How to Stop Hurting Yourself

Do you know how the stock market has performed over the last 20 years? Any idea? Take a guess. Five percent a year? Ten? Twenty? What if we set the over/under at 8.2%? Would you guess that the actual number would be higher or lower than that?

If you're a relatively new investor, you may guess the real answer is lower than 8.2%. It was just last year that the S&P 500 surpassed its most recent high point, which was back in the summer of 2007. Which means that we suffered nearly six years of a market that basically went nowhere. So 8.2% doesn't sound bad compared to that. Also, with savings accounts paying less than 1% per year, and 10-year Treasury notes paying less than 3%, anything more than 8% a year sounds pretty darn good.

But if you're a bit longer in the tooth, perhaps 8.2% may seem a bit paltry. It wasn't very many years ago that we were earning a full 5% on our savings accounts, and most of us old-timers probably think of 10-year Treasury rates as being more in the 6-7% range. So 8.2% doesn't seem too much greater than those numbers, when you take into account the risks of the stock market.

But no matter your preconceptions, the fact of the matter is that 8.2% is the correct answer: the stock market has returned that amount, on average, each year over the 20 years which ended in 2012. In other words, for every $1,000 you started 1993 with, you would have ended up with about $4,800, if you had stayed fully invested in the S&P 500 index the entire time. Not bad, especially since consumer prices in the U.S. advanced about 2.5% each year on average over that time frame.

The Big "If"

But there's a big "if" in that analysis. In case you missed it, we'll repeat it here: "if you had stayed fully invested in the S&P 500 index the entire time."

That's the problem with us fickle investors. When scary times come along, like the one we experienced in late 2008 and early 2009, we tend to either shy away from investing new money in stocks or we withdraw investments we have already made. And when good times come, such as we're currently experiencing, we tend to get excited about getting involved in the stock market.

But how much does this behavior take away from our overall return? It can't be that much, right? After all, the overall trend of the market is always generally upward over the long haul.

Well, the actual answer is that it hurts us quite a lot. The folks at market research firm Dalbar look at this problem from time to time. In a recent report of theirs, they tried to estimate the

return that the average mutual fund investor achieved over the prior 20 years. And the figure they came up with was that the average investor achieved an annual return of just 3.5%.

Gulp. That's a huge discrepancy from the overall market, and a very small return in and of itself. With the overall market going up over 8% per year on average, Dalbar estimates that the average investor earned just 3.5% on their investments. In other words, for every $1,000 invested at the beginning of 1993, the average investor ended up with just $2,000 twenty years later. Plus, that 3.5% figure just barely outpaced the average annual rate of inflation.

Would You Like to Have More Money or Less Money?

So which would you rather have? $4,800 or $2,000? It's kind of a stupid question, right? But, according to the numbers, it's not.

If you are the type of investor who is currently starting to get excited about investing again for the first time in a few years, or if you are the type of investor who was cashing out of everything in the latter part of 2008, then you could be costing yourself dearly over the long term.

If you are either in retirement or close to it, think how much nicer it would be to have 2.4 times as much money as you currently have. Or if you are at an earlier point in your career, think how good a 2.4x raise would feel right about now.

So what's an investor to do? If you take an honest assessment of yourself and realize that you tend to invest more when the market is going up, and withdraw more as the market is going down, then you need to take steps to stop hurting yourself.

Don't Just Do Something, Stand There

We can think of two easy solutions for the problem: First, you could just take away your ability to change course. By that, we mean that you would come up with an asset allocation that's right for your stage in life (say, 100% equities for younger folks, or 70% equities/30% fixed income for people closer to retirement), and then stick with it. Any time you add to or withdraw from your investments, do so in a way that will preserve your target allocation. Or, if you're currently not making any additions or withdrawals, just let your investments sit tight for a year. Then take a look at how far your actual allocation has drifted away from your target allocation, and do a couple of trades to set it back on course.

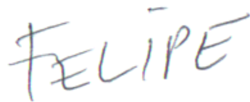
Those words may not mean much to you, so perhaps an example is in order. Let's say you have a $500,000 portfolio to which you are neither adding nor withdrawing money. If you have a 70%/30% split between stocks and bonds, then you have $350,000 in stocks and $150,000 in bonds. Let's say the next hypothetical year is similar in nature to the most recent actual one: stocks advance by about 25%, and bonds decline in value by 2%. Your portfolio at the end of the year would then be $584,500, or about 17% higher. It would be comprised of $437,500 worth of

stocks and $147,000 worth of bonds, for a 75%/25% split. In order to get your investments back to your target of 70%/30%, you would need to sell $28,350 worth of your stocks and use the proceeds to buy bonds. This would cause your $584,500 portfolio to be invested in $409,150 worth of stocks and $175,350 worth of bonds, equivalent to your 70%/30% target.

Get Out of the Driver's Seat

Of course, that example assumes a period of stasis for the portfolio over the course of the year. Probably, though, you will have added or withdrawn cash to the account at some point, which increases the difficulty level of this financial re-balancing act. Which brings us to our next point….

The second solution is even easier than the first. It's to get out of the driver's seat and let a professional drive your investment vehicle. Whether that be a mutual fund manager or a registered investment adviser, have someone else think about the difficult problem of whether to buy or sell something in your account. If you hire someone who has the training and temperament to go against the ingrained human instinct of buying high and selling low, you will only be doing yourself a favor.



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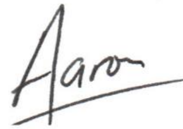

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