Capital Ideas℠

VIEWPOINTS

Preparing Clients for Market Declines

Key Takeaways

- The current bull market run has been remarkably tranquil, but it's important to condition clients to the fact that a correction could come at any time.
- Positioning portfolios to endure potential setbacks has historically been far more effective than making abrupt moves following some kind of market action.
- Our research shows that equities have tended to gain a majority of the time in most market cycles, and providing this perspective (along with setting aside cash for immediate short-term expenses) may be helpful in keeping clients invested even during tough times.

One of the most noteworthy elements of the current bull market has been its remarkable tranquility. Currently in its ninth year, this advance has been marked by extremely low volatility with very few selloffs. It's a historic rally: The Standard & Poor's 500 has posted a positive total return in each of the past 15 months – a feat that's occurred just once before, in 1960, according to S&P Dow Jones Indices.

Still, history tells us that even the most vibrant rallies eventually give way to selling pressure, either temporary corrections or more damaging bear markets. It is difficult to predict when a correction will set in – or when a correction might deepen into a full-fledged bear. The market reminded investors about volatility on Feb. 2 when the Dow Jones Industrial Average fell more than 650 points. That daily decline resulted in a 4.1% loss during the week – the largest since January 2016, which had followed a global market decline sparked by concerns about Chinese stocks.

Nevertheless, it's helpful to understand the nature of past downturns to assist in your conversations with clients. To shed greater light on this subject, our researchers analyzed the length and severity of past market drops. Though the precise causes often vary from one selloff to another, we found that there are two fundamental types of declines: major pullbacks, which often correspond with recessions, and shorter lived downturns that occur in the course of longer lasting rallies.

In the postwar period, the S&P 500 has dropped 15% or more on 16 occasions. Half of those downturns were relatively mild, lasting less than eight months. Nearly one-third of the time, the index was at a new high within 10 months of the previous peak.

As for major pullbacks, the median duration was 17 months, with a drop of more than 30%. Again, these declines are typically associated with recessions.

Thus, gauging the potential depth of a market decline involves trying to determine the stage of the economic cycle. Currently, our research suggests the U.S. economy is not exhibiting any of the obvious excesses or imbalances that historically have foreshadowed economic contractions.

Market Downturns Happened Frequently and They Didn't Last Forever

Dow Jones Industrial Average 1900-2015

	-5% or more	-10% or more	-15% or more	-20% or more
AVERAGE FREQUENCY[1]	About 3 times a year	About once a year	About once every 2 years	About once every 3.5 years
AVERAGE LENGTH[2]	46 days	115 days	216 days	338 days

[1]Assumes 50% recovery of lost value
[2]Measures market high to market low
The Dow Jones Industrial Average is an unmanaged, price-weighted average of 30 actively traded industrial and service-oriented blue chip stocks. Past results are not predictive of results in future periods.

It's important to note that equity valuations have not tended to be reliable predictors of market weakness. In fact, valuations have remained elevated for extended periods without a significant drop in stock prices. There have even been "bull market contractions" in which the P/E ratio actually fell as prices advanced because underlying earnings rose even faster.

Avoid the Urge to Time the Market

Regardless of market conditions, there is a natural human instinct to make portfolio adjustments based on what one thinks will happen. As you know, this impulse isn't confined to periods when stock prices are falling – it's equally tempting when stocks are rising. Just as some clients are inclined to reduce equity exposure following a market decline, others are reluctant to maintain stock investments during a rising market because they worry that a correction might occur.

Our analysis demonstrates that abrupt moves can be costly. Research indicates that it's not only impossible to predict short-term market moves, but that retreating from stocks at the wrong time can significantly damage long-term returns. For example, the S&P 500 had an average annual return of 7.7% from 1997 to 2016. But an investor who missed just the best 40 days during that span would have suffered a 2.4% annual loss.

We studied a range of postwar environments to gauge whether economic signals were a reliable precursor to market declines. In other words, they looked at whether it was possible to time the market based on economic red flags. Going back to 1946, we found that stocks appreciated in 81% of all rolling 12-month periods, including both weak and strong environments. We looked exclusively at challenging times, such as when inflation was high, gold prices were surging or unemployment was elevated.

Surprisingly, we found that equity markets delivered overwhelmingly positive returns even during these tumultuous periods. Only recessions seemed to have a reliably dampening effect on stocks, but avoiding those periods would have required advance warning. Unfortunately, even the most highly regarded economists are notorious for their conflicting – and often incorrect – views about when recessions will materialize.

How Equities Have Done in Various Scenarios

OVER ROLLING 12-MONTH PERIODS WHEN...	FREQUENCY OF STOCK GAINS	FREQUENCY OF STOCK LOSSES
Inflation was greater than 5%	**64%**	36%
There was deflation	**75%**	25%
Gold prices rose more than 20% (since 1970)	**87%**	13%
Unemployment was above 7% (since 1948)	**82%**	18%
Fed funds rate rose 1% or more (since 1954)	**82%**	18%
We were in a recession (since 1947)	**53%**	47%
All 12-month periods (1946–2016)	**81%**	19%

Inflation and Deflation: IA SBBI U.S. Inflation Index, 1946–2016. Gold: S&P GSCI Gold Index Spot, 1977–2016. Unemployment: Bureau of Labor Statistics, 1948–2016. Federal funds rate: Federal Reserve, 1954–2016. Recessions: Bureau of Economic Analysis, year-over-year decline by quarter, 1947–2016. Equity results are represented by the S&P 500 Index from 1946–1969 and a blend of 70% S&P 500 Index / 30% MSCI EAFE Index from 1970–2016. Past results are no guarantee of future results.

Two Ways to Prepare Clients for a Market Correction

1. **Think about setting aside one to two years of living expenses in liquid assets such as high-quality short-term bonds.** Though this is significantly higher than the typical three- to six-month "emergency cash fund" suggested in basic financial planning courses, this approach not only provides any necessary liquidity to meet short-term liabilities, it also helps provide clients with the emotional wherewithal to withstand the inherent volatility of their longer term investments.

   Given that the average peak-to-recovery duration for pullbacks of 10% or more is approximately 21 months since 1926, setting aside this amount seems reasonable. This approach can help prevent clients from making knee-jerk reactions to their strategic asset allocation in periods of increased volatility.

2. **Consider the client's objectives, not just the asset class or style box.** In addition to where a portfolio invests, objectives such as capital appreciation, income, capital preservation or a combination of these allow a reasonable tolerance around asset-class targets that provides portfolio managers with a measured degree of flexibility. This drives a significant part of the client experience, and the results are particularly meaningful in a market correction.

> Do your clients have the right mix of investment objectives in their portfolios? For clients who are especially sensitive to equity declines, consider a growth-and-income strategy, which typically exhibits less volatility and lower downside capture than those focused on capital appreciation.

Of course, none of this inoculates your clients from a sudden or sharp decline. And shocks such as geopolitical events and policy miscues can spark pullbacks. I believe the best strategy is to establish a thoughtful portfolio structure based on each client's time horizon, risk tolerance, risk capacity and personal financial goals. This approach helps clients stick with their portfolio objectives through the inevitable gyrations in the market. The market has been up far more often than it has been down; having a well-diversified portfolio can help your clients ride out the market's ups and downs.

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