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### **Riding Out the Turbulence**

An investment policy statement takes emotion out of investment strategy

Imagine using the following rule to make investment decisions: When the market falls 30%, bail out and sit on the sidelines until it rises to a higher level. This flawed sell-low/buy-higher strategy sounds ridiculous, but it is often the result investors experience when fear overrides reason.

Turbulent markets can bring out the worst in the best-meaning investors. Worries of a market collapse can trigger short-sighted, emotional decisions that lead to poor results.

Despite, or perhaps because of, the big run-up from market lows in March 2009, anyone looking for reasons to abandon the stock market has had plenty to choose from recently. As many do-or-die financial commentators have repeated every few minutes, the euro is teetering, jobless claims remain high, healthcare reform is too expensive, the deficit is out of control, bank credit is still MIA. And so forth.

When the major indices fell seven percent in a few days in early May 2010, many investors had a bad feeling of déjà vu. A panicky sentiment swelled among many market pundits, leaving individuals wondering where to go. Some are surely heading for the exits; others are considering doing so.

#### **Panic is not a strategy**

Fear can be a rational feeling in uncertain circumstances, but retreat is not always the best response to that fear. Investors who leave the market in fear of a decline are often making a decision with long-term consequences based on short-term memories and stimuli. Moving money from stocks to fixed income investments or very low interest savings instruments can provide the emotional satisfaction of “doing something – anything!” but this kind of speculative market timing often leads to being out of the market during a big move up.

A more prudent approach is to create and follow a comprehensive long-term financial plan, guided by a disciplined investment policy statement (IPS).

#### **The investment policy statement**

An investment policy statement takes emotion out of the equation, regardless of what is going on in the markets day to day. Developed with an investment advisor, the IPS describes the investor’s risk tolerance, needs and goals and the investment strategy that will be used to pursue those goals. It should include specific allocation ranges for different asset classes – such as 10-15 percent large cap domestic stocks, 25-30 percent bonds, and so on. When price changes cause allocations to move out of these target ranges, the portfolio should be rebalanced – brought back to its original target allocation.

Because it describes a long-term plan based on long-term goals, an IPS rarely accommodates short-term moves based on fear, greed, fad, hunch, rumor, or whim. Most often an IPS reminds us to stay the course, to trust the risk and return characteristics of different asset classes, even when the path is rocky and uncomfortable. Like the golden rule of winter driving – don’t stomp on



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the brakes if you hit an icy patch – the IPS can provide the fortitude to do nothing when our instincts tell us just the opposite.

The statement itself should be reviewed and revised when the investor’s situation changes – income needed for retirement, the sale of a business, a death or divorce. But changes to the IPS are generally not appropriate if the only things that have changed are recent market performance and the tenor of talking heads.

### **Ignore the animals**

Keeping emotion out of the equation gets more difficult every year. The ever-present financial news channels and web sites, celebrity market commentators, rampant blogging and real-time stock quotes on our iPhones saturate our senses. Ignoring all this minute-by-minute market data and commentary is like going to the zoo and trying not to notice the animals, but getting past all the short-term noise allows investors to stay focused on long-term goals and strategies...and sleep at night.

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Warren Buffett, long known for buying when others are panicky to sell, often reminds investors that a calm, disciplined long-term perspective is crucial.

“Those who invest only when commentators are upbeat end up paying a heavy price for meaningless reassurance,” he states in the Berkshire Hathaway 2009 annual report. “In the end, what counts in investing is what you pay for a business – through the purchase of a small piece of it in the stock market – and what that business earns in the succeeding decade or two.”<sup>1</sup>

Like it or not, the stock market goes up and down, sometimes violently. Over the long term, however, the prevailing direction of the market is up, driven by advances in productivity, new technologies, expansion to new markets and other ingredients of growth. No one can predict the timing of rising stock prices, of course, but one thing is certain – one must be in the market when it rises to participate in the returns. A consistent buy-hold-rebalance strategy assures exposure to the long-term potential offered by equities.

### **Maintaining perspective**

There’s no question that economic, political and market news can be unsettling. But as consumers of the news, it is our burden to keep it in perspective, something the media often fails to do. Non-stop media coverage that hyped unlikely dangers convinced some viewers to stock up on rations for Y2K, a crisis that never materialized. We were also flooded with coverage of H1N1 flu, a serious health threat but one no more deadly than typical seasonal viruses. And highly trained meteorologists armed with the latest technology routinely predict storms that fail to form.

Ultimately, we must recognize that not every news story is a crisis, that not every fluctuation in the market – large or small, up or down – is a signal to buy or sell, that not every dire or exuberant prediction on CNBC will come true. Our best defenses against emotion-based decisions are a thoughtfully designed investment policy statement, patience and calm.



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<sup>i</sup> 2009 Berkshire annual report <http://www.berkshirehathaway.com/2009ar/2009ar.pdf>

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