October 1st, 2004

We Floridians have had to deal with four major hurricanes over the past two months: Charlie, Frances, Ivan, and Jeanne. Hurricane preparedness is simply a fact of life for those of us who chose to live in the Sunshine State. When the local media warn us about a threatening tropical depression, we shutter up our houses, stockpile food and water, and treat our "D" flashlight batteries like gold nuggets. In this case, preparedness is prudent.

Similarly, the national financial media have been warning us of an impending financial hurricane consisting of higher interest rates, global terrorism, and the November Presidential election. The "experts" point to these events as reasons for why the economy, and subsequently the stock market, may produce sub-par results. With the painful bear market of 2000-2002 still very fresh in investors' minds, some may be tempted to prepare our portfolios for disaster as well.

Given the irony, we could not help but dig up one of our favorite Worth Magazine quotes from one of the world's greatest investors, Peter Lynch, in January of 1995:

"Let me go on record with Lynch's prediction: Another big (stock market) correction is on the way. You read it here first. Assuming you agree with my forecast, how can we prepare? Mostly by doing ***nothing****.*

This is where a market calamity is different from a meteorological calamity. Since we've learned to take action to protect ourselves from snowstorms and hurricanes, it's only natural that we would try to prepare ourselves for corrections, even though this is one case where being prepared like a Boy Scout can be ruinous. ***Far more money has been lost by investors preparing for corrections or trying to anticipate corrections than has been lost in corrections themselves.***

A review of the S&P 500 going back to 1954 shows how expensive it is to be out of stocks during the short stretches when they make their biggest jumps. If you kept all your money in stocks throughout these 40 years, your annual return on investment was 11.4 percent. If you were out of stocks for the ten most profitable months, your return dropped to 8.3 percent. If you missed the 20 most profitable months, your return was 6.1 percent; the 40 most profitable, and you made only 2.7 percent. Imagine that: If you were out of stocks for 40 key months in 40 years, trying to avoid corrections, your stock portfolio underperformed your savings account."

Peter Lynch has proved prophetic. In the ten years since this article appeared, the financial press was warned us of the dangers of investing in stocks in light of the Asian Currency Crisis, the internet boom/bust, the Iraq War, and numerous other financial "disasters". Countless speculators (as opposed to investors) spent the last decade frantically moving in and out of stocks in anticipation of these short-term events. As Lynch points out, being out of stocks even for very short time periods has been disastrous.

In contrast, we investors who confidently ignored these short-term events have seen the S&P 500 produce an annualized gain of 11.5% over the last ten years--precisely its average for the past 130 years. Patient investors like us continue to be rewarded by the greatest wealth-building vehicle known to man…the stock market. Discipline is the key. Ignore the noise.

Don Davey   Jeff Kopp