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Down Is Faster

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Current stock market conditions remind us of the adage that “down is faster.” The quick change in investor sentiment from January 26 to today, and the subsequent rapid decline in stock prices highlight the challenge that investors face when trying to anticipate market turning points. The vast majority of investors who have anticipated a decline were “too early.” As mutual-fund manager Peter Lynch has warned: “far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves.”[1]

Now that we have experienced a greater than 5% decline, we can look at the base case probability of the setback extending to a bear market (greater than 20% decline). The following table shows that equity prices experience three to four setbacks of greater than 5% each year, almost one correction of greater than 10% each 12 months, and a bear market decline of greater than 20% every three to four years.

The Anatomy of S&P 500 Declines Jan 1928 to Feb 2018

	Setback > 5%	**Correction > 10%**	**Bear Market > 20%**
Occurrences	301	95	25
Mean per year	3.4	1.1	0.3
Mean number of months	1.2	3.4	10.0
Probability of further decline	31%	26%	
Last Start Date	Jan-18	May-15	Oct-07
Source: Ned Davis Research & Chicago Partners			

The S&P 500 did not experience a greater than 5% decline between February 2016 and February 2018. This two year period without a setback contrasts with the 3.4 setbacks that occur in a typical year. Similarly, the market did not have a greater that 10% decline during this two year period in contrast to the historical norm of almost one correction per year. By the time you read this commentary, the current decline may exceed the 10% threshold for a correction. If so, the probability of the decline extending to a bear market (> 20%) would be 26%.

Analysts have pointed to rising US wages as the proximate cause for the current fall in equity prices. They site rising inflation that could prompt central banks to tighten monetary policy faster than expected. Rising interest rates combined with above average valuations could be contributing factors for the decline. However, investor sentiment may eventually revert to the positive effects on corporate profits of an acceleration in the economic growth rate from the 2% to the 3% range.

[1] Attributed to a mid-1990s interview for Frontline on PBS

Minimize the Probability of a Permanent Loss of Capital

Declines only turn into a permanent loss of capital if the investor sells securities after prices fall below the original costs. This risk can be minimized by accepting price volatility, knowing your tolerance for anxiety during market declines, and owning an effectively diversified portfolio.

Accept price volatility

Try not to dwell on short-to-intermediate-term performance. When you invest in a broadly diversified portfolio of stocks, price fluctuations generally reflect emotional reactions to current events or the near-term outlook, rather than changes that affect the long-term aggregate value of the companies in your portfolio. Long-term growth in corporate profits primarily drives the total value of equity prices higher.

Yesterday's clairvoyant may be tomorrow's un-prophet

The large number of financial markets prognosticators assures that someone, reasonably accurately, predicts when every bear market begins. For example, Nouriel Roubini published a paper in early 2008 titled: *The Rising Risk of a Systemic Financial Meltdown.*

Unfortunately most investors did not know or care about Roubini's views until late 2008 when his thoughts were summarized as: "we are going to have what he calls "stag-deflation," meaning severe stagnation and deflation. Basically, he thinks that we're heading into a depression without extreme government action. He's also warning of possible food riots."[2] Roubini "predicted" the financial crisis, but people who followed his views in late 2008/early 2009 either sold equities and turned unrealized losses into permanent losses of capital, or missed a great investment opportunity in February 2009.

The same person does not ring a bell at the beginning and end of a bear market. Additionally, you will not know who correctly rang the bell until after the events have occurred. Instead of trying to "time the market," determine if you can accept the anxiety created by a bear market with 100%, 60% or 20% of your portfolio invested in equities during the decline.

Diversify

Effective diversification means investing in a variety of assets, with the expectation that positive performance for some investments will neutralize negative performance for others. Diversification requires building a portfolio that includes investments that react differently to the same economic factors, limiting the risks associated with "putting all your eggs in one basket."

Beyond the major assets classes, you can diversify even further by allocating your money to different subclasses. For example, an equity portfolio can be subdivided into domestic vs. foreign companies, large cap vs. small cap equities and growth vs. value styles. The subclasses often perform differently, the essence of effective diversification.

US large cap stocks as represented by the S&P 500 have not experienced a bear market since 2008. In contrast, foreign stocks, small cap stocks and value styles all experienced greater than 20% declines from May 2015 to February 2016. When the S&P 500's next bear market decline occurs, foreign, small cap and value styles may dampen the impact on a global equity portfolio tilted toward small cap and low priced stocks.

Conclusion

The higher expected return for equity securities compensates investors for assuming uncertainty about the timing and magnitude of returns. Accept price volatility, mentally prepare yourself for the next bear

market decline and own a globally diversified portfolio of equity securities. Most important, your portfolio should include short-to-intermediate-term investment grade bonds to meet your anticipated spending needs over at least the next five years.

[i].

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[2] Washington's Blog, What are the People Who Predicted the Financial Crisis Predicting Now?, 12/8/2008