What Kind of Market Detour is This?

THE OBVIOUS

The market starts the year down. As of Tuesday: S&P 500 Index -8.%, DJIA -8.1%, NASDAQ 100 -9.7%, and Russell 2000 Index 12.4%.

WHAT IS THIS?

You are familiar with the kind of blanket statements that start with, “There are two kinds of…” such as, “There are two kinds of people in the world.” So with obvious oversimplification, here is our version of that sort of take on the world when it comes to market downdrafts.

19* Corrections of 5% or more in this Expansion

*Includes Aug-Sep 2015, -5.67%

Correction Period	S&P High	S&P Low	% Decline	“Stocks Fall On…”
2009: May 8 – 15	930	879	-5.5%	Worries that market has gotten ahead of itself
2009: Jun 11 – Jul 7	956	869	-9.1%	World bank neg growth forecast; fears market is ahead of recovery
2009: Sep 23 – Oct 2	1080	1020	-5.6%	Worries about the recovery
2009: Oct 21 – Nov 2	1101	1029	-6.5%	Worries about the recovery
2010: Jan 19 – Feb 5	1150	1045	-9.2%	China’s lending curbs, Obama bank regulation plan
2010: Apr 26 – Jul 1	1220	1011	-17.1%	Europe's debt crisis, flash crash, growth concerns
2010: Aug 9 – 27	1129	1040	-7.9%	Global growth concerns
2011: Feb 18 – Mar 16	1344	1249	-7.1%	Libyan civil war, Japan earthquake/nuclear disaster
2011: May 2 – Jun 16	1371	1258	-8.2%	Europe’s debt crisis, global growth concerns
2011: Jul 6 – Oct 4	1356	1075	-20.8%	Europe’s debt crisis, double-dip recession fears, US debt downgrade
2011: Oct 27 – Nov 24	1293	1159	-10.4%	Europe’s debt crisis
2012: Apr 2 – Jun 4	1422	1267	-10.9%	Europe’s debt crisis
2012: Sep 14 – Nov 16	1475	1343	-8.9%	Fiscal cliff concerns, Obama’s re-election
2013: May 22 – Jun 24	1687	1560	-7.5%	Fed taper fears
2014: Jan 15 – Feb 5	1851	1738	-6.1%	Fed taper, European deflation fears, EM currency turmoil
2014: Sep 19 – Oct 15	2019	1821	-9.8%	Ebola, global growth fears, falling oil
2014: Dec 5 – Dec 16	2079	1973	-5.1%	Falling oil, strong dollar
2014/15: Dec 29 – Feb 2	2094	1981	-5.4%	Falling oil, strong dollar, weak earnings
2015: May 20 – Jul 7	2135	2044	-4.2%	Greece default concerns, China’s stock market collapse
Average			-9.0%	Source: Pension Partners

There are two kinds of market downdrafts. There are shorter, less disruptive detours which happen several times a year during economic expansions. These should be endured without a change in strategy or allocation to equities. Then there are longer, more disruptive detours that happen once an economic cycle and, given their severity and duration, merit an adjustment in strategy to become more defensive.

Data Sources: Current market data, Wall Street Journal 1/20/2016; historical market data, Interactive Data.

Our analysis is that this downdraft is of the first variety, the recurring, shorter detours that happen in the expansionary phase. We believe that the smart thing to do is to take a strategic, rather than tactical, approach and proactively affirm the investment discipline that offers the highest probability of success in the expansion.

Both types of downdrafts inflict anxiety and discomfort. Although they do not *feel* different, they are different. During this economic expansion, which dates back to 2009, this downdraft is the 20th decline of 5% or more. Yet, in spite of this volatility along the way, the S&P 500 Index has returned just about 14% annually during this period. Over the last 50 years, the S&P 500 Index has seen drops of 25% or more six times and five of those occurred during recessions. (The exception was 1987 when the market dropped 20% in one day and 30% in two months. However, in the absence of a recession, it made a rapid recovery and finished just in the positive for the year. Thus, no economic contraction, no change in strategy.) There is an old cliché that the stock market has predicted nine of the last three recessions**.** In our view, this is what is happening here.

Risk Management

"Mr. Market" can be manic and he can be depressive. Not surrendering to the siren call of short-term panics is a defining characteristic of successful long-term investing. There are two kinds of risk management: strategic and tactical. The tactical approach seeks to time the market through each twist and turn of the cycle and is agnostic as to whether we are in and economic expansion or contraction. We believe this approach imposes a high degree of difficulty and can be mostly counterproductive. The strategic approach, while not perfect or precise, seeks to manage risk when the cycle turns down *in the contraction* and to otherwise focus on business merit and opportunity during the expansion. From our perspective, this is both less complex and more effective.

In 2015, earnings were flat and the market was (mostly) flat. In 2016 we expect to see healthier earnings and a healthier market. We believe that focusing on strategy and data for the longer-term will trump tactics and feelings in the shorter-term.

Data Sources: Current market data, Wall Street Journal 1/20/2016; historical market data, Interactive Data.