



## Advice to Investors: Sit Tight and Batten Down the Hatches

Published: January 23, 2008 in [Knowledge@Wharton](#)

The worldwide collapse of stock prices has many victims -- pension funds, insurance companies, hedge funds, financial services firms. But those are players who, if they are smart, have the wherewithal to withstand a steep sell-off. Some will even use short-sales or derivatives bets to profit on falling prices.

What about the small investor, the individual socking away modest sums for retirement or college costs? Should small investors rush for the sidelines? Or should they view this as a buying opportunity and plough more money into the market?

Neither, according to the majority of experts Knowledge@Wharton interviewed in recent days as the markets rushed downward: Wharton finance professors [Jeremy Siegel](#), [Richard Marston](#), [Richard Herring](#) and [Franklin Allen](#); Jack Bogle, founder of the Vanguard Group, the mutual fund company; and Princeton economics professor Burton J. Malkiel, author of *A Random Walk Down Wall Street*.



This is a single/personal use copy of Knowledge@Wharton. For multiple copies, custom reprints, e-prints, posters or plaques, please contact PARS International: [reprints@parsintl.com](mailto:reprints@parsintl.com) P. (212) 221-9595 x407.

While Wharton's Allen says investors would be smart to flee stocks for the safety of short-term Treasury securities, most of the others suggest that the best response is no response at all -- to sit tight and assume that, over the long run, stocks will continue to produce the inflation- and bond-beating returns they have for more than a century.

If a small investor were inclined to do anything, the best move would be to regularly adjust one's holdings as assets change value in order to keep to the desired allocation between stocks, bonds and cash, they say. "I think that the most obvious moves -- shorting financial [company stocks], loading up on emerging markets -- are already priced in such a way that they will not yield excess returns," says Herring. "I'm highly skeptical about the ability of most investors to predict turning points. I think most people would be best served by staying with their strategic allocations and rebalancing if market moves have taken them too far from their targets. Sorry, but it's perfectly standard advice."

### More Bad News to Come?

Allen, the gloomiest of the six, says the U.S. could plunge into a sustained downturn like the one that plagued Japan in the 1990s. "People thought things could get back on track very quickly and they didn't. That's one scenario that could happen here." He recommends a highly defensive position of shifting assets to short-term Treasury securities. Even bank savings may be unattractive because, while they are federally insured, customers could face delays in obtaining their funds after a bank collapse, he warns.

Allen worries that there is much more bad news to come as the credit crisis broadens from subprime mortgages to credit cards and other kinds of debt. The Federal Reserve, he notes, has repeatedly underestimated problems, first saying the subprime crisis was contained and then saying a recession could be averted. In addition, many institutional investors and financial firms are holding securities such as mortgage-backed bonds that are now impossible to value accurately, and it may be some time before

this confusion clears. "There's a lot of risk at the moment," Allen says. "I don't think people understand much what's going on."

While economic data is showing a slowdown in the U.S. and pointing to an ever-growing likelihood of a recession, that information is not of much use to investors, says Marston, adding that even if one knew the exact dates a recession would begin and end, it would not be possible to predict stock-market moves.

"In order to be successful in shifting towards cash and then back to stocks, we must first be able to determine whether we are indeed going into a recession," Marston notes. "We won't know that until about 12 to 18 months after the recession begins. That is the average time it takes the NBER business cycle dating committee to decide that a recession has begun." The National Bureau of Economic Research is the non-profit research organization that identifies recessions' beginnings and endings, always after the fact because of delays in collecting data.

"Even if we knew these dates, we would need to know when to leave the market and when to enter it," Marston adds. "Markets usually start falling prior to the start of the recession, but the lead time is variable over time. Over the last nine recessions, the lead time has varied from one to 13 months."

Typically, stocks start to rise before a recession ends, but in each of those nine recessions, from 1953 through 2001, the rebound started at a different point, from eight months before the end of the recession to, in one instance, 12 months afterward. Investors can take some solace in the fact that stocks do tend to rebound smartly from the low reached in or around a recession. Gains from the market bottom were 59%, 34% and 39% after the recessions of 1982, 1991 and 2001, respectively.

A second issue for investors, according to Marston, is whether there are tactical moves that can reduce a portfolio's risk. Some investors, he notes, turn to high-yield corporate bonds. Many of those appear particularly generous right now, offering yields of 10% or more compared to about 3.5% for the 10-year U.S. Treasury bond. But junk bond yields are high because bond prices have fallen -- so much so that investors have lost money on these bonds this year despite the high yields. Because growing numbers of high-yield bond issuers default during recessions -- fail to make the principal and interest payments promised -- investors have suffered deep losses on these bonds during the past two recessions.

In the stock market, certain sectors have tended to do better than others in past recessions, Marston says. Small-company stocks have typically done better than those of large companies, and value stocks have tended to do better than growth stocks. But it may be too optimistic to expect this now, he adds. Small and value stocks have had big gains in recent years, so it may be too late to buy them. Also, the value-stock indexes are laden with financial-services firms, which are currently being hammered.

Similarly, some investors think foreign stocks are appealing during recessions. Morgan Stanley's Europe Australasia and Far East index have beaten the Standard & Poor's 500 index in four out of the last five recessions, Marston notes. "But in most cases that was small comfort since both indexes fell sharply. So, bottom line: Sit tight and wait for the business cycle to turn up."

### **Stock Turnaround in Sight?**

Jeremy Siegel has stayed optimistic even as many other market experts have become gloomier. On January 21, a day before the Fed's surprise three-quarter-point rate cut, Siegel noted that the big stock sell-offs that day and the previous week might be signaling a brighter period to come. "I think we're getting close to a bottom," he says, arguing that the biggest drops tend to come "near the end of the cycle."

While many experts have come to describe a recession as a virtual certainty, Siegel thinks it may not happen. "I'm getting to be more and more in the minority at this juncture. I'm still saying we're not going to have one.... When you look at the real [economic] data, we don't see anything that says, 'Oh, my God! This is horrendous....' It looks like weakness, not recession."

He does see problems. A consumer-spending pullback or further troubles in the housing industry could trigger a recession, he says, and investors seeking signs of recession would be wise to pay close attention to employment figures. It will be bad news if job creation slows and unemployment rises.

Meanwhile, small investors should be invested for the long term and not looking to speculate on short-term market moves, Siegel says. From this point of view, a downturn is good. "Obviously, long-term investors always do better investing when the market declines, when there are better prices."

Currently, he says, stocks are relatively cheap and bonds are expensive, leaving many diversified investors with more of their portfolios allocated to bonds than intended. Hence, it makes sense to sell some bond holdings and buy stocks to get back on the asset-allocation target, he suggests, adding that real estate investment trusts "have gotten much more attractive now," and therefore deserve a small role in a diversified portfolio -- no more than 10%.

"There's no indicator that will tell you when the stock market is going to hit bottom," Siegel says, but he predicts that U.S. stocks will finish 2008 higher than they started it.

### **Keep Costs Down**

In the long run, says Princeton's Malkiel, investors cannot forecast market moves. Hence, they do best by spreading their eggs among many baskets, so that some holdings will rise as others fall. Many investors now watching their stock prices decline can find relief looking at their long-term bond holdings, which have risen in value thanks to falling interest rates.

One of the keys to finding success as markets fluctuate, he says, is to "recognize that costs matter a great deal. My own view is that the core of every portfolio ought to be indexed, with a very low-cost index fund." Index funds attempt to match returns of the broad market, or specific slices of it, rather than trying to beat the market averages through stock picking. Because they do not use teams of analysts and stock pickers, index funds have very low expenses.

"One can buy bond and stock index funds for approximately 10 basis points, or one tenth of one percent," Malkiel says, referring to the expense ratio, which is the percentage of an investor's holdings siphoned off for fees. Many managed funds charge 1.3% or more per year, a seemingly small amount that can put a big drag on performance by dampening compounding.

"Investors should not panic at times like this, or do any kind of major alteration to a portfolio," Malkiel states, adding that "trying to time the market is a fool's game." Investors also should not count on past patterns always repeating, he says, noting that there is no such thing as a typical downturn. "Each is different from the others. I think that, normally, some of the financial services companies are thought of as defensive ... and that certainly is not the case now."

Malkiel isn't certain the economic slowdown will meet the technical definition of a recession, which is two consecutive quarters of decline in gross domestic product. "But if you think of a recession with a somewhat broader definition -- that things are slowing down dramatically -- that is certainly the case."

Will stocks finish the year higher than they started or lower? "I'm a random walker," Malkiel responds. "I don't think markets are predictable, and the only thing I would say is to repeat the line of J.P. Morgan when he was asked that question. He said, 'Stocks will fluctuate.' That's as far as I am willing to go."

### **Ignore the Market**

Like Malkiel, Vanguard founder Bogle believes no one -- small investor or pro -- can expect to call the market's ups and downs year after year. So he, too, advocates an index-investing strategy meant to duplicate the market's average gains over the long term. Vanguard's core business is index funds.

"First, understand that the stock market is a giant distraction to the business of investing," he says. Stock prices are likely to go somewhat lower, he adds, warning speculators trying to bet on such moves that they ought to get out now. But to long-term investors, his advice is to "ride it out. Don't do anything. That will probably be painful but it probably would be better than trying to guess *when* to get out," he says, referring to investors' tendency to bail out when prices are low and buy again when prices are high, reversing the basic rule of buy low, sell high.

He notes that the dividend yield on the Standard & Poor's 500 is about 2%, and that corporate earnings grow at an average of about 6% a year over the long term. Together, these two factors should provide

investors with average annual returns of 8%, which is more than they can earn in bonds or cash, he says.

Currently, the ratio of share prices to annual corporate earnings is about 18 to 1 for the S&P 500, according to Bogle. If that gradually falls closer to the long-term average of around 15 to 1, it could remove about 1 percentage point a year from stock market returns, leaving investors making a still-healthy 7% a year.

Bogle puts the odds of a recession at 75%. Among the big factors, he says, is the drop in home prices, which is curtailing consumers' ability to use home-equity loans and refinancing to free up spending money. "The consumer, of course, is king, creating about 70% of our GDP," he states, adding, "I think we're in for one of the more significant economic storms of the last 30 years."

---

This is a single/personal use copy of Knowledge@Wharton. For multiple copies, custom reprints, e-prints, posters or plaques, please contact PARS International: [reprints@parsintl.com](mailto:reprints@parsintl.com) P. (212) 221-9595 x407.