EQUIUS ASSETCLASS℠

Modern asset class investing principles, research, and perspectives for long-term investors

October 2018

Market "Corrections" Perspective

Rick Borden, Equius Partners

Over the past couple of years, there has been a parade of people who have been pretty vocal about an impending and significant market correction, some claiming that this is the longest-running "bull market" in history. For the record, it's not. If we look at market cycles as sustained up periods of 20% or more interrupted occasionally by a 20% decline, this period from March 2009 through the end of September 2018 ranks fourth in terms of total return and duration. And it's far behind the third-place finisher (December 1987 to August 2000) on both counts.

Nonetheless, the memory of the carnage of 2008 is still fresh enough to make a lot of people jumpy and susceptible to the notion that it's possible to sell ahead of a decline in the market and then pivot on a dime to get back in before the next rally starts. In reality, though, bear markets are clearly defined only in retrospect; no one has ever been able to consistently predict them ahead of time. Investment legend Peter Lynch said it best: "Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in the corrections themselves."

Thus, being non-clairvoyant mortals, we must adopt a strategy to get us through these inevitable market downturns with our long-term investment plan intact. You know our strategy well by now:

1. **Diversify broadly *within* asset classes**
   This eliminates concentration risk. Investors concentrated today in either individual technology stocks or the technology industry, for example, are feeling this risk as I write.

2. **Diversify broadly *among* asset classes**
   As we've pointed out in previous articles, this market is being propelled by large-growth companies (similar, in ways, to the 1995-1999 period). Investing in small-cap, value, and foreign stocks may serve as a cushion in a declining market.

3. **Maintain a fixed income allocation**
   Many of our clients have an allocation to a short-term, high-quality bond fund. Downside risk is much more limited with this investment, it generates regular interest income, scheduled withdrawals can be taken from this side of the portfolio when stocks are falling, and it can be used to facilitate rebalancing (selling the bond fund and buying stocks at lower prices to restore the proper portfolio balance).

4. **Take advantage of sound counseling**
   We all reach a point in a market decline when emotions that could knock us off our course become a concern. Discussing these emotions with a trusted advisor in a productive and focused way can prevent rash decisions that destroy long-term wealth.

Below is a table showing 27 market cycles since 1926, ranked by total return. I think it's clear that patience during the inevitable declines can be well rewarded.

Period	Duration	Total Return	Annual Return
Dec 1946 to Dec 1961	15 years, 1 month	935.9%	16.8%
Oct 1974 to Aug 1987	12 years, 11 months	843.6%	19.0%
Dec 1987 to Aug 2000	12 years, 9 months	814.8%	19.0%
Mar 2009 to Sep 2018	**9 years, 7 months**	**384.8%**	**17.9%**
Mar 1933 to Feb 1937	4 years	282.9%	39.9%
May 1942 to May 1946	4 years, 1 month	209.8%	31.9%
Jan 1926 to Aug 1929	3 years, 8 months	193.3%	34.1%
Jul 1962 to Nov 1968	6 years, 5 months	143.9%	14.9%
Oct 2002 to Oct 2007	5 years, 1 month	108.4%	15.5%
Jul 1932 to Aug 1932	2 months	91.6%	N/A
Jul 1970 to Dec 1972	2 years, 6 months	75.6%	25.3%
Apr 1938 to Sep 1939	1 year, 6 months	64.7%	39.5%
Dec 1929 to Mar 1930	4 months	21.3%	N/A
Jun 1940 to Aug 1941	1 year, 3 months	21.0%	16.4%
Jun 1946 to Nov 1946	6 months	-21.8%	N/A
Jan 1962 to Jun 1962	6 months	-22.3%	N/A
Sep 1941 to Apr 1942	8 months	-22.4%	N/A
Oct 1939 to May 1940	8 months	-25.7%	N/A
Dec 1968 to Jun 1970	1 year, 7 months	-29.2%	-19.6%
Sep 1987 to Nov 1987	3 months	-29.5%	N/A
Sep 1932 to Feb 1933	6 months	-29.8%	N/A
Sep 1929 to Nov 1929	3 months	-33.1%	N/A
Jan 1973 to Sep 1974	1 year, 9 months	-42.6%	-27.2%
Sep 2000 to Sep 2002	2 years, 1 month	-44.7%	-24.8%
Mar 1937 to Mar 1938	1 year, 1 month	-50%	-47.3%
Nov 2007 to Feb 2009	1 year, 4 months	-50.9%	-41.4%
Apr 1930 to Jun 1932	2 years, 3 months	-79.6%	-50.6%

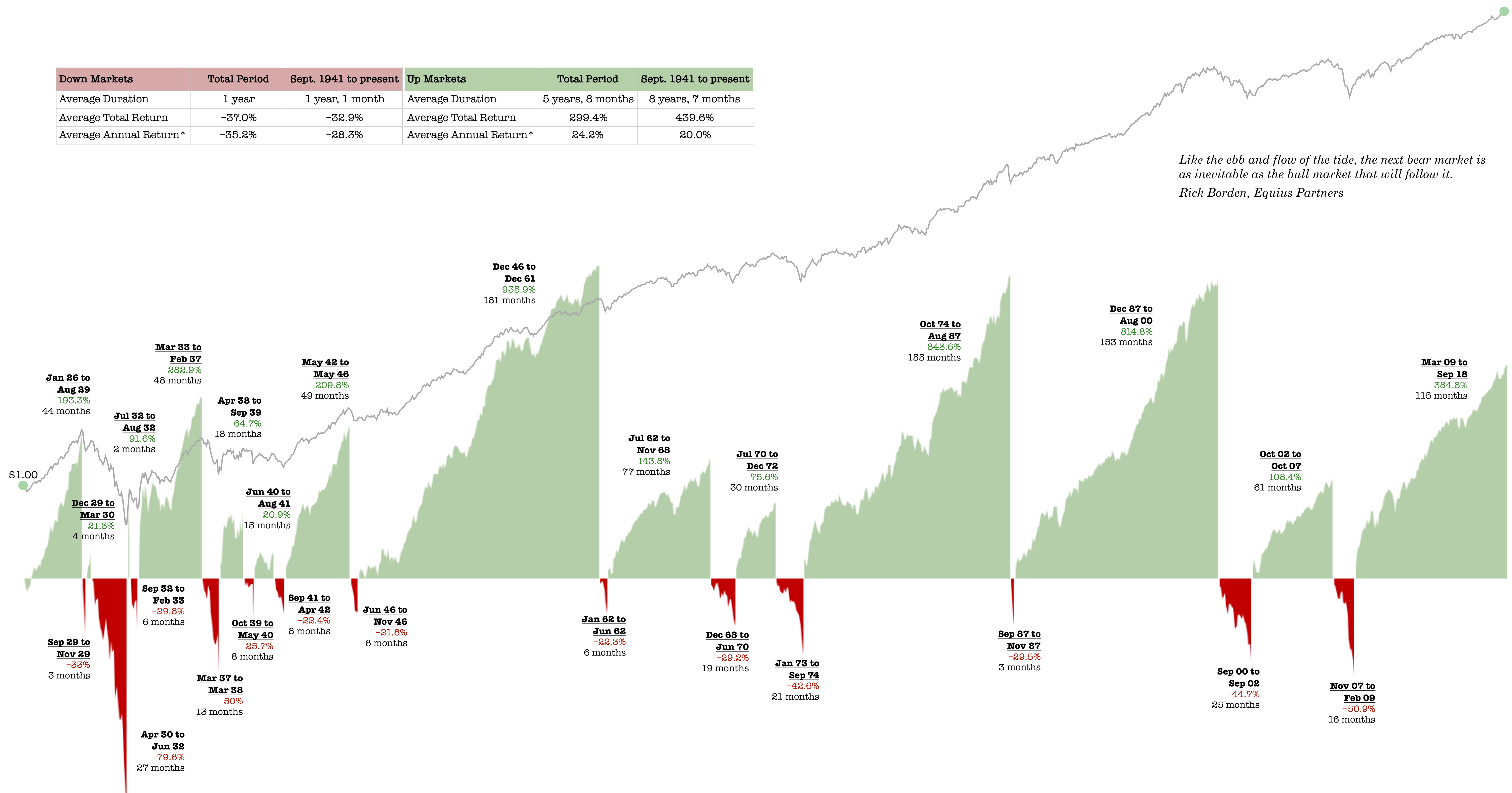
Please see explanation of data and disclosure on page 4. N/A = not applicable since less than one year.

The History of Market Ups and Downs

S&P 500 Index: Total Returns, January 1926 to September 2018

Down Markets	Total Period	Sept. 1941 to present
Average Duration	1 year	1 year, 1 month
Average Total Return	-37.0%	-32.9%
Average Annual Return*	-35.2%	-28.3%

Up Markets	Total Period	Sept. 1941 to present
Average Duration	5 years, 8 months	8 years, 7 months
Average Total Return	299.4%	439.6%
Average Annual Return*	24.2%	20.0%



*For periods one year or longer. Using monthly data, an up market is defined as a sustained rise in stock prices prior to a 20% decline and a down market as a sustained drop in prices prior to a 20% gain. Results for different time periods could differ from the results shown. Past performance is no guarantee of future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio. Source: S&P data © 2018 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. © 2018 Equius Partners, Inc.

A History of Ups and Downs

Jeff Troutner, Equius Partners

Our industry has a long and persistent habit of characterizing up and down markets as bull or bear markets, respectively. The origins of these terms in unclear, but they certainly connote what John Maynard Keynes referred to as animal spirits—instincts, proclivities, and emotions that influence human behavior—in his book *The General Theory of Employment, Interest and Money*. The primary emotions in this case are optimism and pessimism about stock prices.

We prefer to characterize major market cycles simply as up and down markets and remove the emotion. In the chart on the previous two pages, we define an up market as a sustained rise in stock prices prior to a 20% decline and a down market as a sustained drop in prices prior to a 20% gain. There are a number of key observations from this data.

First, the period prior to America's entry into World War II was marked by a series of shorter market cycles that had to be maddening for the relatively few wealthy investors and institutions involved in the stock market back then. After a 33% decline in stock prices that started in September 1929 and included the infamous "Black Tuesday" of October 29, the market recovered by 21% over just four months.

Those who believed that the 21% rise signaled a positive turn for their stock market fortunes were sorely disappointed as the market dropped a devastating 80% over the next two years. Then, in just two short months, the market almost doubled, up 92%! The market timers of the day must have been incredulous.

Fearing they would miss a substantial recovery, they no doubt jumped back in at some point, only to see their stock portfolios drop another 30% over the next six months. For those who had not jumped out of windows by then (yes, that happened), the market rewarded their perseverance with four years of rising prices, with stocks up a total of 283%. Then disaster struck again with a 50% decline over the next 13 months. When you throw in the next three cycles—up 65% in 18 months, down 26% in eight months, and up 21% in 15 months—it's a wonder that anyone tried to time the market ever again.

By September 1941, the market was factoring in the enormous economic risk caused by the war in Europe, and stock prices began to fall once again. The Japanese attack on Pearl Harbor in December 1941 added greatly to the anxiety. But as America fired up its manufacturing base to support the war effort, the market recovered and rose substantially over the next four years. After a brief decline in the second half of 1946, the market enjoyed its biggest sustained up market in history, up 936% through December 1961. After a brief six-month decline, it continued up another 144% for more than six years.

So our second observation should be how much longer the *up* markets have lasted since 1941—almost three years. The down markets haven't changed much, either in duration or degree. Books have been written on why this has occurred, but suffice it to say that better economic and monetary policies, broader participation in the markets, faster and more efficient flow of information, and certain regulations have helped. The U.S. also became the most powerful and most stable economic power on the globe after the war.

I'll close with one more important observation. Look at the difference in *duration* of all the market cycles in the post-war period. Notwithstanding the *degree* of the drops, does it look like anyone in his or her right mind should try to *time* them? Consider the last major decline—from the market bottom in March 2009, stocks rose 26% in three months, 46% in seven months, and almost 66% in 14 months. That was followed by two months when they fell 13%. Over five consecutive months in 2011, stocks dropped over 16%! Yet those investors who stayed focused on the long run have enjoyed (in varying degrees) a stock market rise of 385% since the 2008-2009 debacle.

No one can predict when the next 20% decline (or worse) in stocks will occur. But one thing is certain: the high annual returns you see in the up cycles in Rick's article are not sustainable forever. The 9%-10% expected return for the market includes these unpredictable down markets. Accepting that reality and working it into a sound, consistently applied, and focused long-term plan like Equius offers is really your best choice.

Please see the source of data and disclosures on the prior two pages.

Equius Partners is a Registered Investment Advisor. Please consider the investment objectives, risks, and charges and expenses of any mutual fund and read the prospectus carefully before investing. Indexes are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio. **Past performance is not a guarantee of future results.**

Equius Partners, Inc., 3 Hamilton Landing, Suite 130, Novato, CA 94949

Please email Jeff Troutner at jeff@equiuspartners.com with questions, comments, or suggestions. www.equiuspartners.com © 2018 Equius Partners, Inc.