

Quality Asset Management

Grow Your Wealth with Peace of Mind

Sell or Buy?

By Gil Hanoch, October, 2008

Updated February, 2011

You are in the midst of a severe decline, with a combined length and magnitude that tend to occur a few times in a lifetime. People are in panic. According to the news, you expect the decline to continue for a very long time, and everyone you know is rushing to sell whatever is left of their stock investments. Should you sell?

Target Audience: This article limits the discussion to stock market investors, not speculators. Investors use the long-term growth of stocks to provide them with long-lasting income, as follows:

Stock investor: Invests globally in thousands of companies across sectors, with no individual stock selection, and limits annual withdrawals to a small percentage of the portfolio (for QAM's Long-Term Component – 4% of the peak value of the portfolio).

All QAM clients are investors, since QAM refuses to speculate with their money. Two typical groups of investors are:

1. Young people that need to build a nest egg for their retirement.
2. Retirees that need current income throughout their retirement years.

Discussion: Investors had abysmal experiences in trying to time the stock market (the topic of the next article). When dealing with your life's savings, and when counting on them for your daily livelihood during retirement, you cannot afford to try to guess the turning points of the stock market.

Instead, you can benefit from companies that provide the world population with products and services as cheaply and efficiently as possible. Given that people have not changed their preference for getting these products and services in the most efficient way, the system should keep working, and you should keep enjoying its benefit without speculating on the turning points of the different stages of the business cycle. Now we discuss a few important factors that should keep you strong and relaxed through tough declines.

Government stimulation: After the painful experience of the Great Depression, the U.S. government and many other governments learned that during declines the smartest thing for it to do is stimulate the economy. Note that this principle was adopted by post World War II U.S. governments, regardless of the party in power. It is done in many ways, including reducing interest rates and providing substantial loans and investments that help keep the economy going.

To finance this activity, the government issues bonds that are essentially long-term loans. Given the long-term growth of the economy, the government eventually collects the money to repay its loans. This has proven to work throughout the U.S. history with a track record of no defaults on government loans. This tremendous security, combined with the great fear of the stock market, leads people to buy government bonds en masse right in the depth of stock market declines. As a result, the government is able to raise substantial amounts of money to shore up the economy, at a very low cost (low interest rates on bonds).

The cost of not selling: If you depend on your stock portfolio for current living expenses, it might seem painful to sell at such a decline, and it might seem even scarier to think about the cost of withdrawals if you keep your money invested throughout a prolonged decline.

Let's analyze the cost for Long-Term Component in an extreme case, substantially worse than anything seen in the past 40 years:

1. A 5-year decline averaging at 33% (compared to the worst period as simulated – in 1973-1975: less than 3 years with a bottom of about 40% decline and an average decline of less than 20%).
2. Annual withdrawals of 4% of the peak value of the portfolio.

The damage:

- Each dollar withdrawn at a 33% decline costs 50% extra ($=100\%/(100\%-33\%)-100\%$).
- Therefore, each 4% annual withdrawal costs an extra $4\% \times 50\% = 2\%$.
- In total, the 5-year withdrawal costs an extra $5 \times 2\% = 10\%$.

This dooms-day scenario costs 10% of your portfolio, less than its average growth in a single year!

The benefits of not selling:

1. Given that the economy keeps working in good times and in bad times, declines tend to follow with rapid growth that makes up for the lost time and value of the stock market. Historically, we've seen that the longer and deeper the decline, the more impressive the recovery.
2. You already experienced a lot of the pain. From this point you, most likely, have a lot further to go up than down. For example, if you are at a 30% decline that will bottom at 40%, your current investment:
 - a. Will bottom at an additional **14%** decline ($=100\%-(100\%-40\%)/(100\%-30\%)$), but
 - b. Will go up by **43%** ($=100\%/(100\%-30\%)-100\%$) by the time it recovers.

Conclusion: Stock investors (as defined above) can support their goals more by buying rather than selling at a decline. Since you cannot predict the performance of your portfolio in the next few months, you should stick to your long-term plan and keep the split to stocks vs. bond/cash reserves as stated. Specifically,

1. If you are working and have extra money to save, you can benefit greatly from investing it.
2. If you are retired, you can continue with your limited periodic withdrawals, and continue to enjoy your retirement years with great peace of mind.

Summary

If you are a responsible investor in the stock market, whether you have a time horizon of 30 years, or you depend on your investments for current retirement living (at limited withdrawals, depending on your portfolio), you can benefit from the tremendous power of the world economies to support your financial needs. You can leave the emotional swings of stock investing to the speculators. Instead, you can focus on your daily activities with great peace of mind throughout all market conditions.

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