Wise Investing

The key to building wealth during today's bull markets, bear markets, and corrections.

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You have heard, "those who fail to learn history, are doomed to repeat it." This statement is relevant in many areas, including investing and wealth management. Knowing the history of securities markets will help you avoid some of the past mistakes investors have made and also demonstrates why the slow, steady tortoise approach of investing works, while in contrast, the rabbit approach of market timing and seeking home run investments is a recipe for disaster.

It is extremely important to understand that markets go up, but they also go down. One may understand that in theory, but in reality, when markets go down, some investors lose their focus:

"Should I go to cash?"

"Should I get out now and come back when things start to turn?"

"Should I sell low now and buy back in high?"

Nobody ever really asks that last question, but that may be the effect on one's wealth if one follows the instincts indicated by the first two.

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Understanding the history and terminology of the markets will help navigate the playing field and avoid repeating past mistakes. It is smart to learn from mistakes—but it is wise to learn from the mistakes of others—and much less painful.

Bull Markets (Up Markets)

Many financial experts technically define a bull market as period of increase in value in the market of at least 20%, but there is more to it than that. Bull markets are characterized by optimism, investor confidence, and expectations that strong results will continue. It is difficult to predict consistently when trends in the market will change. Part of the difficulty is that psychological effects and speculation may sometimes play a large role in the markets.

Bear Markets (Down Markets)

Bear markets represent a market condition in which the prices of securities are falling, and widespread pessimism causes the negative sentiment to be self-sustaining. As investors anticipate losses in a bear market and selling continues, pessimism grows. Although figures can vary, for many, a downturn of 20% or more in multiple broad market indexes, such as the Dow Jones Industrial Average or Standard & Poor 500 Index, over at least a 2-month period, is considered an entry into a bear market.

Market Corrections

Market corrections are indicated by a reverse movement, usually negative, of at least 10% in a stock, bond, commodity, or index to adjust for an overvaluation. Corrections are generally temporary price declines interrupting an uptrend in the market or an asset. A correction has a shorter duration than a bear market or a recession, but can be a precursor to either.

Those definitions help define the technical side of market movements, but do little to address the psychological effects on investors.

How Emotion Plays a Major Part in Investment Decisions

When talking with clients about market volatility, we often discuss emotion. Money is personal and emotional. During bull markets and times of investor enthusiasm, emotion can cause irrational decisions to be made, such as buying more of a particular security not because the fundamentals suggest there is value, but because the investor felt short-term exuberance from gains. Emotion can negatively affect a portfolio strategy. Although it is present in bull markets, the largest problems often arise during bear markets. Down markets force people to assess the damage in their portfolios more often, which leads to pain from seeing losses, which leads to more performance monitoring.

The natural instincts of investors are often wrong. Buying low and selling high often requires one to do the opposite of one's instincts.

When markets are stable and calm or rising during a bull market period, we see less breaking news and instant analysis. It is precisely at the time investors need guidance—during corrections and/or bear markets—that news headlines about "plunging equities," "another crash on the way," "death spiral for the markets," and so on proliferate. Such hyperbolic statements make it difficult to make sound financial decisions.

When clients contact us to ask if they should change their strategy, we respond with one simple question: Has anything changed in your life since our last meeting that would alter your goals or change your tolerance for risk?

If the answer is yes, we discuss how the investment portfolio is currently constructed—what type of return is expected as well as the type of volatility. If those factors are no longer aligned, we make the necessary changes. Usually, the answer is no: "I'd still like to retire on X with X amount of money to last X amount of years, and I am comfortable with losses of X." If those goals match the current portfolio, we discuss the emotion of the markets and how best to take advantage of the environment.

The best way to navigate unpredictable elements is to chart a course and stick to it, but remain flexible to avoid getting trapped. Adjustments are needed at times—but one must adjust strategically, rather than emotionally.

Experience builds expertise—but experience cannot be gained overnight. Understanding the history of the securities markets helps one gain experience more quickly and less painfully.

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