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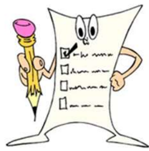
FINANCIAL PERSPECTIVES



Panic is Not an Investment Strategy

Data by Schwab Center for Financial Research
By Liz Ann Sonders
March 10, 2020

If markets are good at one thing, it's reminding investors that stock prices don't simply go up, uninterrupted, forever. Markets decline. It's an unavoidable part of investing. What matters is how you respond. Or, more to the point, how you don't respond in some cases. If you've built a portfolio that matches your time horizon and risk tolerance when markets are calm, then a surge in turbulence may not feel so devastating.

That's not to say you should never respond to market moves. Rather, it's more of a reminder that good planning is like a pre-emptive dose of Dramamine—it can help neutralize some of the nausea before the turbulence hits.

Panic and greed

When it comes to panic, the most obvious example is trying to sell investments when the markets are dropping. This is a great way to invert the adage about buying low and selling high. Never has information about the global economy and markets been more readily available and disseminated. As a result, global markets have become more interconnected. In turn, our reaction mechanisms are heightened—but not necessarily to our advantage. Investors should rarely, if ever, react in a purely emotional fashion to a dramatic move in the market.

As we saw when this year began, greed can also lead us astray in several ways. First, there's the temptation to load up on aggressive higher-risk assets in the hope of a big payoff. But there is a dark side to an aggressive posture's potential higher returns: the risk taken in getting there. Aggressive portfolios' higher historical returns have had a much wider range of returns—that is, a higher standard deviation, with greater "drawdowns," or peak-to-trough declines, and volatility. And most importantly, those higher returns typically are generated through "stick-to-it-iveness," not lucky bets.

Then there's the temptation to try to "time" markets. It's enticing to try to catch the next big investment wave (up or down) and allocate assets accordingly. But there are very few time-tested tools for consistently making those decisions well.

The time-tested and oft-expressed adage of "time in the market is more important than timing the market" is relevant to highlight in these trying times. As you can see in the chart below, using the S&P 500 as a proxy for the U.S. equity market, an investor in that index would have seen diminished returns by simply "missing" some of the best single up days.

Time in the Market is More Important Than Timing the Market

Source: Schwab Center for Financial Research with data provided by Standard and Poor's. The example is hypothetical and provided for illustrative purposes only. Return data is annualized based on an average of 252 trading days within a calendar year. The year begins on the first trading day in January and ends on the last trading day of December, and daily returns were used. Returns do not assume reinvestment of dividends and the example does not reflect the effects of taxes or fees. When out of the market, cash is not invested. Market returns are represented by the S&P 500® Index which represents an index of widely traded stocks (purple bar). Top days are defined as the best performing days of the S&P 500 during the seventy-year period. Indices are unmanaged, do not incur fees or expenses, and cannot be invested in directly. For more information, please see Schwab.com/Index Definitions. Past performance is no indication of future results.

Taking the analysis above to a more detailed level. We know that large drawdowns in the stock market test the mettle of investors' fortitude. Those who are fear- and greed-oriented are more likely to sell into major drawdowns; and to the extent they take an "all-or-nothing" approach by trying to "get out" (or "get in") they risk missing some of those best days. In fact, as you can see in the table below, most of the best single days in the post-1950 history of the S&P 500 came either during bear markets or immediately following major drawdowns (when the "get out" investors likely already sold). In fact, of the 20 single best days for the S&P 500 since 1950, 15 of them came during bear markets; with all five of the occurrences during bull markets coming immediately after large drawdowns or bear markets that had just concluded.

Top 20 S&P 500 days (since 1950)			
Date	Daily return (%)	Bull/Bear	Prior to rebound, S&P 500:
10/13/2008	11.58	Bear	dropped -15% in prior week alone; in midst of bear market
10/28/2008	10.79	Bear	dropped -11% in prior week alone, in midst of bear market
10/21/1987	9.10	Bear	down nearly -30% in prior week
3/23/2009	7.08	Bull	recently concluded -57% bear market
11/13/2008	6.92	Bear	in bear market of Global Financial Crisis; no bottom until March 2009
11/24/2008	6.47	Bear	in bear market of Global Financial Crisis; no bottom until March 2009
3/10/2009	6.37	Bull	just concluded -57% bear market
11/21/2008	6.32	Bear	in bear market of Global Financial Crisis; no bottom until March 2009
7/24/2002	5.73	Bear	down -48% from March 2000 high
9/30/2008	5.42	Bear	in the midst of a -30% drop from October 2007 high
7/29/2002	5.41	Bear	down nearly -40% and attempting to stabilize
10/20/1987	5.33	Bear	down nearly -30% in prior week
12/16/2008	5.14	Bear	in deeper bear market after rebound attempt; no bottom until March 2009
10/28/1997	5.12	Bull	down -11% in same month
9/8/1998	5.09	Bull	down -18% in prior three months
5/27/1970	5.02	Bull	just concluded -36% bear market
1/3/2001	5.01	Bear	down -16% from March 2000 high
12/26/2018	4.96	Bear	down -20% in prior 4 months
10/29/1987	4.93	Bear	stabilizing in aftermath of Black Monday
10/20/2008	4.77	Bear	stabilizing but still off October 2007 high

Source: Charles Schwab, Bloomberg, as of 3/9/2020. This example is for illustrative purposes only. Bull and bear markets classified using rounded +/-20% changes in S&P 500. Note: March 2000-October 2002 and October 2007-March 2009 are considered bear markets. Past performance is no indication of future results.

As Liz Ann Sonders says, “Are you telling investors to get in or get out?” Neither “get in” nor “get out” is an investment strategy. They simply represent gambling on moments in time, when investing should always be a process over time.

As we’ve seen this year, greed can quickly pave the way to panic. Investors may think they understand their risk tolerance—until they don’t. There’s a big difference between financial risk tolerance (the ability to financially withstand volatile markets) and emotional risk tolerance. The gap between the two is often quite wide and only becomes evident in tumultuous market environments.

Relying on the rearview mirror

Too often, investors use a rearview mirror to make investing decisions, treating past performance as a guide to future results. Many aggressive investors have learned the hard way that they had a lower tolerance for a big loss in the short term than they thought. And to maintain their aggressive allocations via rebalancing, they generally had to double down on the asset classes that generated those steep losses and shift away from the asset classes that had weathered the storm.

Conservative investors should heed the lesson, as well. A conservative portfolio's lower historical returns have come with significantly less-severe drawdowns and volatility. For some, the lower return is worth the sleep-at-night benefits. But the reality is that many investors want all the upside when markets are performing well, but none of the downside when they are not. That is highly unrealistic.

One of the most important areas where FMA helps our Clients is the financial advice we provide in assisting them in the development of a long-term strategic asset allocation plan specific to their financial needs, and emotional and financial risk tolerances.

Admittedly, the development of a long-term strategic asset allocation plan isn't the hard part—it's sticking to it that often becomes the real challenge. That can be especially difficult when markets are volatile. But if we use our brains over our hearts, we can expect a more successful investing future.

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