Wealth Management

The Crescent Group

RBC Wealth Management

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As almost all investors know, U.S. stocks fell in February. In fact, U.S. stock markets had their first official correction in two years. Corrections are defined as a 10% decline in stocks from peak to bottom. The S&P 500 Index, a closely followed measure of U.S. stocks, declined 10% from its peak level on January 26, to its recent bottom level on February 8. As of the end of February, the S&P 500 sat 5.5% below its highest level ever. Unfortunately, intra-year stock market declines occur every year, and they are simply part of the process of successful long-term investing, much as turbulence is part of a successful airline flight. While the January/February market correction was normal in every sense, it seemed to have an outsized impact on investor emotions due to the length of time U.S. stocks had gone without a correction. In this commentary, we review some of the important lessons investors should take away from what happened with the recent correction[1].

First, as we mentioned above, intra-year stock market declines are normal, healthy, and happen every year. In fact, the stability U.S. stocks exhibited between the 2017 presidential election and January 2018 was actually abnormal, not the volatility we experienced last month. During the 38 years ended 2017, the S&P 500 experienced an intra-year decline from peak to bottom every year, with the average intra-year decline equaling 13.8%. Despite that average annual intra-year decline, stocks earned positive annual returns in 29 out of those 38 years, with the S&P 500 returning about 11% annually, and climbing 2,377% in total. And yes, we also labeled the January/February market correction healthy. If markets keep going higher and higher all the time with no pause, they would simply set themselves up for an all-out crash, something that few investors want[1][2].

How did you handle last month's correction? Another important takeaway from last month is that the light can change from green to red at any time, with no warning. That's exactly what happened last month, and it will happen again. In fact, it will happen regularly. It's important to mentally set these expectations so that you don't make the wrong decision when it happens. As we mentioned, last month's correction fit closely within the realm of average, since last month's decline equaled 10% and the 38-year average has equaled 14%. But what happens when we have an abnormal correction? Something like what happened in

October 1987 (21% decline in the S&P 500 in one day), the 2000 to 2002 correction (49% decline), or the 2007 to 2009 correction (57% decline). A 50% decline sounds big, and it is. It's five times the size of the decline we experienced in January and February. The bad news is that something approaching that level of decline is guaranteed to happen at some point. The good news is it won't impact your financial goals as long as you make the right short-term decisions. For example, investors who panicked and sold their investments during the financial crisis have missed important parts of one of the greatest market runs in history. Meanwhile, those investors who did the opposite and put all their money into the stock market at the S&P 500's pre-crisis peak in October 2007, watched their holdings promptly crash 57% over the next two years, and held through the end of February 2018, have received a return of about 7.4% per year. The important thing to do during a financial panic is not cave in to emotions and sell. You'll often hear investors say that they can't afford another 2008. But actually, who can't afford to receive a 7.4% annual return over the long term? The key to success is acting correctly when a market crash happens. I.e., not selling. Investors who know they get spooked during market declines should make sure they have an advisor who doesn't get spooked. Having an advisor who does what you want them to do doesn't help you, it hurts you. You want an advisor who has the confidence to do what's right, and explain to you why it's right, even if it doesn't feel right at the moment[(1)(2)].

Some investors erroneously think they can time the market. A recent Forbes article did a great job of describing why this doesn't work: "Successful market timing requires two correct decisions: when to get out and when to get back in. Guessing right once is a 50/50 proposition. Guessing right twice drops the odds to only 25 percent. One wrong guess and you shoot yourself in one foot; two wrong guesses and you shoot yourself in both feet." With only 25% odds of success per market timing attempt, you are basically gambling. Some professional investors profess themselves as able to successfully time the market, and some individual investors fall prey to them. As the Forbes article further describes: "I've sat on many panels during industry conferences where portfolio managers gloat over how they predicted a market crash, or a jump in interest rates, or the fall in gold prices, etc. What these gurus fail to mention (and what I point out) is that most of them were not able to repeat their good fortune. They failed to get their clients back into markets before the recovery and couldn't repeat the process consistently.[(3)]"

Reflecting on large market crashes, and attempts to avoid them with market timing, may seem strange at a time when U.S. stocks sit near all-time high levels. But just as successful investors must exercise emotional restraint when markets plummet, they must also do so when markets push higher and higher, possibly into bubble territory. Of course, the emotional fortitude required differs during periods of pessimism versus exuberance. Whereas investors must avoid selling when markets crash, they must avoid getting caught up in what's most popular during excessive market optimism. Put simply, if you want a different outcome from everyone else (all-out crash lead by the most speculative investments that have gone up the most), you cannot be a part of those investments on the way up. Warren Buffett wrote about this last month in his annual shareholder letter, issuing a sobering description of his investment approach in the current market: "In the meantime, we will stick with our simple guideline: The less the prudence with which others conduct their affairs, the greater the prudence with which we must conduct our own". Buffett's own experience during the 1990's technology bubble highlights what can happen when you invest with prudence while everyone else speculates: from August 1998 to March 2000, Berkshire Hathaway's stock declined 47% while the S&P 500 increased 28%. Why did Buffett underperform? Because he exercised prudence while others didn't, and was not invested in the most speculative companies that went up the most. Over the following nearly ten years, Berkshire stock increased 344% through February 2018, while the S&P 500 increased 149%. So while prudence can look dumb over the short-term, it was the right long-term decision. As Buffett further noted in his letter last month, "What investors then need instead is an ability to both disregard mob fears or enthusiasms and to focus on a few simple fundamentals. A willingness to look unimaginative for a sustained period – or even to look foolish – is also essential.[(1)(4)]"

Some investors might describe our Group's approach to investing as unimaginative, and we have no problem with that. Especially when "imaginative" involves taking risks and speculating. We know that the current investing environment requires heightened prudence, and that's why we invest in the highest quality companies with mundane products and services, selling at reasonable prices. Our investment approach allows us to avoid what's hot and popular right now in order to protect our investors from bubble corrections, while earning them the return they need to achieve their financial goals. We have confidence that this is the correct approach to succeed over the long term.

Best Regards,

The Crescent Group
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Sources:

(1) S&P Dow Jones Indices LLC
(2) JP Morgan
(3) Forbes
(4) Berkshire Hathaway

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