What would you do after a Steep Decline?

By Gil Hanoch, April 4, 2007

Close your eyes and imagine the following future. Over the next 2 weeks, your portfolio declines by 20%. You read the news trying to understand what caused such a rapid decline. There is no forecast for a recovery in the foreseeable future. This is what you learn:

1. Millions of Americans took mortgages that require only minimal payments in the first few years, and now they cannot afford to make the full payment. They defaulted on the payments and lost their homes. Some lost their investment homes and some lost their primary residence.
2. As a result, the market was flooded with homes for sale and the real estate market crashed.
3. Homeowners who were able to keep their home have a lot less equity in their home, if any. They cannot take more loans, and they have no money for discretionary spending.
4. As a result, the whole economy is heading into a recession.

As you are debating about how to deal with the situation, the decline is going on uninterrupted. A year passes, and the portfolio is down 50%. You go back to the news to assess the situation, and it looks worse:

5. We are officially in the midst of a recession. Corporate profits are low, unemployment is up.
6. The tension with Iran is increasing. There is a real fear of war.

You hold onto your investments, checking the news daily, hoping for a solution to come, but things get worse. Your portfolio just reached a 60% decline! The explanation:

7. The world is consuming a lot more energy, while the tensions with major oil exporting countries are only increasing. There is a rapid increase in oil prices. The price per barrel just crossed $150 (up from $60), resulting in a collapse of economies all over the world.

You see in the front page of the investment magazines: **"We are facing a New Reality"**. "We have never seen anything like this before. A new reality requires a new way of thinking and planning." People are rushing to rescue the rest of their money from the declining stock market.

What would you do? Before reading the answer, please try hard to envision this situation. Try to digest all the emotions, information, news and talks around you. How would or should you handle this situation? Would you sell your whole stock portfolio to stop this stress and the very real risk of further declines? Would you sell part of the portfolio? Is it smart to keep holding on to the portfolio as it is going straight down?

I should emphasize that this scenario is very possible. There is no reason to think that each of the things above could never happen. There is also no reason to believe that there will not be declines worse than we have seen in the past few decades. The big question is: Did your investment plan take into account such a possibility? Should you keep following it blindly?

Answer. As long as you have a well thought out plan, you can do the following:

1. Avoid obsessing about the news in order to get investment solutions. Your well crafted plan should be the only answer to your investments. Listening to the news very frequently and reading investment magazines that track recent events will not do any good for your investments and is definitely not good for your health.

2. Open your investment plan and read what it says. It should specify how to deal with recessions. Specifically, for QAM clients, it should specify a certain amount that you should keep in reserves for recessions. If you have more than the amount specified, and don't intend to spend it soon, add it to the portfolio. If you have less and no source of income to replenish it, it's fine. For any cash needs beyond your income, you should use the reserves, until the portfolio recovers. Once it recovers, you sell enough of it to replenish your cash reserves.

Why be Optimistic? Please refer to the article " Should you sell your declining stock?" (Hanoch, May 2005) for a detailed explanation for why globally diversified portfolios are always expected to recover.

There is no way to know for sure how long declines can continue despite the continued production of companies. The good news is that the longer or deeper the declines, the faster they are likely to reverse and the bigger and quicker the increases. The more the portfolio declined, the more it makes sense to hold on to it.

In addition, by holding a globally diversified portfolio that reflects whole economies all over the world and avoiding any type of stock selection or market timing, your portfolio declines are likely to be shorter than average.

Test yourself. Look at your investment plan. If you are thinking: "This is my investment plan for normal times, but there are always cases that we cannot anticipate and that require different thinking", you are setting yourself up for failure. It is too late to plan when you are in the midst of a crisis. You are not only emotionally biased, but you may be in financial trouble if you did not keep enough money outside the stock market, *before it declined*.

For every $4,000 you take out at a 60% decline, you pay an additional $6,000 penalty (that's 150%). Explanation: $10,000 declined to $4,000. When taking out $4,000 after the decline you paid a penalty of $6,000. You should keep enough cash in reserves for you to feel comfortable not withdrawing from your stock portfolio during the worst declines, unless there is no alternative. **If you have any doubts, you are not keeping enough in reserves, or you do not understand your plan.**

Peaceful Investing! Once you set the plan right, you will realize that there are no "New Realities" and there is no need to check the news or reassess your plan for a 5% or even 50% drop. You will not be caught by surprise with declines and will not panic when they happen. You will just accept them as a part of life and go on with your life. If you are lucky enough to have spare income during these declines, you can even make profits of 100% or more during the 2-3 years of recovery, by adding money to your portfolio in the midst of the declines.

CAUTION: This article refers to globally diversified stock portfolios that stay unchanged (other than rebalancing to the target allocation) throughout all market conditions. The results are not likely to be true when using individual stock selection or market timing. In addition, this article refers to plans written by QAM – different investment plans are likely to require different actions.