Steadyhand

The hardest decision in investing

A guide to getting back into the market

Markets are gyrating wildly. Stocks are dropping. It's getting scarier every day. You've done well with your investments over the last decade, but don't feel you can absorb any more downside. So, you sell your stocks and stock funds, and move into a money market fund or GIC.

Your move, which we'll call decision #1, is totally understandable. It's the easiest, most comforting action you can take, but unfortunately, it doesn't allow you to relax for long. After a few good nights' sleep, you have another decision to make — when and how to get back into the market.

No matter how good your timing turns out to be on the first decision, the strategy can only be deemed a success (or failure) after you've made the second one.

This report focuses on decision #2 — getting back into the market. We call it the *hardest decision in investing.*

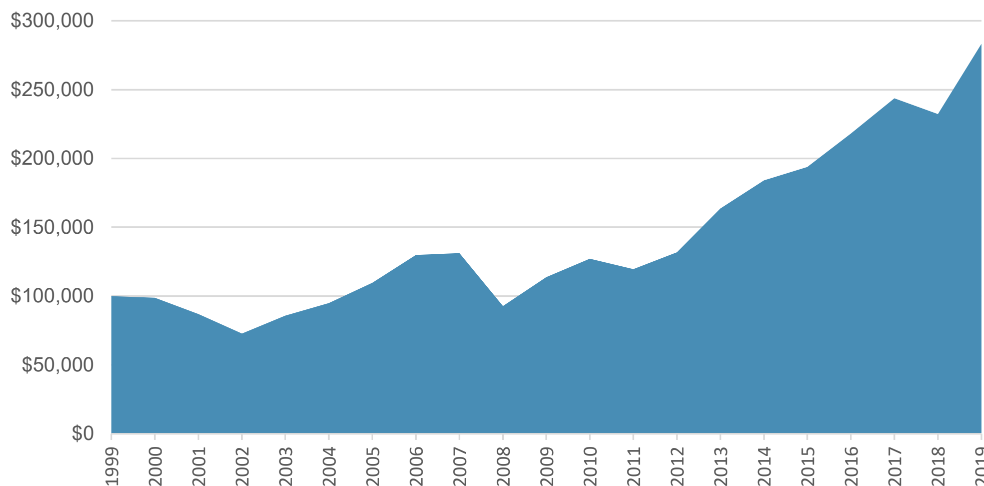
The missed cycle

We're writing this report because this is an important issue. We've seen it come into play time and again. Investors who move out of the market have great difficulty getting back in. We've had prospective clients fill out all the paperwork to become a client and then never fund their account. They couldn't take the first step to getting invested again.

There's empirical evidence that many Canadians were underinvested throughout most of the last bull market that began in March 2009. The *2014 BlackRock Investor Pulse Survey* showed that almost two-thirds of Canadians' financial assets were parked in low-yielding, short-term instruments. This, despite the fact that those surveyed indicated their ideal cash level was between 20% and 31% of assets, depending on age and portfolio size.

Diversified stock portfolio 2000-2019

(50% Canadian stocks; 50% Global stocks)



Why is it so hard?

You were decisive when you sold. The risks were in plain view and you acted quickly. The decision to buy back in, however, will be anything but decisive. There are several reasons why we say this.

First, buying back into stocks is a positive act and we're wired to favour the negative. Research shows that past losses make us prone to a behavioral bias called loss aversion — the tendency to strongly prefer avoiding losses over obtaining gains. In other words, we feel and remember the losses more than the gains (up to 2.5 times more according to some academic research).

The second reason is that our loss aversion is fed by a steady stream of bad news. Companies, industries, and regions that are doing well don't get the media's attention. Government deficits, job cuts, corporate losses, bankruptcies, and the threat of recession are what's featured on page 1.

This negative tilt continually reinforces the view that being out of the market is the right thing to do.

Third, the stock market interprets news differently than we do in our daily lives. You're waiting for things to improve before you invest again while Mr. Market is focusing on what the headlines might be 12-18 months from now. This disconnect makes it likely that you'll miss a good portion of the recovery because the turnaround may start with little or no good news being reported.

And decision #2 is difficult because the stakes are high. For most investors, moving into cash and short-term investments represents a huge deviation from their long-term plan, or what we refer to as SAM (strategic asset mix). This big bet makes investing, which is hard enough at the best of times, even more pressure packed.

The decision to buy back in will be anything but decisive

Whipsawed

You now see why we call getting back into the market the hardest decision in investing. But it could be worse. If the sell decision turns out to be ill-timed and stocks have risen since you sold, the psychological challenge increases exponentially. Your move has already cost you money and the possibility of being whipsawed — the market turns around and goes down after you buy — can be psychologically crippling.

Why invest?

Before exploring ways to implement decision #2, it's important to revisit why you should invest at all.

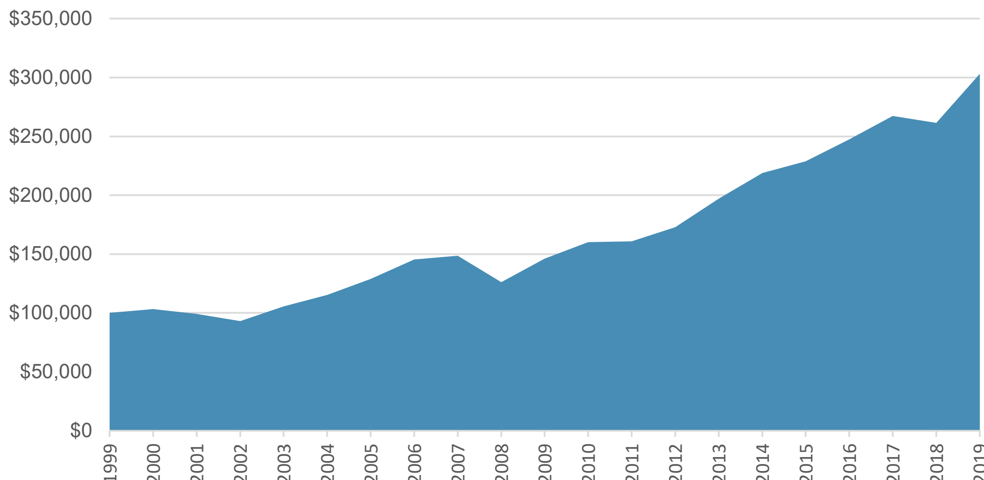
There are a small minority of investors who are either in their twilight years or have enough money such that they don't need to invest, but most of us don't have that option. We need to build our asset base so we can pay ourselves an income in retirement.

Putting money into savings vehicles that offer a set return and no downside risk doesn't help you achieve your long-term goals. These products offer a modest return that, after any fees and taxes, lose ground to inflation.

Let's put it in dollar terms. You have $100,000 in savings and put it into an account that earns 2%. After 10 years, you have $120,000 (before taxes) which buys fewer goods and services than the $100,000 did a decade earlier.

To build your wealth, you need to generate a return in excess of inflation. For that, you need to apply a simple formula: risk + time = return. Historically, a combination of risks — equity risk; interest rate risk; and credit risk — and time have handily beat inflation.

Up and to the right: Growth of a balanced portfolio 2000-2019
(40% Canadian bonds; 30% Canadian stocks; 30% Global stocks)



We use the phrase 'combination of risks' advisedly because a portfolio that's diversified across asset types (cash, bonds and stocks), industries and geographies will feel the market downdrafts less and be assured of a full recovery.

Getting back in — A two-step process

Reinvesting your retirement savings requires a methodical approach. We recommend a two-step process that starts with determining where you're going and then lays out a plan to get there.

Where you're going

You shouldn't spend a minute thinking about how you're going to invest until you know where you're going. Step one is to determine how your portfolio should be positioned for the long term. It requires that you put the current market landscape and your recent stock sales aside and go back to square one.

You need to put a plan together that answers the following questions:

- How long before you'll need to draw on your nest egg?
- How much of your retirement income will come from your investment portfolio?
- How much short-term downside are you willing to take (i.e. a drop in your portfolio value)?
- Are there other priorities to take care of — i.e. debt reduction, house maintenance, life insurance.

From these answers, you can determine a mix of assets that will serve your family over the next 5-10 years. We call this your strategic asset mix, or SAM.

When setting your SAM, it's important not to get anchored on your previous mix of assets, or your current one. The mix you had prior to moving into cash proved to be too aggressive, so it may not be appropriate going forward. The current, cash-heavy mix is almost certainly inadequate for building wealth over the long term.

Step 1 should be done right away, even if you can't see yourself investing in the immediate future. There's no excuse for being ill prepared for what's ahead.

Getting there

In simple terms, there are two approaches you can take to reinvest your portfolio. You can redeploy your cash (1) all at once, or (2) gradually.

We're not going to spend any time considering the first option because we don't believe it's realistic. That's because it brings with it a tendency to try to time the market precisely (buying just before the market goes up). This pursuit of perfection turns an already difficult decision into an impossible one. *Reinvesting in the market is not about maximizing return. It's about getting it approximately right and winning the behavioural battle (outlined above).*

For this reason, we recommend buying in increments, or what's called 'dollar-cost averaging'. For example, investing $100,000 by making monthly contributions of $10,000 over the next 10 months. Averaging into the market takes the intensity and emotion out of each transaction and helps manage the inevitable post-purchase dissonance.

The magnitude and pace of your steps depends on a number of factors:

- The purpose of the money.
- How far you are from your SAM.
- The length of time you'll be investing.

We've laid out below some general rules for investors at different stages of their investing careers. To be clear, these tips are a starting point, not a set-in-stone process. Your situation is unique and requires a custom solution.

Accumulators ***(investing for the next 30-50 years)***

If you're in this category and are sitting on the sidelines, you're taking a huge risk. Your goal is to generate an above-inflation return over the long term. Secure savings vehicles are not designed for this purpose and are a mismatch with your objectives.

You're a long way from your plan and need to do something soon. This means getting back to your SAM in a matter of months, not years. You should get started right away, even if you've only been out of the market for a short time.

As noted above, *the first step is an important one, even if it's a baby step. It gets over a big psychological hurdle and establishes a pattern going forward. Don't go too long without doing something.*

Soon-to-be or just retired *(investing for 20-30 years)*

With interest rates so low, it's a difficult time to be a retired investor. Any investment product that has the potential to earn an above-inflation return comes with some volatility and risk of loss.

If you're in this category, a reinvestment strategy to consider is dividing your portfolio into separate buckets based on when the money will be needed — i.e. current living expenses versus 30 years from now. Start by carving out the amount you'll need to cover expenses for the next 5 years. This bucket is your 'spending reserve' and should be invested in short-term savings vehicles.

Then, with the next five years taken care of, allocate the rest of your assets to years six through 30. This 'Over 70' bucket has a longer-term objective and is similar to the accumulators' portfolios (discussed above). It's a long way from where it should be, so the time frame to reinvest should be short.

The bucket approach makes decision #2 easier to stomach because you know the 'Over 70' account won't be needed for many years. It has time to recover from any market downturns. The combination of your spending reserve (0-5 years) and long-term assets (6-30 years) won't add up to the SAM you picked in step 1, but it moves you a long way in that direction. The hope is that you will get more comfortable investing and shrink your spending reserve over time, perhaps to 2-3 years. As this happens, the long-term assets will account for a larger portion of your portfolio and you'll move closer to your SAM.

Retirement *(investing for 10-25 years)*

If you're an established retiree, your strategy should be similar to the Just Retireds. The savings instruments you have in the 6-25 year bucket ('Over 80 or 90') are also mismatched with their purpose.

Elder years *(investing for 5-10 years)*

If you're in your later years, you may not need to invest again. The general rule is, if you need the money in the next three years, you shouldn't be taking any risk. Savings accounts and GIC's are the way to go. For 3-5 years out, it gets trickier. You want some return but it's still a short time frame in terms of investing. Any investment should be conservative (i.e. a bond fund or income-oriented balanced fund) and the pace of dollar-cost averaging should be gradual.

There is one caveat to this. For money you know will not be required for living expenses, you may wish to take a different tack. If, for instance, a portion of

your nest egg is designated to go to your children (or charity), you may want to invest this bucket in a SAM that matches their goals and needs. For example, if your daughter's RRSP and TFSA are 80% invested in stocks, you may consider following her lead with her part of your portfolio. Or, if you're going to help with a down payment or grandchild's college tuition, then the money should be set aside in a more secure, savings vehicle. In other words, pick an asset mix that reflects the recipient's needs, whether she knows the money is coming to her or not.

Final Words

This report is intended to help with one of the most difficult dilemmas investors can find themselves in. The suggestions and strategies offered are intended to help move your process along.

You should view being out of the stock market as a temporary state. A cash-heavy portfolio doesn't fit with your goals. *Your long-term success depends on not only making a good sell decision, but also making a second decision — when and how to get back into the market.*

The decision to reinvest needs your full attention, even if you can't see yourself investing in the near term. It is, after all, *the hardest decision in investing.*

Disclaimers

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