Make hay while it's sunny

By James B. Cloonan

Over three years ago, during what many would now call the first leg of the current bull market, this column discussed the need for the individual investor to be more concerned and work harder during bull markets. In view of the recent market activity, I think it would be wise to review these thoughts.

Unlike some areas of endeavor where effort is most necessary when things are tough ("When the going gets tough, the tough get going"), investors should be most concerned with yield during bull markets. Overall long-term portfolio returns are a function of how well the portfolio performs in strong bull markets. In other words, make hay while the sun shines.

Many investors, however, tend to relax during periods of favorable stock market performance and work vigorously in an attempt to generate favorable returns during flat market periods or during downward market trends. It's easy to relax in periods of escalating stock prices merely because things are so rosy.

Consider a properly diversified, well-managed, long-term, growth-oriented portfolio of common stocks that has attained an annual rate of return of 13% over the long-run. This return compares quite favorably with a long-term market return of 9% annually. If portfolio performance, say, over a four-year period, were decomposed to annual rates of return, we might see the following relationship to the market:

Year	1	2	3	4
S&P	22%	-12%	6%	20%
Growth portfolio	36%	-14%	4%	26%

This type of pattern, in fact, emerges in studies of the "small stock effect." The message that ultimately must emerge is that there is not much that can be done to improve portfolio performance in weak markets—except to decline to participate. Superior long-run portfolio returns are generally derived by substantially outperforming the market in good times. Quite often, however, investors are blinded by their portfolios' absolute returns during bull markets. The additional returns which could have been earned through the application of a little more effort are often overlooked.

If we consider the "best year" returns in the above example, a passive approach to portfolio management would have earned a 22% return, which is the market rate of return. It is quite easy to see where investors might think that they are doing "well enough" and reduce their efforts to outperform the market. However, it is times such as these that generate the opportunities for long-run success. Therefore, we should actually increase our investment management efforts. It is imperative that investors manage their portfolios very carefully during the high yield portion of the market cycle.

Let's turn our attention for a moment to the other leg of the market cycle. If, during market downturns, we lose 8% to 10% of invested capital (allowing for dividend returns), we tend to get depressed. We should not. The market is always going to react to business and economic cycles, and long-term investors should measure their performance relative to broad market averages. A properly diversified, long-term, growth-oriented portfolio can be expected to perform a little worse than the market during adverse conditions and substantially better during boom periods.

While short-term gyrations are not important to long-term investors, it is probably a good idea for such investors to evaluate their portfolio performance on an annual basis through comparison with the yields (growth and dividends) of a broad market index. Thus, investors can obtain insights into their performance (and management skills) during all market phases.

A common retort to this is: "Since I don't live on 'relative' portfolio yields, not losing very much (relative to the market) during bad times isn't very encouraging." However, on the assumption that stocks in general will provide positive yields over the long-term, relative yields actually become absolute yields. If you feel that this assumption is invalid, then you shouldn't be in the stock market in the first place.

The results of 1985 fit the desired pattern. It was a bullish year, with the S&P 500 up 26.33%. The Shadow Stocks, however, were up 40.61% and the diligent investor making an effort to select the best portfolio from the Shadow Stocks should have done somewhat better.

If you don't beat the S&P in bull markets, you either need to sharpen your skills or go with an index fund.

James B. Cloonan is the president of AAII. His column is his own opinion and is not necessarily the Journal's.