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Cadence clips

FOCUSED ON WHAT MATTERS MOST.

Anatomy of a Meltdown

When the stock market loses value quickly as it has done this week, people get understandably nervous. It's not helpful to turn on CNBC to get live updates from the trading floor and to listen to talking heads demand action from someone, anyone!, to stop this equity crash, as if things that go up up up should not be allowed to go down, especially this quickly. So much time has passed since the pain of the 2007-2009 financial crisis that it is easy to lose perspective and forget how to prepare for and how to react to a real stock market decline, so every double digit drop feels like a tragedy.

By now we've convinced ourselves that we should have seen the 2007-2009 financial crisis coming. From its post-tech bubble lows in March of 2003, the S&P 500 index increased 100% and peaked mid-day on October 11th, 2007. From that peak it declined, and ultimately bottomed out mid-day on March 6th, 2009, losing nearly -60% of its value in the process. It's easier to remember the tumultuous fall months of 2008 than it is to remember the market actually peaked a year earlier in 2007. We've seen a few smaller corrections over the past seven years, but they've played out over months instead of years, and relatively quick losses in value have been followed by relatively quick, and in some cases astonishingly quick, recoveries, to the point that we may be forgetting that most significant stock market losses take years to fully occur. The key is to not change strategy during these volatile periods and to plan ahead of time for the longer term moves that cause the significant losses in value.

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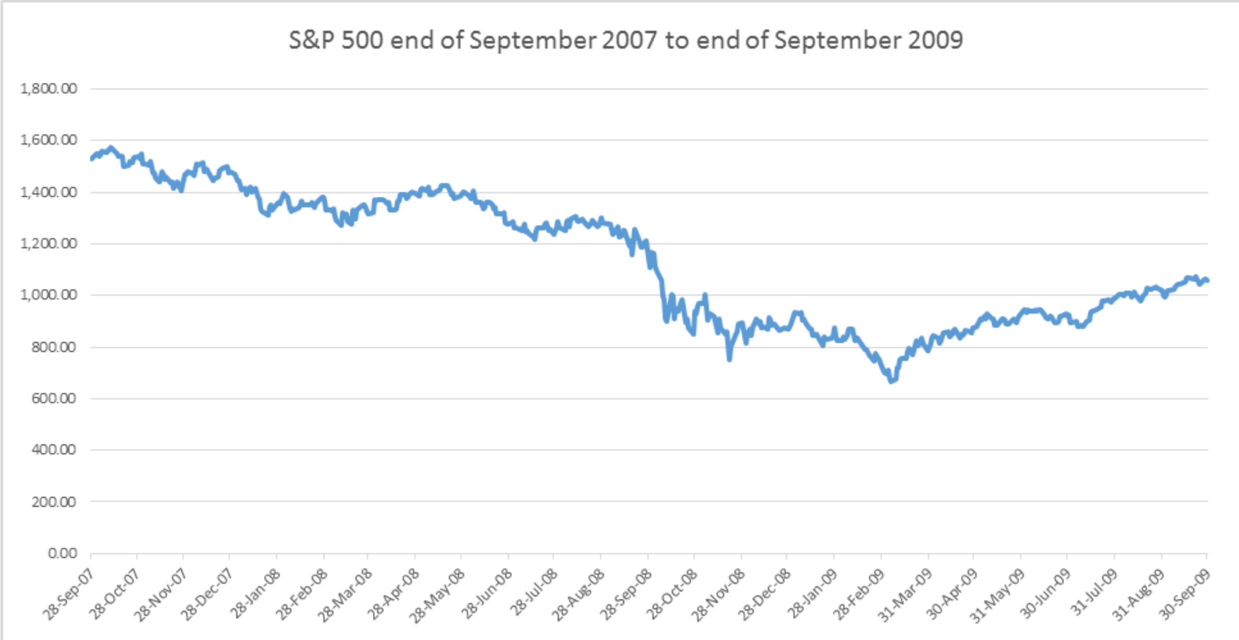
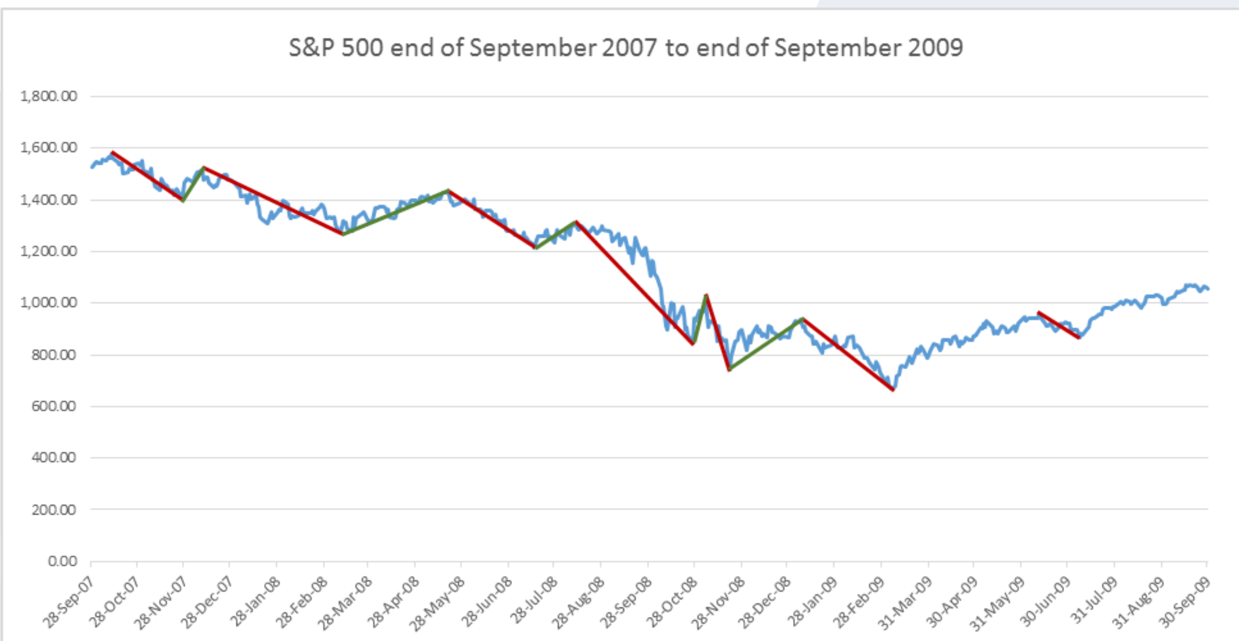
When you look at a graph of the 2007 S&P 500 peak, the loss through early 2009, and the beginning of the recovery, it looks like a long, slow, obvious decline followed by a smooth, obvious recovery:



The seemingly obvious downward move followed by an obvious upward move is an optical illusion; what you are really seeing is a series of large down, back up again, back down even more moves:



What happened after October 2007 was seen as normal for a stock market coming off a multi-year 100% increase. As a result, by August 11, 2008, investors were aware of the ups and downs to that point in the year, but they were also aware of continued violence in the Middle East, skyrocketing gas prices, and the spectacle of the Beijing Summer Olympics. Trouble in the financial and housing markets was just starting to be noticed, but was definitely overshadowed initially by Barack Obama and Sarah Palin.

That is why even though by early August 2008 the market was down -17% off its October 2007 high, the gradual ups and downs did not indicate the panic selling that was about to happen in the fall of 2008. When scrutinized, the individual ups and downs over that time period show an ever weakening market amidst almost ever larger bounces positive:

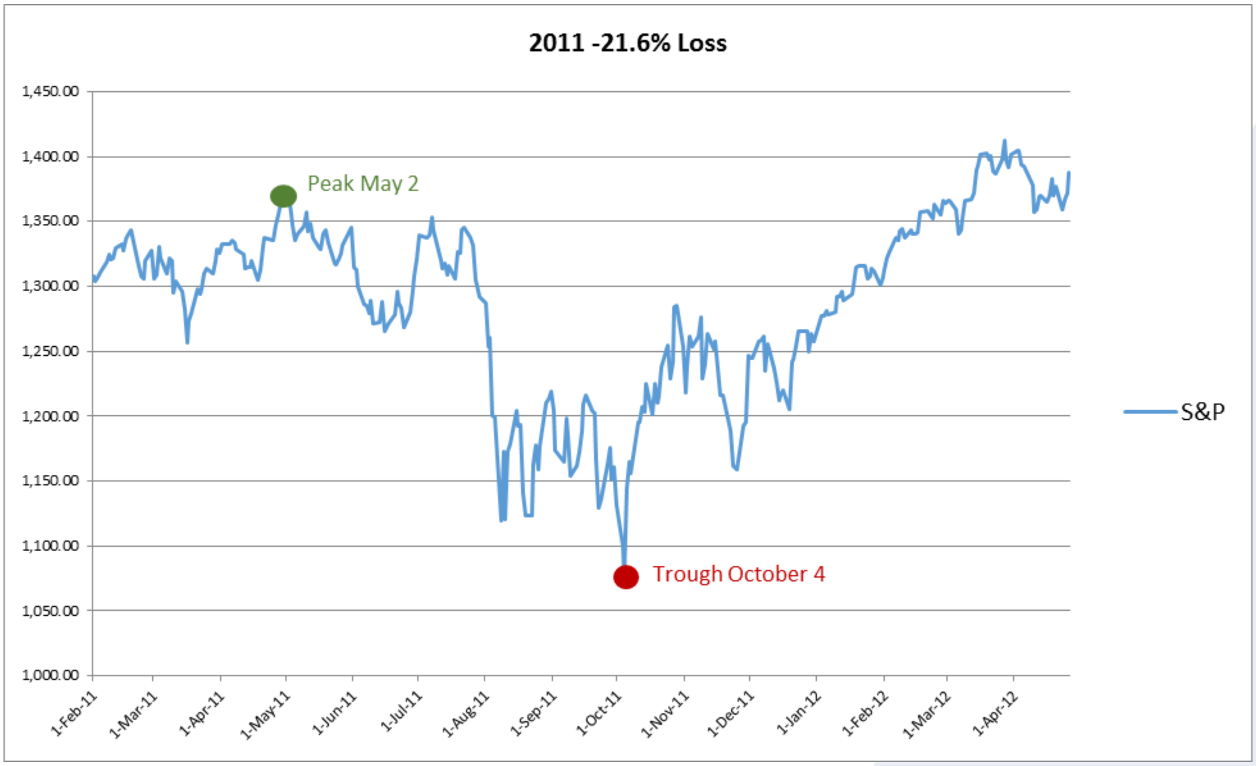
	Gain/Loss from Previous Date	Cumulative Loss Since Peak
10/11/2007	99.8%	NA
11/26/2007	-10.7%	-10.7%
12/13/2007	+5.8%	-5.6%
3/10/2008	-14.4%	-19.2%
5/19/2008	+12.0%	-9.5%
7/15/2008	-14.8%	-22.9%
8/11/2008	+7.4%	-17.2%
10/27/2008	-35.0%	-46.1%
11/4/2008	+18.5%	-36.2%
11/20/2008	-25.2%	-52.3%
1/5/2009	+23.3%	-41.2%
3/6/2009	-28.1%	-57.7%

Up and down and up and down. What you may notice is even as the stock market was decreasing and then crashing, the upward bounces were getting larger and larger save for once. Any one of those bounces could have been the start of the recovery as opposed to just a momentary pause in the march downward. Despite how large that stock market drop was and how many extremely negative days were included, half of the 20 best stock market days between January 1, 1950 and December 31, 2012 occurred during the 2007-2009 financial crisis. Doesn't that seem incredible? While the market was losing nearly -60%, it was also logging half its best days over a 62 year period. And that's why it's so difficult to know just where a downward move will stop: frequently there are large upward moves nestled in there, including historically large single day increases.

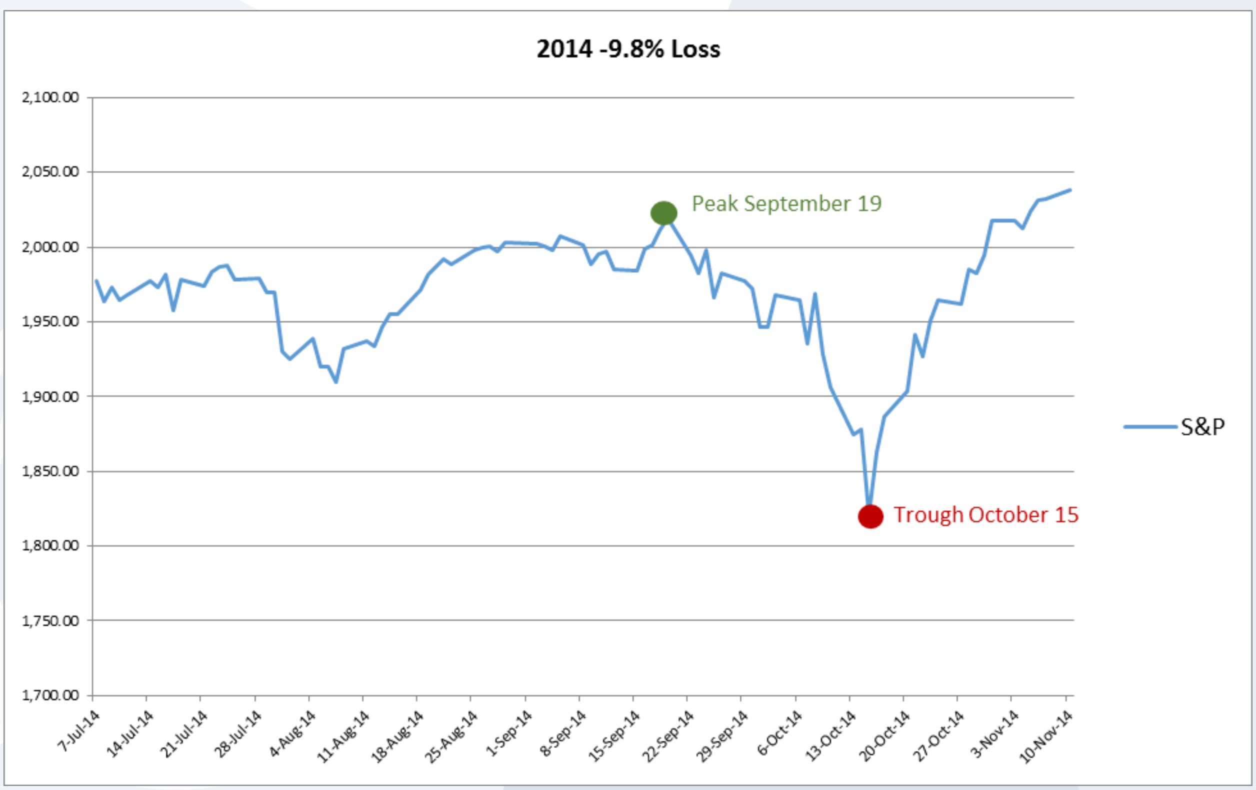
Even the recovery off that March 6, 2009 low wasn't as smooth as it looks. That final downward sloping red line in the second graph is greater than a -9% loss from June 11, 2009 to July 8, 2009. Can you blame anyone for thinking "here we go again" at that point? In general, you do not know you're in a historic bear market until really late in the process, because -10% and -20% moves are very common. In fact, what's uncommon about the past six and a half years since the stock market rebounded off the financial crisis low is how few corrections we've experienced since then. (Technically, a "correction" is a -10% drop or greater.) As a result, perhaps it's easier for us to interpret what has happened over the past two weeks as disastrous. We're just not used to stock market losses any more.

What should we do in the short-term?

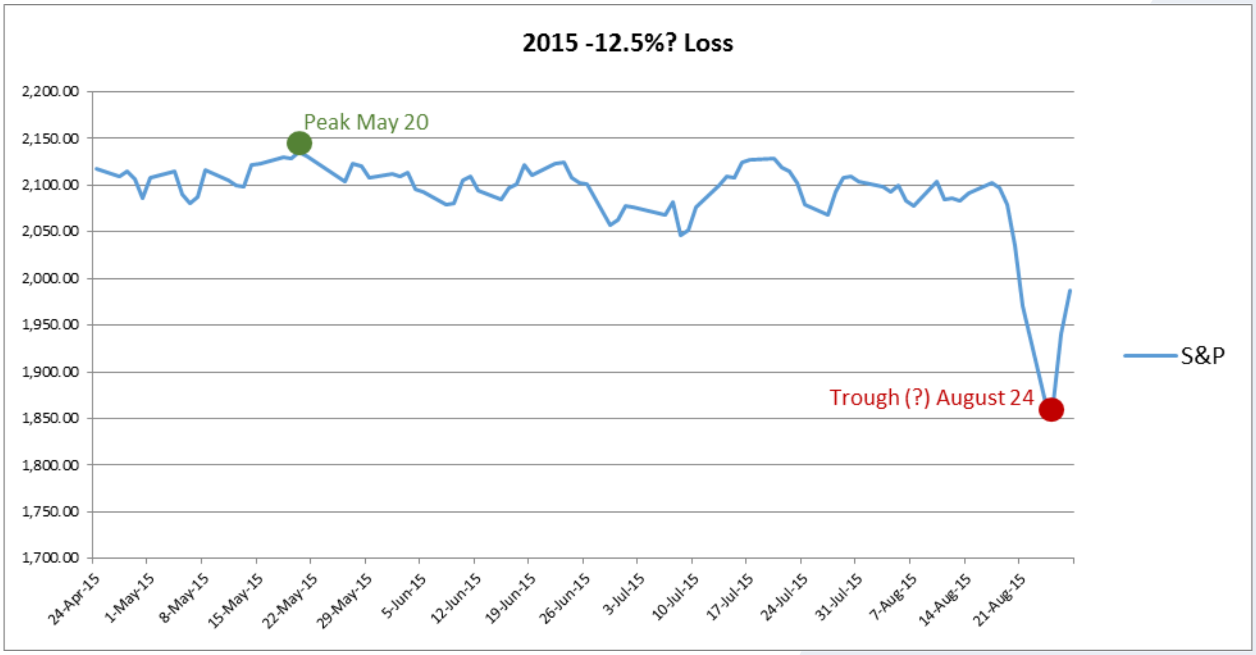
The only real market corrections we have had since 2009 occurred in 2011, 2014 (almost a correction), and these past two weeks. Let's look at what those moves on the S&P 500 looked like:



The -21.6% loss in 2011 took five months to fully manifest, had a volatile series of up and down moves preceding and following it, and took five months from the trough to get back to break-even. Unlike 2007-2009, though, even with more than a -20% loss, the market rebounded and grew to historic levels. So not every -20% loss signals a meltdown. Not even close.



By contrast, the nearly -10% loss in 2014 took only a month to hit bottom, was not characterized by extreme volatility before, during or after, and took only two weeks to fully recover. Looks like no big deal, right? This was less than a year ago, so we remember all the speculation was where that fast decline would lead. There was no way to know while it was happening that it would stop when it did and that it would recover so quickly. So not every -10% loss leads to a -20% loss, and as we learned above, not every -20% loss leads to a -50%+ loss. Which leads us to the past few weeks. . .



As you can see in the graph above, "the past few weeks" actually peaked back in May. The S&P 500 has been trading in a very narrow, low volatility range since then, at least until last week when it seemed like the bottom fell out. So, where do we head from here? Does the recent -12.5% loss turn into the jagged up and down and eventual larger loss like 2011 did, does it mirror what happened less than a year ago and bounce back aggressively and continue growing on its merry way, or will the peak on May 20 be the last time we see that level for years like back in 2007? The financial crisis did start with an even smaller loss than this, after all.

We can't know what exactly happens from here. No one does. Although we may have opinions on where the markets will trend over the next 3-5 years, shorter-term outlooks can be much less predictable. One of our roles as advisors is to make sure you do not over react to short term moves like 2011, 2014, and what we're experiencing now, while at the same time not losing too much in the next 2007-2009 scenario. We can't predict the immediate future, but we can certainly plan for it and take steps to manage it.

Where do we go from here?

1. Keep the longer term in mind. If we get worked up over -10% to -20% losses in the stock market, we may be tempted to change our longer term strategy over a short term result that ultimately resolves itself and continues higher. That is why we always have exposure to stocks, though we may reduce our exposure to them at times. It's always difficult to keep the longer term in mind when there's short term volatility. The month in month out performance may be what we experience, and it can be a roller coaster at times, but we have to prevent ourselves from getting too worked up over the ups and downs each month and remember we have a longer term strategy in place.

2. Know how much your current allocation could lose. We already estimate this for our current clients, and we use this estimate with your tolerance for risk and your financial planning needs to determine an appropriate investment strategy.

3. Know if you can afford to lose that much. We also already do this for our financial planning clients. Knowing how much you might lose and if you can afford to lose that much allows us to position your investments based on your needs and where we think the financial markets might head. Previous to the events of the past few months, we had already decreased our clients' exposure to stocks and increased their exposure to those asset classes we believe will reduce the scope of losses they will experience in the event of a financial crisis level event.

4. Diversify your investments appropriately. The traditional way of diversifying portfolios until recently was to mix bonds in with your stocks. There are many historical periods where doing such would have reduced losses. That was true during the 2007-2009 financial crisis, however to a much lesser extent than people were anticipating. Before that event, a half stock, half bond portfolio that included exposure to foreign markets as well was considered to have just a 1% chance of returning less than -20% over a given time period. During the financial crisis, the same allocation lost almost -30%! What investors learned during the crisis was there are moments when both stocks and bonds can be down at the same time, and while having bonds in a portfolio will usually reduce losses, it is still possible to lose more than you were expecting.

A portfolio with 20% in alternatives to stocks and bonds during the financial crisis, with the rest split evenly between stocks and bonds, would have reduced that loss to under -24%. Still not better than -20%, but there's one additional way we diversify our client accounts to protect against large market events that can protect against some of the smaller moves like we've seen lately as well.

Any conversation about how to protect portfolios against large losses is not complete without our mentioning how we use actively managed strategies to help us do so, especially since we believe so strongly in superior long-term returns through minimizing losses. During the financial crisis, a portfolio that contained a 30% sleeve of our two separately managed strategies, Market Trend and Contrarian, with the rest allocated like the portfolio above would have been down under -19% during the financial crisis and would have been back to break even by the end of 2009. Compare that to the stock market's nearly -60% loss and five years to break-even, and a 50/50 stock/bond portfolio's estimated -30% loss and two and a half years to get back to break-even. A lot of bad financial decisions can be made in a year, and the sooner a portfolio grows back, the less likely an investor will panic and do the wrong thing at the wrong time.

Even over shorter time periods, strategies such as these can take the sting out of a falling stock market. While the S&P 500 was losing that -21.6% in 2011, Market Trend was down -5.4%, and Contrarian only -2.6%. The fast nearly -10% drop in the S&P 500 in 2014 would have been reduced by Market Trend's 5.3% gain and Contrarian's 3% gain. Even during this recent stock plunge, Market Trend was 3.2% positive as of August 24th, and Contrarian 0.57% positive. (Return information for our strategies prior to 2013 is back-tested, whereas it's actual client composite return data is used for the last two market corrections.)

That is not to say these two strategies don't underperform stocks or bonds over certain time periods, as they certainly do. But a portfolio diversified by not just bonds, but also by alternatives and Cadence Wealth's separate strategies has been able to reduce what would have otherwise been larger losses.

Where we go from here is hard to predict, and no one should base their investment decisions on guesses. Short-term stock losses of -10% to -20% are relatively common, and rarely lead to larger -40% to -50% events. However, we do believe that while the world's outstanding debt has more than quadrupled over the past 30 years while global GDP has only doubled, it is only a matter of time before stock market moves like we've seen lately do lead to yet another major financial market meltdown. Whether this recent correction is the one that will ultimately lead to it remains to be seen. The anatomy of each meltdown is never the same, however the prescription for minimizing losses and recovering value is much more common: diversify appropriately, don't panic in the short-term, and have confidence in the long-term.

Our Thoughts

Last month we talked about how even though the major stock indices were holding up, they were exhibiting signs of weakness under the surface. Further, we reflected on the fact that historically, when we have extremely rich valuations in stocks, it's this internal weakness or shift in risk appetite that ultimately brings things to an end. Well, the last couple of weeks go a long way toward reinforcing our position on the matter. The real question at this point is – can we safely venture back into stocks with greater weightings as a result of the recent decline, or should we sit tight?

If you're a short term trader, this drop could provide an opportunity to take advantage of a quick bounce, as most big market drops are followed by some pretty good sized up-days. As we mentioned in the prior piece, some of the biggest daily gains for the market came in the middle of the financial crisis in 2008. When markets fall, it's rarely a straight trip down. However, since knowing when these days will occur and how long they'll last is impossible – notice we didn't say nearly impossible – we wouldn't advise you to go this route. If you believed however, that the market was fairly valued, healthy, and the longer term outlook for stocks was good, then this would provide a legitimate "buy the dip" opportunity, and assuming we agreed with you, we'd advise you to do so.

We're sticklers for facts however, and the facts tell a different story. Markets continue to be well overvalued, weak under the surface, and the global economy is showing signs of faltering. Historically we know this to be a horrible time to own stocks. John Hussman of Hussman Funds in his weekly letter dated August 24 wrote that since 1940, investors who would have put money to work only at times when the markets reflected its current characteristics (which took place 8% of the time) would have lost 93% of their money. This suggests loud and clear that the odds of this bull market getting back on its feet and carrying on for any length of time are pretty slim. Could it recover its losses over the short term? Sure, but holding onto them is something else entirely.

Our feeling is that the dramatic decline over the last few days viewed in light of the aforementioned market conditions is suggestive of a ship that's kept the market afloat for the last 6 years breaking apart. Whether stocks rally for a few days or weeks from here is largely irrelevant, as the odds are pretty good that the hull's already been breached. As exciting as these big bounce-back days might be, we'd advise against buying this dip.

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WEALTH MANAGEMENT