

November 2008

It's Always Darkest Before the Dawn

Overview: Bear markets almost always cause a strain to even the most iron-willed of investors. The intense media coverage accompanying such events seems to magnify the situation. At times like these, it may help to turn to history as a guide. The following discusses how markets have behaved in the past during difficult times.

It's hard to stay positive with so much going on. The stock markets are plummeting, taking with them the livelihoods — both present and future — of so many, including those closest to you. Companies are cutting back, downsizing or even shutting their doors altogether.

No doubt about it; these are difficult times. And possibly the worst news is that no one knows what the future will hold. The markets may stop their sliding and gain traction by the end of the year. They may be heading to the worst patch seen since the Great Depression (or possibly even worse). They may start the year with a bang and make the recent turmoil a quick footnote in history.

The truth is that all of us, investors and advisors alike, must look to history as a guide for what may happen in the future. No two bear markets are alike, but a common thread has been that the markets have recovered and come back stronger. And they have done so in the face of all the bad news, both regarding market performance and general economy indicators. Consider the following:

Market Performance

Since 1970 and prior to this past October, there had been 13 months when the S&P 500 Index (representing large-cap stocks), the CRSP 6–10 Index (representing small-cap stocks) and the MSCI EAFE Index (representing international stocks) all fell more than 7 percent. The average loss was –10.7 percent for the S&P 500, –14.3 percent for the CRSP 6–10 Index and –10.3 percent for the EAFE. Those who reached their GMO (Get Me Out!) point and withdrew from the market missed out on spectacular returns. In the subsequent 12 months, the S&P 500 returned 16.6 percent, the CRSP 6–10 Index returned 30.1 percent and the EAFE returned 13.2 percent.¹

It is important to note that the same has been true of stocks in emerging markets. Since 1990, there have been seven months when the MSCI Emerging Markets Index joined the three indexes mentioned above in falling more than 7 percent. During these months, its average loss was –13.3 percent. In the subsequent 12 months, the average return to the index was 28.4 percent.²

Unemployment

One of the most dominant figures being displayed right now is the nation's unemployment rate. In October, the unemployment rate hit 6.5 percent, and projections are calling for the rate to climb as high as 8 percent. (Some forecasts indicate it may go higher.) Such news may cause some to panic about their investments. However, consider the following from Ned Davis Research. When the unemployment rate has been higher than 6 percent, the S&P 500 has risen 15 percent per year on average. This compares with a return of just 2.1 percent per year in “good times” when the unemployment rate is 4.3 percent or lower.³

Consumer Confidence

If the Consumer Confidence Index (CCI) is an indicator of people's mindset during this difficult time, then things haven't been this bad in a very long time. During October, the CCI dropped to 38, its lowest level since the Conference Board began tracking the index in 1967. A natural reaction would be to think that stocks are going to continue to plummet. Historically, however, that has not been true. Prior to October, the CCI had fallen below 55 on 10 occasions. The average return of the S&P 500 during the 12 months following such a dip has been 16.2 percent.⁴

Recessions

The signs are everywhere that the country may be heading for a deep recession. A natural reaction may be to pull back on stocks and flee to safer investments. What will likely surprise many is that while the return to the S&P 500 was below its historical average, it was not only still positive, but it returned 7.4 percent, which is 2.3 percent more than the return on riskless one-month Treasury bills. Thus, if investors could have perfectly timed each recession — getting out before it began and back in right after it ended — they would have been worse off than if they had simply remained invested throughout the period.

Summary

Times like these are tough, and all the evidence in the world may not be enough to stem the pain of seeing so much hard-earned money seemingly fly out the window. The natural reaction is to want to do something. But what would it be? The problem is that no one knows for certain what the best course of action will be. Peter Bernstein, author of *Against the Gods: The Remarkable Story of Risk*, once said, “Even the most brilliant of mathematical geniuses will never be able to tell us what the future holds. In the end, what matters is the quality of our decisions in the face of our uncertainty.”⁵

The best things those feeling the pain of the markets can do is to talk to their trusted advisor about pursuing the best course of action. That course may include changing portfolio allocations if they discover they misjudged their ability, willingness and need to take risk. That course may mean adjusting goals to properly account for all that has happened in the past few months. That course may even mean doing exactly what they are already doing — remaining disciplined and adhering to their well-designed strategy.

¹ **Market Downturns: A Historical Perspective.** Dimensional Fund Advisors, June 30, 2008.

² Ibid.

³ Mark Gongloff, **Absent From This Downturn: Worker-Investor Dichotomy.** *The Wall Street Journal*, October 29, 2008.

⁴ **Investor Letter.** Heartland Funds, July 22, 2008.

⁵ Peter Bernstein, **Wimps and Consequences.** *Journal of Portfolio Management*, October 1999.

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