

The Rule, Not the Exception

July 16, 2010



The period from March 2009 through April 2010 was a great reprieve for investors. The S&P 500 Index had lost 51 percent from November 2007 through February 2009. Over the following 14 months, in one of the greatest rallies ever, it gained 65 percent.

In May 2010, the market was once again buffeted by a crisis that began with fears of Greece defaulting on its debt. Those fears were exacerbated by the concern that the crisis would spread to other countries (such as Portugal, Italy, Ireland, Hungary and Spain), causing a “contagion” similar to the Asian Contagion crisis that began in Thailand in 1997. That crisis hit the U.S. markets the following year. In just July and August of 1998, the S&P 500 Index lost more than 15 percent. The fear of a repeat performance in 2010 hit global equity markets hard, and volatility soared. Once again, investors began to panic.

The most important lesson investors can learn about equity investing is it always entails a high degree of risk, and frequent crises — whether political, economic or caused by Mother Nature — are the norm, not the exception. Since 1973, we have experienced at least 15 crises, or about one every 2.5 years. Despite that track record, the S&P 500 Index and the MSCI EAFE Index have both provided returns of more than 8 percent per year. In fact, it is because stocks are perceived as very risky that they have produced such large returns: Investors demand a large risk premium to accept the risks of equities.

Those who know their financial history understand that frequently occurring crises are the norm. What we don’t know is when the next one will be, how long it will last and how deep it will be. Unfortunately, as much as we would like to think otherwise, there is no one who can protect us from crises because they are unpredictable.

Over the past few months, we’ve heard plenty of bad news on many different fronts, but that doesn’t mean the market has to go lower. Prices have already fallen because of risks of which we are now fully aware. If the news turns out to be as bad as already expected, prices don’t have to go lower. If the news turns out to be bad but not as bad as expected, prices will rise. Therefore, it is too late to act on the bad news.

Clearly, there are risks, including housing prices continuing to fall, the Greek crisis becoming a contagion, overly aggressive new regulations, increasing taxes and even the threat of trade wars. That is why the market is priced where it is.

Investing in stocks is always risky. The market has certainly provided us with enough reminders of that over the recent past as we have experienced two of the five worst bear markets in just the past 10 years. In a strange way, the recent crisis has provided many investors with another opportunity to make needed changes. When investors realize they are taking more risk than they have the ability, willingness or need to take, the right thing to do is to correct the error. Smart investors know that hope is not a strategy.

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