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Riding Out Turbulent Seas

With all the market turmoil, we wanted to reach out to our friends and clients to discuss portfolio safety. While steep market losses are never pleasant, they are unfortunately a part of life. On average, markets go down on almost half of all trading days, and even well diversified portfolios will lose money in about one third of the years. Fortunately, in the long run, such losses are rarely important when following a long-term investment strategy.

In these times, it is important to focus on long run goals. For example, even investors in their 70s will have some of their money invested for 30 or more years. Worrying about short-term losses for investments that will be held for decades can lead to bad decisions. Investing in the stock market is analogous to crossing the ocean. If one must dodge every wave, one is traveling in the wrong ship. It's better to plan for travel in a ship that is designed to withstand the waves and make the long journey. The rough seas may not be pleasant, but with a safe ship that is designed for the purpose, we should be confident we will reach our destination.

Constructing the Sea Worthy Ship

Part of the process of building a safer long-term investment strategy is developing the proper mix of assets. While stocks were hammered yesterday, bonds did pretty well for the most part. Below is a screen shot that shows the value of a stock investment and the value of a bond investment over the last three months. Notice that when stocks took a dive in the last few days, bonds actually moved up. During the 2008/2009 market crash, bonds had some of their best returns. Mixing various types of stocks and bonds can dramatically improve the odds of achieving long-term goals. Sure, bonds typically do not have high average returns, but we are building a sea worthy ship, not a speedboat. Determining the proper mix of bonds and stocks (and other assets) requires a precise understanding of how long the money will be invested, the goals of the investor, the investor risk tolerance, and a solid dose of statistical analysis.

Another strategy we follow at Guideway is to stick with simple domestic asset class indexes, rather than encourage a separate component of international investments. While this idea may be contrary to popular practice, our reasons are multi-fold. First, globalization is making international assets behave more like domestic assets. Similarly, domestic companies are deeply invested in foreign operations. Not recognizing or accounting for the degree of international influence already present in domestic stocks could cause an overextension in the sector if other international funds are also purchased. A very large part of the S&P 500 revenues comes from overseas operations, thus US companies are similar to a global mutual fund. Finally, the historical record of international funds is far too short to make reliable long-term statistical forecasts. A healthy 50-year-old couple must plan to be invested for at least 50 years. Making a 50-year investment plan with a fund that has 20 years of history is highly dubious. Unfortunately, it is a common practice.

Finally, the last part of putting together a reasonable portfolio is to keep expenses low. Imagine a stock portfolio that has earned 10% on average historically. There is a good chance future returns will be lower than past returns, so let's assume returns are about 7%. Inflation could easily be 4%, which would make the inflation adjusted return about 3%. If advisor and fund fees are 1.5%, that leaves only 1.5% for you. If, on the other hand, advisor and fund fees are only 0.5%, you would enjoy 2.5% of returns. That's 67% more. The point is that seemingly small fees can have large effects on a portfolio, which is part of the equation in riding out market volatility. Financial planners and advisors can be well worth the fees, but just be careful those fees are reasonable and in line with the value provided.

Again, we believe that building a ship that can withstand the waves rather than dodging the waves is the best practice. Just keep your Dramamine handy.

If you would like some help making your portfolio ship-shape, we offer a retirement fitness review for a reasonable, flat amount.