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Examining Equity Market Drawdowns

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Snapshot

- Equity market drawdowns, or peak-to-trough losses, are more common than realized, and they do not necessarily signal further market troubles.
- We believe investors can prepare for and soften (but not eliminate) the impact of drawdowns through proper and prudent diversification.
- Equity markets can be noisy in the short-term, while underlying fundamentals take longer to play out. It is important to avoid emotional reactions to this short-term noise.

Equity markets have spoiled investors over the last few years with prolonged market rallies, relatively muted pullbacks, and sustained periods of low volatility. The downturn in the fourth quarter of 2018 served investors with a stark reminder of just how volatile equity markets can be. While these lows can feel painful in the moment, it is important to understand they are part and parcel of the risk an investor must bear to earn equity returns.

Significant market drawdowns are fairly common and represent an inherent part of equity investing. There are methods that investors can use to mitigate the impact of stock-market downturns, including:

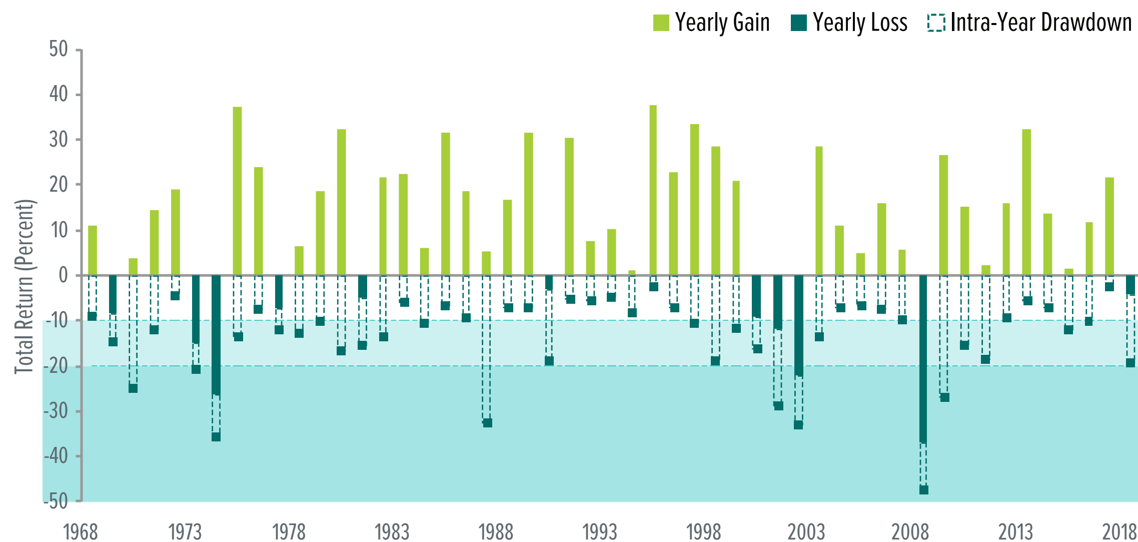
- Ensuring your investment strategy aligns well with your investment objectives to help avoid incurring more risk than is necessary
- Maintaining proper and prudent diversification
- Refraining from reacting emotionally to short-term market movements

Fourth-quarter 2018: Back to reality

Market sentiment in the first three quarters of 2018 remained similar to that of 2017, with low volatility and limited, infrequent pullbacks. Then the fourth quarter struck—when U.S. large-cap stocks fell 19.4% from peak to trough (as represented by the S&P 500 Index). The year ended with what was the worst December for the stock market since the Great Depression, spurring ceaseless debates among market pundits about how much worse things could get.

In reality, while the market drawdown at the end of 2018 was larger than average (since 1928), it was not out of the ordinary. In fact, it was fairly in line with typical equity-market behavior. This is illustrated in Exhibit 1, which captures all market drawdowns and yearly returns for the last fifty years.

Exhibit 1: Substantial drawdowns are actually fairly common



Sources: Bloomberg, Standard & Poor's, SEI. Returns represented by S&P 500 Index. Drawdown periods are captured intra-year and calculated as total returns. As of 12/31/2018. Past performance is no guarantee of future results.

Within the exhibit, we can see how often market corrections (defined as declines of 10% to 20%) really happen:

- From 1968 to 2018, the *average* intra-year pullback measured almost 14%—which qualifies as a correction.
- In 29 of these years, or almost 60%, there was a mid-year correction.
- All but four years experienced a pullback of at least 5% (with 2017 being one of the four exceptions).

Interestingly, these drops were hardly a marker for full-year results:

- 18 out of the 29 years in which corrections occurred still finished in positive territory and produced an average annual return of 17.5%.
- In the 29 years that experienced corrections, the market still managed to generate an average annual return of 5.7%.
- The years with no market corrections averaged an annual return of 18.4%—less than a 1% improvement to the 18 positive years in which corrections occurred.

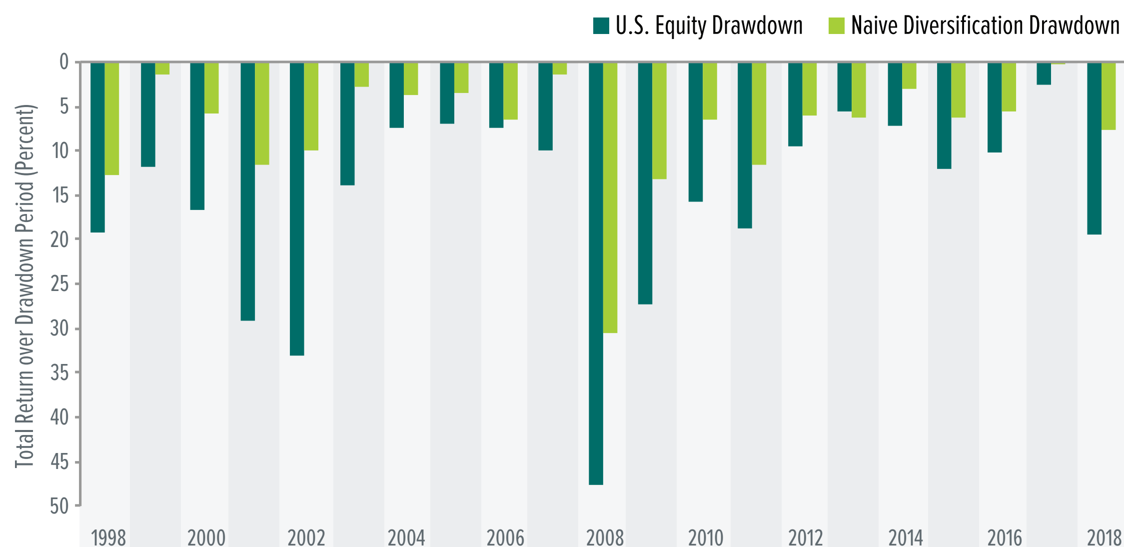
Thoughtful diversification can help dampen drawdowns

Consistently predicting when, how often, and with what magnitude market drawdowns will occur is impossible. However, we believe investors can prepare for and soften (but not eliminate) the impact of drawdowns through proper and prudent diversification across an array of asset classes with low or negative correlations. Exhibit 2 demonstrates this point, comparing a standalone portfolio of U.S. large-cap equities versus a naively diversified portfolio (meaning that each asset class is weighted equally) during each intra-year drawdown period since 1998.

We found that the single asset class underperformed the naively diversified portfolio in all but one of the years examined—in 2013, when unusual events associated with the taper tantrum weighed harder on international equity markets than those in the U.S. Even here, the performance difference was minimal.

This is not to suggest that investors should simply adopt a naïve diversification strategy. But the relative success of such a rudimentary approach to diversification does illustrate, in our view, the importance of maintaining exposure to a broad range of asset classes. At SEI, diversification within portfolios goes beyond a simple equal weighting of several security types: they are thoughtfully designed based on deep, skillful research in an effort to help investors meet a wide array of return objectives over varying time horizons.

Exhibit 2: Even simple diversification can help soften the downside



Sources: Bloomberg, Bloomberg Indexes, Standard & Poor's, MSCI, SEI. Returns are captured over intra-year, max drawdown periods determined by SEI (see Exhibit 1). U.S. equities are represented by the S&P 500 Index. Naïve diversification strategy is equal-weighted and composed of the following indexes: S&P 500 Index; Russell 2000 Index; MSCI EAFE Index (Net ,Total Return); MSCI Emerging Markets Index (Net 2001–2018/Gross 1998–2000, Total Return); Bloomberg Barclays U.S. Aggregate Index (Total Return); Bloomberg Barclays U.S. Corporate High Yield Index (Total Return); Bloomberg Barclays Emerging Market Aggregate Index (USD, Total Return); Bloomberg Barclays U.S. Treasury Inflation Notes Index (Total Return); Bloomberg Barclays U.S. Aggregate 1-3 Year Index (Total Return); and Bloomberg Commodities Index. All returns are in USD. As of 12/31/2018. Past performance is no guarantee of future results.

Seeing through the noise

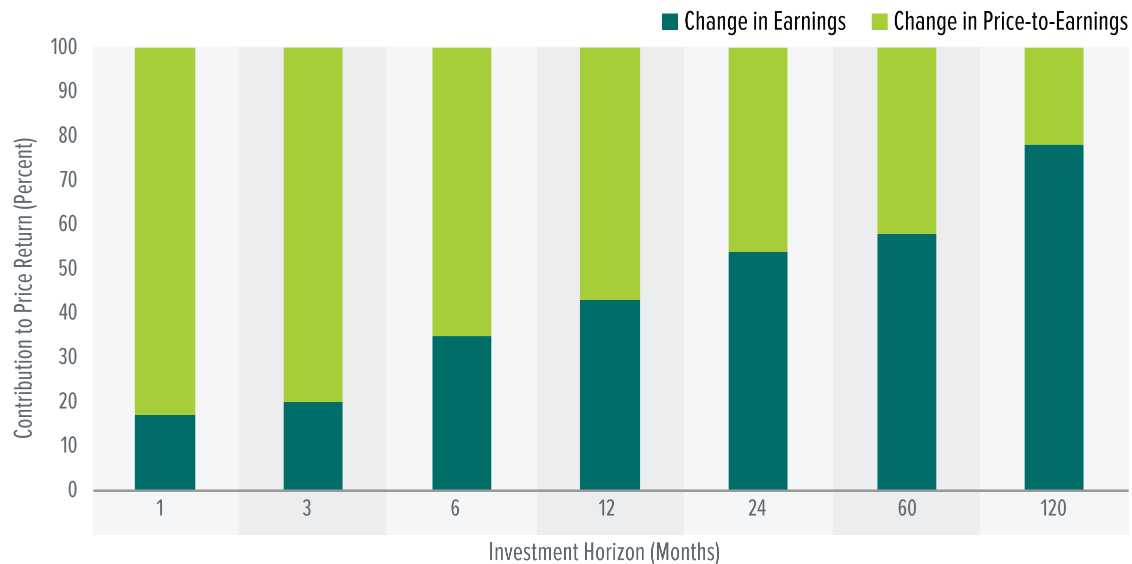
Shorter-term market activity tends to dominate the focus of news media and market pundits. But such a short-term focus is rarely useful to investors, who typically have longer-term goals with timeframes that are measured in years, rather than months or quarters. We therefore think it's important to tune out the noise of shorter-term market events—and having an appropriate and well-diversified portfolio can help investors do just that.

Equity markets are driven by underlying fundamentals and investor sentiment, with each having varying impacts on returns, depending on the time horizon. Market fundamentals ultimately boil down to aggregate corporate earnings, which can be expected to move in line with economic growth over time. Meanwhile, sentiment is oftentimes represented through valuations (that is, how much investors are willing to pay for each dollar of earnings).

Investors continuously change how much they value each dollar of earnings depending on the long-term growth outlook. When sentiment is high, investors are willing to pay more (and stocks are considered "expensive"); and when sentiment is low, investors are willing to pay less (and stocks are considered "cheap"). However, unlike corporate earnings (which should ultimately align with economic growth over long time horizons), we believe the long-term impact of valuations on returns is a zero-sum game—meaning that any gains or losses tied to valuations changes should eventually be expected to reverse course. After all, investors will not continue to pay an ever-increasing amount for each dollar of earnings.

While sentiment and other factors can heavily affect equity markets in the short-run, corporate earnings—and ultimately economic growth—are the long-term fundamental drivers of return. This is empirically illustrated in Exhibit 3, which compares the relationship between time horizon and the impact of earnings and valuations on equity-market returns.

Exhibit 3: Fundamentals Play an Increasing Role over Longer Horizons



Sources: Standard & Poor's, Thomson Financial, Factset, Credit Suisse. Changes in Earnings derived from forward earnings-per-share and Changes in Price-to-Earnings derived from forward price-to-earnings ratio. Median contribution to return. From 1964 through 2018.

In the exhibit, we can see the extent to which investor sentiment drives market behavior over shorter periods of time. For example, over a one-month period, less than 20% of returns are attributable to corporate earnings. Even over periods of up to a full year, valuation changes drive well over half of returns. But fundamentals, rather than sentiment, begin to take the driver's seat as time horizon lengthens. The 10-year period is dominated by earnings, and this trend should only grow stronger as the horizon continues to extend. While it may not always be gratifying in the moment, one key to a successful investment experience is seeing past short-term, unpredictable noise—remembering that it takes time for equity-market fundamentals to fully play out.

SEI's view

As risk comes with reward, drawdowns are a natural component of equity investing—and this is perfectly acceptable as long as investors are taking prudent, well though-out risks.

Calculated risk-taking involves pro-active (rather than reactive) decision-making—through proper and prudent diversification—along with maintaining a strategic asset allocation consistent with both ability and willingness to take on risk. In our view, no matter where you stand on the risk spectrum, the key to a successful investment experience is refraining from emotional reactions to short-term noise and keeping your mindset in line with your goals and objectives.

Glossary of Financial Terms

Correlation: Correlation is a measure of the degree to which the prices of two securities move together.

Forward price-to-earnings ratio: The forward price-to-earnings ratio is the ratio of a company's share price to its expected earnings over the next 12 months, which can be used to help determine whether a stock is undervalued or overvalued.

Index Definitions

The Bloomberg Barclays Emerging Markets Aggregate Index is a hard currency emerging market index representing U.S. dollar-denominated debt from sovereign, quasi-sovereign and corporate debt issuers.

The Bloomberg Barclays U.S. Aggregate Bond Index is an unmanaged benchmark index composed of U.S. securities in Treasury, Government-Related, Corporate, and Securitized sectors. It includes securities that are of investment-grade quality or better and have at least one year to maturity.

Bloomberg Barclays U.S. Aggregate 1-3 Year Index is an unmanaged benchmark index composed of U.S. securities in Treasury, Government-Related, Corporate, and Securitized sectors. It includes securities that are of investment-grade quality or better and have maturities of between 1 and 3 years.

The Bloomberg Commodities Index is composed of futures contracts and reflects the returns on a fully collateralized investment in the Index. This combines the returns of the Index with the returns on cash collateral invested in 13-week (3-month) U.S. Treasury bills.

The Bloomberg Barclays US Corporate High Yield Index measures the U.S. dollar-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.

Bloomberg Barclays U.S. Treasury Inflation Notes Index is an unmanaged index composed of all U.S. Treasury Inflation- Protected Securities rated investment grade and have at least one year to final maturity.

The MSCI EAFE Index is an unmanaged, market-capitalization-weighted equity index that represents the developed world outside North America.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization weighted index designed to measure the performance of global emerging market equities.

The Russell 2000 Index includes 2000 small-cap U.S. equity names and is used to measure the activity of the U.S. small-cap equity market.

The S&P 500 Index is a capitalization-weighted index made up of 500 widely held U.S. large-cap companies.

Important Information

This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice and is intended for educational purposes only.

There are risks involved with investing, including loss of principal. Diversification may not protect against market risk.

Index returns are for illustrative purposes only and do not represent actual fund performance. Index returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

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