Feeling panicky?
Here are four reasons not to overreact

When the market indexes plunge and your portfolio shrinks, it's natural to think about bailing out of your investments, particularly stocks. But before you head for the exits, consider four reasons why sticking with your investment plan, and resisting the temptation to sell, may be your smartest move.

Reason 1: Market-timing is a losing strategy.

You may be thinking you should sell now and get back into stocks later when the market "settles down" and the economy starts to recover. But this approach—called market-timing—can lead to disappointing returns. In effect, it puts you at risk of selling low and buying high.

If you do try to time the market, how are you going to know for sure what's the "right" time to get in and out? There is never an announcement that a declining market has started or ended. The direction of stocks can change very quickly; market rallies often occur suddenly and over very short periods. If you happen to be out of the market during those times, you could miss all or most of the gains for that year. This is sometimes called "out-of-market" risk, and it's a risk you should consider when making decisions about your investments.

"Market-timing is extremely difficult," said Donald G. Bennyhoff, a senior investment analyst with Vanguard Investment Strategy Group. "To profit from market-timing, you have to be able to get out before the low and be able to get back in before the market moves decidedly higher. It's impractical. It may sound good in theory, but market-timing mostly fails in practice."

Reason 2: Investors have been rewarded for taking risk.

The steep and sudden stock market drops we've seen recently are certainly unsettling and may have done serious damage to your portfolio. But this very risk is why, over the long term, stocks have outperformed bonds or cash investments. "To take the risk of investing in stocks, people have to see a higher return potential than they would get from a typically safer asset," said Mr. Bennyhoff. "Taking risk isn't always rewarded in the short term. But, historically, risk has generally been rewarded over the long term in the form of higher average returns."

The risk of loss that goes along with investing in stocks is one of the reasons Vanguard recommends that investors consider well-diversified portfolios of stocks, bonds, and cash appropriate for your situation.

Reason 3: Playing it "safe" can lead to a shortfall.

Right about now, fleeing stocks for the safety of U.S. Treasury bills or an FDIC-insured certificate of deposit seems very appealing. For your short-term financial needs, these cash investments can be good choices. But, they may not be suitable for your long-term goals—like saving for a comfortable retirement—because the returns are likely to be too low.

Remember, your investments will need to outpace inflation over time, otherwise you'll lose purchasing power. Historically, it's been stocks that have helped investors compensate for inflation by delivering higher average annual returns than cash investments or bonds.

"It's very important to consider that risk is not only market risk; other risks like inflationary risk need to be part of that equation," Mr. Bennyhoff said. "Even investors about to retire may still have investment horizons of 20 or 30 years, so they still need to consider the effects on their portfolios of inflation. Stocks, with their higher after-inflation returns, have a record of helping investors preserve their purchasing power."

Reason 4: Emotional decisions often lead to regrets.

In times of market turmoil, it's difficult to take a long-term view and resist the urge to react to the latest big swing in the financial markets. Our instincts tell us we have to do something *now*. But Mr. Bennyhoff suggests staying calm can help you avoid making moves you later regret.

"Generally speaking, it tends to be a very bad idea to make emotional decisions in times that are already emotionally charged," he said. "If the market had a bad day yesterday and you come in today and sell, that doesn't make up for yesterday's losses. Actually, what you're doing is just capturing your losses."

That's not to say you should never make changes to your investments. As your circumstances change—when you reach retirement, for example—it makes sense to revisit your investment plan and make adjustments if necessary.

"Changing your asset allocation because of a meaningful change in your life might make a lot of sense, but changing just because of market movements makes less sense," Mr. Bennyhoff said. "The idea is that the change shouldn't be driven by the market decline; it should be driven by something more significant and permanent."

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