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McGarrity: The Stock Market II - Log Cabin Democrat (Conway, AR) - May 31, 2017 - page 1

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In my last column, I predicted the stock market would go down, although I was unwilling to predict when this would occur. In response to my column, Dave Nelson, ever the pragmatist, asked a great question. He wanted to know: does the coming decline in the stock market imply that I should reallocate my investments away from stocks? If President Truman had heard my answer, he would have known that it came from an economist. Truman often said that he wanted a one-handed economist. He got tired of economists qualifying their advice and predictions by saying one event is likely to happen, but on the other hand a different event could occur under certain conditions.

Using both hands to answer the question, I will say that whether an investor should stay in the stock market really depends upon his or her time horizon. If Dave holds stocks in his retirement account, he should leave these stock investments alone. The coming decline in stock prices will not hurt Dave. At 52, Dave may plan to work for another 20 years. During this time, the stock market will have many ups and many downs. In fact, the typical business cycle lasts about 5 years. Therefore, Dave can expect about four more complete business cycles, with their ups and downs, during his working career. Dave's retirement is far enough into the future that he can ignore an upcoming drop in stock prices. His investment value will recover with time.

It would be a mistake for Dave to pull his money out of stocks and leave it in a safe investment that offers a low interest rate. By protecting his money with the safe investment option, Dave's retirement account would not grow very much over time. In contrast, by leaving his money in stocks and accepting the fact that the return rate will vary widely from year to year, being both positive and negative, Dave can expect his stock investments to earn on average 7% a year. At a 7% return rate, Dave's current stock holdings will quadruple in 20 years. If he has put away $500,000 into a stock fund, he can expect it to grow to $2 million by the time his wife throws his retirement party.

Get ready; here comes my other hand. If Dave owns stocks and plans to spend the money in a year or two, he should not keep this money in the stock market. Actually, he should sell these stocks irrespective of my prediction of what will happen to the stock market in the near future. Stocks are simply too risky to use as a

place to store wealth when you might need the money soon. Stock prices fluctuate substantially from year to year. Dave could be stuck selling stocks when the share prices have fallen. This was not a concern in his retirement account because any one bad investment year will be offset by other good years. The fluctuations will average out over a long period of time. However, during a short period of time, these price fluctuations represent a significant financial risk that all investors should avoid.

My answer to Dave's question is definitely less straightforward than President Truman would have liked.
However, as Albert Einstein once said, "Everything should be made as simple as possible, but not simpler." My answer to Dave's question, and economists' answers in general, require two hands to avoid being too simple.

Joe McGarrity is a professor of economics at the University of Central Arkansas. Contact him by email at joem@uca.edu.

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