Market Correction: Making Things Better?

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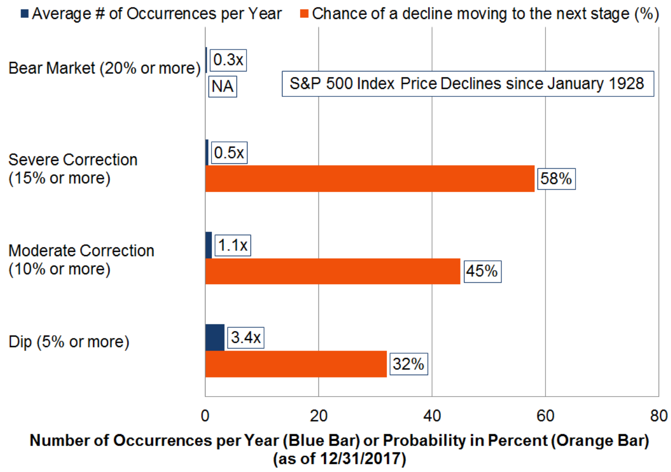
- After a historically long period of equity market gains, investors finally faced a stock-market correction—that is, when the value of an index declines 10% or more from its most-recent high.
- Despite the panic they tend to cause, stock-market corrections are necessary for the health of the overall market.
- On average, a correction in the U.S. stock market occurs about every two years and takes three months to recover.

Equity markets began 2018 with a continuation of the strong returns witnessed in 2017. After the best January performance in more than 20 years, the markets pivoted lower in February; the S&P 500 Index turned negative for the year on February 5 and was down 10% from its all-time highs by February 8.

The banality and virtues of stock-market corrections

Despite alarms triggered by stock-market corrections, they aren't typically tied to economic crises and are quite common. Exhibit 1 provides some perspective. On average, U.S. stock-market corrections occur about every two years.

Exhibit 1: Moderate Corrections are Normal



Source: Ned Davis Research, Standard & Poor's, SEI

While corrections may make it unpleasant to view your portfolio balance, they actually serve a useful purpose. Without the occasional pullback, stocks become overpriced or inflated, and a bull market swells to a bubble that eventually bursts—resulting in a sudden decline across broad sections of the market (known as a market crash). And a crash is far more likely than a correction to lead to a bear market (which is a price decline of 20% from a recent high).

Statistically speaking, the most recent correction was in line with expectations, as the prior one took place in January 2016. Investors at the time watched with concern as their portfolios tumbled on worries over economic growth, falling oil prices and the effectiveness of central-bank policies.

Before that, we had a pullback in August 2015 when the Dow Jones Industrial Average, the S&P 500 Index and the NASDAQ Composite Index all fell over 10% from their respective highs in the wake of China's slowing economy and concerns about potential Federal Reserve interest-rate hikes. The event was the first U.S. stock-market correction since 2011. This was unusual in that it had been four years since the last one—more than double the average amount of time between corrections. By early November 2015, the markets had recovered most of their losses.

Given the volatility that typically follows a severe selloff, it's understandable that stock-market corrections cause consternation among investors. But still, why would the word "correction" be associated with something that causes investments to lose value? The simple answer: A decline *corrects* market exuberance that may otherwise result in stock prices rising faster than is justified by underlying company earnings.

What to do when the stock market corrects?

What should you do when markets correct? Just wait. U.S. corrections typically last about two or three months and, despite their regularity, the average annual return for the S&P 500 Index over the last 50 years has been about 10% (according to Bloomberg, as of 12/31/2017). So there's a good chance investment losses suffered in a correction will be recuperated in the long run.

Despite the immediate panic the recent pullback has caused, it is serving a crucial purpose: resetting the market's valuation and investors' expectations to more reasonable levels. Plus, investors with spare cash on hand can treat the lower stock prices caused by a correction as a buying opportunity. And, perhaps most importantly, if you overreact by selling investments, you could miss out on gains when the market bounces back. After all, as Merriam Webster says, a correction is just "the act of making something better."

Index Definitions:

S&P 500 Index: The S&P 500 Index is an unmanaged, market-capitalization-weighted index that consists of the 500 of the largest publicly-traded U.S. companies and is considered representative of the broad U.S. stock market.

Dow Jones Industrial Average: The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and NASDAQ.

NASDAQ Composite Index: The NASDAQ Composite Index is an unmanaged, market-capitalization-weighted index that consists of all securities listed on the NASDAQ exchange. It is often used to gauge the performance of global technology stocks.

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The performance data quoted represents past performance. Past performance does not guarantee future results.