Richard Bernstein Advisors

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RBA Quick Insights

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The good side to a bad market

If you're a consistent investor, bad markets can be a good thing

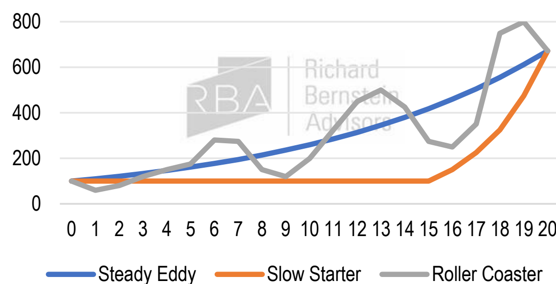
Benjamin Graham is credited with the idea that, in the short-run, the market is a voting machine but in the long-run, the market is a weighing machine. So long as companies continue to grow their profits over time, the market will eventually recognize the value of companies' underlying earnings power. Under this assumption, it is worth considering the impact that different market scenarios can have on long-term wealth accumulation. While bull markets are more fun than bear markets, ugly markets can provide significant benefits. Most importantly, if you are a consistent investor — and not a retiree in the drawdown phase of your investment lifecycle — bad markets can be great for growing long-term wealth.

What type of market do you prefer? Steady Eddy, Roller Coaster or Slow Starter?

Imagine three hypothetical paths for the stock market over a 20-year period. In each of these scenarios, the stock market value appreciates by a compounded annual rate of 10%. In the Steady Eddy scenario, the market goes up by 10% each year. In the Slow Starter scenario, the market is flat for the first 15 years and then plays rapid catch-up in the final five years. In the Roller Coaster scenario, the market experiences a series of booms and busts. If an investor were to invest $100 at the start, it would be worth $673 at the end of the 20-year period in all scenarios (Chart 1).

However, the outcomes can change significantly if one assumes additional investments are made through time. We ran scenarios assuming an investor made additional $100 contributions each year, and then another version where the $100 contributions grew by a steady annual inflation rate of 2.5% (Table 1).

Chart 1: Three hypothetical 20-year market scenarios



Source: Richard Bernstein Advisors LLC, Bloomberg, S&P
Note: Each scenario results in 10% compounded annual returns

Table 1: Initial $100 investments with different contribution rates

Market scenarios	No additional contributions	With contributions	With contributions that keep pace with inflation
Steady Eddy	$673	$6,400	$7,628
Roller Coaster	$673	$7,488	$8,852
Slow Starter	$673	$11,960	$14,872

Source: Richard Bernstein Advisors
Note: "With contributions" assumes constant $100 annual contributions. "With contributions that keep pace with inflation" assumes the $100 initial contribution grows 2.5% per year.

A quick examination of the outcomes offers some important conclusions:

1. While providing the smoothest ride, Steady Eddy results in the least wealth accumulation for consistent contributors. The Slow Starter provides the most wealth accumulation for consistent contributors. Ultimately, what matters is the investment purchasing power of your contributions over the investment period. It doesn't matter if you're buying stocks or gasoline, lower prices mean you can buy more stocks (or gasoline) for a given amount of money.

2. Any of the scenarios with contributions are dramatically better than any of the scenarios without contributions.

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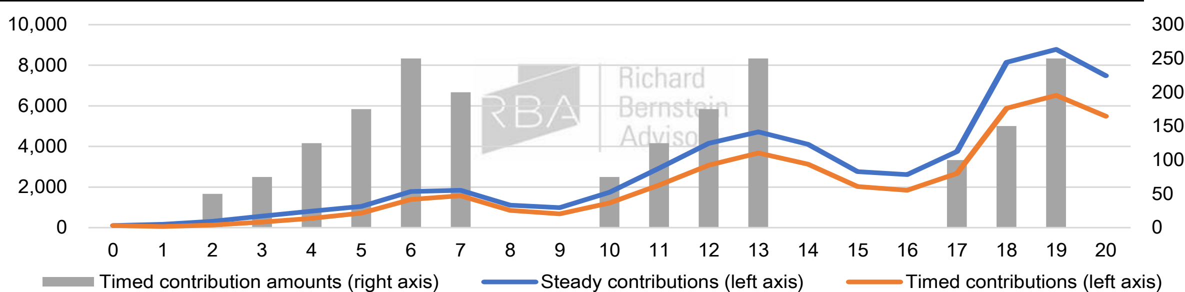
This second conclusion highlights the importance of continued investment contributions. However, due to investor psychology and income variability, few investors — institutional investors and individual investors alike —follow through on plans to make consistent investments. As a result, investment contributions tend to rise and fall with markets, peaking at or near market highs and drying up during bear markets. To reflect the impact of this market timing on the Roller Coaster scenario, we assumed the same total amount of contributions, but the size of each contribution was tied to market performance. As you would expect, investing more at high prices and not investing at low prices significantly reduced the total wealth accumulated over the 20-year period. In this example, the timed contributions led to 27% less wealth accumulation, equivalent to 1.5 percentage points lower returns per year (Chart 2). **Bottom line: weak markets can actually boost long-term wealth creation, but only if you continue to make contributions. Dollar cost averaging only works if you stick to the plan.**

Chart 2: Comparing the Roller Coaster market scenario based on steady contributions and timed contributions



Source: Richard Bernstein Advisors LLC

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