THE Wealth REPORT

When markets drop, is your first instinct to sell or stay put? Do you try to find the best time to jump into the market after a downturn? Those are just two of the mistakes you could be making with your investments — and they could be hurting your long-term success.

5 COMMON MISTAKES INVESTORS MAKE WHEN MARKETS DROP

Overview

When volatility rises and markets drop, many investors — both new and seasoned — get nervous about the possibility of losing money. They worry that their assets won't recover and that their financial plan will be negatively impacted. These investors frequently end up making emotion-driven investing decisions — decisions that prove to be mistakes over the long term.

Read on to learn about a few of the frequent mistakes investors make during a market decline, and the actions to consider taking instead when markets turn rocky.

Mistake #1: Panic Selling

The desperate feeling of seeing long-term gains freefall in a portfolio can lead investors to sell off their assets in an attempt to thwart potential losses. Unfortunately, selling at the wrong time can lock in losses.

The worst part of panic selling is when an investor goes to cash — and stays there. Many times, when the market rebounds, some of the most robust advances are early in the recovery. The investor who waits, worried about another potential decline, may miss out on those early gains. Plus, some investors may want to jump back into a rising market but keep waiting for another dip. Meanwhile, they lose out on potential gains.

For example, take the case of Sheila and Paul.* Both invested $5,000 per year from 1980 until the end of February 2022. By staying fully invested during that time, Sheila achieved a 12% annual return and eventually accumulated $4.3 million. Paul, on the other hand, sold after each market downturn and ended up missing out on two consecutive years of positive returns. He still averaged a 10% annual return but accumulated only $2.5 million.[1]

Mistake #2: Anchoring to a Specific Price

Sometimes, we get it in our heads that certain items should cost a certain price — and when the items cost more than that price, it can feel too expensive. For example, if you're used to paying $2 for a gallon of gas, you may feel "ripped off" when a gallon of gas goes much higher than $2.

This concept is known as anchoring, and it can also apply to how we perceive an asset's value. If all you know about a stock is its price today, you might assume how much it will grow over the next year. But what you may not know is how much it grew or declined and why it performed the way it did in the past. Instead, you become biased by its current price, and you "anchor" your investment decisions based on that information.[2]

It's important to understand the anchoring bias because we often adopt it without even knowing it. As an investor, you should work with an advisor who will help you vet many underlying fundaments to gauge both the future performance of holdings and whether they are well suited for your investment strategy and goals.

Mistake #3: Clinging to a Declining Asset

Some investors cling to stocks that are losing ground when, in fact, selling in a declining market could be a prudent tactic. The two key factors to consider are the long-term prospects of that stock or sector and the potential upside of harvesting a loss to help improve long-term tax efficiency.

If your holdings in a taxable investment account are declining and not well-positioned for long-term gains, you may want to harvest those losses to offset future gains from stocks that are rising and are better positioned for the current economic and market environment.

Mistake #4: Trying to Time the Market

"Buy low and sell high." That's typically the overarching principle of investing — but it can become a challenge when you try to time the exact right moment to buy or sell. Timing the market is generally ill-advised, especially when it's based on daily market fluctuations. This method could also generate substantial transaction costs and capital gains taxes that make it more expensive than just staying on course.

One tactic you may consider instead is to deploy dollar-cost averaging to your portfolio. With this strategy, you invest a certain percentage into your accounts at regular intervals. When markets decline, you can take advantage of lower prices. Plus, you don't risk a large portion of assets all at once, putting you in a good position to realize gains when markets go up.[3]

Mistake #5: Not Doing Anything

Sometimes traffic gets backed up on the highway in the opposite lanes from where a wreck has occurred. It's human nature to stare in horror at something bad that has just happened. Unfortunately, this occurs among investors as well. Watching your portfolio sink during a market decline may leave you feeling powerless and stuck.

However, long-term price shifts — both upward and downward — are actually an opportunity to improve your portfolio's asset allocations. When stocks drop, bonds may rally and vice versa. By rebalancing on a regular basis, you can redeploy your investment dollars to take advantage of current opportunities for growth and possibly improve your tax-efficiency. Rebalancing losses can also realign your portfolio with your goals by reducing risk, often leading to improved risk-adjusted returns over time.[4]

Final Thoughts

We all know that making emotion-based financial decisions isn't always the best approach — but it's not unusual to let fear get the best of us when markets drop. Being a prudent investor means we need to learn to adapt to the market's natural ups and downs, recognizing our personal tolerance level for volatility and staying focused on long-term rewards.

Historical performance has shown over and over that stock markets will recover and grow after a drop.* However, if you find yourself worried about your portfolio when volatility rises, we recommend speaking with a financial advisor. He or she can review your investments and make sure you're still on track to reach your goals. You may also want to consider rebalancing your portfolio or incorporating other assets with insurer-backed guarantees, such as annuities.

Investing can be stressful at times. However, knowing what mistakes investors make during downturns and ways to avoid them allows you to better pursue your financial goals, particularly when you stay focused on investing over the long term.

[1] Dan Hunt. Morgan Stanley. May 24, 2024. "Top 5 Mistakes Investors Make in Volatile Markets." https://www.morganstanley.com/articles/top-5-investor-mistakes. Accessed Sept. 3, 2024.
[2] Kendra Cherry, MSEd. Verywell Mind. Oct. 8, 2023. "How Anchoring Bias Affects Decision-Making." https://www.verywellmind.com/what-is-the-anchoring-bias-2795029. Accessed Sept. 3, 2024.
[3] Dan Hunt. Morgan Stanley. May 23, 2024. "How to Handle Volatility." https://www.morganstanley.com/articles/how-to-handle-volatility. Accessed Sept. 3, 2024.
[4] John Rekenthaler. Morningstar. July 16, 2024. "When Rebalancing Creates Higher Returns — and When It Doesn't." https://www.morningstar.com/columns/rekenthaler-report/when-rebalancing-creates-higher-returnsand-when-it-doesnt. Accessed Sept. 3, 2024.

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