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The Emotion of Market Declines

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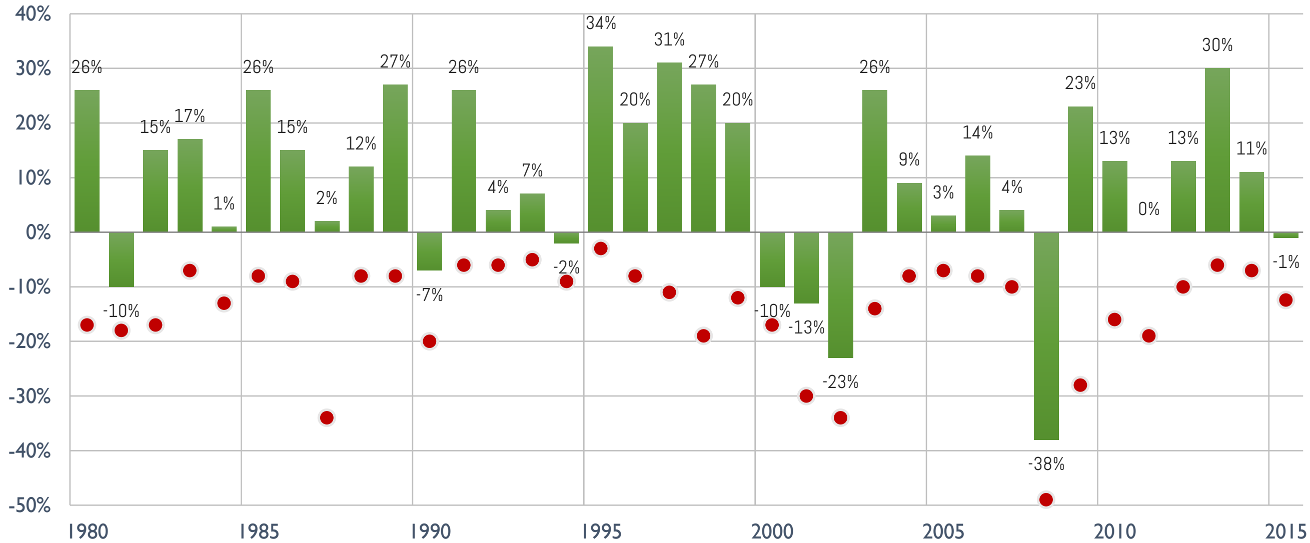
Even though we all know market fluctuations are a normal part of equity investing, large market declines are scary to most investors because they often happen rapidly and feel random.

What investors lose sight of is that equity market returns over the past thirty-five calendar years have been mostly positive, despite significant market declines in each calendar year. The chart below demonstrates this point by examining market activity from 1980 to 2015. The lowest point of the stock market during each calendar year is shown by the red dots, compared to the market's return for the full year, as shown by the green bar.

CALENDAR YEAR RETURNS AND INTRA-YEAR DRAWDOWNS OF S&P 500 PRICE INDEX (1980 – 2015)



Source: Dow Jones Indices LLC, December 2015

The average intra-year pullback in the Standard and Poor's 500 Index ("S&P 500") since 1980 has been roughly 14%, a little less since 2009. Despite the 14% intra-year decline, the S&P 500 has closed positive in 27 out of 35 years, 77% of the years in that period. In another study, when examining market peaks and bottoms over a longer time horizon (January 1928 through September 2015, we find that after declines of up to 20% from previous peaks, a new market high is reached within less than 12 months a remarkable 99% of the time (FN).

The chart provides a visual perspective of "normal" yearly market volatility with equity investing. Yet for the typical investor, emotional behavior can often lead to panic selling during market declines. Inevitably, many investors sold during the declines and missed out on the upside as the market recovered. Unfortunately stock market returns rarely come evenly. Setting expectations, understanding behavior and establishing plans about how to react to inevitable market movements can help investors keep their hands off the panic button and improve their long-term investment results.

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From the Behavioral Viewpoint

What is going on?

1. We as humans have a natural aversion to loss. In fact, a loss feels twice as bad as an equivalent gain, according to Daniel Kahneman, author of "Thinking, Fast and Slow." During a market decline, investors feel bad due to **loss aversion**.

2. Another deeply rooted behavior that gets triggered is **herding**. Our instincts make it difficult for us to do something different than what we perceive the majority of others are doing. In a down market, investors may assume that there is some valid reason the market is down and that they are missing something important.

3. To make matters worse, we recall our own personal history of negative events. The tech bubble, financial crisis, oil price declines or other personal recollections of financial loss can lead to **confirmation bias**. Once we believe we are heading for a global financial meltdown, we look for evidence in the form of media coverage, expert commentary, and trusted relations to confirm our belief while ignoring or rationalizing contradictory evidence.

4. Together, these cognitive biases present an often distorted view of reality. In these trying moments our emotional response is to simply **get out of the market** until things calm down.

What can we do?

1. We need to learn to engage what Kahneman refers to as "**System 2**" thinking. While "System 1" thinking is automatically engaged to get out of danger quickly, System 2 marshals logic, perspective and higher forms of cognition in order to come to a more optimal decision. In this case, simply by remembering that the market will set a new high within a year 99% of the time helps to soothe the immediate pain of a market pullback.

2. Creating and following an **investment plan** can establish a disciplined process that is easier to follow when tough times hit. Like many other areas in life, planning beforehand can lead to better results during hardship.

3. Hiring a professional **financial advisor** who has lived through many market cycles can help an investor stick to his or her long-term goals and act as a trusted resource and coach.

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