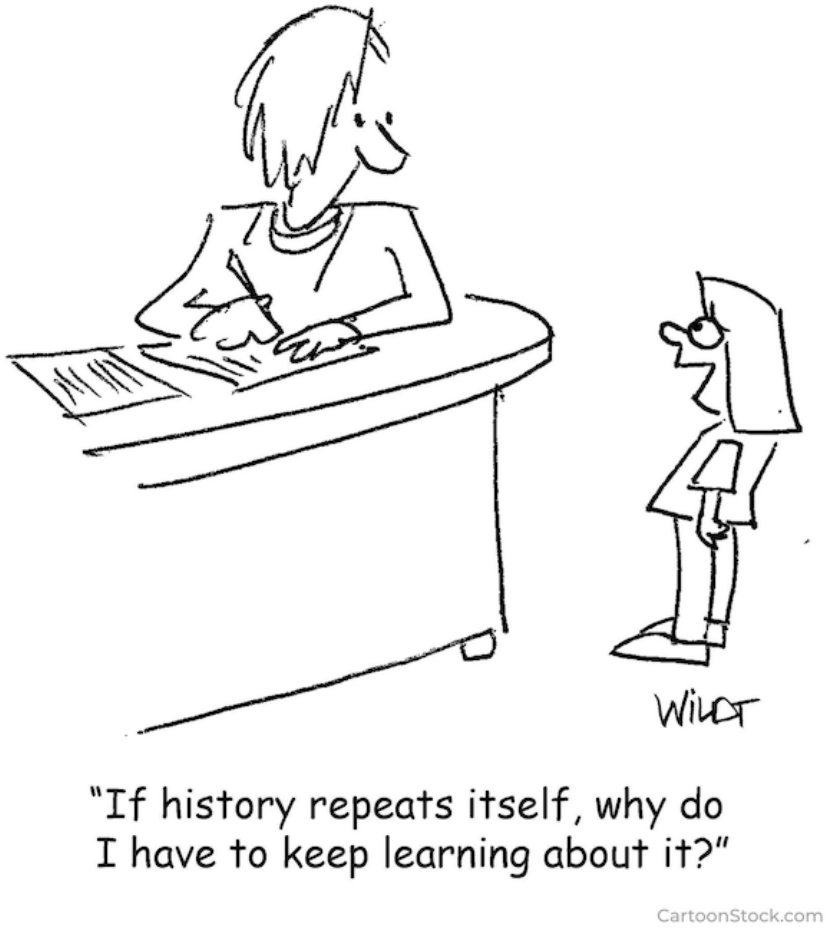
Market Corrections Can Be Scary Experiences

"History Doesn't Repeat Itself, but It Often Rhymes" – Mark Twain.



It has been a wild market the past few weeks. The Iran War, uncertainty surrounding mid-term elections, the AI downturn, and finally the Jensen Huang - Nvidia blow-up have all driven prices significantly lower. Investor anxiety is higher than usual given the recent downside volatility leaving some clients understandably concerned.

With that in mind, I was thinking back to one of the most successful investors and mutual fund managers of our time, Peter Lynch. Peter Lynch is a legendary investor and active philanthropist best known for managing the Fidelity Magellan Fund from 1977 to

1990. During his 13-year tenure, he achieved an average annual return of +29.2%, turning the fund into the best performing mutual find in the world before retiring.

Starting in 1992 he began writing a regular column for Worth Magazine with co-author and financial writer John Rothchild. The below edited piece appeared in Worth's, September 1995 issue. I cut it a bit short as the authors argued against including fixed income in a diversified portfolio, which in retrospect has proven incorrect and highlighted by various critics. However, his main points regarding risk and return in the stock market are all relevant lessons to today's turmoil. *"History doesn't repeat itself, but it often rhymes."*
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Fear of Crashing
By Peter Lynch with John Rothchild
Worth Magazine
September 1995

Think the market's headed for a fall? No argument here--unless you think you know when, or that there's a better survival strategy than owning great stocks.

The Dow's passing 4700 has brought new worries about a nasty correction. The worrying started as soon as we recovered from the last nasty correction, in 1990. There's no end to the list of probable causes for a repeat: Too many mutual funds are chasing too few stocks, stocks are overpriced, the dividend yield on the Dow is at an all-time low, and-- this one is my favorite—not enough investors are worried.

Let me go on record with Lynch's prediction: Another big correction is on the way. I'd bet the ranch on it, if I had a ranch. It may come this year, next year, or the year the Red Sox win the World Series (don't hold your breath!), but sooner or later, it will happen. You read it here first.

On what do I base this bold assertion? Stocks have declined 10 percent or more on 53 occasions since the turn of the century. That's roughly one correction occurring every two years.* And on 15 of these 53 occasions, stocks have declined 25 percent or more. That's one nasty correction (also known as a bear market) every six years.

For all I know, another bear may have arrived on the scene by the time this article reaches the newsstands. Or the equity gods may wait until the Dow reaches 6500 before they decide to knock it back to 4700, today's highs becoming tomorrow's lows. Or we could drop from today's levels straight down to 3100.
Make no mistake: Corrections can be scary experiences. People lose confidence in the economy, in their portfolios, and in the companies in which they've invested. It's like a storm that rolls in and blackens the sky. Fear sets in.

If only we didn't have indexes--the Dow, the Standard & Poor's 500, and so forth--that enable us to track the ups and downs of "the market," we'd never have this problem with corrections. Do you know what the range is between the high and the low price of the average stock on the New York Stock Exchange in any given year? Fifty percent. So most stocks fluctuate 50 percent from top to bottom every year, without any fanfare.

We remember the 1000-point drop in the Dow from August to October 1987, the scariest correction in recent times. But we forget the 1000-point rise in the Dow in the 11 months preceding that drop--a remarkably fast gain, considering that it had taken the Dow four years to tack on the previous 1000 points. If we had been sequestered like a jury during all of 1987, we would have come out thinking the market was flat for the year, and nobody would have panicked.

But we do have indexes and we are preoccupied with their ups and downs, so we will have scary corrections. If we tack on another 1000 points from here and the Dow rises to 5700 in short order, the chances of another big decline increase considerably.

Assuming you agree with my forecast, how can we prepare? Mostly by doing nothing. This is where a market calamity is different from a meteorological calamity. Since we've learned to take action to protect ourselves from snowstorms and hurricanes, it's only natural that we would try to prepare ourselves for corrections, even though this is one case where being prepared like a Boy Scout can be ruinous. Far more money has been lost by investors preparing for corrections or trying to anticipate corrections than has been lost in corrections themselves.

The first mistake is hedging the portfolio. Anticipating a drop in the market, the skittish investor begins to dabble in futures and options, the kind of investment that will make a profit when stocks decline. People think of this as correction insurance. It seems cheap at first, but the options expire every couple of months, and if stocks don't go down on schedule, people have to buy more options to renew the policy. Suddenly, investing isn't so simple. Investors can't decide whether they're rooting for stocks to falter, so their insurance will pay off, or for a rally, for the sake of the portfolio.

Hedging is a tricky business even the pros haven't mastered-- otherwise, why have so many hedge funds gone out of business in recent years? Hedge-fund managers have been sighted in unemployment lines.

The second and more prevalent mistake is the ritual known as lightening up. This time, our skittish investors, again fearing the correction is imminent, sell some or all of their stocks and stock mutual funds. Or they put off buying stocks in companies they like and sit on their cash, waiting for the crash. "Better safe than sorry," they tell themselves. "I'll wait for the day of reckoning, when all the suckers who didn't see this coming are

wailing and gnashing their teeth, and I'll snap up bargains left and right." (But once the market reaches bottom, the cash sitters are likely to continue to sit on their cash. They're waiting for further declines that never come, and they miss the rebound.)

They may still call themselves long-term investors, but they're not. They've turned themselves into market timers, and unless their timing is very good, the market will run away from them.

Market timing was quite popular about 2700 Dow points ago, when clients of mutual funds were encouraged to switch back and forth from stock funds to the money market, thereby avoiding any unpleasant corrections. The signals were sent out by self-appointed heads of "switching services" who charged hefty fees (as high as 3 percent a year) for their canny advice. People were paying their switch fund advisors two to eight times as much as they paid in management fees to the funds themselves.

Whereas in most states barbers have to pass a test before they are allowed to cut hair, there is no test for switch forecasters. My advice for anyone who is still paying for such a service: Go back and carefully check the results before you give another penny to a switching service. Have you really avoided the corrections, or have you avoided the best months of the greatest bull market in history? It pains me to think how many people have done the latter.

A review of the S&P; 500 going back to 1954 shows how expensive it is to be out of stocks during the short stretches when they make their biggest jumps. If you kept all your money in stocks throughout these 40 years, your annual return on investment was 11.4 percent. If you were out of stocks for the ten most profitable months, your return dropped to 8.3 percent. If you missed the 20 most profitable months, your return was 6.1 percent; the 40 most profitable, and you made only 2.7 percent. Imagine that: If you were out of stocks for 40 key months in 40 years, trying to avoid corrections, your stock portfolio underperformed your savings account.

The same computer that gave us that revelation also contributed the following: If you invested $2,000 in the S&P; 500 on January 1 of every year since 1965, your annual return has been 11 percent. If you were unlucky and managed to invest that $2,000 at the peak of the market in each year, your annual return has been 10.6 percent.

Or if you were lucky and invested the $2,000 at the low point in the market, you ended up with 11.7 percent. In other words, in the long run it doesn't matter much whether your timing is good or bad. What matters is that you stay invested in stocks.

Recently, Forbes published its hit parade of the richest people in the world, and I was reminded that there's never been a market timer on the list. If it were truly possible to predict corrections, you'd think somebody would have made billions by doing it.

The fact that nobody has done so ought to tell us something about our chances of dodging the drops. Warren Buffett weighs in at No. 2 on the Forbes list. He got there by picking stocks and not by switching in and out of them.

Buffett switched only once in his career, in the late 1960s, when Wall Street fell so hopelessly in love with a select group of growth companies that no price was too high to pay for them. At the point of maximum silliness, McDonald's was selling for 83 times earnings and Disney for 76, whereas in saner times, they might sell for 20 times earnings. These two companies, and 48 others in the so-called Nifty Fifty, were so overvalued that it took them ten years to catch up to their price tags. So if you're looking for more concrete advice than I've offered so far, take a tip from Warren Buffett and get out of stocks that are selling for 83 times earnings. Otherwise, stay the course and resist the temptation to outsmart corrections.

In telling you this, I'm assuming you're in stocks for the long haul: two score years or beyond. Never invest money in stocks if you are going to need it for some other purpose in the foreseeable future. Twenty years is a reasonable horizon for investing. That ought to be long enough for your stocks to overcome the worst of times, such as the stretch between 1966 and 1982, when the Dow stumbled from a peak of 1000 to a nadir of 777 And here's a reassuring point: When you include the dividends, stocks in the S&P; 500 gave a total return of 75.37 percent during that depressing 16-year period, or 3.5 percent annualized. Thanks to dividends, corrections aren't necessarily as bad as they're made out to be.

As soon as you realize you can afford to wait out any correction, the calamity also becomes an opportunity to pick up bargains.

The table on page 83 shows a few examples of how the four nastiest corrections in recent history (1973- 74, 1981-82, 1987, and 1990) actually paid us a favor by giving us the chance to buy great companies at fire-sale prices. If it's happened before, it will happen again.

THE ANATOMY OF A CORRECTION

How have different types of companies fared in those four corrections? Do all stocks correct equally? To answer those questions, I enlisted the help of Deborah Pont, my dogged researcher at Worth, who in turn enlisted the help of Standard & Poor's, the Frank Russell Co., and Safian Investment Research. Together, we came up with a large table (on the next page) involving four broad categories, each represented by an index. Large companies are represented by the S&P; 500; small companies by the Russell 2000; growth companies by the Safian growth index; and cyclical companies by the Safian cyclical index.

It's obvious from these numbers that growth companies were the star performers during and after two of these corrections, and they held their own in the Saddam Hussein correction of 1990.The only time you wished you didn't own them was 1973–74, when growth stocks were grossly overpriced, as we've already mentioned.

For those who haven't boned up on the subject, a growth company is a steady performer that can prosper in all economic conditions, as opposed to a cyclical, which lurches from rags to riches and back again. A typical lineup of growth companies includes those that make software and soft drinks, drug makers and fast-food chains, specialty retailers and service-related businesses, and even a cigarette manufacturer, Philip Morris. Sam Stovall, editor of Standard & Poor's Industry Reports and an avid student of corrections, calls these the "eat 'em, drink 'em, smoke 'em, and pay-for-it-by-going-to-the doctor type stocks."

After the infamous 1987 bear market, when investors in the Dow industrial stocks were traumatized by a 33 percent loss from the August top to the October bottom, including the terrifying 508-point one-day drop, investors in growth stocks were still ahead by 8.5 percent and getting a good night's sleep. In 1990, growth stocks lost a bit more ground than the cyclicals on the downside but far less than the three other categories of stocks, and they've kept pace with the cyclicals on the upside.

I've long been a fan of growth companies, but in the course of collecting data for this article, I was amazed to discover that since 1949, an investment in the 50 growth stocks on Safian's list has returned over 230-fold, while the cyclicals have returned only 19-fold. Whether they are owned individually or as an element of mutual funds, growth stocks have given their owners fewer heartaches and many happy returns.

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ASSET CLASS & SECTOR OPINIONS		
OVERWEIGHT	**NEUTRAL**	**UNDERWEIGHT**
Cash & Money Markets	U.S. Treasury Notes & Bonds	Mortgage-Backed Securities
Large Capitalization Technology	International Developed Market Equities	Investment Grade Corporate Bonds
Aerospace & Defense	Healthcare	Leverage Loans (Floating Rate Debt)
Energy Related Equities	Consumer Discretionary Sector	Treasury Inflation Protection Securities
Utilities	Communication Services Sector	High Yield Corporate Bonds
Precious Metals	Materials Sector	Local Currency EMG Bonds
Emerging Markets Equities	Financial Services Sector	Leisure & Hospitality
	Consumer Staples	Small Capitalization Stocks
	U.S. Real Estate & Related Equities	

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