Client's Corner

How Would a 20% Market Decline Affect You?

LAST WEEK, I SAW A "NEWS" ITEM ON MY USUAL FINANCIAL "news" website, to the effect that a high-profile market strategist was "warning" of the "risk" of a 20% decline in stock prices.

I'd seen essentially the same headline, attributed to a different expert/guru/seer, the previous week. And another the week before that. I confidently expect to see it again next week. Somebody somewhere is always opining about a market decline of some significance. And financial journalism, which feeds avidly on anything that's even potentially negative, will be sure to pick up on it every time.

In many instances, one finds that the "expert" being quoted isn't even predicting such a pullback; he or she is simply making a case that—if this, that, and the other current economic/business trend continues—it ***might*** take a bite out of corporate earnings for the next couple of quarters. And if that were to happen, the equity market ***might*** back up, to discount the effect of said bite. But this is not a distinction that financial headline writers are apt to make.

Nor is it the distinction I'm encouraging you to make. Rather, I'm inviting you to ask a larger, better question. To wit:

"Yes, it's certainly possible that, at any given time, the equity market may pull back more than a little, or more than momentarily—say 20%. *How would that affect me, in terms of my ability to pursue my long-term investment/financial plan?*"

Let's assume, for example, that you are accumulating capital primarily for retirement. You and your financial advisor have made a plan that would—assuming no more than long-term average equity returns—endow you at retirement with a sum of capital from which you could begin to withdraw a lifestyle-sustaining income.

It should be clear to you that a 20% equity market decline would present you with an opportunity. As long as the weakness lasts—that is, until the long-term uptrend in equity values reasserts itself ***as it has always done in the past***—your capital contributions will be purchasing shares at somewhat depressed prices.

This is actually a good thing. That is, as in every other aspect of our economic lives, it is better to acquire the things we will always need to own when and if they go on sale. Sadly, when it comes to accumulating equities, the salutary effect of market declines is somehow not intuitive. (As I suggested a few months ago in one of these essays, in 50 years I've never experienced a significant market decline during which someone didn't come to me and ask, "Should I stop contributing to my IRA/401(k)?")

Thus, the accumulating investor should always—with a little gentle encouragement from his/her financial advisor—be experiencing equity market declines as an opportunist rather than as a victim.

This situation is admittedly much more problematic in the case of people already retired, and withdrawing from the equities they accumulated throughout their working years. They have every reason to be acutely concerned about withdrawing from a declining asset base. The principle here is quite clear: upon discovering that you're digging yourself into a hole, the first thing to do is stop digging. Which simply means—as your financial advisor has no doubt counseled—that you begin your equity withdrawal journey in retirement with significant cash reserves.

You might wish to consider holding, say, two years' living expenses in a cash equivalent. Warren Buffett has said that he's instructed the trustees of his wife's trust to invest 90% of the proceeds in equities and hold 10% in cash. The principle is the same, and it's sound: particularly in the early years of retirement, you need to be able to cut back significantly—and even stop altogether—withdrawing from equities. Cash reserves are the conceptual solution: I gladly defer to your advisor as to the specifics in your particular circumstances.

I hasten to add that getting out of equities altogether can't be the answer. Your mortal enemy in retirement isn't the occasional equity "volatility." It's the relentless, grinding, inexorable increase in your cost of living over decades in retirement.

A preponderantly fixed-income approach to a rising-cost retirement not only fails to solve this problem; it exposes you further to it. You will need the potentially rising cash dividends of mainstream equities to fight off inflation—which they've historically done superbly. Just in the last 30 years, for example, while the Consumer Price Index about doubled, the cash dividend of the S&P 500 increased nearly fivefold. (Would I be piling on if I pointed out that the Index itself is up more than 10 times in those 30 years? If so, I apologize.)

The issue, then, when the perennial warning/forecast of a market decline surfaces yet again, is not to wonder if it's accurate or not. It either is or it isn't; there's no way to be sure. The question is: ***how would it affect me?*** If you're accumulating, it's an opportunity. And even if you're withdrawing: you can be holding significant cash reserves, if needed, to ride it out.

You can't predict, but you can plan.

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