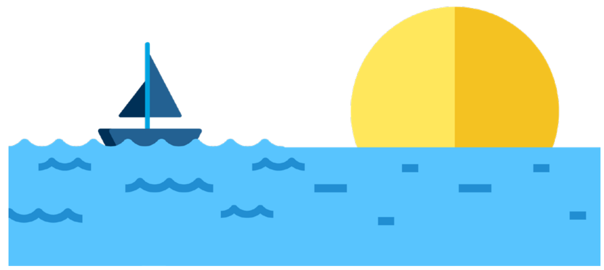
Why you should stay invested, even during volatile markets

It's only natural to get queasy when markets fall. Whatever you do, don't bail out of the market. Here's why.



Most investors will, at one time or another, experience the stomach-dropping panic that comes with a falling stock market. It's normal for your fight-or-flight stress response to kick in, urging you to take money out of your portfolio and head for more secure financial ground, probably in cash. But while it may seem counterintuitive, staying invested in volatile markets is often the best course of action. Here are four reasons why.

1. You want to avoid locking in losses

When markets fall, most investors don't lose any actual money—it's just a loss on paper. They still own the same number of shares as they did before; true losses are only realized if they sell the stock at the lower price.

Unless you're in retirement and removing money from your portfolio, it's likely you probably hadn't planned to sell your stock anyway, since investing is typically a long-term endeavour. So, why get out now? It's important to keep your ultimate investment goal in mind and your time horizon—investors usually have longer than they think.

(If you do need funds within the next one-to-three years, you may want to keep your money out of equities and in short-term bonds or guranteed investment certificates instead so that you don't have to pull money out of your portfolio during a downturn.)

Remember: you want to sell a stock when the price is high, not low. If you follow a knee-jerk reaction to sell in an apparent downturn, all you may be doing is taking a loss.

2. Down markets are normal (and, when thinking long-term, usually brief)

The markets have been relatively strong over the last decade, with the S&P 500 rising by 342% since March 9, 2009—the day markets began to rebound after the recession. (Canada's S&P/TSX Composite Index hasn't fared as well, but it is up 122% since then.) While rising markets have certainly been good for investors, it's also caused a lot of people to forget that stocks do fall from time to time. Yet, whenever people hear about a market decline, they start to fear the worst.

What people don't realize, though, is that most downturns are reasonably minor and short lived. Since 1945, for example, the S&P 500 Composite Index has experienced, on average, declines of 5% or more three times a year, declines of 10% or more once a year, and declines of 15% or more once every four years. The length of those downturns ranged, on average, from about a month and a half, to four months, to nine months, respectively. True "bear markets"—when the S&P 500 declines 20% or more from its previous high—have occurred only eight times since 1926, and have lasted, on average, just under a year.

With that in mind, it doesn't make sense to sell if the market will bounce back after a few weeks or months. And, more importantly, it's hard to know when it will. A better idea is to create a diversified portfolio with different asset classes and equities in different sectors to fortify your portfolio and prevent it from falling more than the overall market. That, and keeping the fact that it's normal for downturns to happen in mind, you won't feel as much panic the next time stocks fall.

3. You can't time the market

One of the main arguments for not panicking during a downturn is that it's impossible to predict when the market will rebound again. It may be easy to jump out as stocks are falling—even then you can't know if you're selling at the top or the bottom—but no crystal ball will tell you when to buy back in.

This is a critical point. Research shows that investors who attempt to time the market by selling and repurchasing stocks later fare worse than those who buy and hold those same investments. Sure, if you somehow sold in October 2008 and then bought back in on March 9th, 2009 you would have done well, but the vast majority of investors did not buy back on that specific date. In fact, many retail investors waited years before getting back into equities. If they had just held on to their stocks during the drop, they would be better off today.

For instance, according to S&P Capital IQ, if you bought into the S&P 500 on October 1st, 2008, you'd be up 157% today. If you sold your stock and got back in any time after September 2011, you'd be worse off today than you were right before the financial crisis.

Instead of trying to time the market, rebalance your portfolio. If you want a 60% allocation to equities and a 40% to bonds, but your allocation falls to 50/50 as the market drops, consider selling 10% of your bond allocation and investing that money in equities instead. Not only will you maintain your desired asset mix, but you'll be buying low, too.

4. Over the long-term, you'll achieve better returns than bank interest

Keep in mind that the stock market is for all kinds of investors—not just those who like loading up on stock. If you can't stomach the typical ups and downs, then consider creating a more conservative portfolio that has a higher allocation of fixed income than equities. (You may not want to make the switch in the middle of a downturn, for all the reasons listed above.)

While a bond-heavy portfolio will provide lower returns than an equity-focused one, it may still be better to invest this way for the long-term instead of putting cash into a savings account, which will likely generate an extremely low rate, depending on the institution.

Obviously, nobody likes to see their portfolios shrink. So, when markets get rocky, try to keep some perspective. Remind yourself that most downturns are short and, so long as you stay invested through the recovery, you will likely recoup those losses and then some.
