BerkeleyHaas
Haas School of Business
University of California Berkeley

Making S.M.A.R.T. Financial Decisions

Investing in Risky Markets

Professor Terrance Odean

Do you like roller coaster rides? I used to. I'm not so sure anymore. I went on a ride at the Minnesota State Fair with my niece two years ago. It wasn't exactly a roller coaster ride, more of a big arm that swung up into the night sky and left me dangling upside down. This is a picture that my daughter took of my niece and me on the ride. Two of those dangling legs are mine. When the ride shot me up into the night sky, my mind was telling me that everything was fine, but my body snapped into panic mode. I would have happily paid the price of several tickets to be right back on the ground. You know, later I laughed about the experience. But, of course, that was an amusement ride. It's not so amusing when your panic is triggered by your portfolio plummeting.

The US stock market has had many drops worthy of a roller coaster. Take a look at this roller coaster ride. The S&P 500 dropped sharply from March of 2000 to October 2002, and plunged again from October 2007, to March 2009. It was a pretty wild ride. So far, the US market has always recovered. But not before a lot of investors sold near the bottom. A good piece of investment advice is not to pay close attention to the market. If your investment horizon is 10, 20, or 30 years, you know, there's no reason to track the daily ups and downs of the S&P 500. However, it's nearly impossible to ignore a big crash. And if you're a long-term investor, sooner or later, you're going to experience a crash. So it's best to figure out now what you're going to do when that happens.

Some financial advisers will try to determine how well you can handle risk by asking questions such as, would you sell your stocks if the market dropped 30%? The problem with that question is it implies that the market drop is 30% and no more. Obviously, if you know that you're at the bottom, you're going to stay in. But what would you do if the market dropped 30% and no one knew what was going to happen next? And there'd be people on TV screaming that the market was going to go down another 30% and other people claiming that this was the best buy opportunity of a decade. All you know is that you don't know.

Not right now, but sometime this week take a few minutes and try to imagine how you would feel in this situation. What would you do if the market dropped 30%? What would that market drop do to your portfolio? If you didn't know what was going to happen next, would you stick with your current investment portfolio? Would you sell all your stock funds? If you think you'd sell, your portfolio allocation is probably too risky, and you should consider lowering the percentage allocated to stocks. Even an ideal asset allocation from an economic perspective isn't going to serve you well if you sell in a panic when the market drops. This isn't an easy exercise. Not only because it's not fun to imagine such a situation, but because it's hard to predict in advance how we will react. Also, you know, our attitudes towards risk change when we're tired, hungry, having a bad day, or having a good one. So you might choose different times to imagine what you would do in a market crash. Also try to think about different situations. Would you feel differently if you were with friends than if you were alone? If you felt fear, is there someone you could talk with who could help you control your sense of panic? Some people love the thrill of a roller coaster ride. Some don't. Fortunately, there isn't much chance to make bad decisions, if you get scared on a roller coaster.

Whether you hold your hands up over your head and scream with joy or group the railings for dear life, the ride is over soon. But the roller coaster ride of the market is more treacherous. Some people get too enthusiastic at the tops. Some people panic at the bottoms. Investing is serious, and mistakes can cost you dearly. So far, those who have stuck with the market's ups and downs have been rewarded for doing so. However, to be a buy and hold investor, you need to choose a portfolio that you can stick with, even when the right gets rough.