INVESTMENT INSIGHTS

Analysis, Insights and a Different Perspective November 2021

TIME TO PREPARE FOR MARKET VOLATILITY

The Eastern proverb "prepare the umbrella before it rains" sends an elegant yet powerful message that one must prepare for the storm before it arrives. In the literal sense, it is handy to own an umbrella before it rains instead of looking for one at the same time as everyone else. More figuratively, this message is about preparing for challenges before they arrive. In this issue of Investment Insights, we look at how investors can prepare for stock market volatility.

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KEY POINTS

- Typically, the stock market declines more frequently than what investors have experienced recently.
- Keeping volatility in perspective and maintaining a long-term view can help many investors pursue their financial goals.
- A good financial plan can help investors stick with their investments when they experience difficult markets.

The stock market had a volatile start last month. Between the last day of September and the first three days of October, the stock market, as measured by the S&P 500 index, moved 1% for four days in a row.[1] From its all-time high in September, the market was down more than 5% in October.[2] While this is the first 5% decline in the S&P 500 in over a year, investors often get worried about their investments when volatility increases. A lack of mental preparedness results in heightened worries when experiencing market volatility. The recent stock market pullback, however, gives investors an opportunity to revisit market volatility so they can be prepared moving forward.

1 Source: S&P Dow Jones Indices LLC, S&P 500 [SP500], retrieved from FRED, Federal Reserve Bank of St. Louis.
2 Source: S&P Dow Jones Indices LLC, S&P 500 [SP500], retrieved from FRED, Federal Reserve Bank of St. Louis.

WHAT IS NORMAL VOLATILITY?

Predicting market volatility and downturns is often very difficult. As an investor, you need to know that market volatility and downturns happen regularly. Thus, while it might be impossible to know when markets will experience difficulty, it can be wise to expect frequent periods of volatility.

The table below shows the frequency of stock market dips, corrections, severe corrections, and bear markets from 1951 to 2020. As reflected in the data, the S&P 500 has experienced a dip (a decline of 5% or more) about three times per year on average in this period. Hence, historically speaking, the recent market decline has occurred about three times per year.

Stock Market Declines - Standard & Poor's 500 Composite Index (1951-2020)				
Size of decline	DIP (-5% or more)	Correction (-10% or more)	Severe Correction (-15% or more)	Bear Market (-20% or more)
Average frequency	About three times per year	About once per year	About once every three years	About once every six years

Assumes 50% recovery of lost value. Source: Capital Group, Standard & Poor's.

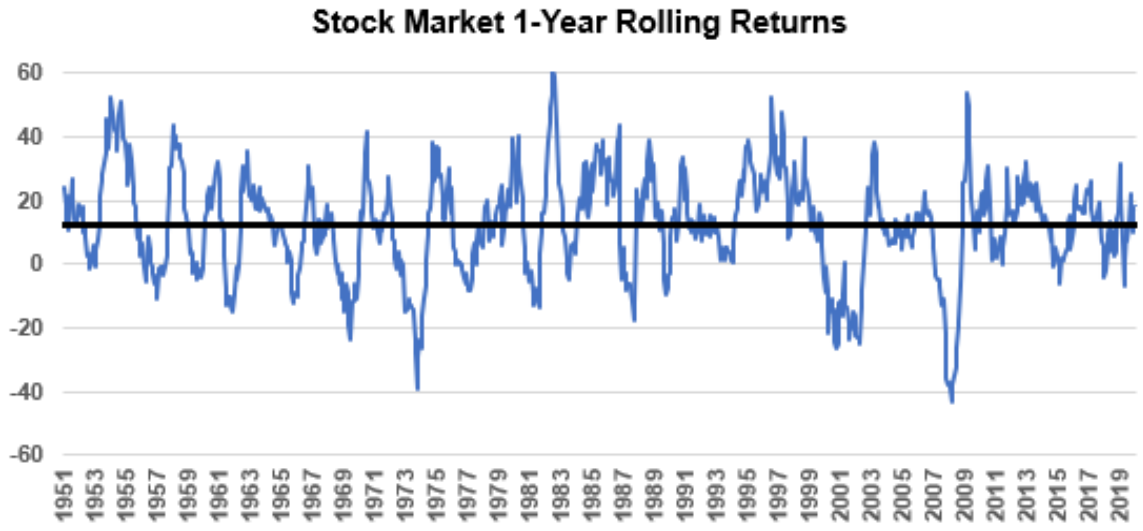
Stock market corrections (a decline of 10% or more) are also common. During the same 69-year period, these have occurred about once per year on average. Severe corrections and bear markets (declines of 15% and 20% or more, respectively) have been less frequent but still occur once every 3 to 6 years on average. Thus, investors have experienced corrections, severe corrections, and bear markets often throughout history.

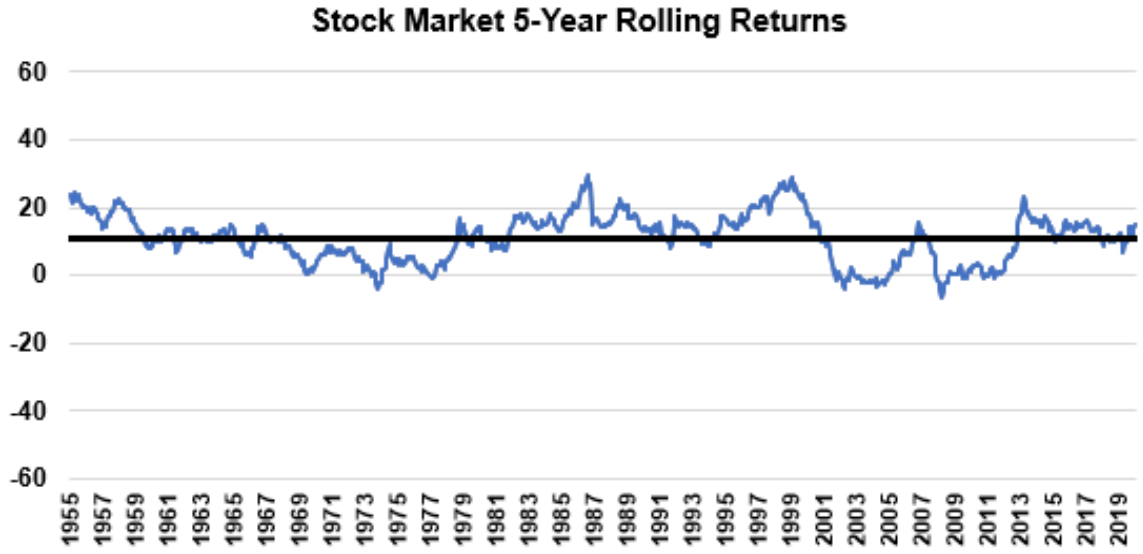
Using history as a gauge of market volatility may not be accurate because stock markets may be more volatile in the future. Expecting at least the same level of market volatility to occur in the future can serve investors well. Without the right mindset about stock market volatility, it is possible to fall victim to recency bias, which is the tendency to overemphasize the importance of recent events. For example, it has been more than a year since the last time the stock market declined by 5%. New investors may not have experienced a single 5% market decline until recently and may expect that this is how the stock market typically evolves. By understanding the frequency of market declines, the investors are less likely to worry about their investments when the market declines. As they move forward, planning for volatility in the stock market can help investors prepare their mindset and keep their emotions in check when they experience difficult markets.

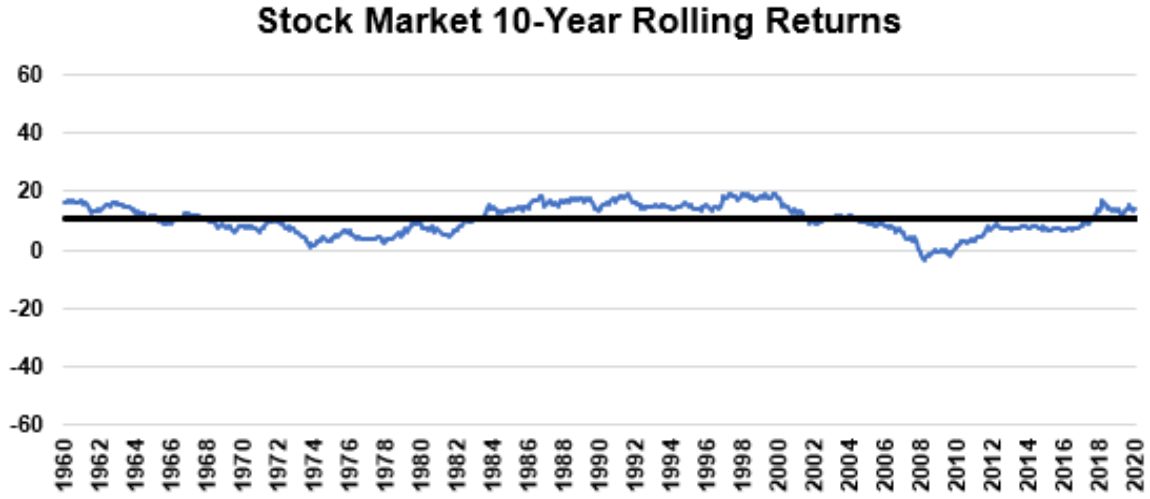
LONG-TERM VIEW

Our study of stock market history tells us that it declines frequently, and sometimes, losses can be fairly large. Although the stock market is highly unpredictable, it has historically rewarded patient investors who are able to stomach the short-term pain.

The following graphics illustrate this and show variation in stock market return (blue line) relative to the average return (black line) over 1-year, 5-year, and 10-year time periods between 1951 and 2020.







Author's calculations using IA SBBI US Lrg Cap Index monthly rolling periods. For illustrative purposes only. Index is not available for direct investment; therefore, its performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is no guarantee of future results.

Based on the graphs, it's clear that the range of outcomes vary vastly from their averages over any rolling one-year time period. As the time period increases in duration, the variation also reduces, coming closer to its average. Historically, maintaining a long-term view has rewarded investors who are able to ignore the short-term volatility. Thus, in addition to understanding the normal levels of market volatility, maintaining a long-term view can help investors work towards their investment goals.

PREPARE WITH A PLAN

Understanding the frequency of market declines and the benefits of maintaining the long-term perspective are some of the core tenets of a successful investing plan. Incorporating these principles into your broad financial plan can help you stay on track and pursue your financial goals. Your advisor can help tailor your plan based on your personal needs. To develop or revisit your financial plan, contact your financial advisor today.

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