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Why Wait? Making the Right Investment Decisions Now

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During the summer of 2004, a woman I know had her entire investment portfolio in bonds. She knew that investment experts generally recommend holding a broadly diversified stock and bond portfolio. Despite that, she asked "Why would I want to invest in the stock market right now with prices drifting sideways and downward?" As it turned out, she was asking that question just before US and international stock markets made a significant advance.

If she chose to wait and the stock market rose, would she regret missing out? If she waited and prices continued to fall further, would she feel okay investing after an even larger drop? What if she chose to invest and then prices continued to fall? Should she get out? What if it rebounded right after she did? What if it didn't?

This article examines the difficult question of when to make asset allocation changes and discusses how to avoid consistently making investment mistakes.

The Goal: Buy low and sell high

Historically, the greatest buying opportunities have occurred after the largest stock market declines. Similarly, the best times to sell have been after large stock market advances. Yet, contrary to the historical evidence, most investors feel more comfortable investing in the stock market when it has been performing well recently.

According to TrimTabs.com data, during February of 2000 (near the all-time high for the US stock market), investors poured a record $36.5 billion into stock mutual funds. Seventeen months later in July of 2002 (after the S&P 500 had fallen over 31%) they withdrew a record $49 billion. This is a multi-billion dollar example of bad market timing by individual investors.

This is also an example where risk and reward are related. After the stock market has had a large advance, many people feel more comfortable investing in it. This is a period of generally low perceived risk and low risk investments have low expected returns. After a large stock market decline, many investors feel that the market is very risky and future expected returns are higher.

Buying investments should be like buying fruit at the grocery store in that you should select whatever has gone on sale and gives you the best value for your dollar, not whatever has gone up the most in price recently.

Do the previous examples mean that you should wait for a significant stock market decline before making investments? Unfortunately that strategy doesn't work consistently either. Figure 1 shows the investment of a dollar in the S&P 500 at the beginning of 1988. By the beginning of 1998 (with dividends reinvested), that dollar had grown to $5.25. During that time period, there were no significant stock market declines. An investor waiting for a decline to invest would have never entered the market and missed out on huge investment gains.

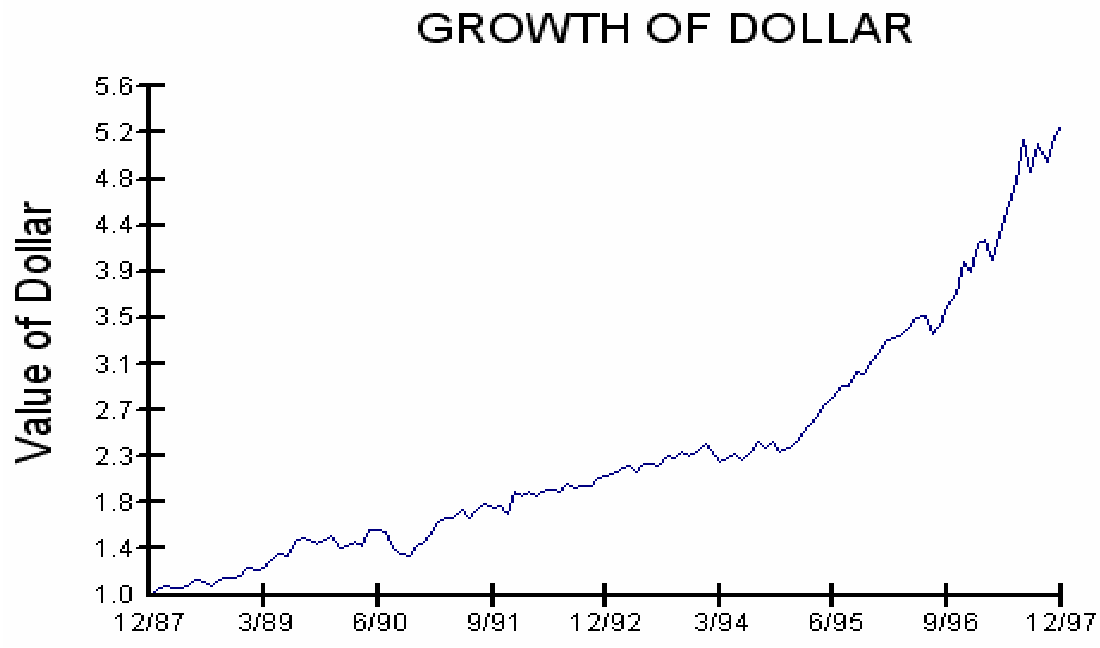

Figure 1. Growth of a dollar invested in the S&P 500 in January 1988

The Prudent Approach

So, what does work? First we need to accept that no one can reliably predict the stock market. The best general advice is to always hold a broadly diversified portfolio of stocks and bonds that focuses on obtaining the best risk/reward position. In determining the best risk/reward portfolio, we need to consider current asset price and valuation levels such as the price-to-earnings (P/E) ratio, the dividend income yield, the price-to-book value ratio, and so on. For example, as of March 31, 2000 Dimensional Fund Advisors (DFA) reported the P/E ratio of their S&P 500 index fund as 28.7, which was extremely high by historical measures. Their REIT index fund by comparison had a reported P/E ratio of 13.9, which was low by historical measures. A dollar invest in the S&P 500 fund at that time and held through November 2004 was worth only $0.85, compared to $2.51 for a dollar investment in the REIT index fund. The primary reason for the big discrepancy in returns was that the asset classes reverted back in the direction of their typical valuation levels.

While reverting back to mean valuation levels is not entirely predictable, it is a better bet than loading up your portfolio with assets whose prices have already risen dramatically.

So, when is the right time to make investment decisions? The answer is now. At any time we can construct a broadly diversified portfolio. We can consider valuation ratios and interest rates in deciding on the exact percentage allocations to cash, short-term bonds, intermediate-term bonds, long-term bonds, inflation-indexed bonds, growth stocks, value stocks, small-company stocks, large-company stocks, international growth and value stocks, international large, and small stocks, emerging markets, Real Estate Investment Trusts (REITs), and so on.

The investment portfolio should be specifically designed with the goal of providing the maximum possible expected return for the level of anticipated risk. Likewise, the goal is to provide the lowest possible anticipated risk for the expected return. Extremely broad diversification allows us to optimize the risk/reward characteristics of our investment portfolio.

Rebalancing

If we revisit the multi-billion dollar example of bad market timing discussed above, an interesting question is: Who were the sellers at the market peak and who were the buyers at the trough? These investors were the “smart money” and they are the ones we want to emulate. Securities transactions, like all financial transactions, have both a buyer and a seller. Since mutual fund investors poured $36.5 billion into stock mutual funds during February of 2000, other investors must have sold the underlying stock shares to them and taken $36.5 Billion out of the stock market near the peak.

In addition to those who considered valuation ratios, one group of investors who bought low and sold high were those who had selected stock and bond holding percentages for their portfolio and rebalanced back to those percentages. Let’s examine the case of an investor who held a diversified portfolio with 60% stocks and 40% bonds. As the market rose in the late 1990s, she would have found that her stock positions had grown to more than 60% of her portfolio. In order to rebalance her portfolio back to her target 60/40 ratio she needed to sell stocks and buy bonds. After the stock market fell from its peak, she needed to sell bonds and buy stocks in order to get back to her 60/40 allocation. These simple mechanical actions caused her to sell high and buy low.

How often should an investor rebalance? If we study different portfolios over past time periods we come up with different optimal rebalancing frequencies. Unfortunately, we don’t know what the ideal frequency for the future will be, but about once a year is a good plan. Another prudent technique is to rebalance whenever your stock or bond percentage drifts from your target by more than a pre-selected amount such as 5%. With this method, the investor discussed above would rebalance her portfolio whenever her stock percentage went below 55% or above 65%.

Conclusions: Calculations, not feelings

You should base your investment decisions on mathematic calculations, not feelings. You can learn to estimate long-term returns of asset classes by learning about and using analytical tools such as the Dividend Discount Model, the Gordon Equation, application of the Discount Rate, price-to-earnings ratios, price-to-sales ratios, price-to-Book Value ratio and historical data. When looking at earnings, use average earnings over several years to avoid big distortions from temporary recessions. Legendary investor Benjamin Graham used to say that in the short term, the stock market is a voting machine, but in the long term, it's a weighing machine.

If you choose not to do this analysis yourself, you can work with me or another fee-only investment advisor who can help you build a diversified portfolio.

A broadly diversified portfolio can be constructed at any time, so now is the right time to do it. Periodically rebalancing back to our target portfolio helps control risk, improve returns, and causes us to sell high and buy low.

Suggested resources for additional information on these topics:

The Four Pillars of Investing by William Bernstein
The Successful Investor Today by Larry Swedroe
The Intelligent Asset Allocator by William Bernstein
Asset Allocation by Roger Gibson
Bickford Investment Management Services Website: www.bickfordinvest.com
Dimensional Fund Advisors Website: www.dfaus.com
Vanguard Website: www.vanguard.com

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