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Keep Your Money in the Market

We've been through ups and downs before.

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As the world economy reels under the weight of the worst financial crisis since the Great Depression, we have been left with a broken financial system. Financial institutions around the world have suffered life-threatening, self-inflicted wounds by purchasing over a trillion dollars of complex mortgage-backed securities backed by dodgy loans based on inflated real-estate values. These assets have been financed with enormous leverage and with short-term debt. Just prior to its "rescue," Bear Stearns had a debt to equity ratio of over 30 to 1, making it susceptible to a "run on the bank," although Bear was not a commercial bank but rather part of the "shadow banking system" built on derivatives.

The long-run solution to the present crisis must involve substantial deleveraging and a recapitalization of our financial institutions. In the meantime, credit has been essentially frozen and a world-wide recession seems almost inevitable.

But just because stock markets have panicked, investors should not. The best position for investors today is not "fetal and 100% in cash." We are not going to have a depression, and we have survived financial crises before. A century of investing experience, as well as insights from the field of behavioral finance, suggest that investors who bail out of equities during times like these are almost always making the wrong decision.

It is very tempting to try to time the market. We all have 20/20 hindsight. It is clear that selling stocks a year ago would have been an excellent strategy. But neither individuals nor investment professionals can consistently time the market. The herd instinct is extraordinarily powerful. When the economy and the stock market were booming in early 2000, investors could easily convince themselves that prosperity would continue without interruption and that stocks catering to the "New Economy" were surefire tickets to wealth. Individuals poured more money into equity mutual-funds during the last quarter of 1999 and the first quarter of 2000 than ever before. And not only was the timing wrong but so was the selection of funds. The money flow was directed to the hot Internet funds. Investors liquidated "value" funds that owned less exciting businesses, whose stocks sold at only modest multiples of their earnings and book values.

The herd instinct works exactly the same way in bear markets. Nervous investors convince themselves that every "light at the end of the tunnel" is a train coming in the opposite direction. Panic is just as infectious as blind optimism. During the third quarter

of 2002, which turned out to be the bottom of a punishing bear market, investors redeemed their mutual funds in droves. My own calculations show that in the aggregate, investors who moved money in and out of equity mutual-funds underperformed the buy-and-hold investors by almost three percentage points per year during the 1995-2007 period.

Look at history: The market eventually bounded back from the damaging stagflation of the 1970s and the savings-and-loan crisis of the early 1990s, when a whole industry had to be rescued. Stocks also recovered from the Asian crisis of the late 1990s. Similarly, investors who held on after the more than 20% one-day stock-market decline in 1987 were eventually well rewarded.

So what should investors do? By all means, young 401(k) investors, and those in their prime earnings years, who are stashing away funds from every monthly paycheck, should stay the course. If you decide to eschew equities during periods of ubiquitous pessimism, you will lose all of the advantage of "dollar cost" averaging (buying more shares when prices are low than when they are high). Asset allocations should be shifted to safer securities over time as the investor ages, but only gradually and on a set schedule as through a "target maturity fund."

If you are now approaching retirement and failed to move to a more conservative asset allocation, you should not do so now in response to a time of panic. If anything, well diversified investors should, at the end of each year, consider rebalancing to ensure that your portfolio composition remains consistent with the risk level appropriate for your financial circumstances and tolerance for risk. But this is likely to mean shifting into equities and not out of them.

Suppose you started the year with a portfolio of half stocks and half Treasury bonds. You are likely to find that the value of your bonds has gone up, as Treasury yields have fallen, and your stock portfolio has declined. Suppose the allocation at rebalancing time is two-thirds bonds and one-third stocks. The appropriate strategy is then to sell safe bonds and buy more equities to bring the stock/bond ratio back to 50%. Over the past decade, rebalancing a 50-50 portfolio each year has added to investors' returns and reduced risk.

We will have a serious recession now, but a 1930s-style depression is highly unlikely. We will not let the money supply decline by 25%, as we did in the '30s, and automatic stabilizers (like unemployment insurance) are now a significant element of fiscal policy. Don't forget that the U.S. economy is still the most flexible in the world and our "innovation machine" is alive and well.

No one has consistently made money by selling America short, and I am confident the same lesson is true today.

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