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The Best and Worst of Times
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We are two years into this stock market recovery and about halfway through what a typical recovery period looks like following a severe downturn similar to the Financial Crisis. For investors who have remained engaged, the recovery has provided investment gains that are beginning to bring portfolios back to pre-crisis levels. And while almost no one emerged from this period unharmed, there are some poignant lessons to be taken away.

The first rule for investing to protect savings is simple: Investors have to earn at least enough to keep pace with inflation over time or else it will erode their purchasing power. These study takeaways highlight real returns, or returns after inflation has been considered.

Going back to the Great Depression, investors typically in times of crisis have flocked to the safest investments, which have traditionally been considered to be bonds. But surprisingly – or not so surprisingly, depending on which way you look at it – the worst time to get into bonds is as a crisis unfolds.

This may sound counterintuitive, since bonds have just had the best 30-year time frame we have ever seen, with One Month T-Bills producing returns about four times their average, while Five Year Government bonds and Long-term corporate bonds each had returns 10 times their average.

And while bonds have been on a seemingly endless run, large cap value and small cap value stocks are finishing their worst 30 year period ever.

But consider this: as we conclude the best 30 year time frame we have ever seen for bonds, stocks have recorded their worst performance ever. Small cap value stocks returned 892 percent between 1979 and 2009 – while still outperforming bonds' best performances (690 percent cumulative returns for long term government bonds between 1981 and 2011). The worst of times for small cap value stocks beats the best of times for bonds.

Bonds actually produce 30 year negative real returns a third of the time, regardless of whether we are looking at short or long term, government or corporate bonds.

Still, many investors are looking at the bottom line right now, not to the future. To give bonds their due, the truth is they performed well during the Financial Crisis and economic downturn, as they often will during these periods, whereas stocks fared poorly.

Right now there are some parallels to the Great Depression – a sluggish economy, high unemployment and a discouraged population – and scared investors are holding bonds for safety. But keep in mind, from 1936 to 1966 bond investors lost 40 percent of their purchasing power, the real value of their investments, over a time period that began during a deep economic downturn.

Poorly performing stocks actually makes the asset class more attractive. In fact, if history is any guide, bonds will likely offer little appeal to investors in the coming years. Remember, we are only about halfway through our recovery period, and stocks are still giving investors average, albeit not spectacular, returns.

The best time to buy stocks for the long-term is when nobody wants them and you can buy cheap, which is what savvy investors did during the Great Depression. Investors who held S&P 500 stocks between June 1932 and June 1962 saw 2,447 percent cumulative real returns and 13,242 percent for small cap value.

The key to smart investing is to maintain a longer time horizon than tomorrow or next week and to have the conviction to go against the grain, especially when greed and fear are running rampant. By doing so, you will capitalize on the irrationality of other investors and find yourself one large step ahead of the curve.