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# Putting Market Declines in Perspective

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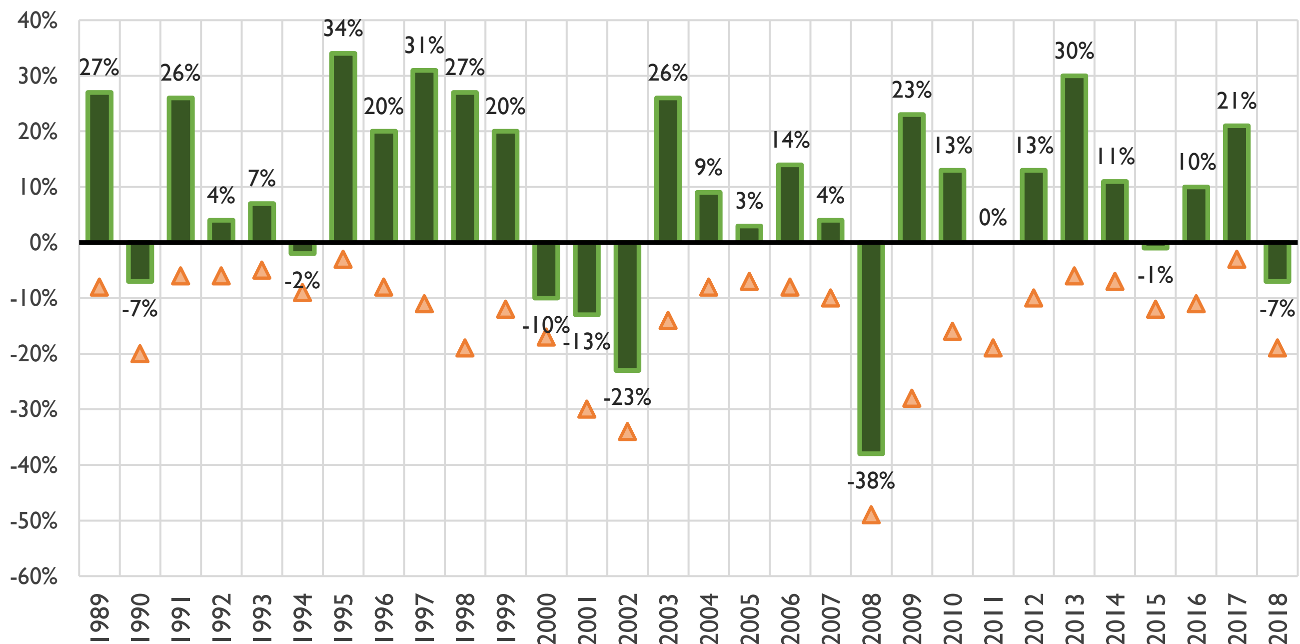
Even though we all know market fluctuations are a normal part of equity investing, large market declines can be scary because they often happen rapidly and feel random. What investors lose sight of is that equity market returns over the past thirty calendar years have been mostly positive, despite significant market declines in each calendar year. The chart below demonstrates this point by examining market activity over the past 30 years. The lowest point of the stock market during each calendar year is shown by the orange triangles, compared to the market's return for the full year, as shown by the green bars.

CALENDAR YEAR RETURNS AND INTRA-YEAR DRAWDOWNS OF S&P 500 PRICE INDEX (1989 – 2018)




Source: Dow Jones Indices LLC, December 2018)

The average intra-year pullback in the Standard and Poor's 500 Index ("S&P 500") since 1989 has been roughly 14%, a little less since 2009. Despite the 14% intra-year decline, the S&P 500 has closed positive in 21 out of 30 years, or 70% of the years in that period.

The chart provides a visual perspective of "normal" yearly market movement with equity investing. Yet for the typical investor, emotional behavior can often lead to 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 stay invested 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, losses feel twice as bad as an equivalent gain, according to Daniel Kahneman, author of "Thinking, Fast and Slow." During market declines, investors feel this **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 a valid reason the market is down and that they are missing something important.

3. We also recall our own personal history of negative events. The tech bubble, financial crisis, oil price declines or other personal recollections of financial loss that can lead to **confirmation bias**. Once we believe we are heading for a meltdown, we look for evidence in the form of media coverage or expert commentary to confirm our beliefs.

4. Together, these cognitive biases can present a distorted view. In these trying moments our emotional response is to **stay 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 engages logic, perspective and other higher forms of cognition in order to make more optimal decisions.

2. Creating and following a predetermined **investment process** can establish discipline that is easier to follow when turbulent times come. Like many other areas in life, planning beforehand can lead to better results.

3. Working with a **financial advisor** who has lived through many market cycles, can help investors stick to their plans.

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