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Playing the long game can earn your portfolio big rewards

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VIEWPOINT
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The song "Mr. Bojangles" is a staple on radio stations that feature songs from the 1970s, even though it was written in 1968. Most of us have heard the popular version, by the Nitty Gritty Dirt Band, which hit No. 9 on the Billboard charts. However, the original version by upstate New York native Jerry Jeff Walker is still relatively obscure.

"Mr. Bojangles" recounts an experience Walker had when he was sitting in a New Orleans jail after being arrested for public intoxication. It is a true story of a talented homeless man with whom Walker shared the cell. In addition to reaching number nine on the charts, the song has been covered by diverse musical heavyweights such as Bob Dylan, John Denver, Neil Diamond, Whitney Houston, Sammy Davis Jr. and many others.

In a 1998 article on Walker, the Dallas Business Journal noted that his albums typically sell 30,000 to 50,000 copies, not many by the standards of the artists noted above. So it's fair to say that commercial success from record sales has not been a great source of wealth for Walker, despite spending his life as a professional musician. Public information isn't available, but royalties on just "Mr. Bojangles" alone have probably accounted for more income than all of Walker's records combined.

Do you think when Walker was in his Louisiana jail cell he was thinking about how that episode would be pivotal in his life? Probably it wasn't a "wake up call," since he was an admitted alcoholic and didn't stop drinking until many years after his legal skirmish. Interestingly, what likely was a bad day for Walker actually turned out to be an opportunity that would set him up financially for the rest of his life.

We may not be "down and out" today the way Walker described his circumstances in the song. However, today's environment of sickness and economic decline is certainly challenging for many. It has also taken a heavy toll on the capital markets.

As of this writing, the stock market has fallen over 35% from its peak in February. That's a painful drop, and it may get worse. The worst historical bear markets have seen stocks drop by around 50%. Despite the magnitude of their drops, a characteristic that 100% of historic bear markets have in common is that they eventually ended. And when they ended, stocks tended to experience some of their best returns coming off those bear market lows.

The best way to participate in this is to not sell out of the market. Just like Woody Allen's rule for success, showing up and being in the market will account for a lot of the ultimate returns you achieve. That can be difficult emotionally when the markets are rapidly declining, and your account balances keep shrinking. However, the best investors are made during these periods.

Warren Buffett famously invested $5 billion in Goldman Sachs in 2008 while similar investment banks were literally going out of business. He was able to negotiate terms that mere mortals wouldn't have access too, such as preferred shares with a hefty 10% dividend and a large chunk of warrants to buy additional shares at an attractive price. However, his courage in the face of financial turmoil is what mattered. Buffett's ultimate total return on the trade is difficult to calculate since terms were ultimately renegotiated, but suffice it to say he made billions. It is certainly an advantage to have $5 billion in idle capital when stocks are down, but even more modest individuals have the opportunity to profit handsomely from market downturns if we have the risk tolerance to get in or stay in the game when things look the worst.

Beyond just being present to participate in the markets, there are deliberate moves you can make to improve your odds of financial success. The first is to realize every loss available in the taxable portion of your portfolio. It may seem contradictory to advise selling stocks, but just because you sell doesn't mean that you have to be out of the market. Doing tax swaps by selling investments at a loss and immediately repurchasing similar (but not identical) investments can keep your portfolio exposures in place but net you significant tax benefits. These losses can be used to offset capital gains and modest amounts of ordinary income. They also carry forward indefinitely and can be used to offset gain and income in the future.

Another approach is to identify the most attractive market segments and buy them when they are at their cheapest. What if you could buy an investment that has historically outperformed the overall U.S. stock market by 2.5% annualized over the past nine decades? What if this investment was trading at a historically low valuation? Would you buy it? Most people wouldn't when they realize that I'm talking about value stocks, and that they have underperformed the overall stock market for the past 10 years. However, for true long-term investors, such a scenario is a dream come true. Not only have value stocks outperformed the market over long stretches, but their subsequent gains have been even more impressive after long periods of sub-par performance. It is uncomfortable to buy into something that has underperformed for ten years but having the courage to seize these types of opportunities is how many of the investment greats have made their money.

A recent white paper from institutional investment firm GMO points out that the U.S. stock market has never suffered a permanent impairment of capital from starting points when the market was trading at a long-term price-to-earnings ratio of 13 or less. Even with the recent downturn, U.S. stocks still trade at a long-term P/E of around 25, well above its historic average. So, the overall stock market may not be cheap, but much of the rest of the world is. Valuation ratios for the developed international world are less than 15 times earnings, and for the emerging markets they are even lower. Since international stocks have been poor performers relative to U.S. stocks in recent years, they may also be difficult to stomach, but they will likely experience strong returns in the coming decade.

Good investing can be hard, but great investing takes an almost inhuman amount of emotional control. It is easy to look at the recent past to make decisions, but it is wise to remember Wayne Gretzky's advice to "skate where the puck is going, not where it has been." The best returns often come to those who are able to turn their worst days into their best days, just like Walker. So, while your portfolio may be down, this just might be the opportunity that sets you up financially for the rest of your life.

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