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What A Natural Disaster Can Teach Us About Investing

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"We don't know. We can't see the future. The flow does what the flow does."

— Rod Macland of Pahoa, HI to CNN reporters at KITV—TV

As folks in Pahoa, Hawaii waited to see whether lava flowing from the eruption of the Kilauea Volcano would run right over their homes, one resident shared this gem of wisdom with CNN reporters.

His words are just as applicable to stock market pyrotechnics as they are to the unpredictable whims of Mother Nature.

There's a lot to be learned from a volcanic eruption.

We truly don't know what the markets will do, and we can't predict the future. What we do know is that there are two primary ways to lose money when faced with volatility:

By panicking and running the wrong direction when the lava starts flowing down the hill.

By remaining paralyzed on the sidelines long after the volcano erupts, because we are afraid it might explode again at any time.

In other words, we buy something at or near the all-time high, and when it falls in value, we panic and sell it at fire sale prices. Or, we hold onto our cash with a death grip, since we're afraid that prices are either too high or heading much lower — even while everything around us goes up, up, up.

The financial media sure isn't helping quell fears. Although the current economic recovery is in its sixth year, and markets have had a rally for the ages, those armchair quarterbacks insist that we need to get ready now, because the next correction is on the horizon.

They may be right, but we should all heed the words of America's favorite investor, Peter Lynch, who said, "Far more money has been lost by investors preparing for corrections or trying to anticipate corrections than has been lost in corrections themselves."

What money losing missteps is Mr. Lynch warning us to avoid? If you guessed the aforementioned panic and paralysis, you guessed right. Since accurately timing a market correction is just as impossible as determining which way the lava will run down the mountain, you can't rely on your primal instincts to protect you.

You must take a deep breath, accept that market corrections and volatility are fundamental to the nature of the stock markets, and surrender to the flow. There will ALWAYS be a correction lurking just around the corner.

Take recent headlines. If you logged onto your computer lately, you know that Kilauea erupted and there are at least a half dozen global issues that spell impending market doom. We've had Ebola in West Africa, unrest in Russia, protests in China, ISIS threats, Federal Reserve uncertainty, and stock market valuation concerns.

Doom is always impending — so don't worry too much about it.

Next week we'll move on to a whole new set of real or perceived cataclysms. The crises may cycle too rapidly for us to feel the revolution, but there will always be something disastrous happening somewhere.

If impending doom is a constant, then going to cash in anticipation of impending doom probably isn't going to work — at least not with anything resembling predictability. Markets (and volcanoes) can crater or blow up for any reason at any time, so the real risk isn't that markets might correct one day. They inevitably will. The real risk is that we aren't mentally or emotionally prepared when the inevitable correction strikes, so panic ensues.

Fortunately, panic is a choice you can opt out of. There are many, many people who calmly saved and invested over any number of up and down years and found themselves ... wealthy. Market losses happened to them in the same way they happen to everyone else. The only difference is how they behaved during the dips and dives: They remained mindful of their long-term goals. They went with the flow. And they did not panic.

If you'd like to join the club of volatility—accepting, elite non—panickers, there are three specific action steps you can take before the next volcano erupts:

You can be prepared for a potential disaster.

1. Plan.

Be mindful of the tradeoffs you have to make to ensure that you save enough for your long-term goals. As you plan, make conservative return assumptions and run a stress test analysis to see exactly how low your portfolio might go and still remain "on plan."

2. Understand.

Become a student of economic history. Study the unfolding and recovery of the many and various market calamities that have occurred over the last 200 years or so. Note that every single one of them was reported as "the end of the world" at the time it was happening.

We humans have short memories, so we need to stretch our perspective far enough to see that we have all been through this before and will go through this again.

3. Meditate, breathe, or walk.

Do something habitually that brings you to a place of calm reflection. Slow down the frames of your personal financial horror movie, so that you can see how panic takes hold of your psyche before you fall into that trap. In reality, none of us can control how fast the lava flows towards our home, and no one can predict or control markets. No one. Accepting and internalizing this fact is the key to avoiding needless panic.

How can you prepare for the next — and every other — market correction? The bad (and good) news is that there is only one thing you can control that will definitively improve your financial outcomes: your behavior.

The flow does what the flow does, but if you can plan, understand, and breathe your way through the next Bear market, rather than heading for the hills in a panic, you might find yourself actually thriving on the other side.

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