3 Lifelong Investment Lessons Taught by the Financial Crisis

Description

“Never let a good crisis go to waste” – Winston Churchill

Dear Fellow Fools,

It’s been five years since the bankruptcy of U.S. investment bank Lehman Brothers left the financial world on a precipice. Thanks to unprecedented government intervention, some degree of footing was maintained — but the Lehman bankruptcy and ensuing financial crisis continues to be a favourite talking point for the media and the pundits of the world.

We investors can read all the books, take all the courses, and get as many letters behind our names as we want. But investing is a lot like life — the most important aspects are often learned by doing. There are few substitutes in this industry for practical experience.

And in my mind, no textbook will ever be convincing enough to substitute for what I learned as an investor during the financial crisis that Lehman’s bankruptcy spurred. In this week’s Take Stock, I’d like to share the three most significant lessons the financial crisis taught me.

Lesson 1: Cash is king

In my personal portfolios, I went into the financial crisis fully invested. It’s something I regret to this day. I had no liquidity — which left me unable to act through the teeth of the crisis.

The textbooks and know-it-all strategists say that if you see a better opportunity out there, sell what you have and move into it. To that, I say … easier said than done. Try loving a company’s prospects one day and then seeing its stock trade down by 50% two weeks later for nothing that is company-related. You’re simply not going to sell that stock — even if the best opportunity in the world comes along. Our brains won’t let us. It’s too painful to realize that loss.

It’s far less of a psychological hurdle to always have access to cash in your portfolio, even if it’s just a bit, and put it to work when a fire-sale comes along. The argument against cash is that is earns you nothing. This is true in the short term if you think of cash as simply an absolute holding. Instead of thinking of cash as dead money, think of it as a portfolio management-related tool that allows you to pounce on a golden opportunity whenever it comes along. In that context, cash can in fact earn you a great deal!

Cash is anything but dead money if it's put to the proper use.

Lesson 2: Leverage kills

This one is two-pronged. Although I was fully invested, I was very happy to not have been using margin and investing beyond my means. Utilizing margin to purchase stocks can do wonders to your returns on the way up. But it can be an outright disaster on the way down.

You see, on the way down, two of an investor's least favourite words tend to come into play: "margin call". A margin call from your broker can force your hand into selling a position at what potentially could be the very worst time. At least if you've invested without leverage, you can ride through the downturn and not be forced into taking a capital loss.

The other angle is on the company side. Simply, companies that are reliant on free and easy access to the debt market don't do well in financial meltdowns. When you're looking at a company, take its financial position very seriously. Financial risk can kill a company under the wrong conditions and this, like a margin call, can lead to the permanent impairment of your capital.

Lesson 3: Markets always come back

While the scale of the 2008-2009 financial crisis may have been unprecedented, market meltdowns have occurred before, and will again. Show me a market meltdown, though, and I'll show you a market comeback. Over the long term, the stock market simply can't be held down.

To be clear, it's not that the market doesn't go down. It does, and it can stay depressed for long periods of time. However, once the clouds part, the returns can be spectacular.

The chart below utilizes Professor Robert Shiller's data to demonstrate 10-year market returns in the U.S. since 1871 (far more historical market data is available in the U.S. than in Canada). The average return over these 10-year periods was +38.1%. The best 10-year period produced a +222.5% return (1989-1999) and the worst resulted in a loss of 62.7% (1911-1921). Of the 133 periods included, 44 (or 33%) were negative.

US mkt 10 yr returns

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Source: Robert Shiller

This data can be framed in a bunch of different ways, but the primary message is this: Over the long term, *the market goes up a lot more frequently than it goes down*. And remaining invested over the long term is the best way to ensure you come out with a positive return when all is said and done.

While it would have been nice to have cash on hand, the fact that I wasn't forced to sell anything during the crisis, and didn't need the money I had tied up, allowed me to benefit from this powerful long-term trend.

The Foolish bottom line

One of the great things about the world of investing is that hardly a day goes by that doesn't offer a chance to learn something new. Whether it be about the market, a company, or ourselves, investing is a game of constant evolution.

The financial crisis that began five years ago packed an undergrad, post-grad, and doctorate degree worth of learning into about a two-year period. It was life-altering in many ways, one of which was the lessons that it taught. These three takeaways from the financial crisis of 2008-2009 will stick with me for the remainder of my investing life.

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