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# **The Uneven Path in Building Wealth** *(Originally published in The Wall Street Transcript 28 March 1988)*

*By Robert Zuccaro, CFA*

Building wealth in the stock market requires an understanding of stock market cycles and patience. Intellectually, most investors understand the ups and downs of the stock market, but often find it difficult to put into practice. On the heels of the unprecedented stock market crash on October 19, 1987, many investors who were comfortable owning stocks when the Dow was at 2700 panicked when the Dow plummeted to 2000 in one day. They became sellers instead of buyers.

Without question, investors like to see a gain right after making an investment. However, many investors never consider how a declining stock market can work to their advantage. For the sake of illustration, let's assume that annual contributions of $10,000 are made to a 401K plan at the beginning of each year for ten years. Let's further assume that the plan earns an average return of 10% per year using two different assumptions.

| | **Case 1** | | **Case 2** | |
|---|---|---|---|---|
| **Year** | **Annual Return** | **Market Value** | **Annual Return** | **Market Value** |
| 1 | -10% | $9,000 | +30% | $13,000 |
| 2 | -10 | 17,100 | +30 | 29,900 |
| 3 | -10 | 24,390 | +30 | 51,870 |
| 4 | -10 | 30,951 | +30 | 80,431 |
| 5 | -10 | 36,856 | +30 | 117,560 |
| 6 | +30 | 60,913 | -10 | 114,804 |
| 7 | +30 | 92,186 | -10 | 112,323 |
| 8 | +30 | 132,842 | -10 | 110,091 |
| 9 | +30 | 185,695 | -10 | 108,082 |
| 10 | +30 | 254,403 | -10 | 106,274 |

In Case I, the plan loses 10% in each of the first five years followed by gains of 30% each year in the second five years. In Case II, this sequence is reversed with gains of 30% in each of the first five years followed by losses of 10% in each of the second five. The rates of return are identical in both cases, but in reverse order. Results for both cases are shown in the above table.

As can be seen, more than twice as much wealth was created in the ten years when initial investments were made into a declining stock market. There is no doubt that investors become discouraged when the market goes down and often lose patience by selling their stocks only to find out later that they ended up with the worst of both worlds, incurring losses and then being absent from the ensuing market recovery. Distress selling makes little sense as the stock market has recovered 100% of the time from every downturn in history - no matter how severe. Sometimes having a strong stomach becomes more important than having a good mind in dealing with the stock market.

Wealth built in the stock market can grow geometrically due to the magic of compounding. Small percentage increments of return can lead to dramatic gains in wealth over time due to the compounding effect. Let's take a look at the past rates of return for various asset classes over the past 30 years.

| **Annual Return 30 Years** | |
|---|---|
| S&P 500 | 9.8% |
| Salomon Bros. High Grade Corp Bonds | 6.2 |
| 91-day T-bills | 5.9 |
| Consumer Price Index | 4.7 |

The relationship of returns associated with the above classes of assets is as one would expect. The riskier the asset class, the greater the return over time.

Converting the rates of return in the above table into dollar wealth demonstrates the power of compounding. An initial investment of $1,000 in each above asset category in a 401K plan would have grown to amounts shown below over 30 years.  Thus, we can see the magic of compounding at work.

**Growth of a $1,000 Investment Over 30 Years**

| | |
|---|---|
| S&P 500 | $16,514 |
| Salomon Bros. High Grade Corp Bonds | 6,032 |
| 91-day T-bills | 5,605 |
| Consumer Price Index | 3,999 |

We believe the stock market will always remain as the best place to build wealth. Investors can become rich in the stock market over time, but only if they are patient. Admittedly, they can become poorer in some periods as well. Or are they really getting poorer when given an opportunity to invest at lower prices. Whatever happened to that old adage, "Buy Low? Sell High?"