

# Integrity in Investing: Is Selling After a "Correction" Correct?



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Consultative Wealth Management

**Financial professionals and analysts generally describe any stock market decline of 10 percent or more from a previous peak as a "correction."** Should investors sell to protect themselves from further declines, or should they consider market declines as an opportunity to purchase more stocks at favorable prices?

As happened earlier this year, as is often the case, stock prices in markets throughout the world fluctuated dramatically or the week ending August 27. On Monday, August 24, the Dow Jones Industrial Average fell 1,089 points—a larger loss than the "Flash Crash" of May 2010 that had a trillion dollar impact on global markets<sup>1</sup>—before rallying to close the day down "only" 588 points.<sup>2</sup> Prices fell further on Tuesday before recovering sharply on Wednesday, Thursday, and Friday. Although the S&P 500 and Dow Jones Industrial Average rose 0.9% and 1.1%, respectively, for the week, many investors found the dramatic day-to-day fluctuations unsettling. If you recall, similar volatility occurred for the week ending October 2.

Based on closing prices, the S&P 500 market index of large cap U. S. stocks declined 12.35% from its record high of 2130.82 on May 21 through August 24. Assuming that drop was a bona fide market "correction," it is not clear how investors should respond to that information without an expanded knowledge of financial history:

- A. Should investors take action by selling to protect themselves from further declines, or
- B. Should investors consider it an opportunity to purchase equities at more favorable prices?

### A short study of market history

How much did U. S. market indices actually change during a full year, rather than just the calendar year? Despite almost instantaneous market price access transfixing viewer attention, the net price change for one full year as of August 31<sup>st</sup> was only 0.48%; as of September 30th, it was

-0.61%—or just about flat for those investors not paying close attention, perhaps having more worthwhile activities than monitoring daily changes of different markets.<sup>3</sup>

Based on longer term S&P 500 index data, stock prices have declined 10 percent or more on 28 occasions between January 1926 and June 2015. Obviously, every decline of 20 percent or 30 percent or 40 percent began with a decline of 10 percent. As a result, some investors believe that avoiding the large losses they fear can be accomplished easily by reducing or even eliminating equity exposure once the 10 percent threshold has been breached. In fact, many of the new so-called "robo-advisor" programs automatically reduce a portfolio market exposures when a "correction" occurs to presumably "protect" account assets.

### Market timing rarely works well

The lure of market timing is seductive. If only we knew—or special access to that secret realm for whom no other investors are privy except "us"—thereby allowing "us" to sell stocks just before a big decline to safely hold cash while everyone else loses, our long-run returns could be exponentially higher than they would by staying invested at all times, compared with simply maintaining a structured asset allocation with forced rebalancing to purchase stocks at then-lower prices, but not the lowest price in a market decline.

Who wouldn't want getting high returns with limited risk or possibly even with no risk? Many financial advisors, hedge fund managers and sales people competing for commissions suggest—without directly claiming—that know how, using some financial vehicle or scheme that



allegedly has a special ability to beat the market based on some purported past performance. *Caveat emptor.*

But for any market timing strategy to be profitable is a two-step process, which must be repeated successfully again and again, year after year:

- A. Decide when to sell stocks (**and** which to sell),  
AND
- B. Decide when to buy stocks (**and** which to buy).

Avoiding short-term losses runs the risk of missing even larger long-term gains on a rebound. Regardless of whether stock prices have advanced 10 percent or declined 10 percent from a previous level, they always reflect:

- 1. The collective assessment of the future by millions of market participants,  
AND
- 2. The expectation that equities in U.S. and global markets have positive expected returns.

**Exhibit 1** below shows that U.S. stocks have typically delivered above-average returns over one, three, and five years following consecutive negative return days resulting in a 10 percent or more decline. Results from non-U.S. markets are similar. Draw your own conclusions for an informed strategy.

Contrary to the common belief of many investors and most traders, dramatic changes in security prices during a correction or market downturn are not a sign that the financial system is broken. Rather it's confirmation of what we would expect to see from time to time if markets are working properly.

The world is an uncertain place. The role of capital markets worldwide is to incorporate changing political, social, technological, meteorological, financial and economic developments into security prices. Markets rapidly and often instantaneously transmit, aggregate and incorporate that new information—both positive or negative—remembering the past and speculating about the future—into security prices. Investors who accept these dramatic price fluctuations as characteristic of publically traded markets and their role in providing sufficient liquidity for the

markets have an enormous advantage over those who are confused or unnerved by sudden and surprising day-to-day events impacting the markets in response whether to unexpected news, or just happening as trading blips.

Those minority of investors with financial assets committed to owning the associated risks of long-term equity ownership—in sensible market portfolios suitable for their situations—have a huge advantage in achieving their desired long-term planning outcomes. These investors starkly contrast the majority of those “renters” of risks, speculating as they seek quick short-term returns, selectively picking hot stocks or ETFs or hedge funds as they monitor prices moving upward, betting they are smart enough (or have hired some smart advisor with an even smarter computer) to get out of falling markets before everyone else is scrambling for the exits. Good luck.

### Concluding our brief study of risk

Lest investors or speculators, novice or veteran, young or old, ever forget, the 28th anniversary of “Black Monday”, October 19<sup>th</sup>, 1987 recently passed. Without warning, the Dow plummeted almost 23% in a single day, and investors endured a 45% decline for October. Speculators were traumatized for years after. Yet for committed investors following an informed long-term strategy, the Dow itself still finished the year 1987 2.2% higher than it began, and the broader S&P 500 Index was 5.2% higher for the entire year.

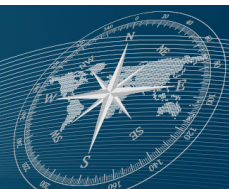
As an epitaph for those speculators and traders whose portfolios suffered horrible torment, or for those uninformed investors who panicked and cashed out of their stock holdings all too soon, R.I.P. With today's super high-speed computers on dedicated broad bands using sophisticated algorithms trading in milliseconds, that kind of “flash crash” could potentially happen in seconds, with or without the aid of a cyber-attack. As a wag once remarked: “There are old pilots, and there are bold pilots; but there are no old, bold pilots.”

1 As per Wikipedia, “2010 Flash Crash.”

2 “Wild Ride Leaves Investors Grasping,” Wall Street Journal, August 25, 2015, and “Investors Scramble as Stocks Swing,” Wall Street Journal, August 25, 2015.

3 Maybe painting the house (or a room inside), and watching the paint dry.

Adapted and expanded from Weston Wellington, “Should Investors Sell After a “Correction”?” (September 2015)



## Exhibit 1: RETURNS AFTER CORRECTIONS

### US LARGE CAP: JANUARY 1926–JUNE 2015

Cutoff for Decline	Frequency of Such Declines	Avg. Horizon for Decline (Trading Days)	Avg. Magnitude of Decline
5%	262	4.1	-7.55%
10%	28	4.6	-14.25%

### Annualized Compound Return

for Next 1 Year	for Next 3 Years	for Next 5 Years
13.24%	9.43%	10.02%
23.56%	8.89%	13.33%

Unconditional annualized compound return for full sample is 9.32%.

### INTERNATIONAL LARGE CAP: JANUARY 2001–JUNE 2015

Cutoff for Decline	Frequency of Such Declines	Avg. Horizon for Decline (Trading Days)	Avg. Magnitude of Decline
5%	58	4.8	-7.71%
10%	9	5.6	-13.33%

### Annualized Compound Return

for Next 1 Year	for Next 3 Years	for Next 5 Years
17.30%	9.03%	9.38%
24.73%	12.69%	12.89%

Unconditional annualized compound return for full sample is 4.05%.

### EMERGING MARKETS: JANUARY 1999–JUNE 2015

Cutoff for Decline	Frequency of Such Declines	Avg. Horizon for Decline (Trading Days)	Avg. Magnitude of Decline
5%	74	4.8	-8.12%
10%	15	5.5	-14.04%

### Annualized Compound Return

for Next 1 Year	for Next 3 Years	for Next 5 Years
24.82%	11.84%	10.33%
42.23%	13.36%	11.20%

Unconditional annualized compound return for full sample is 9.49%.

Declines are defined as periods with consecutive days of negative index returns with cumulative losses at or above the cutoff. Annualized compound returns are averages across all declines.

US Large Cap is the S&P 500 Index, provided by Standard & Poor's Index Services Group. International Large Cap is the MSCI World ex USA Index. Emerging Markets is the MSCI Emerging Markets Index. MSCI data copyright MSCI 2015, all rights reserved.

Past performance is not a guarantee of future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio. Values change frequently and past performance may not be repeated. There is always the risk that an investor may lose money. International investing involves special risks such as currency fluctuation and political instability. Investing in emerging markets may accentuate these risks.

## Exhibit 2: GROWTH OF WEALTH: THE RELATIONSHIP BETWEEN RISK AND RETURN



Diversification does not eliminate the risk of market loss. Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect expenses associated with the management of an actual portfolio. Asset allocations and the hypothetical index portfolio returns are for illustrative purposes only and do not represent actual performance. Global Stocks represented by MSCI All Country World Index (gross div.) and Treasury Bills represented by US One-Month Treasury Bills. Globally diversified allocations rebalanced monthly, no withdrawals.

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