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We Are Here To Help

When market volatility spikes, investors yearn for the safety and comfort of cash. However, it’s important to always consider who is on the other side of a trade and why they are so willing to make your pain go away.

Rough Patches

There is an old saying that stocks go up in escalators and down in elevators. Although it may feel like ancient history by now, the fourth quarter of 2018 was a harsh reminder of this truism.

From October 1st through December 24th of that year, the S&P 500 fell 19.6% (1). The volatility caught even the most astute investors off guard and likely fueled some interesting conversations around dinner tables that holiday season.

To better understand how the stock market has responded to times like these, the table below shows the worst performing quarters for the S&P 500 from 1940 - 2017. The bold row at the bottom indicates that the average loss for the worst of the worst quarters was just over 20%.

While this is a painful move in just three months, notice the subsequent one, three, and five-year returns. The numbers are staggering. It is as if the market was placed in a slingshot, pulled back, and released.

Last year was no different. After falling 19.6%, the S&P 500 rebounded to deliver a phenomenal 39.9% one-year total return through December 24th 2019 (1).

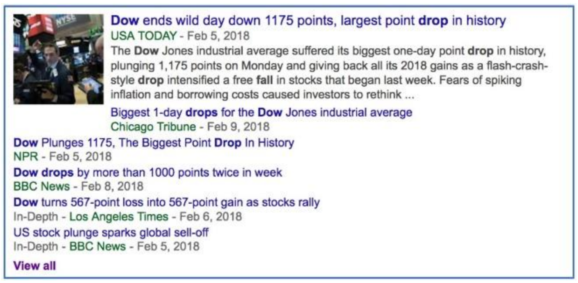
What's going on here? Why would the market recover so consistently when the drivers of each downturn were presumably different? To answer such questions, consider this not-so-hypothetical scenario.

Volatility begins to rise for whatever reason and catches the eyes of nervous investors. The media begins to run relatively benign stories of large one-day losses and how they compare to history.

S&P 500 Since 1940		Forward Performance		
Quarter Ending	**Quarterly Performance**	**One Year**	**Three Year**	**Five Year**
Sept 1974	-25.2%	38.1%	72.7%	117.5%
Dec 1987	-22.6%	16.8%	48.8%	109.0%
Dec 2008	-21.9%	26.5%	48.6%	128.2%
June 1962	-20.6%	31.2%	69.2%	94.8%
Sept 1946	-18.0%	6.4%	24.5%	115.4%
June 1970	-18.0%	41.9%	57.4%	56.3%
Sept 2002	-17.3%	0.3%	27.0%	66.3%

1 A Wealth of Common Sense (https://awealthofcommonsense.com/2018/12/buying-when-stocks-are-down-big/)

For example, The Dow Jones Industrial Index (DJIA) fell 1,175 points on Monday, February 5th, 2018 (1). At the time, it was the largest point decline in history, which led to the following headlines:



Dow ends wild day down 1175 points, largest point **drop** in history
USA TODAY - Feb 5, 2018
The **Dow** Jones industrial average suffered its biggest one-day point **drop** in history, plunging 1,175 points on Monday and giving back all its 2018 gains as a flash-crash-style **drop** intensified a free **fall** in stocks that began last week. Fears of spiking inflation and borrowing costs caused investors to rethink ...
Biggest 1-day **drops** for the **Dow** Jones industrial average
Chicago Tribune - Feb 9, 2018
Dow Plunges 1175, The Biggest Point **Drop** In History
NPR - Feb 5, 2018
Dow drops by more than 1000 points twice in week
BBC News - Feb 8, 2018
Dow turns 567-point loss into 567-point gain as stocks rally
In-Depth - Los Angeles Times - Feb 6, 2018
US stock plunge sparks global sell-off
In-Depth - BBC News - Feb 5, 2018
View all

2https://www.google.com/search?q=dow+drop on 2/6/2018

Comparing point declines in an index provides zero insight. Only percentage moves matter. The Dow closed the prior trading day at 25,520.96, so a drop of 1,175 points equates to a 4.6% decline (1). While this may sting, it is by no means the largest daily loss in history.

But the media does not care. These headlines get people to click on links, and that sells advertising. Market timers and the most skittish investors sell early, which only adds more fuel to the fire. Stories that counter the bears' narrative get pushed back to page eight (below the obituaries). Economic data and other fundamental drivers are no longer front-page material.

The stock market decline accelerates to the point where it begins to flirt with a "correction" (a decline of 10% from a recent high). This gives the media the green light to run stories of a looming recession and invite fearmongers to primetime shows to prophesize the end of the world.

Individual investors sitting at home begin to panic. What if this is another 2008? Nobody saw that coming, so why is this time any different? After a few weeks of sleep deprivation, the fear and panic become too much. They call their financial advisors and beg them to make the pain go away.

And as they breathe a sigh of relief after the risky stocks in their portfolio get replaced with the perceived safety of cash, take a guess who is on the other side of that trade with an ear-to-ear grin. Me.

I and other professional investors become our most charitable selves in these times. Can't take the misery of owning stocks that are down over 20% in a matter of weeks? We are here to help. We will gladly take that off your hands, and in the process, convert your short-term pain into long-term misery.

Because the volatility eventually dies down. Panicked sellers exit the market, and stocks stabilize. This prompts the media to quickly shift the narrative, publishing stories of a "recovery" and "buying opportunity" as economic data makes its way back to the front page. Sellers are left to kick themselves for acting so rash, and some may never return to risky asset classes because the scars run too deep.

The Bottom Line

Here's one way the pros differentiate between panic and the start of a recession. Stocks are fueled by economic growth over the long run, and the U.S. economy is a massive machine. The fundamentals driving it change slowly and can be observed.

Think about an oil tanker. Course corrections for a ship longer than a football field take a while to complete, and the trained eye can often see where it is headed by checking its wake, propeller speed, etc.

The U.S. economy is that oil tanker, and when the stock market is moving around like a speedboat, professional investors take notice because something other than fundamentals is usually driving prices.

More often than not, emotions are what decouple the stock market from the economy. But the pros know that emotions do not permanently derail $20 trillion economies, so they step in, buy up what they can, and then patiently wait for stocks to go back to being fueled by the economy.

The bottom line is that blood in water attracts sharks. Don't forget this the next time fear and panic cause volatility to spike.

Sincerely,

Mike Sorrentino, CFA

Chief Investment Officer

Three Key Points

1. Market volatility tends to encourage investors to make bad decisions.

2. Big quarterly losses in stocks tend to precede impressive rebounds.

3. Always remember who is on the other side of a trade when selling into panic.

Sources

1 Bloomberg

Disclosures

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