Client's Corner

Of Temporary Declines and Permanent Losses

THERE IS A CURIOUS KINK IN HUMAN NATURE THAT IS VERY detrimental to success in equity investing.

To wit: in virtually every area of our economic lives, we are attracted to things when they go on sale. Bargain prices draw us in, and we consider stepping up our purchases of items we need, or might just want. Examples: January white sales. End-of-model-year car sales. Black Friday.

(Conversely, we shy away from things that seem to be getting relentlessly more expensive. We seek substitutes, trade down, or just avoid the costly items altogether until their prices normalize. But that's an essay for another day.)

This perfectly normal, supremely rational way of conducting our economic lives suddenly turns completely on its head when it comes to the prices of quality common stocks. When, because of a genuine economic and/or financial disruption, stock prices decline by (let's say) a third—which they have done, on average, about every five years since the end of World War II—we begin actively to fear that we are experiencing a permanent loss of our capital. And we are gripped with an impulse to sell before that permanent loss gets even worse.

This is a very powerful, instinctive human response. And, given time, it has historically turned out to be a serious mistake. Indeed, for some people, it has turned out to be a mistake from which their long-term retirement planning can never recover. The tragedy of this is that all the historical evidence demonstrates the mistake of panic selling into a declining market. Still, people keep doing it.

A moment ago I said that the equity market—for which my proxy is the S&P 500 Index—has declined an average of about a third from a peak to a trough, on an average of around every five years since the end of WWII. For the record, the S&P 500 was about 16 when the war ended. As I write, it is around 2,800. (These historical data, the source of which is the Nobel laureate Robert Shiller, do not include dividends.) This suggests that, however deep the many price declines may have been in the interim, the long-term appreciation in the values of the 500 Index companies has erased those declines and carried equities on to new heights.

Two points, very quickly. First, I'm not making a prediction—past performance is no guarantee of future results. Second, I do not in any way minimize the seriousness of the economic and financial crises which touched off all the significant but ultimately fleeting stock price declines in the past—right up to the present-day COVID-19 pandemic. ***What I invite you to observe is that in every case so far, the declines were ultimately surmounted.***

Thus, in a well-diversified portfolio of quality equities, there has historically been a critical difference between a severe but temporary price decline and a permanent loss of investor capital. The former, as we've seen, is almost commonplace. But the latter has historically not happened ***provided the investor held on***.

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We have had occasion in the very recent past to observe this phenomenon up close. Engulfed by the pandemic, the S&P 500 fell from a new all-time closing high on February 19 into bear market territory—down 20% on a closing basis—in a record 16 days. In 33 days—through March 23—it went down 34%. Investors flew out of equities on a scale not seen since the Great Panic of 2008-2009, and safe-haven money market fund assets soared past $4 trillion for the first time in history.

But does it seem probable that the enterprise value of 500 of America's (and the world's) largest, most innovative, best-financed, best-managed companies ***was permanently diminished by a third in those five weeks?***

I hope this essay will prompt you to take up two key questions with your financial advisor. First, is it possible that stocks are like everything else in our economic life—that when their ***prices*** become deeply discounted, their enduring ***value*** as good companies might actually be increasing? That they may just be, in a very real sense, "on sale"?

And second, might a significant decline in the price of a well-diversified, high-quality equity portfolio be something entirely different from a permanent loss of capital? Indeed, is it not historically probable that a temporary market decline becomes an irretrievable loss of capital ***only if and when you sell?***