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Staying Sane In Wild Markets

By William J. Bernstein, Money Magazine

It's ugly out there. As of late July, Standard & Poor's 500 stock index was down almost 13% for the preceding 12 months. With the housing market on the skids and energy prices soaring, the economy seems more vulnerable than it has in decades. At times like these, you may be sorely tempted to flee stocks before your 401(k) gets any droopier.

Don't do it. The stock market is really just a mechanism that rewards investors for bearing risk. During buoyant economic periods, risks seem low. That pushes up prices, so you should expect lower returns going forward. Likewise, when risks seem high - as they certainly do now - higher returns should follow. This principle is admittedly easier to recite than it is to follow, especially if you haven't been through a few market cycles. So until you have as many gray hairs on your head as I do, here's a primer on staying sane in volatile markets.

Brush up on your history

If you are going to be in the stock market - even if it's just a 401(k) account - you should take a little time to steep yourself in market lore. (It's painless: I recommend Edward Chancellor's "Devil Take the Hindmost" for an entertaining introduction.) When the market goes haywire, you'll be able to say to yourself, "I've seen this movie before, and I know how it ends."

Consider, for example, the story of the late 1970s, which saw double-digit inflation. By 1979, BusinessWeek declared "The Death of Equities." So-called paper assets like stocks and bonds could hardly be given away, while the wealthy and investment pros snapped up precious metals, real estate and collectibles. Who in their right mind would have bought stocks then? The smartest and most disciplined investors. In the 1980s the S&P 500 returned 404%.

Of course, it's easier to keep your head if you haven't just had your portfolio ripped to shreds by a bunch of speculative investments. A little history will help guide you past bubbles too. Imagine you are at a party in 1999. Everyone is happily chatting about their favorite dotcom or their brilliant tech fund manager. Can you guess which ones will soon lose their shirts? Without the benefit of hindsight, it would be tough. The guy who was out on a limb on Enron, for example, might have displayed dazzling knowledge of discounted cash-flow analysis and the latest trends in broadband.

Were I allowed to ask just one question of partygoers, it would have been, "Who was Samuel Insull?" Answer: He was a financier and utilities tycoon who turned out to be a kind of Ken Lay of the Great Depression. (Insull was acquitted though.) No, a little market trivia wouldn't have been enough to predict Enron's fall. But knowing how quickly the market can turn heroes into zeros can help keep you from going totally crazy for the next big thing.

Get to know the numbers

It's useful to have an appreciation of what the modern markets can throw at you. You'll often read that stocks return about 10% a year on average. Don't focus too much on that figure. With today's stocks paying relatively modest dividends, future returns will probably be a bit lower. And besides, long-run averages mask the big short-term swings you'll need to be psychologically prepared for. Instead, spend a little time staring at the graphic above and to the right. It plots the history of two-year returns for large-cap stocks. Why two years? That's how long most bear markets stick.

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Market Watch

	8/29/2008	YTD
DJIA	11,543	-12.98%
S&P 500	1,282	-12.69%
NASDAQ	2,367	-10.76%

By The Numbers

MORE VOLATILITY - The S&P 500 had 29 trading days in 2006 that experienced at least a 1% gain or loss, or approximately 1 every 9 trading days. The number of "at least 1%" up or down days increased to 65 in 2007 or approximately 1 every 4 trading days. Through the close of business on 8/21/08, the number of "at least 1%" movement days is 66 YTD or approximately 1 every 2 ½ trading days (source: BTN Research).

STILL MADE MONEY - In the last 30 calendar years (1978-2007), the S&P 500 has experienced 4 different bear markets (i.e., a decline in the index's value of at least 20%). The 4 bears had drops of 26%, 33%, 20% and 49%. In spite of the tumbles, the S&P 500 has been up +13.0% per year (total return) over the entire 30-year period, even after the negative impact of the 4 bear markets (source: BTN Research).