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Buying the Dips Doesn't Work for Everyone

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As the Dow Jones Industrial Average has lurched hundreds of points up or down — mostly down — in the past few days, investors have received one constant message: Buy on the dips. If stocks go down further, buy more.

On social media, the banter of many investors has been full of bravado — almost daring the malevolent gods of the market to do their very worst.

The Intelligent Investor
By Jason Zweig
COMMENTARY

But don't let other people's bluster fool you. If you're young, the sudden popularity of the idea that market declines are manna from heaven should make you nervous, even though it's right. If you're in or near retirement, it should scare you, because it's wrong.

As Warren Buffett wrote in 1997, stocks are like hamburgers: If you're going to be purchasing them

regularly for years to come, you shouldn't want them to go up in price. Any drop in the stock market, so long as you have the gumption to take advantage of it by buying more, is good for anyone who is still saving and investing for the future.

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On the other hand, if you are at or near the age when you need to make regular withdrawals from your portfolio to fund your retirement, a fall in the stock market can be catastrophic, and you need to decrease – not increase – your exposure to it.

That's not merely because stocks can take years to recover from losses and you have fewer years left as you age. The problem is what retirement researchers call "sequence risk." The order in which stocks earn good or bad returns can matter — a lot.

A 30-year period in which the stock market drops at the beginning and rises toward the end can have the identical *average* annual rate of return as a three-decade period in which stocks rise at the beginning and fall at the end. But the results will be drastically different.

Let's say you're in your 20s. At this point, your 401(k) and similar accounts hold only a small fraction of the total retirement savings you'll accumulate over your working lifetime. Meanwhile, the money you can add each month while stocks are down is sizeable enough, as a proportion of your total assets, to add a noticeable boost to your wealth if stocks eventually recover.

Now imagine that you're in your late 50s. You've already amassed nearly all of your lifetime retirement savings. And the amount of money you can use to buy more stocks at bargain prices is a pittance in comparison to what you will lose on the stocks you already own.

The 20-year zone centered on the age of retirement — from around age 55 to 75 — is when "the greatest amount of your capital is likely to be exposed to sequence risk," says Peter Chiappinelli, an asset-allocation strategist at GMO, a Boston-based investment firm that manages $117 billion in assets.

The final straw: Once you do retire, you might have to fund your expenses at least partly by taking money out of your stock portfolio. If those withdrawals coincide with falls in the stock market, you are effectively "selling on the dips and locking in all the losses," says Wade Pfau, a professor at the American College of Financial Services in Bryn Mawr, Pa., who studies retirement income. "Even if the market recovers, your portfolio can't recover at nearly the same rate, because you've already taken that money out of stocks, and it's gone forever."

There are a few steps you can take to mitigate sequence risk.

Research by GMO shows that owning underappreciated "value" stocks, and reducing exposure to stocks in general during periods of investing euphoria, can mitigate the risk of bad losses at the worst possible times. In your 401(k), you could favor value-oriented stock funds – and, at a time like 1999, when stocks were trading at a record 44 times their long-term inflation-adjusted earnings, you would scale back on equities and tilt toward cash and bonds.

The more cash you hold, the less you will need to fund your retirement spending by having to sell stocks when stocks are down. Treasury Inflation-Protected Securities, the U.S. debt instruments designed to keep pace with the rising cost of living, also reduce the need to sell stocks at bad prices.

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If you have an ample cushion of cash and bonds, you could defer taking Social Security until age 70, thus locking in a much higher stream of income later in life and helping to make up for any interim decline in stocks. Each year beyond age 62 that you defer taking Social Security raises your eventual payout by an average of 7.3%, estimates William Bernstein, an investment manager at Efficient Frontier Advisors in Eastford, Conn.

So-called "single-premium income annuities" can provide regular, lifelong inflation-protected payouts; however, they can be expensive and not all financial advisers are familiar with them.

Another possibility, says Prof. Pfau, is to consider taking out a line of credit under the Home Equity Conversion Mortgage program guaranteed by the federal government, using it only during periods when the value of your stock portfolio is declining. This way, you reserve the right to borrow against your home at reasonably competitive rates. But you would draw on the money only at times when you would otherwise have to lock in losses on your stock portfolio.

No single approach can solve the problems of sequence risk all by itself, say retirement analysts. Taking more than one of these measures will help, but probably the most powerful way to protect yourself is by being prudent. As you approach or move into retirement, remember that the advice to buy more stocks every time they drop probably doesn't apply to you anymore.

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