

# 10 years in the school of hard knocks

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**Emotions still drive many individual investors, but the housing bubble and Great Recession have taught some that discipline is the key to successful wealth management.**



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**I**t turns out that a plunging stock market, a bursting real estate bubble and a near-meltdown of the global financial system still aren't enough to change human nature.

"We see people making the same behavioral mistakes they have always made," says Stephan Cassaday, chief executive of Cassaday & Company in McLean. "Investors are still driven by their emotions. What doesn't ever change is the emotional component."

The roller-coaster ride of the past 10 years—which took investors from the euphoria of housing and stock market bubbles through a massive drop in asset values and the Great Recession then on to the recovery and new stock market highs—has not affected the behavior of the average investor, according to top Northern Virginia investment advisers.

"In many cases, they haven't learned a single thing," says Gordon Bernhardt at Bernhardt Wealth Management in McLean. "Behavioral finance teaches us that investors will make the same mistakes day after day."

The mistake that many investors made during the crisis and made again during the market volatility this past summer was to get panicky and sell when the market was going down, converting their assets to cash instead of holding on to the stocks or even buying more in anticipation of the inevitable rebound.

"People tend to buy when they are comfortable and sell when they are uncomfortable," Cassaday says.

That said, the anguish most investors experienced during the economic downturn is still fresh enough in memory that some, especially those who have financial professionals to help keep them on track, have come to appreciate the importance of discipline in investing.

At the same time, competition among financial services providers, increasing sophistication of products and even technological advances have put more tools at their disposal.

“What investors should have learned is that you can’t outguess the market,” Bernhardt says. “You should always stick to the asset allocation plan you have.”

By the time the financial crisis came along in 2008, the bursting of the tech bubble in 1999-2000 was “a distant memory,” recalls David Mount of the Wise Investor Group in Reston.

“One lesson that is universal is the importance of having an investment plan in place,” Mount says. “It takes emotions out of the equation.”

Those who were hurt in that earlier tech crash didn’t learn that lesson. “It made them wary of tech stocks and curbed their unbridled enthusiasm for stocks,” says Wayne Zell at the law firm of Odin, Feldman & Pittleman in Fairfax. “But they redirected their investments into real estate with no idea there was a downside.”

Susan Chesson at Focus Wealth Management in Fairfax says the new crisis in 2008 was a wake-up call for many investors. “It reminds you that there are risks in the market,” she says. “They still feel the emotional scars; emotions are still quite raw.”

The sharp downturn in stocks brought home the need for a broadly diversified portfolio that includes other types of assets, like bonds, says Marjorie Fox at FJY Financial in Reston.

“Before they said, ‘Why do I have to have money in bonds, which are doing less well than stocks,’” she says. After the stock market plunged, however, “they really got why bonds are important.”

Most of Fox’s clients have some portion of their portfolio in bonds, anywhere from 30 to 70 percent, “despite how frustrating it is in this low-interest environment.”

Some investors, she adds, “have so much money” they don’t even need the growth potential that stocks provide and prefer to hold mostly bonds as a way of preserving capital.

A typical portfolio, however, is more likely to be 60 percent equities, 30 percent bonds and 10 percent cash. The challenge is to maintain that asset allocation during the ups and downs of the markets by rebalancing the portfolio.

“Rebalancing is really the key,” Chesson says. “When the stock market is dropping, buy more. When it’s frothy, sell.”

Emotionally, investors resist selling a stock when it is rising, and yet that is the way to capture gains.

“Rebalancing is the only way you can buy low and sell high,” Chesson says. Investors who rely on market timing to buy low and sell high are bound to fail. “The odds of getting it right once are slim and twice impossible,” she says.

This is part of the discipline investors need to make good returns over the long haul, advisers say. As scary as the downturn was in 2008, those who remained disciplined benefited.

“Those who sold missed incredible rates of return,” Bernhardt says. “It is a mistake to take your losses.”

The bonds should be short and intermediate investment-grade bonds, advisers say. Those bonds with higher yields, tempting as they are, won’t provide the stability a portfolio needs.

“We counsel clients not to look for high returns in bonds,” Fox says. Investors who chased the higher yields in Puerto Rican bonds, for instance, have now lost 30 percent of their investment, she notes. “Right now you don’t get stability in emerging markets.”

The best strategy, according to Cassaday, is to “remain fully invested in a broadly diversified portfolio, with risk mitigated by asset allocation.”

This is true even for investors who are either approaching or are already in retirement. While the 40 percent plunge in stock prices in 2008 alarmed investors, most can afford to ride out a bear market, even in retirement.

“No one needs all their money at one time,” Cassaday says. “It never, ever happens.” Those who need to tap their portfolio during a stock downturn can draw on the cash or bond component.

“Nobody should have to sell stock to pay for college tuition or retirement,” Chesson says. The bond and cash component should be sufficient to meet the investor’s needs over the intermediate term so that they can weather the inevitable downturn in stocks.

“Reminding them of the inevitability and unpredictability of a downturn is our greatest service to clients,” Cassaday says. “We tell clients to hold on to the side of the kayak.”

Nowadays, investors are looking at a potential 30- to 40-year time horizon even as they approach retirement, which is more than enough time to ride out a bear market.

“I don’t know what’s going to happen,” Bernhardt says. “But I do know that in 10 years, equities will be higher than today.”

Investors do themselves a disservice if they constantly fret over the general volatility in the markets or the ups and downs of a particular stock. “You’re better off lining the birdcage with the financial section,” Bernhardt says, and sticking to the long-term view.

On the other hand, notes Chesson, some of the new software tools available can help investors see the advantages of a disciplined approach to investment.

“They can actually see that investing in a falling market pays off,” she says. Those who sell in a downturn end up trailing returns by a substantial amount.

Quarterly reports from portfolio managers have grown much more visual and now graphically display the higher returns from maintaining discipline.

“Now, in a market downturn, I get more calls asking whether they should buy more,” Chesson says.

Some investors have grown smarter in other ways over the past 10 years, advisers agree, partly as a result of going through the financial crisis, but also as part of a general maturing process as the baby-boom generation approaches retirement.

“One thing people have learned is that the accumulation of a huge debt burden is not beneficial,” notes Zell, citing the millions of people who lost their jobs or their homes in the wake of the crisis. “They are now more inclined to pay down debt than to engage in speculative investment.”

Zell also says investors are becoming much more aware of the fees they are paying even for management of index funds as competitive pressures force portfolio managers to become more transparent. “It’s just beginning to filter through,” he says. “It doesn’t matter whether you are using an independent adviser or a mutual fund; it is a service that costs money.”

As investment advice becomes more of a commodity, however, it puts pressure on these fees, he says.

By the same token, though, investors are also waking up to the fact that there is risk hidden in almost any investment, and professional guidance can help them understand just how much risk they are undertaking.

“You can do all the investigating you want, [but] you’re still going to have risk,” Zell says. “Warren Buffett is an extremely educated investor. He does more research than most people have time for. But he has lost a lot of money on investments, too.”

Investors don't escape this risk even if they go for index funds or exchange-traded funds that simply track a market or a particular sector.

"Passive investing has gigantic risks," Cassaday says. His firm counsels strongly against ETFs, for instance. "Some people want to just put all their money in an index, but they don't understand them [and] don't understand what they do."

Boring down into a second and third level of potential return, as active portfolio managers do, is more likely to produce growth in a portfolio, he says. For instance, an index of European stocks might be following the downward trend in that market, while a European-based company like Nestlé, which realizes most of its sales outside Europe, can still be a good investment. Ditto for emerging markets, which investors have been fleeing as those market indexes turn down. But Beijing Enterprises Water Group, Cassaday says, is still a safe stock to invest in. "People will always need water," he says.

Fox says many of her boomer clients seem to have matured simply as they grew older, especially after they lost one or both parents.

"For one thing, they have seen the value of good estate planning," she says. Either they have benefited from smart moves made by their parents, or they have waded through a messy transition because there was no planning.

The lesson of having the necessary liquidity available has also made investors more aware of having an income strategy for retirement, she says.

One new tool that is attracting adherents is an asset dedication strategy. This is a further refinement of relying on the bond component of a portfolio for cash needs because it manages the holdings so that just the right amount of bonds mature at the end of a year to supply cash needs for the coming year.

Risk management expert David Wexler at Greenberg, Wexler & Eig in Bethesda has seen investors paying much more attention to insurance products over the past 10 years, especially in the wake of the financial crisis.

The market crash in 2008, for instance, wiped out the portion of many portfolios that investors had earmarked as a legacy for their heirs and prompted them to take a new look at life insurance as an appropriate substitute.

"Life insurance is a risk management tool that can hedge wealth creation and furnish a legacy that wouldn't be subject to market risk," Wexler says.

In addition, the underlying asset structure in a life insurance policy—largely fixed-income assets—will generally be producing a higher yield than direct investments in fixed income.

Another consequence has been an uptick in interest in long-term care insurance, Wexler says. "Many people thought they were wealthy enough to self-insure," he says. "But the loss of assets, or the necessity of selling assets and paying tax, has increased interest in insurance."

In short, Wexler says, the downturn prompted people to look differently at risks in the economy and to consider insurance as a tool to transfer risk.

It remains to be seen how long any of these lessons will last, advisers say. Cassaday sees signs in increased stock market volatility of individual investors returning to the market and once again buying and selling according to their emotions.

"The people who learned anything are still in the minority," Bernhardt says. "The biggest challenge for them is to keep their emotions in check."

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