Who Needs the Stock Market?

By Matt Bell and Mark Biller, Sound Mind Investing

The Dow Jones Industrial Average plummets 635 points on Monday. The next day it soars 435 points. Then down another 520 on Wednesday, up 423 on Thursday, and the week comes to a merciful end with a 126-point Friday gain. Those are real numbers from one very scary week in mid-August 2011.

While the stock market isn't often *that* exciting, it isn't for the faint of heart. In fact, in order to invest in the stock market, it's best to check your heart at the door. But not your mind, because if you look at it logically, investing in the stock market actually makes sense.

NOTHING GROWS LIKE STOCKS

If the stock market were a plant, it certainly wouldn't be a sunflower, reaching ever upward. The market is more like a zucchini plant, growing up, then sideways, with some sudden downward swoons thrown in for good measure. Zucchini plants will never win any beauty contests, but they *are* productive. Similarly, while the stock market can get ugly at times, history has shown it to be a very productive long-term builder of wealth.

In fact, the stock market offers investors their best hope of generating returns that will outpace inflation and taxes. That's the main reason to stick with the stock market through all of its thrilling ups, painful downs, and frustrating sideways moves.

LESSONS FROM HISTORY

According to Vanguard, a bond-only portfolio would have generated average annual returns of 5.6% since 1926, versus 9.9% for a stock-only portfolio. But be warned: these average returns look better than they actually are. That's because inflation and taxes are relentlessly reducing the value of our investment dollars. Inflation has averaged roughly 3% per year over many decades, and while taxes are highly variable based on income and other factors, they reduce annual investment returns even further. If you earn 5.6% from a bond portfolio, but surrender 3% to inflation and another percent or two to taxes, you haven't made nearly as much progress in terms of your actual buying power as it first appears. The sad fact is those bond returns are largely just protecting your buying power, not adding to it. Only stocks have a long-term track record of significantly outpacing inflation and taxes. Most people need that extra oomph in order to meet their retirement saving needs—very few are able to save so much that merely protecting their buying power is sufficient.

Of course, it's important to recognize that these long-term averages are made up of many highs and lows. Since 1962, the stock market has averaged one correction of 10% or more roughly every other year. That makes stock market investing a "two steps forward, one step back" type of dance.

And as the recent past has illustrated, sometimes the market forces us to take *two* steps back before letting us take any steps forward. Because of the brutal recession of 2008, the S&P 500 generated an average annual gain of just .22% for the 5 years ended 6/30/12. Bonds actually outperformed stocks during this period, with the Barclays Aggregate Bond Index turning in average annual returns of 6.7%.

MANAGING THE RISK

Because no one knows how the stock market will perform in the future, it's wise to mitigate that risk by making sure your portfolio is properly diversified. SMI's approach to the asset allocation process involves choosing a diversification strategy based on your investing time horizon and risk tolerance. Numerous academic studies have shown that this asset allocation decision accounts for the lion's share of your long-term investment results. (One study went so far as to say it can be traced to as much as 90% of the final outcome.) This fact surprises many people who assume, incorrectly, that choosing the right specific investments is the most important component of investing performance.

The starting point of asset allocation is choosing the proper balance between stock-based investments and bond-based investments. How you strike that balance impacts the results you can expect and how much volatility you're likely to experience along the way. The more your allocation leans toward stock-type investments, the more volatility you can expect, but also the higher your expected long-term rate of return. While many people might prefer to avoid the volatility of stocks, most can't afford to choose all bond-type investments. If they did, they'd miss out on the gains necessary to outpace inflation and taxes.

Our May 2012 cover article, "The Crucial Role of Diversification in Reducing Risk," demonstrated how asset allocation impacts results and volatility. It compared those factors across seven mutual fund portfolios, starting with a portfolio that invested only in the stocks of small-growth companies. Over a 24-year time period, it generated impressive 10.3% average annual returns. However, those returns came at a high cost: the volatility of this portfolio was 38% *higher* than the stock market as a whole.

Each subsequent portfolio was increasingly more diversified, with the final one spreading its investments across funds in five different stock-based asset classes while also including bonds and some inflation hedges such as gold and real estate. This portfolio generated still-impressive average annual returns of 9.1%, but with volatility 18% *lower* than the stock market.

STICKING WITH THE STOCK MARKET

So, who needs the stock market? Most investors. Typically only the oldest and most conservative investors should consider a 100% bond portfolio. If your financial situation allows you to eliminate the volatility of stocks and invest only in bonds, great! There's no point in taking more risk than necessary. But for everyone else, including most retirees, SMI recommends at least some exposure to the stock market.

Assuming you've implemented an investment strategy based on an appropriate asset allocation, and assuming you're willing to stick with your strategy even when the market gets ugly (see this month's editorial), stocks remain your best hope of generating the investment returns you'll need in order to achieve your investment goals.