

Quality Asset Management

Grow Your Wealth with Peace of Mind

Asset Allocation during Declines

By Gil Hanoch, April, 2009

When you face a substantial decline in your portfolio, it becomes tempting to keep the money in cash until the recovery begins. The greater the decline, the greater the temptation. Watching the news and reading economic analyses makes it even tougher to stick to your long-term plan. As demonstrated in the previous article, "Can You Avoid Market Declines?" (Hanoch February 2009), finding the bottom of a decline is virtually impossible. The problem is compounded by the difficulty in buying back when the portfolio is lower and the economic atmosphere is worse. Fortunately, if you established a well thought-out plan in advance, you may not need to face this temptation.

During declines, people try to reduce "Market Risk" – the risk of a decline in stock prices. There are two additional risks that should always be considered as well: "Inflation Risk" – the risk of losing purchasing power over time, and "Longevity Risk" – the risk of outliving your money. As you will see below there is a clear tradeoff – reducing market risk increases inflation risk and longevity risk.

The reason for the smaller focus on the other two risks is the eagerness to deal with the current pressing problem, and the need to feel in control. Since the latter two risks are not imminent, people tend to neglect them in favor of market risk.

The best way to deal with market risk is to sell some stocks. If the plan was not designed in advance to prepare for substantial declines, this is an unfortunate necessity during a decline. When done, it should be a cold and rational decision that is followed in the long run, especially as stock prices go up. The desire to get back in the market as economic conditions improve is likely to lose you money and increase your inflation and longevity risks. Let's review these now.

Inflation Risk: During severe declines, governments (both democrat run and republican run, each with their own emphasis) tend to stimulate the economy, and create the risk of inflation in upcoming years. If you hold cash or bonds during this period, you risk losing your purchasing power, since an investment that is free of market risk is almost guaranteed to lose money after taxes and inflation. This means that while maintaining the stock allocation can result in a number of years until recovery, cash or bonds are not likely to ever recover your losses.

Since inflation is the increased prices that companies charge for their products and services, company ownership (stocks) is the best way to protect yourself from inflation risk.

Longevity Risk: By selling stocks during severe declines, you realize the substantial losses, but risk missing out on the gains during the recovery. As a result, you risk outliving your money. If you maintain the lower allocation to stocks in the long run, the loss in purchasing power of your cash and bonds increases the risk of outliving your money.

By keeping your money in stocks, you miss the speculative opportunity to outperform your stock portfolio, but you also ensure that you gain the impressive long-term after-costs returns of stocks.

Conclusion

If your annual withdrawals from your portfolio are conservative (e.g. 2%-5%, depending on the portfolio), and your portfolio is globally diversified, with no individual stock selection or market timing, you may be facing greater inflation and longevity risks than market risk, especially during declines in your portfolio. In such case, you may want to think twice before selling stocks and changing your plan.

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