

# Quality Asset Management

*Grow Your Wealth with Peace of Mind*

## “This Time it's Different!”

*By Gil Hanoch, July 6, 2006*

Have you ever heard someone say, “This time it's different! This time the stock market may not recover from the recent declines?”

Throughout recorded history the stock market never declined without a full recovery. How is that possible? In order to answer this question, we need to understand what a stock is. A stock represents ownership in a company. In order for a highly diversified portfolio to decline without recovery, the concept of companies should stop working. This requires people to prefer to build their own homes, manufacture their own cars and grow their own food.

By now it is probably clear to you that there is no real risk for an irreversible decline. But our basic instincts keep leading us to expect declines following declines. This is the result of a psychological bias that makes us put more weight on the recent history when trying to understand long-term trends.

This is a natural human instinct. We tend to prepare for earthquakes just after living through a big one. We prepare for floods after our home was flooded. Similarly, we expect declines to continue, possibly without recovery, just after a decline has started.

It is as illogical as it is natural to expect this. The stock market tends to go up and down in value in a cyclical way. These cycles vary in length and magnitude and have no predictable pattern, so you cannot predict the near-term future based on the recent past. If you want to make the most thoughtful bet on the future change, it would be a reversion to the long-term average. This principle worked during all past declines and is the one principle that agrees with the idea that people like using companies to make life easy.

Once you understand this idea you can live relaxed through all market declines. But in addition to peace of mind, there is a large financial benefit. When the stock market declines, many people are unable to fight their human instinct, and sell stocks after they declined in value. At the same time, investors that understand the cyclical nature of the stock market, make an extra effort to buy during the decline periods. This can be financially rewarding beyond any imagination; the bigger the recent decline the bigger the reward. The next article will review how the portfolio Long-Term Component by QAM could be used to multiply people's money at unheard-of speeds during the worst declines.

Note that the recovery tends to be most dramatic in its early phases. As a result, people who wait to identify the bottom before buying in, usually give up most of the gains compared to people who buy as soon as they have the extra long-term money in their hands.

Since we have never experienced an irreversible decline in the stock market, and having one in the future is against the human nature of wanting to get things done easily and cheaply, the risk for it is nearly nonexistent. If you have the urge to worry about something, you can focus on more likely risks: an earthquake, flood, fire, sudden death and plenty of other rare but possible catastrophes. Otherwise, you can just enjoy life, while seeing your money grow rapidly – not every day, but over the long run.

### **Caution:**

1. The discussion above is based on holding a highly diversified portfolio, while making no changes based on any type of analysis or predictions. Changes must be limited to rebalancing in order to bring the accounts in line with the intended portfolio allocation.
2. You should keep money outside the stock market (in cash or low risk bonds), to provide for your living expenses during significant recessions. This amount should be planned in

advance, specified in a written investment plan, and kept regardless of the market conditions. The recommendation to add money to the stock portfolio during declines refers only to money available beyond these reserves.

### **To Summarize**

Our basic intuition and instincts are our biggest enemies in investing! By setting them aside and using cold logic, we can benefit from financial peace of mind at all times. In addition we can enjoy enormous financial rewards if we happen to come by some spare money that we can invest for the long run during declines.

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