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## Introduction

People are worried. According to the pundits (who are always right – aren't they?), the world is apparently on the verge of ending (again). Europe is in a shambles, Japan's disaster is ongoing, the U.S. economy is beginning to sputter, there are floods, fires, famine, locusts...

Wait, maybe I am going too far. I don't think we have locusts yet.

Nonetheless, I am here to tell you that a drop in the market is coming, whether you like it or not. The issue that I hope to address in this edition of Why We Plan is what you should do about it.

## A Little Bit of History

Most people realize that in order to receive the benefits of a long-term investment plan they will have to contend with a few short-term ups and downs along the way. What most people generally do not realize is that these ups and downs occur pretty frequently.

Capital Research and Management Company did a study of all market declines (using the Dow Jones Industrial Average) from 1900 through 2010. Their research revealed the following:

### A history of declines (1900–December 2010)

Type of decline	Average frequency <sup>1</sup>	Average length <sup>2</sup>	Last occurrence	Previous occurrence
-5% or more	About 3 times a year	47 days	Aug-10	Jul-10
-10% or more	About once a year	115 days	Jul-10	Mar-09
-15% or more	About once every 2 years	217 days	Mar-09	Mar-08
-20% or more	About once every 3 ½ years	338 days	Mar-09	Oct-02

**Past results are not predictive of results in future periods.**

Source: Capital Research and Management Company<sup>SM</sup> <sup>1</sup> Assumes 50% recovery rate of lost value. <sup>2</sup> Measures market high to market low.

The research suggests that there will be a decline of 5% or more an average of *3 times every year*. About once a year, one of those 5% declines will actually turn into a decline of 10% or more. Further, about one-half of those 10%+ declines will actually become a 15%+ decline (in other words, we'll end up with one of those about once every 2 years). Finally, once every 3.5 years, on average, one of those 15%+ declines will actually turn into a bear market decline of 20%+.

The good folks at Ned Davis Research, an institutional research firm, came up with very similar results and actually quantified the depth of the average decline for each category. Their period of review extended from January 2, 1990 through May 13, 2011:

Type of decline	Number of Occurrences	Mean Decline (%)
-5% or more	379	11%
-10% or more	122	19%
-15% or more	60	26%
-20% or more	32	35%

Putting both charts together, based on history, you can expect the market (in this case, the Dow Jones Industrial Average) to drop by 5% or more roughly 3 times each year, with the average decline being about 11%. Scrolling to the end, about once every 3.5 years, you can expect a decline that averages about 35% (based on data from 1900-May 2011).

Ultimately, the questions you are considered about are what **can** you do about it and what **should** you do about it? You generally have two broad options (for both, we are assuming you are starting with a well-conceived long-term investment plan). You can either get out of the market and wait for things to get better, or you can maintain your discipline and stick to your plan.

We'll examine both alternatives.

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## Timing is Everything

A large number of people believe that they should be able to get out of the market before it declines and then re-enter once "things get better". In fact, after the bear market that ended in March 2009, a number of people began claiming that they had systems that would help their clients do just that (of course, I do not recall many – if any - of them claiming to have that skill *before* the market declines).

The challenge, of course, is that you need to be right twice. First, you need to know the correct time to get out. Then, you also need to know the correct time to get back in.

Let's focus on the first decision – knowing when to sell. In order to know when to sell, you need to be able to predict *consistently* when the market will decline. It is fairly easy to use hindsight to know when the market was overvalued, for example. Unfortunately, it is much more difficult to do that prospectively. Worse, even if you can accurately determine that the market is overvalued, it can continue going up (think back to the dot.com era). So, you might be right about valuations and decide to get out, but you also might have to watch the market go up anyway. Which then begs the question, how much will you be able to watch it go up before you jump back in? What if you get out and it goes up 7% and then has one of those 5% declines that happen 3 times per year and then starts going up again? The timing is very difficult.

In order to avoid these issues, you may decide that you'll wait for things to start looking bad and then you'll sell. The obvious question is what rules will you use to sell? Will you use stop losses? If so, what will your limit be? If you place your limits too tightly, you will likely end up being forced to sell your positions very frequently. Conversely, if the limits are too loose, you may end up experiencing the bulk of the decline anyway since the vast majority of declines are of the more minor variety.

Maybe you'll decide to use technical analysis to help you. There are death crosses, head and shoulder patterns, etc. Once again, you will need to decide which to use and how religiously you will follow them. The problem with technical analysis, though, is that most studies have found that these strategies are not profitable after you factor in the related transaction costs.

Finally, you might just decide that things "feel" bad and since all your friends are talking about it, it must be time to get out. One question: when was the last time you remember the "crowd" being right?

Thus, it appears that timing the "out" can be quite a quandary. What about getting back in?

Once they get out, most people want to wait for things to "get better" before they get back in. The key issues to keep in mind, though, are (1) at the bottom, very few people think that things are "better" and (2) many rebounds from the bottom tend to be sharp, so the likelihood is that you will miss the bulk of the up move.

The issue is made all the more difficult when you realize that moves – both up and down – rarely happen in a straight line. Big down moves are often punctuated with sharp rallies called "suckers rallies" or "dead cat bounces". I will let you figure out why.

Combine these issues and you find that most people end up selling after most of the down move has already occurred and then end up buying back in after most of the up move has occurred. In essence, they tend to sell low and buy high – the exact opposite of what they should be doing. In a fair number of cases, *people end up buying back at a level that is higher than where they sold.*

The cold, hard reality is that timing the market consistently over time is very difficult, if not impossible. We can all name some of the greatest investors of all time – Warren Buffett, Peter Lynch, Sir John Templeton, etc. - none of which are market timers. There is one final point. If someone developed a system to effectively time the markets, do you think they would share it? The reality is that if everyone starts doing the same thing, the advantage disappears. So, if I could become a billionaire by keeping my little secret to myself, why would I share it with you for \$39/month (or even \$1,000/month) as you may hear advertised on a regular basis?

Which leads us to the second option...

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## Discipline is Hard

Having been through countless declines, corrections and a few bear markets, believe me when I say that discipline is hard! It is much easier to believe that we can outsmart the markets. Unfortunately, we just touched upon that point, and it really is not as easy as one might like to believe.

The reality is that a good, long-term investment plan should result in a diversified investment portfolio designed specifically to accomplish your goals. What that means is that you will likely have some cash for near term spending, some bonds, some U.S. stocks, some non-U.S. stocks, etc. Moreover, within each of those categories, you may be additional diversification. On the U.S. stock portion, for example, you may have exposure to multiple industries, companies of different sizes, companies headquartered in different areas, etc.

All of those pieces should make it really difficult to identify the “market”. For discussion purposes, let’s assume that your portfolio is 5% cash, 35% bonds and 60% stocks. Moreover, let’s assume that the stock portion is 70% U.S. and 30% non-U.S. Finally, let’s assume that the U.S. stock portion is 75% large companies and 25% small companies.

Given those parameters, what does a drop in the “market” really mean? When most people think about the “market”, they are referring to the S&P 500 or the Dow Jones Industrial Average - in other words, a relatively small number of large companies in the U.S. From the above assumptions, large U.S. companies only represent about 31.5% of the portfolio. If the “market” drops 5%, that equates to about a 1.6% drop in your portfolio (if all other “markets” are flat). A 20% drop, which is much scarier, equates to a 6.3% drop in your portfolio (once again if all other “markets” are flat).

Now, you might be thinking that the other markets will not be flat. That’s true. Some, like the bonds, might actually be positive. By being diversified, you should have exposure to markets that do not necessarily move together and might actually move in distinctly different manners.

The key point is that the drops that grab the headlines might actually have very little immediate impact on your portfolio. Moreover, all the efforts you might take to avoid those drops may not help you at all.

Now, here’s the kicker. You shouldn’t even need to touch the portion of your portfolio that is actually exposed to those fluctuations for at least 5-10 years. While it does happen, the likelihood of that portion of your portfolio actually being down when you need it is slim, particularly if you are taking the opportunity to rebalance or tilt your portfolio when things get out of whack (which means actually buying when things are down and selling when things are up).

Once again, being disciplined and sticking to a long-term plan can be difficult; we get it. However, it has been our experience, and history agrees, that despite the difficulty, it offers the greatest opportunity for you to actually achieve your goals.

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## Wrapping it Up

*“In bear markets, stocks return to their rightful owners”*

- Attributed to J.P. Morgan

*“A bear market is a period of time during which people who think this time is different sell their common stocks – at prices that will never be seen again – to people who know that this time is never different”*

- Nick Murray

So there you have it. A drop in the market is coming. In fact, over the course of your investing life, they have come and will likely continue to come with some regularity. Despite that fact, over time well-diversified portfolios have continued to grow in value. Not every day, week or month, but over meaningful periods. You have a choice. You can try to play the odds and become the one person in history who can avoid these downturns by successfully predicting when to get out and when to get back in time and time again. Conversely, you can accept the fact that there will be some volatility but that it is generally short-lived and, in a well-diversified portfolio, volatility in one area has a negligible impact on overall wealth.

Given our experience, we'll stick with what we know works.

Please feel free to call or email if you would like to delve into this issue in greater detail. As always, we appreciate your trust and support.