell bonds, which in this example have outperformed, and reinvest the proceeds in stocks, which have underperformed and are likely relatively cheap. You would buy stocks "on sale," and set your portfolio up for significant gains when the subsequent rebound arrives.

Next, consider tax-loss harvesting. When the stock market really falls, there are usually plenty of losses in your portfolio, if only on paper. Realized capital losses, meaning losses on investments that have been sold in the current tax year, can result in a tax benefit. Capital losses may be used to offset capital gains in the current year, used to offset a modest amount of ordinary income in the current year, or carried forward indefinitely to offset capital gains and income in future years.

So, aggressively realizing losses during a bear market could offset capital gains for years to come, thus making your portfolio very tax efficient. This helps ensure you keep as much of your return as possible, rather than surrendering gains to Uncle Sam.

Just because you sell stocks for tax purposes, it doesn't mean you have to be out of the market. In fact, it is best to marry a tax-loss harvesting program with the rebalancing strategy discussed above. For example, assume you have a large-cap stock mutual fund that declines in value by 20 percent. You could sell this fund, realize the loss for tax purposes and then immediately reinvest the proceeds in another large-cap stock fund. This would allow you to realize the tax benefits of the loss, but also remain fully invested.

The one caveat is that you can't sell an investment for a loss and then repurchase it within 30 days, or the loss will be disqualified by the Internal Revenue Service. But, you could buy another investment with very similar characteristics, allowing you to keep the integrity of your portfolio intact but still optimizing your tax situation.

While stock market downturns can be downright scary, they also represent significant opportunity. Rational steps to improve your portfolio when stock market valuations are low not only allow you to rebalance without paying taxes, but also may help bank enough losses that you won't have to pay capital gains taxes for years into the future.

With intelligent decisions, a little patience and a focus on the long term, you could end up turning a bad situation into a profitable opportunity for the future.

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