Gains and losses: the Illusion Puzzle

This is a hypothetical case.

Mr. Smith is reviewing his account online and sees the following information:

1. Market value at the end of 2021 was $150,000
2. Current market value (June 10, 2022) $110,000
3. Initial investment $100,000 sometime in 2021
4. Smith has sold nothing nor bought anything since inception

Observing these data, Smith thinks he has lost $40,000. After all, his account is $40,000 less than it was a little over 5 months ago. Is he right? But looking at it from a different angle, the current market value of $110,000 is $10,000 more than he initially invested. From this perspective, he has gained $10,000. What should Mr. Smith think? Did he lose $40,000 or gain $10,000. Let's look a little deeper.

Smith is caught in an illusion. It's an illusion because he has neither a loss nor a gain and neither will incur until he sells. The $40,000 loss he thinks he has incurred is nothing more than his account giving back previous gains that were never realized. The same logic holds for the $10,000 gain. It, too, is an illusion because he has sold nothing; he has not realized a penny of gain until he does. Smith’s perceived gain and loss is an illusion; it’s all on paper. Now, if he were to sell out the entire account, he would, at that time, realize a gain of $10,000. In other words, his unrealized gain is not real until he sells at which time it becomes realized.

This illusion can create real problems for some people. It can lure you into making an important decision based on a misperception of reality. If you see your account is down by $40,000 from its high as Mr. Smith does in this case, you could panic and tell me to sell everything to stop the bleeding. With no other intervening factors, such an emotional response to a highly volatile market would be a big mistake for several reasons.

First , you would be moving all your holdings to cash where it is exposed to inflation currently running at 8% per year. That means a loss of purchasing power as long as you keep your funds on the sidelines. In addition, you would lose the opportunity to experience any upturn in the market, and nobody know when that upturn will occur. History clearly shows that the market does not stay down, on average, for more than 12 months. After downturns, history further shows it turns up for the following 48 months, on average.

A third reason is that you may think selling everything now, waiting for the market to calm down, and then buying back in is a smart tactic. That is a fantasy world of make-believe. The market has never been calm although many pundits on Wall Street will tell you when it is and when it isn't. The reality is that they don't know. Market timing is a myth perpetuated by people who have a vested interest in making transactions at your expense.

A final reason is that by reacting to market conditions, you are allowing it to decide an action for you as opposed to you deciding what is in your best interest. Investment decisions should be based on your unique needs. Of the two factors affecting all investment programs, your needs over which you have some control take precedence over the market where you have not control.

Understanding how gains and losses work is an important part of your financial education. Knowledge is power. If watching the market gives you severe anxiety, change your perspective by focusing on your long-term goal, whatever that goal may be and be sure that I know what it is. If you call me to ask what we should be doing at this crazy time, unless your personal circumstances have changed in ways I do not know about, I will advise you to try not to get upset and trust that capitalism and democracy will work overtime. Both have a positive track record over hundreds of years. No other system comes close to matching these two interconnected pillars upon which the US has built the most powerful economy in the world.

All the best,

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