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FEATURE ARTICLE

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# Lessons From 2009

**Overview:** Each year, Larry Swedroe takes a look back at the investing lessons the markets provided in the past year. The market's early-year swoon and subsequent rebound in 2009 not only tested investor discipline, but also validated why prudent investing principles are important.

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Investors were likely relieved to see the markets end the year on such a positive note. Still, it is important to take stock of what has happened in the past year. Here are some lessons that the markets taught (or re-taught) in 2009.

**Tax-Loss Harvesting Is a Year-Round Job**

There is an old saying that "There's a time for everything and a season for every activity." While this may be true for activities like harvesting crops, it is not true of harvesting losses for tax purposes. Tax management is a year-round job, as 2009 demonstrated. While the bear market of January, February and early March provided investors with plenty of opportunity to harvest losses, those who waited until December to perform the activity likely lost the opportunity as many losses turned into gains. Portfolios should be checked all year, especially since short-term harvested losses can be the most valuable.

A loss should be harvested whenever the value of a tax deduction significantly exceeds the transactions cost of the trades required to harvest the loss, immediately reinvesting the proceeds in a manner avoiding the wash-sale rule.

**The Largest Gains Often Come When Least Expected**

While there were some pundits who may have called the timing of the bear market correctly, I am not aware of anyone who predicted that a great bull market would begin on March 9. And that should not surprise anyone.

Markets have often provided their greatest returns when least expected. Consider that from July 1932 through June 1933 (right in the midst of the Great Depression), the S&P 500 Index (then the S&P 90) returned 163 percent. Here are some other examples:

- After a negative year in 1934, the S&P index provided a total return of 133 percent from April 1935 through February 1937.
- 1953 was a down year for the market, but the S&P index provided a total return of 117 percent from October 1953 through November 1955.
- 1957 was another down year for the market, but the S&P index provided a total return of 55 percent from March 1958 through July 1959.

- 1973 and 1974 were terrible years for the market. Over the next two calendar years, the S&P index provided a total return of 70 percent.

Thus, the S&P 500 Index's rally of 67.8 percent from March 10 through year-end was certainly not unprecedented. Unfortunately, far too many investors were not there to earn those returns, as there was a net outflow of funds from the U.S. equity market in 2009.

**Once Investors Sell, It's Hard to Get Back In**

When the surf is rough, lifeguards place the red flag on the beach, warning swimmers not to go in. When it quiets down, the green flag goes up, indicating it is safe to go back in the water. Unfortunately, the same is not true with stocks — there are no green flags to let investors know when it is safe to buy again.

Consider the case of an investor who found out that he was overconfident of his ability to stand the stress of the kind of bear market we had in 2008. By November 20 of that year, he realized he had overestimated his willingness to take risk. He sold out of stocks with the S&P 500 Index closing at 752. His plan was to wait until the market had been up for more than 30 days (or when the green flag would be up).

With the S&P 500 closing at 903 at the end of the year (and having missed out on a rally of 20 percent), he bought again, believing that it was now safe to get back in. Unfortunately, the market dropped another 25 percent by March 9, and he had enough. He missed a tremendous rally.

Will this investor ever be able to buy again? One of the problems with market timing is you have to be right twice, not just once.

**Investors Buy Five-Star Funds, But Own Three-Star Funds**

One of the most common investment strategies employed by individual investors is to buy mutual funds highly rated by Morningstar. However, these investors forget that past performance is not a predictor of the future. Consider the performance of domestic equity funds with five-star ratings:

- The five-star class of 2004 carried a five-year rating of slightly more than three stars by 2009.
- The 2005 group did slightly worse, with an average rating of 3.05 stars for three years.
- The 2006 group now had an average rating of less than three stars for three years.

Why do people ignore the SEC's warning on mutual fund performance? The bottom line is that using Morningstar's ratings system is like driving while looking through the rearview mirror.

**Summary**

Whether the markets are doing well or poorly, they are always providing important investing lessons. Investors would do well to ensure that these lessons are properly addressed in their investment plans.

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