Coping with Stock Market Volatility

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Focus on finance

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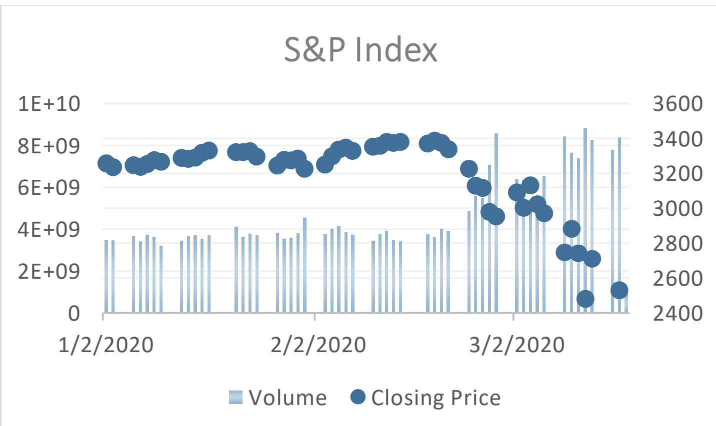


*As of mid-March, 2020, market indices such as the S&P Index and the Dow Jones Industrial Average had lost more than 20% of their value from mid-February, qualifying current stock market conditions as a bear market. In the past weeks, investors have watched as stock market prices have plummeted worldwide due to the spread of the coronavirus and disruptions in the market for oil. What can a long-term investor do in such chaotic and downward trending markets?*

**We offer the following thoughts to help long-term investors to cope with the current stock market chaos.**

### Who are Long-Term Investors?

While day traders exploit market price swings to trade stocks and bonds at a profit, long-term investors purchase and hold them at favorable prices for the long-term. Investors seek to save and invest for future goals, such as a children's college education, retirement, or perhaps, a down payment on a home. For investors, fluctuating prices are an opportunity to purchase stocks when prices are low and to sell them when prices are high.

### Reacting to Stock Market Prices

Much of the time, stocks are priced fairly because markets are stable and not subject to strong emotions, either fear or exuberance. But from time to time, prices of securities are ridiculously high or low, driven up by market exuberance and down by fear.

**The natural reaction to stock market prices is the opposite of what it should be.** *When prices are rising, we want to buy, but we ought to sell. When prices are falling, we want to sell, but we ought to buy.*

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When prices are rising, we don't want to be left out and hope to profit by buying today and seeing a higher price tomorrow. When prices are falling, we don't want to lose money and feel pressure to sell today, hoping to avoid a larger loss tomorrow. As a consequence, when prices are high and rising, we feel pressure to buy, and when prices are low and falling, we feel pressure to sell.

## AN INVESTOR HOLDS FOR THE LONG-TERM, JUST LIKE A HOMEOWNER

One way to overcome this natural reaction is to think about owning a home. When real estate prices are rising, we want to sell and profit, but of course, if we sold, we would still need a place to live. We buy a house because we need shelter and expect to live in it for the long-term. When real estate prices are falling, we might want to sell to avoid a loss, but again, we would still need another house.

Much like the homeowner, an investor purchases and holds stocks and bonds to realize value in the long-term. If you think of your investments in like manner to your home, then you can more easily avoid the siren call of buying when markets are rising and selling when markets are falling.

## Rebalancing to Sell High and Buy Low

If you are a long-term investor holding a portfolio of stocks and bonds allocated in accordance with your risk tolerance, *you can use rebalancing to help yourself buy low and sell high*.

To illustrate, imagine an investor who has decided on a 40%-60% ratio between bonds and stocks and holds a $100,000 portfolio, $40,000 in bonds and $60,000 in stocks. As of mid-March, due to falling stock prices and rising prices of treasury notes, his initial $100,000 portfolio could be $45,000 (50% of total) in bonds and only $45,000 (50% of total) in stocks, a total of $90,000. In order to rebalance, *he sells $9,000 of bonds and purchases $9,000 of stocks*, resulting in $36,000 in bonds and $54,000 in stocks (40% bonds and 60% stocks). By rebalancing, the investor has bought stocks when their prices were relatively low.

If stock prices had risen instead of fallen, his portfolio could be $115,000, $35,000 in bonds and $80,000 in stocks. In order to rebalance, *the investor sells $11,000 of stocks and purchases $11,000 of bonds*, resulting in $46,000 in bonds and $69,000 in stocks (40%-60%). By rebalancing, the investor has sold stocks when their prices were relatively high.

**Bottom line:**

- **Avoid the temptation and desire to buy stocks in a rising market,**
- **Resist the fear and desire to sell stocks in a falling market, and**
- **Rebalance your portfolio annually or whenever your allocations of stocks and bonds differs by more than 5% from your target risk allocation** (for example, in a 40%-60%, bond to stock risk allocation, rebalance when stocks are less than 55% or more than 65% of the portfolio)**.**

**Looking forward to our April - June, 2020, newsletter, we will be discussing the Secure Act and its impact on estate planning. Don't miss it.**

***Comments on this article or topics you would like to see discussed?***
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