On Declines

If your February statements were anything like mine, you saw a decline of about 9%. That's in the two short months since December 31st.

Right now is a great time to look at market declines. You might be surprised.

Simple extrapolative thinking might have worked well in primitive times, say for hunting deer. Modern times, however, are not kind to certain aspects of the human mind. We tend to use mental shortcuts called 'heuristics' that can lead to persistent logical errors. And persistent logical errors can be fatal to investment success.

These errors aren't just little tricks that you can read about in a newsletter and understand. The nick of pain - or impending doom - when your million-dollar portfolio drops by $150,000 is as compelling to the human mind as the mirage of water on a desert highway is to a 10-year old. The perception is impossible to avoid; it is what you do about it that matters.

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Chris provides financial planning, investment planning and full implementation services to about 100 families.

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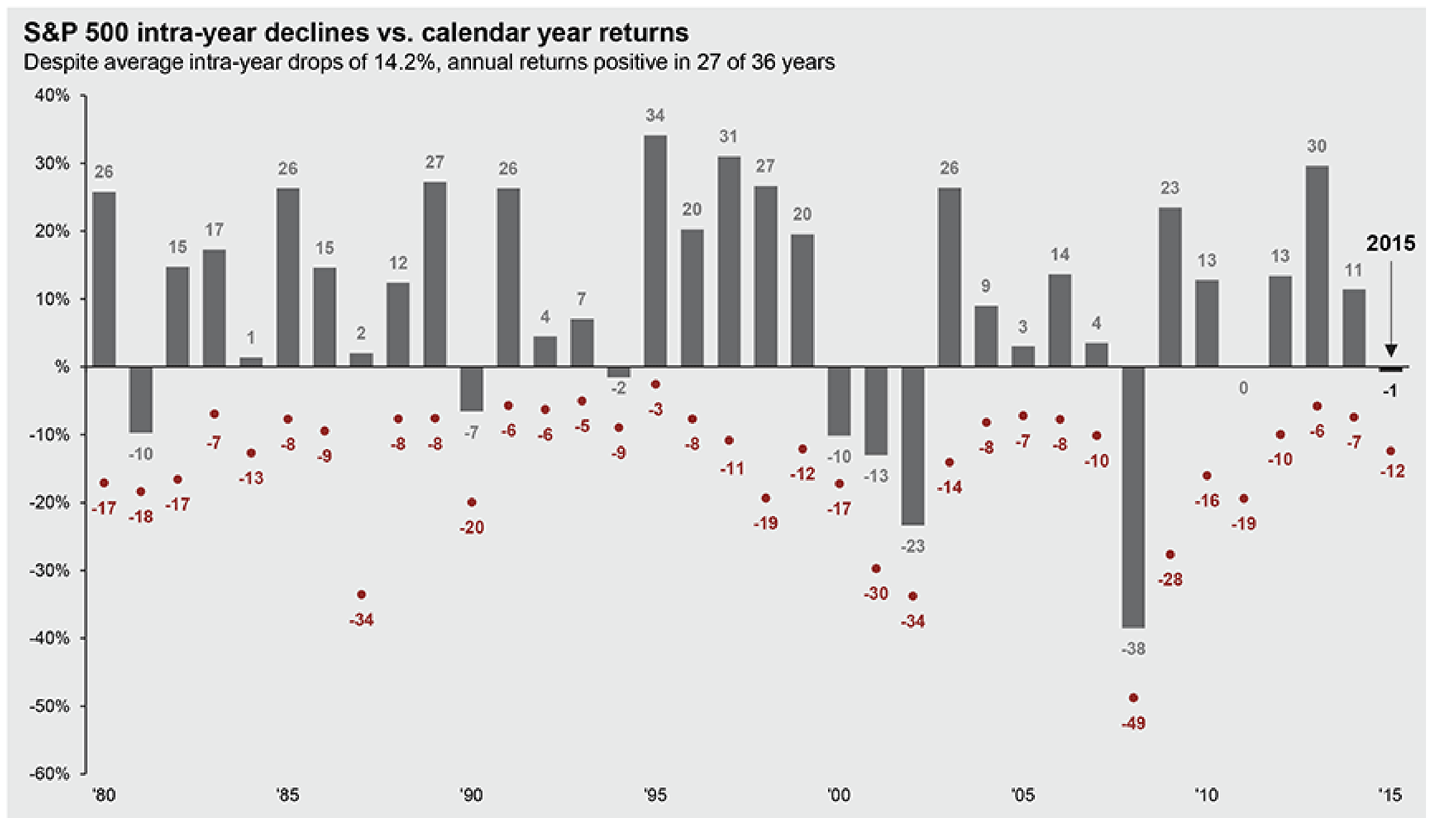
The world is full of ‘experts’ telling you what to do: second opinions from financial salespeople competing for your business, to the UBS analyst – quoted in headlines around the world – at the bottom of the little correction in February saying ‘sell everything and buy bonds’. Our primitive minds, alerted to danger by a sudden drop, become receptive to a ‘flight or fight’ response.

Inexperienced investors (and advisors) are suckers for these mistakes. Professional and other experienced investors, on the other hand, have seen so many price declines that they are not tricked by the optical illusions. Learning about them is usually a much more expensive and time-consuming process than watching the water mirage disappear before your eyes on the summer car trip.

The chart below comes to us courtesy of Nick Murray, longtime investment industry commentator often quoted in these pages.



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.
Returns are based on price index only and do not include dividends. Intra-year drops refers to the largest market drops from a peak to a trough during the year. For illustrative purposes only. Returns shown are calendar year returns from 1980 to 2015.
Guide to the Markets – U.S. Data are as of December 31, 2015.

The vertical bars represent the market returns for each calendar year from 1980 to 2015, 36 years in all. The red dots are the maximum decline from a high point to some low point within a calendar year, called the intra-year decline.

So in calendar 1980 for instance, (my first year in the business) the market was up 26%, although the intra-year decline was 17%. In 2012, the market was down 10% at some point (the summer, if memory serves) yet finished up 13% for the year.

Look at the red dots. The market declined at some point every single year in the last 36; as little as -3% in 1995 and as much as the monster 49% in 2008. The average is a little over 14%.

The chart shows, with wonderful simplicity, that declines of 7 – 20% happen all the time. Almost 90% - 31 out of 36 - years had a decline of 7% or more.

The second important point is that even with declines of 7% happening all the time, there were only 8 down years in 36. Think about that. In my entire career, there have only been 8 negative years (including 1994 and 2015's declines of 2% and 1%, which hardly count). Ask yourself: seriously, why are we so terrified of markets?

Third is when you string all the 36 years together, the S&P 500 grew from about 120 in 1980 to around 2000 today, a seventeen fold return. This represents a long term average return of about 8%, not including dividends. With dividends the returns are about 10%, according to Ibbottson Associates, a market research firm.

This, folks, is as clear a picture of the nature of the equity markets as you can hope to see. Markets go up and down. All the time. Yet the long term return is fabulous. So why are we so afraid of markets?

Volatility Obscures the Trend

The answer is serious volatility. The average intra-year volatility at 14% actually swamps the long-term average return of about 10%. The true signal, a 10% long term return, is lost in the noise. And statistically irrelevant but scary noise is pure heaven for financial journalism.

Most people see the volatility, not the trend. They see $150,000 come off a million-dollar portfolio and they become fearful. Their brains are genetically tuned to hear the certainty of financial news media that things are sure to get worse.

They fall victim to a lethal combination of negative daily noise, human instinct, and poor advice. They sell out of a perfectly good portfolio to buy whatever did well yesterday. Or less dramatically, but just as damaging to their long term success, they answer a risk assessment questionnaire saying they are low risk, or medium risk (whatever those undefined terms mean).

I appreciate that I am preaching to the converted, because none of you have changed your strategy, and I love you all for that. But I also know, from the several phone calls that I have had and from talking to industry people, that the anxiety level is fairly high. And an anxious investor is an easy mark for a 'flight to safety' sales pitch.

Our natural instinct, triggered by mental shortcuts or heuristics, is to pay attention to claims that this is indeed the end of the modern world. It is as difficult to ignore the sense of alarm as it is to not see the mirage of water on the desert highway in summer. You can't.

The feeling of alarm irresistably draws our attention away from our longer term considered decisions. We become susceptible to 'fight or flight' type responses. We are suckered into thinking that our advisor hasn't earned his fees, or the fund manager hasn't earned hers, because, can't you see, the portfolio has gone down! And why are we paying fees for a portfolio to go down?!

The Lesson

The instructive point in all this is to firmly plant into your memory banks, today while the images are still fresh, how dead certain financial journalism was that January and February 2016 were the beginning of the end of the modern world. Take a moment right now, before The Donald becomes the next reason for the world to end, to plant in your memory banks the fear, and the tension in the headlines of the past 8 weeks.

Make a mental note of how we were assured by financial journalism that oil at $30 was something sinister, not the death throes of a cartel being destroyed by an abundance of oil from modern technology. Recall that the US consumer was going to fall apart somehow, as energy costs fell by half.

Note too that China, now with as many middle class consumers as the United States, was going to implode. And note that the US market actually declined, from the high of 2109 on November 3rd to the low of 1829 February 11th, 2016 was a piddling 13%[1]. Not even an average decline. So far anyway.

I have no idea if this little correction is over or not. Only a fool pretends to know. But the point is to see from the chart that declines of 14% are as common as mirages on a desert highway. They do not portend the end of the modern world. They portend exactly nothing.

Only by reminding ourselves, as the 10-year old in the family car eventually does, that the water appearing in the road ahead is a mirage, not actually water, do we learn not to hit the brakes on a perfectly good investment strategy.

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[1] S&P500 Source: GlobeAdvisor

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