Timing out of Gains

Let's say you're looking at a stock market that has lost 81% over the past 2.7 years during a time of severe economic contraction. The headlines are not encouraging: the country is mired in depression, and so, too, is the rest of the world. Are you feeling bullish, or is this a great time to unload your stocks and stop the bleeding?

If you decided to unload, then you would have missed at least some of the dramatic market increases that started in 1937--4.7 years of annualized 32.1% gains, for a total gain of 266%.

Okay, suppose the market has dropped a total of 63% over a torturous 13.6 year period, and Business Week magazine has just proclaimed "The Death of Equities." Buy? Sell?

Again, the correct answer would have been "buy." After 1982, the S&P 500 gained a remarkable 666% over the next 18 years.

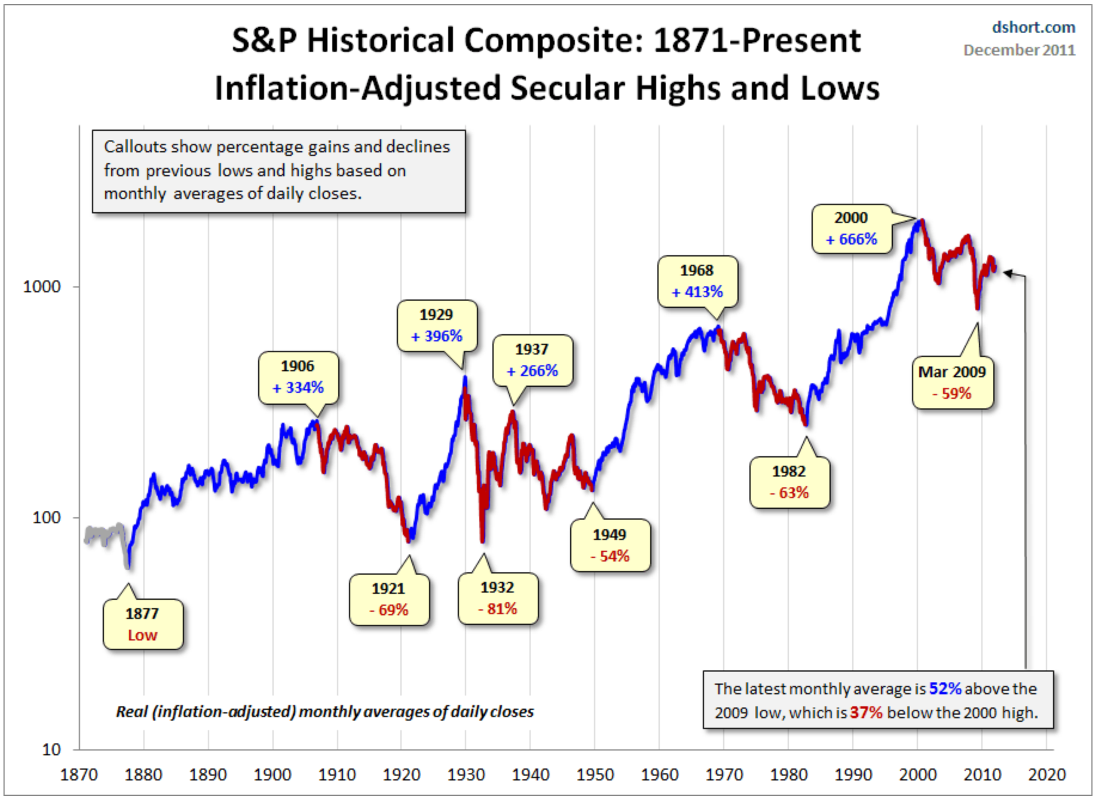
The accompanying chart, created by Doug Short for the Advisor Perspective services, shows a number of market ups (blue) and downs (red) since 1871, and the thing you notice is that virtually every major market move, up or down, was unexpected. The bull markets came as a surprise, and the bear markets came at times when the markets seemed to be on a long-term roll. (The scale here is logarithmic, which means that if the chart were expressed in absolute terms, the long-term rise would look much steeper.)

In truth, the decision that faced most investors in 1921 (market down 69% over the previous 15 years) or 1949 (market down 54% over the previous 12 years) was not whether to make some kind of dramatic move into stocks. The decision, made daily as the newspaper carried discouraging news over and over again, was whether to stay invested in stocks and eventually reap the gains (396% and 413% respectively) that nobody could have predicted in advance.

The most important long-term statistic to come out of this analysis may be the dramatically different size of the gains and losses. Taken together, the various bulls since the market trough in 1877 brought investors gains of 2,075%--an average of a 415% gain per bull market. The bear markets, in aggregate, cost investors 329%--an average downturn of 65%.

Nobody knows when the markets are going to suddenly take off after a bearish period, and the longer and deeper and more discouraging the downturn gets, the less likely the next bull market seems. But history suggests that patient investors get more return during market upturns than they lose when the markets drop. Long-term, trying to outsmart the market and sidestep losses would have led to missing even bigger gains.

Source: http://www.advisorperspectives.com/dshort/updates/Secular-Bull-and-Bear-Markets.php


S&P Historical Composite: 1871-Present
Inflation-Adjusted Secular Highs and Lows
dshort.com
December 2011
Callouts show percentage gains and declines from previous lows and highs based on monthly averages of daily closes.
1877 Low
1906 + 334%
1921 - 69%
1929 + 396%
1932 - 81%
1937 + 266%
1949 - 54%
1968 + 413%
1982 - 63%
2000 + 666%
Mar 2009 - 59%
Real (inflation-adjusted) monthly averages of daily closes
The latest monthly average is 52% above the 2009 low, which is 37% below the 2000 high.
1000
100
10
1870
1880
1890
1900
1910
1920
1930
1940
1950
1960
1970
1980
1990
2000
2010
2020