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Reflections on Recovery: Rejecting the Banker's Offer

by Matthew S. Olver, CFP®, March 2011

Last week marked the 2nd anniversary of the gut-wrenching stock market lows of the 2008-2009 bear market. On Monday, March 9, 2009, the Dow Jones Industrial Average closed at 6,547 while the S&P 500 Index ended at 676 and the question everyone was asking was "how much lower can it go?" Unemployment was still on the rise; consumer confidence was hitting new lows; US taxpayers had just taken over AIG while people were speculating on the cascading effect of a potential GM bankruptcy; Obama's budget proposal and his actions were being decried for potentially bringing an end to American capitalism.

Many market prognosticators were only fueling investor fears. On March 2, 2009, Jim Cramer, of CNBC's *Mad Money* notoriety, remarked that he could envision a scenario where the Dow plunges to 4,000. The morning of March 10th, Nouriel Roubini, one of the few economists who predicted the crisis, wrote that a 40% further fall from current levels could not be ruled out. Articles about the possibility of a further 25% decline to 5,000 on the Dow were being written in respected magazines from *Smart Money* and *Forbes* and venerable newspapers like the *Wall Street Journal*.

In client meetings, we had been cautioning clients about making major changes to their asset allocations as markets had historically rebounded sharply after reaching their bottom. However, our exhortations were beginning to fall on deaf ears; either because the belief was that we had a lot further to fall before that rally would happen or that this time was different.

I would love to be able to say that we distributed our article *"Deal or No Deal?"* to clients on Friday, March 6, 2009, because of some clairvoyant wisdom [click here to revisit the article]. We continued to believe that corporate and economic performance drive stock price performance over the long-term. And we were confident that conditions that contributed to the Great Depression were by and large not present this time and that Mr. Market was being too pessimistic for many financially sound companies. But we certainly did not have any evidence or data to support when or why the market was going to rebound *this time*.

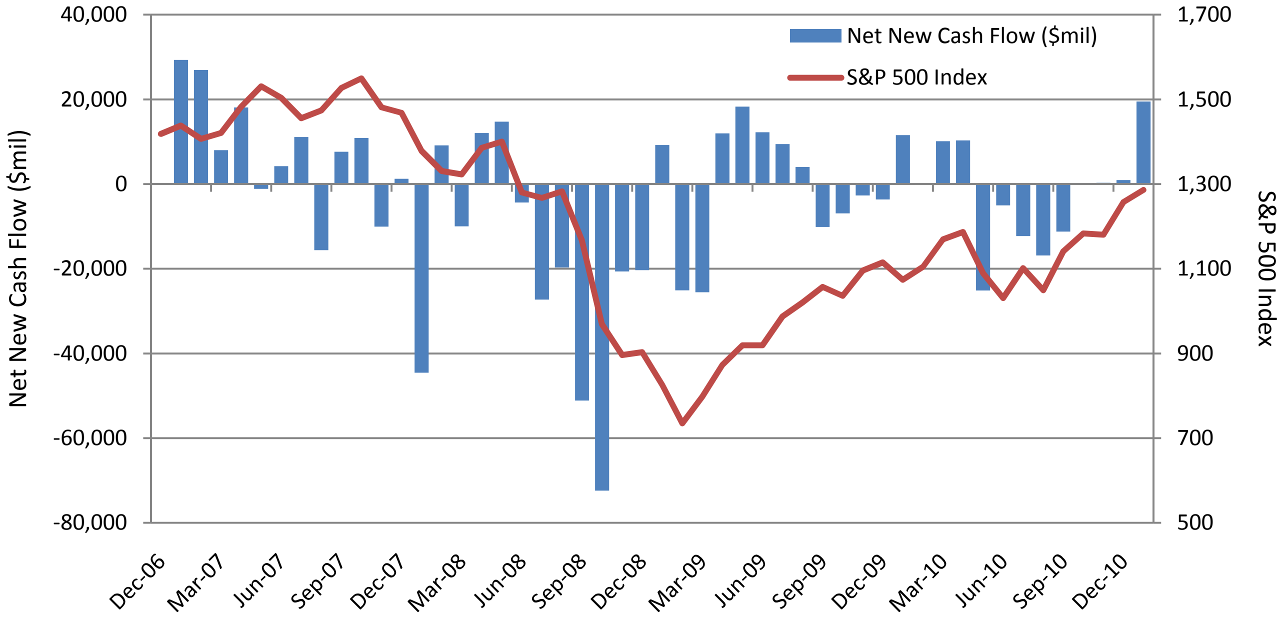
The recovery that began two years ago has been nothing short of spectacular. Although the equity markets are still below their all-time highs from October 2007, they have nearly doubled from their March 2009 lows. The Dow Jones Industrial Average closed on March 9, 2011 at 12,213 while the S&P 500 Index ended at 1320 – it's fastest climb since 1955.

Since the market crash we've detailed many of the improvements in economic indicators in our quarterly market commentaries but a primary reason for the sharp rebound is just how pessimistic the expectations got by March 2009. And as conditions initially improved (or at least stopped getting worse), investors started to react, led by traders trying to cover their profitable short positions and the markets started their ascent.

Unfortunately, many investors who got out of the market were skeptical of the recovery. First, believing it was just a bear market "sucker's rally" that would only drop right back down. Then believing it had moved too far too fast and had to come back down. Then believing the "other shoe to drop" from a commercial real estate foreclosure crisis would bring it back down. Then believing the BP oil spill, the European debt crises, the US debt and deficits, the Hindenburg Omen, the election, the expiration of the Bush-era tax cuts, or a declining dollar would take their toll on the markets and threaten a double dip recession (to name a few).

Warren Buffett was on CNBC the morning of March 9, 2009, prophetically stating: "You can get fearful very quickly, but you don't get confident, you know, in five minutes. You can get fearful in five minutes, but you won't get confident for some time."

It seemed like it wasn't until the beginning of 2011 that I started hearing the majority of the market prognosticators express more confidence in the economy and give a positive view for the markets for the coming year. Individual investors have followed suit. According to the Investment Company Institute which tracks mutual fund cash flows, investors continued to pull money out of stock mutual funds in 2009 and 2010. But January 2011 saw the biggest net new inflow since February 2007. So these investors are finally feeling confident enough again in the equity markets to take on more risk – but only after they missed out on one of the best performing two-year periods in market history.



Net New Cash Flow reflects monthly change in equity mutual fund assets based on actual sales, redemptions and exchanges as reported in the Investment Company Institute's "Trends in Mutual Fund Investing." Flow estimates are derived from survey data collected covering more than 95 percent of industry assets and are adjusted to represent industry totals.

Sadly, this is the second time in the last decade that some skittish investors got burned by trying to time the market. And it's not just individual investors. In fact, I happened to be reviewing some old notes recently when I came across a summary of a conversation from February 2003. A friend had a family member whose advisor just called stating that, in his 25 years experience, he had never recommended this, but he is seeing indications that stocks are going to continue to go down and is recommending that his clients completely get rid of all of their stocks in their portfolio. That call was almost exactly one month before the market hit bottom during the 2000-2002 bear market – after it had already declined 43% from its high in 2000.

Let's assume that by the end of that year (2003), the advisor was convinced the markets were on the mend (after missing out on a 36% initial rally), got his client back into stocks, and vowed never to make another market call for the rest of the decade. Through the end of 2010, his client would still be down 15% from where they started on January 1, 2000. Conversely, if that same investor had bought the S&P 500 Index in January 2000 and just held it the entire time period, he would be up about 15%. On a $1 million portfolio, that is a $300,000 mistake, which will only get compounded over the remainder of this client's lifetime. The results would be even worse if the advisor repeated the mistake during the 2008-2009 bear market.

I am not trying to pick on this particular advisor, rather just use it as an example of how investors can be their own worst enemy, as the DALBAR studies have confirmed year after year. We have a hard time not letting our gut reactions into our investment decision making because it is wired into who we are as humans. This includes the overconfidence in our own abilities to identify trends and hindsight bias, where we look back now and think we knew what was going to happen and, therefore, can predict what will happen the next time.

The fact of the matter is the future is essentially unknowable. There are too many interconnected components and potential events to predict the future with any accuracy. We don't know how the European fiscal crisis will play out or how the uprisings in the North Africa/Middle East will end. We don't know the full economic impact of the recent tsunami or how the burgeoning US debt and deficit issues will be resolved. We don't know when unemployment will come down, when the next correction will happen or where the stock market will end this year. And we would be extremely cautious of anyone who says they do.

Our job is to help prepare you for the uncertainty and the variety of scenarios that may play out; to develop a game plan to meet your financial goals and diligently implement that game plan through a disciplined investment philosophy. Our objective is to properly design an investment strategy and diversify the portfolio so that you don't have to take the banker's deal when you don't want to; that you will always have a smart place from which to take distributions when you depend on the portfolio to maintain your lifestyle, preserve your independence throughout your lifetime, and accomplish your other life goals.

Most importantly, while we cannot control the markets, we can control how we respond to them. A big part of our job is to help you manage your reactions and maintain an appropriate perspective. Through our actions and our communications, our objective is to help you stay committed to the game plan which we believe is best suited for helping you achieve your goals.

Thank you for the opportunity to serve as your investment advisor and to help you accomplish your financial goals in the years ahead.