

Never Let a Crisis Go to Waste: The Real Lessons of 2020

Long-term investors understand that financial markets can behave unpredictably over the course of days, weeks and months. How an investor reacts to this short-term uncertainty can play a significant role in whether they achieve their financial objectives. This is why it's important for investors to have both perspective and a long-term plan in place during volatile times. The only thing we can control is our own behavior.

Fortunately, experience can play a big role in helping investors to stay disciplined and composed. Living through a turbulent period is worth more than reams of investment data and statistics. The feeling when the stock market appears to be in free fall and the financial media is in a bear market frenzy is a sensation that can only truly be experienced, not taught. The feeling in our gut that this time might be different, despite all of the academic and intellectual knowledge in our heads, is impossible to ignore.

Thus, despite the rapid recovery in the stock market, it's important for investors to focus on the right lessons in order to prepare for the next inevitable market bump. Even if history records the first half of 2020 as a blip for markets, it was a test of investor fortitude nonetheless.

What should investors take away from the last several months?

First, it's not unusual for the stock market to fall several percent points, even in a single day. Over the course of 2020, a theoretical investor that checked their statement regularly would have experienced ten distinct 5% pullbacks in the stock market as it fell into bear market territory. While this is the most since 2011 when the U.S. dollar was downgraded and the market plummeted, these types of declines occur often.

Second, despite large pullbacks in the market every single year, the U.S. stock market more often ends on a positive note than a negative one. Specifically, the last decade has seen intra-year stock market declines ranging from -3% to -34% (with dividends) due to a range of issues including the federal budget, Eurozone crisis, trade wars, geopolitical risk, a pandemic, and more.

Still, the stock market finished in negative territory only one of those years. While this provides no guarantees for the future, market recoveries tend to occur if underlying fundamentals are still intact or can recover quickly. Today, the fact that many parts of the economy can rebound quickly after the initial COVID-19 crisis and economic shutdown has spurred a stock market recovery.

Third, over-reacting to negative headlines or recent market performance often backfires as market sentiment shifts. These swings can happen quickly and unexpectedly, as was the case earlier this year. Attempting to time the market is not only difficult but might be impossible to do consistently. Over the past 25 years, exiting the market after every large daily pullback has resulted in significantly poorer performance whether one stays in cash for one week or one year. Thus, it's often better to simply hold onto a properly positioned portfolio.

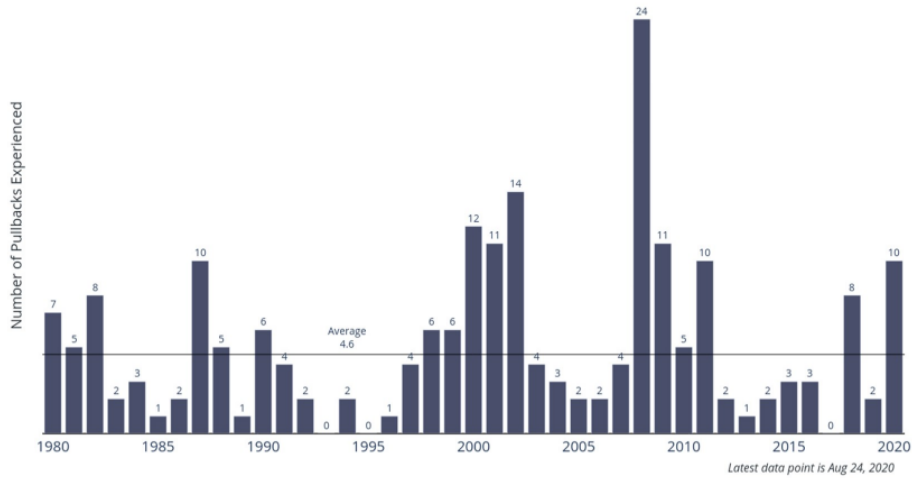
As the saying goes, never let a crisis go to waste. Now that the dust has settled for a bit, it's important for investors to reflect on the experience of the last several months and consider how they might react the next time volatility strikes. The circumstances will undoubtedly be different but having the right perspective and discipline will stay the same.

The following three charts highlight important lessons for long-term investors.

Volatility

Stock Market Pullbacks

The number of 5% S&P 500 pullbacks experienced by investors each year



The above chart shows the number of distinct 5% market pullbacks a theoretical investor would experience in any given year. Through the first 8 months of 2020, investors have experienced 10 of these declines.

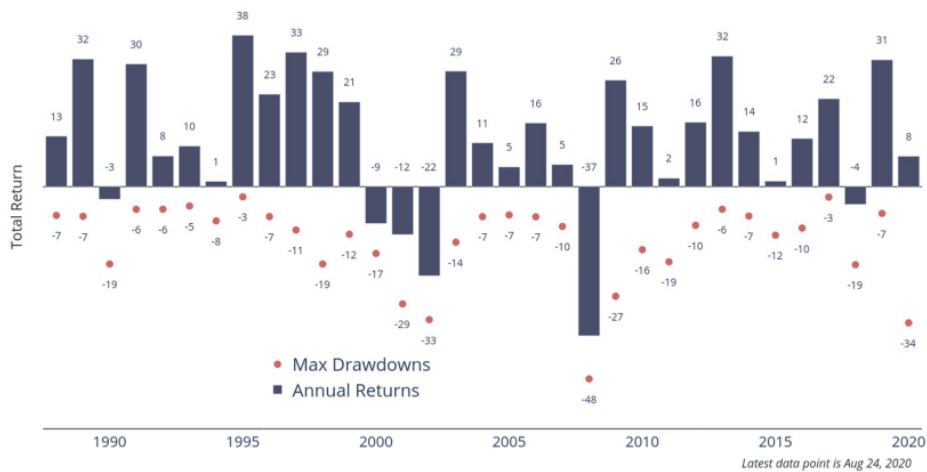
Source: Clearnomics, Standard & Poor's
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While this is the highest level since 2011, it is not unusual for many of these to occur in any given year.

Volatility

Total Returns and Pullbacks

S&P 500 Index total returns. Max drawdown represents the biggest intra-year decline



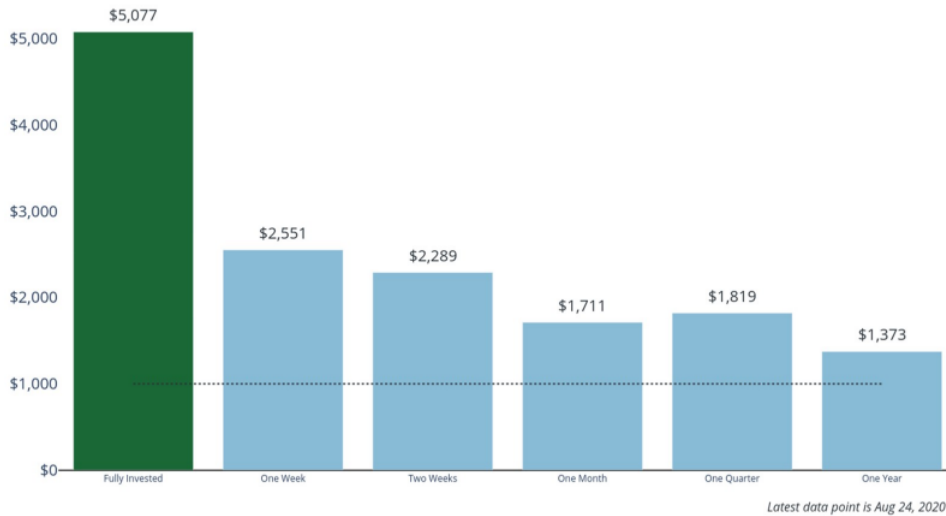
Source: Clearnomics, Standard & Poor's
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Although the stock market fell into bear market territory this year, it has since rebounded and is now near record highs. This is a common pattern across history - the stock market may pull back in any given year, but often ends on a positive note. While there are no guarantees, those investors who can focus on years instead of weeks are more likely to benefit from these long-run gains.

Staying Invested

Staying Invested: Timing the Market

Over the past 25 years, the effect of exiting the market the day after a -2% market move or worse, and staying out for each period of time shown. Based on an initial \$1,000 investment using S&P 500 returns before transaction costs



Source: Clearnomics, Standard & Poor's

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Over-reacting to short-term market performance can often lead investors astray. Over the past 25 years, running to the exits after a large daily decline has been detrimental to portfolios. This is true even if investors only flee to cash or other safer assets for a short period of time. This is because the stock market can often recover unexpectedly and has tended to rise over the course of years and decades. Missing out on these long-term gains is often more detrimental than the initial stock market pullback.

The bottom line? With the markets now calm, it's more important than ever for investors to reflect on the last several months. Learning important lessons from this period can serve investors throughout their financial journey.



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