In The Grasp of the Bear, 2020

Saturday's With Jim

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Dear Friends,

We have no claim to calling the exact beginning or the end of a bear market where stock index losses run 20% or more from the prior highs. But we do have control over how much of the market loss we will experience. Today we project into a gloomy time where the big gains of the last eight years are all but forgotten and markets are down 25% and threatening even more mayhem on stock investors.

Why We Own Stocks If They Can Disappoint Terribly

We own stocks because over the long run their prices track the earnings of the companies which issue them and the earnings track inflation plus anywhere from about 3% to 8% a year. So why are stock prices so volatile over days, weeks and months? Earnings can't be known except after they are announced and in the short run investor reaction to news and events causes stock prices to bob like corks, most times without much direction. Moreover, today's icon company may well be made irrelevant by technology and other innovations. In short, common stocks are great inflation beaters over decades, but they come in a boom-bust wrapper. Complicating the matter further, investors' herd mentality causes them to take stocks to great heights when some great story pushes stock prices parabolically up, only to see the bottom fall out when the bubble pops. All negatives aside, a diversified portfolio of common stocks protects against losses arising from a few failed stocks while gaining the performance of the overall market, more or less, and a handy risk premium over bonds to boot. But all of the good about stocks is thrown into dim memory when investors show anguish and despair when they are in the grips of a one or two year bear.

The Importance of Buying Right and the Greater Importance of Staying Calm

Suppose we started with $100,000 in 2002, at the bottom of the last bear market. By 2007, when the bear was tiring, we would be up well over 100% to about $220,000. Even if accounts dropped 25%, we would still have $155,000 – up 55% from the 2000 low. On the other hand, if we became fully invested at the top of the market in 2007, our $100,000 would have shrunk to $75,000. Looking at the difference between $155,000 and $75,000 brings home the message that not only must we stay calm as stocks are dropping, we must be highly selective about the prices (valuations) we pay for our stocks at ALL times.

Asset Allocation and Valuation Management to the Rescue

The following technique keeps us invested in good and bad times. We have found that the key to long-term investing lies in matching our needs and tolerances with the mix of stocks, bonds, real estate and cash that will likely get us to some set objective, without causing us to sell in despair at the bottom of a bear market in stocks. With "the right stuff" we can weather just about anything the market throws at us.

But We Do a Bit More

We are "business cycle" investors in that we adjust our stock, bond and cash allocations according to the progress of the business cycle from boom to bust. This means that, as the business cycle expands causing the economy to grow, we will be a bit more invested in stocks than we would be if the business cycle were falling from a high. The tweaks aren't much, but they will cause us to do just a bit better than the asset allocation would suggest when the business cycle is rising and when the business cycle is falling. In other words, we are more invested in stocks in good times and less invested in stocks in bad times.

So what?

The greatest mistake investors make, we think, involves setting their accounts according to the investment mood of the day while ignoring their capability and emotional makeup to withstand loss. Inevitably, failing to follow their needs and tolerances will result in disappointment, perhaps disappointment so severe as to keep them from investing ever again. "Know thyself" and behave accordingly offers disaster prevention. Being invested at all times in tune with the preventive measures we have discussed in this note is the first and most important step an investor can take.

We are grateful that you chose us to facilitate your financial journey. Thank you for investing with us.

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