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Buy-and-rebalance approach best course for long-term wealth

ON INVESTING
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The current economic expansion is now 117 months old. Looking at data that goes back to 1854, this is just shy of the record 120-month expansion that occurred from 1991 to 2001. It seems likely we'll soon exceed the prior record, but how long can the economy continue to grow, and how long can the stock market continue its associated bull run?

Despite a lot of time and resources spent on economic and financial forecasting, there really is no way to know for sure when cycles will roll over. The only certainty is that it will eventually happen. Economic cycles are a part of life, and for investors that means cyclicality in the financial markets as well. While stocks have historically moved higher over time, they ebb and flow in the short run, driven partly by economic news and behavioral factors.

The question we as investors must face is how will we behave when the worst happens? History suggests most of us won't respond well, which could cost us a lot of money.

However, it doesn't have to be that way. There's ample evidence from prior downturns to show us that even nasty bear markets are temporary. Data going back to at least 1871 shows several market drops, some of them quite steep, followed by an eventual recovery and a strong trend of growth over time.

This makes sense. During economic recessions and bear markets, some people lose their jobs, but most people still go to work each day. Even in the depths of the Great Depression, 75 percent of the working population was employed. People naturally try to maintain their lifestyles and improve their financial circumstances. They earn money, spend, save for their kids to go to college and for their eventual retirement. Spending patterns may change marginally, but for the most part we live the same lives. This is true of businesses as well. Most businesses survive economic downturns and continue to invest for future growth. New investments lead to new innovations. The economy has often faltered, but it has never collapsed.

So, why do people sell out of stocks when they decline in value? If the market rises over time, downturns are temporary and they cannot be predicted, it seems irrational to sell into stock-market weakness.

Sure, if you could time the market, it would be great to get out at the highest point and reinvest at the low. Returns from such a strategy would far exceed a buy-and-hold approach. However, this approach requires two correct decisions: when to get out and when to buy back in. Even if you are lucky enough to get the first decision right (because it typically would be luck rather than skill that results in such an outcome), it would be highly unusual to be able to call the market bottom as well. Anecdotally, we generally see people sell out after the market has already fallen, and they don't feel comfortable reinvesting until it has recovered. This usually results in a money-losing scenario, rather than preserving wealth.

Even experts can't get this right. The late Jack Bogle used to show a graph of stock mutual fund cash holdings. Veteran stock pickers should have some insight into market cycles, but their cash holdings were largest at stock market lows and smallest at stock market highs, the opposite of what would earn the strongest returns. There are numerous studies with similar lessons. So, if the experts can't get it right, why do we think we will fare any better?

A better approach is to realize the truth. Although markets go up over time, there are cycles, which are temporary and unpredictable. Don't try to time them. As boring as it sounds, a buy-and-rebalance approach will almost certainly earn you more long-term wealth than moving in and out of the stock market.

If you need to take action to feel you are empowered during the next bear market, try rebalancing. It is likely your stocks will fall below their long-term target during a bear market. Buy more to get them back on track. That may seem counterintuitive, but it will help you recoup losses faster when the recovery begins.

You might also look for opportunities to realize capital losses for tax purposes. Stocks that are down in value could be sold for a loss that you can use now or in the future to offset capital gains. It makes sense to lock these in opportunistically even if you don't need losses now. However, realizing a capital loss doesn't mean you have to be out of the market. Make sure you reinvest the proceeds of any sales right away to keep your stock exposure on target.

You might also keep some cash around, or have an alternate source of liquidity. It is easier to remain sanguine during downturns if you know you can pay the bills. Either holding onto some cash or having an untapped home equity line of credit can help solve short-term liquidity crunches.

Finally, having a diversified asset allocation plan can help buffer your portfolio in a stock market decline. There are certainly times, like the downturn in 2008, when diversification is of less value, but holding a wide array of truly uncorrelated investments, including domestic and international stocks, high-quality bonds, real estate, and other alternative asset classes could help reduce the pain when stocks next decline.

They say death and taxes are inevitable. I would add economic and stock market downturns to that list. Short-term losses are part of investing. Without risk we wouldn't have any return. So, if you are in the market, take an honest look at your emotional state as it relates to your investments. How did you respond in the past when stocks went down? With the market still at relatively high levels, there is time to reposition your portfolio to better correspond to your state of mind.

For those willing to endure short-term risk and employ a few smart tactics to take advantage of downturns, there can be significant long-term rewards. However, if you are prone to emotional decisions, and can't resist the urge to sell in down markets, it would be better to get more conservative now.

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