Avoid the Pain Trade When Stocks Hit New Highs

The pain of losing money is worse than the pain of missing out on gains

Right now, stock markets are up smartly for the year, but this might not be the time to start buying. Remember that it is most dangerous to start investing at the peak, because every winning streak inevitably ends.

Are we at the peak? Many economists are suggesting so. The truth is that no one knows. But jumping into a rally late is never a good idea.

As the S&P 500 and the Dow Jones Industrial Average strung together a series of wins recently, more and more reluctant investors bought into the rally for fear of missing out. Behavior like this is simply bad investing.

The Pain Trade

We in the portfolio management world call this a "pain trade" because it's so painful to watch the market go up while sitting on the sidelines.

Shy investors wait until the market is near exhaustion before they can't take it anymore and put their money to work. As stocks rise to overbought levels, more of them get in, the market overheats and eventually corrects. This is why researchers say that investor behavior can cause severe underperformance in both bull and bear markets.

The Rise of the Little Investor

With U.S. stock indexes breaking records as they have lately, otherwise risk-averse folks pile into the market, heating up prices even more. And often these risk-averse folks are smaller investors. They get into the market when risk is highest and set themselves up for failure when valuations inevitably move downward.

The pain of losing money is far worse than the pain of missing out on gains. Ask yourself this: would you prefer to be out of the market, wishing you were in or in the market, wishing you were out?

With that said, you should treat your portfolio like a dimmer rather than an on/off switch. Turn it up when risk levels are low, and scale it back and take profits when risk levels are elevated.

Uncertainty and Risk are Not the Same

There is a huge difference between uncertainty and risk. With risk, we know the outcomes. Uncertainty means that the outcomes are unknown, but we must prepare for them. We know what happens in high-risk periods in the market because we previously saw the fallout that ensued afterward. Enjoy it while it lasts, but don't allow a month or two of new highs trick you into thinking the market can't lose.

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