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SIENA CAPITAL MANAGEMENT™

# Do You Suffer From Market Fatigue?

**Overview:** It can be hard to hear the best course of action during tough market times may be to do nothing. It can be even harder to repeatedly hear the message as things seem to get worse. But it is a message we would not repeat if we did not truly believe it was in your best interests. The following discusses why our message is not wavering despite market conditions.

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Stay the course. We repeat that advice again and again. Yet, in the face of a persistent down market, a common refrain from investors has gone something like this: "Yes, that advice has worked in the past. However, this time is different. It obviously isn't working now! The market just keeps going down and down. There must be a better alternative than to sit and do nothing."

While we empathize with investors who feel a great sense of loss, we don't believe we are being stubborn. Our advice has always been — and will always be — based on the scientific evidence, not on our opinions about where the markets may be headed.

In light of everything going on, it is no wonder many investors seem to be worn out and discouraged with the market. Even some investors who have weathered big drops in the past seem to be losing hope. They experience a rally, only to see another crisis and another crash. Making matters worse is the yields on safe, high-quality fixed income investments (the only kind you should consider) are at extremely low levels, levels not seen in decades.

What is an investor to do? Our advice is simple: If you have a well-developed plan, one that doesn't take more risk than you have the ability, willingness and need to take, then you should stick to it.

**Market Efficiency**

For us to believe that we should abandon a long-term, buy-and-hold strategy, we would have to first be convinced that markets are no longer efficient, that the market is now mispricing assets and is reacting slowly to new information. It is hard to imagine that markets have gotten slower at reacting to news. In fact, markets incorporate news into prices almost instantaneously.

We believe the market was and continues to be highly efficient. It is just that the news has been persistently worse than expected, causing prices to fall. This is what usually causes a bear market. Nevertheless, we encourage investors to keep the longer term in mind. While the third quarter of 2011 was indeed a rough stretch for the world's financial markets, the S&P 500 is up just over 1 percent through the end of October, and it is up more than 95 percent from the bottom of the market in 2009 through the end of October.

**Market Timing**

As for trying to time the market, we again rely on the historical evidence. When a client suggests just getting out until things are clear again, we point out that the evidence on market timing is even worse than on stock selection.

One reason market timing fails is because so much of the market's return occurs during very brief and unpredictable periods. Another reason is because investors have to be right not once, but twice. Deciding to get out is easy compared with deciding when to get back in. Investors who go to cash may be "whipsawed." They will get out after a severe drop, miss a big rally and jump back in only to experience another severe loss. They end up worse than if they simply stayed the course. That is why we believe going to cash is not the winning strategy.

Recall the litany of problems the markets faced from March 9, 2009, through March 30, 2011. There was never a green light letting investors know it was safe. It was red the entire time. That's why investors were pulling out hundreds of billions from the market, and many missed the greatest rally since the 1930s when the S&P 500 provided a return of more than 100 percent. Even worse is what happened to some investors who thought they saw a green light.

Consider an investor who finally throws in the towel after watching the S&P 500 fall from about 1,450 in February 2007 all the way to 752 on November 20, 2008. Worn out by the bad news and losses, the investor decides to sell. However, there is a problem.

With interest rates at current levels, there is no way to achieve previously stated financial goals without taking risks. The investor does not want to buy riskier fixed income investments, having watched how poorly they are doing. The investor is determined not to make the mistake of confusing yield with return. Instead, the investor decides to wait until the following year to see if the market recovers. By January 6, 2009, the S&P 500 has risen almost 25 percent to 935. Of course, by then, the investor has missed that rally while waiting for that green light. So now it feels safe to buy. Unfortunately, by March 9, 2009, the market has dropped back all the way to 677. So, the investor sells again.

What are the chances the investor can succeed following this pattern of jumping in and out of the market? That is the problem with trying to time the market.

**The Relationship Between Risk and Expected Return**

If the perception of risks is high, so must be the expected return. And the historical evidence is that investors acting on their own persistently demonstrate a pattern of buying high (after bull markets, when risk premiums are low) and selling low (after bear markets, when risk premiums are high). This destructive behavior is evidenced by the fact that investors typically underperform the very mutual funds in which they invest.

**The Difference Between Information and Wisdom**

We can define information as facts or opinions. In terms of investing, wisdom is information that can be exploited to generate excess (above market) profits. When we ask people why they are so willing to abandon their well-designed plan, they say something like: "Isn't it obvious that the situation is terrible?" Then they give a laundry list of negative items. The question they fail to ask is this: If it is in fact obvious, isn't the bad news already built into prices? After all, that is why prices have already gone down.

They also fail to understand the following: If things are so bad, that must mean the market is perceived as risky. If the market is risky, expected returns are now higher. Why would investors decide to sell now when expected returns are higher than when they originally bought?

Many investors have considered selling because of concerns about the Greek crisis and the fear of contagion throughout Europe. The emotions created by crises cause us to lose perspective — like forgetting that fairly regular crises are actually the norm. Should investors sell? To answer that question, one must understand these concerns are well known by the market and are already reflected in prices. As Wall Street legend Bernard Baruch once stated, "Something that everyone knows isn't worth knowing."

Investors feeling the need to sell should also consider that there is a "universe of risk." Because all stocks must be owned by someone, someone must hold the market risk. For everyone who wants to sell, someone else must be willing to buy at the same price. And they will only buy in a time of distress if they believe the market price fully reflects the high risks.

**Summary**

Some investors see the crisis and the risks, but they cannot see beyond that. In that moment, it can be difficult to hear the message to stay the course, even as things appear to be getting worse. But it is a message worth repeating because it is the best advice. History provides us with that evidence.

Thus, our advice will continue to be the same, because the science demonstrates that this is the most likely way to achieve one's goals. When we find compelling evidence, published in peer-reviewed academic journals, that there is a superior alternative strategy, we will do what smart people do — they change their strategy in the face of new evidence.

Noted author Peter Bernstein offered this insight: "Even the most brilliant of mathematical geniuses will never be able to tell us what the future holds. In the end, what matters is the quality of our decisions in the face of uncertainty."



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