

Quality Asset Management

Grow Your Wealth with Peace of Mind

A Strategy for Avoiding Stock Declines during Recessions

By Gil Hanoch, June, 2009

Can you think of the easiest way to avoid continued stock-market declines, during a recession? This article presents the most common strategy, based on ideas from various investors. It guarantees that you stop your stock losses, and you are likely to feel a big sigh of relief. There is one catch – read on for details.

The strategy has different variants, but the basics are common and are very intuitive:

1. Follow the economic news. Whenever you hear concerns about the economy start selling your stock portfolio. If it seems like we are getting into a deep recession, sell your whole portfolio, until things look better.
2. Keep following the economic news. Once the economists become more positive, start buying stocks. When the economic outlook looks really good, make sure you are invested heavily in stocks.

The benefits of this strategy are easy to identify:

1. Whenever the economy is doing poorly and you hear gloomy news on a daily basis, you get to be outside the stock market. You can smile seeing your accounts retaining their value, while people around you are nervous about their investments.
2. When everyone is optimistic, you get to have your money in the stock market, enjoying being invested when there is such excitement around.
3. At all times, you can feel good about your actions. Not only are they intuitive – many people around you are acting the same way, providing a great support network.

There is one big catch: The stock market does not go up and down together with the economy and the sentiment on the news. It tends to precede the economy by 6-12 months. Whatever news you hear is already reflected in stock prices, and only the unknown affects the stock market moving forward. As a result:

1. When you hear about the economy doing poorly, the stock market is already down substantially. When you learn that we are in a recession, the stock market tends to be past most of its decline. For example the 2008 recession was announced by the National Bureau of Economic Research on December 1, 2008 – close to the stock market bottom.
2. When there is optimism, the stock market has already experienced a substantial portion of the recovery.
3. Given the predictive nature of the stock market, bottoms tend to be reached at the moment of greatest pessimism. By selling on pessimism, you are likely to sell low. Optimism and comfort are reached when the stock market is much higher.

The strategy presented virtually guarantees that you sell low and buy high! While it provides great psychological comfort, it comes at a price of giving up some of the greatest run-ups in stock prices in history, and getting substantially reduced long-term returns.

For example:

1. On December 9, 1974, the cover story of “Time” magazine, “Recession’s Greetings” was very gloomy. A year later, the Dow Jones Industrial Average was up 47.7%, with a new “Time” cover story: “U.S. Shopping Surge”.
2. On March 10, 2009, there was great pessimism about the world economies as the stock market hit bottom. A couple of months later, the globally diversified portfolio, Long-Term Component, was over 50% higher, as there were some initial signs of optimism.

Summary

It is easy to invest in a way that feels good. This article provides the guidelines for that. Unfortunately, doing what feels good bears a large price tag on your investment performance. You have to make a choice between what feels good for you and what is good for you.

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