Client's Corner

The Folly of Waiting for the Bottom

THE EQUITY MARKET RESPONDED TO THE SUDDEN ONSET OF the COVID-19 crisis with total shock: the S&P 500 Index fell from a new all-time high into bear market territory (a close down 20%) in a record 16 days. In less than five weeks, it closed down 34% from its February 19 peak. Whereupon, even as virus infections and deaths continued to rise sharply, and economic data went from bad to dreadful, the market suddenly made back about half its loss. As I write, it's just over 2,800.

These are the facts as we find them. The question becomes: what is a long-term, goal-focused investor to do?

The very worst thing he/she might do, clearly, is to sell out in fear. With that one exception, the most disastrous decision a serious investor can make is "waiting for the bottom."

Other than by sheer accident, no one catches the bottom—not least of all because we won't know it ***was*** the bottom until we're well past it. Moreover, bottoms are usually made even as the news headlines are near an apogee of fear, when buying seems unthinkable. One of the worst monthly job-loss numbers on record—774,000 jobs gone in a month—was reported on Friday, March 6, 2009. On the following Monday the market bottomed, and proceeded to return, with dividends reinvested, over 16% annually for very nearly 11 years.*

This conundrum becomes even more acute when, as in the current instance, the market has already rallied very significantly from a panic low—raising at least the possibility that, despite the clearly worsening economy, the market bottom may already be in.

The plain fact is that no one can know whether the low has been made. So instead of obsessing about the unknowable, we might at least begin to find a way forward by ***reframing the question***, as follows.

Let's assume that you have a sum of money which should—given your long-term goal of a dignified and independent retirement—be invested in quality equities ***at some point***. Let's further assume that you fear the current rally is an illusion, that the lows do indeed remain to be tested. You've decided to keep your powder dry until then. How shall we assess the risk/reward ratio of your strategy?

If you're right, you will enhance your position to the extent of some 20% by entering the market at, say, S&P 2,200, rather than the current 2,800. That's the full extent of the potential reward in your scenario. What, then, is the risk of implementing this strategy?

In point of fact, that risk is immeasurable, because there is no finite limit to the extent the equity market may rise in the coming years ***with you still out—waiting for the pullback that doesn't come.*** (Or that, when it does come, doesn't drive the market down to your chosen entry point.)

Now, let's turn this assessment on its head. Say you decide that the low is probably in—that even as the near-term economic numbers continue to worsen, the market has chosen to look across the valley, and likes what it's seeing. You deploy your capital here—but turn out to be dead wrong; the market does indeed fall back to the neighborhood of 2,200. Here the risk/reward situation has reversed: your "loss" from being temporarily wrong is about 20%, ***but your upside remains, albeit from a lower level, immeasurable.***

I'm confident that a rational long-term investor and his/her advisor—***with enough humility to simply say "We don't know"***—will have no trouble making the right choice, if these are the only two alternatives.

But happily, they're not. How about splitting the difference?

Let's say you decide that, regardless of whether it tests the lows or not, the market can't make any important headway until the plague and the resultant economic calamity are behind us. And you don't expect that to happen much before (say) Thanksgiving. One possible strategy: deploy your investable sum in equal installments from May through November.

Or suppose you just can't shake the fear of a test of the old low. Fine: put a quarter of your capital in at each 200 point drop starting here around 2,800. Ah, but then suppose prices don't get all the way back down to 2,200; what's Plan B? Well, if and when the market makes a significant new all-time high (at 3,500, say), accept that the game is probably up, that the long-term advance is getting back in gear, and that you'd better get aboard.

These strategies are potentially effective whatever your downside target (or fear) may be. And ***any*** strategy that gets you systematically investing in the long-term equity portfolio your retirement plan demands is vastly preferable to arbitrarily picking a bottom—or, worse, waiting for a bottom that isn't obvious until the next advance is already well under way.

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* Source: "Is This Time Really Different?" by Michael LaBella, Legg Mason's Head of Global Equity Strategy, March 31, 2020