

U.S. Market Recovery After Financial Crises

During financial crises, stock prices suffer. However, they typically recover over time.

These images illustrate the cumulative returns of an all-stock portfolio and a balanced (60% stock/40% bond) portfolio after five historical U.S. financial crises. In the short term, uncertainty from such external shocks can create sudden drops in value. For example, each portfolio posted negative returns one month after the October 1987 stock-market crash. Over a longer period of time, however, returns were much more attractive, and investors who stayed the course reaped considerable rewards.

Fear and uncertainty might lead investors to sell their investments during tough times, putting downward pressure on prices. Trading because of these emotions can be detrimental to a portfolio's value. By selling during downward price pressures, investors might realize short-term losses. This is compounded as investors wait and hesitate to get back into the market, possibly missing some or all of the potential recovery. The lesson here is that patience can pay dividends.

Diversification can also limit losses during turbulent market conditions. The dot-com crash in 2000 resulted in rather large losses for those invested entirely in stocks. In fact, every period analyzed actually produced a loss. On the other hand, the balanced portfolio's losses were less severe, and after five years it actually generated a gain. One of the main advantages of diversification is reducing risk, not necessarily increasing return, over the long run. While stocks offer the potential for higher returns, the downside risk can also be extreme. A diversified portfolio can help mitigate such extreme swings in value.

Government bonds are guaranteed by the full faith and credit of the U.S. government as to the timely payment of principal and interest, while returns and principal invested in stocks are not guaranteed. Stocks have been more volatile than bonds. Diversification does not eliminate the risk of experiencing investment losses.

About the data

Stocks in this example are represented by the Standard & Poor's 500[®], which is an unmanaged group of securities and considered to be representative of the stock market in general. Bonds are represented by the 20-year U.S. government bond. Calculations assume monthly data. The data assumes reinvestment of all income and does not account for taxes or transaction costs. For the U.S. savings and loan crisis, August 1998 was chosen because that was the month the Financial Institutions Reform, Recovery and Enforcement Act of 1989 was signed into law. For Long-term Capital Management, September 1998 was chosen because that was the month the hedge fund was bailed out by various financial institutions.