What Can We Gain From All This Pain?

SYNOPSIS

- The first three weeks of the New Year delivered investors an 11% drawdown in the S&P 500, and many are justifiably concerned that stocks could continue to fall even further.
- Historical data shows that drawdowns occur very frequently but rarely result in a down year for the S&P 500.
- Staying invested when stocks feel as if they are dropping every day is extremely difficult, but that's why the long-term rewards can be so plentiful.

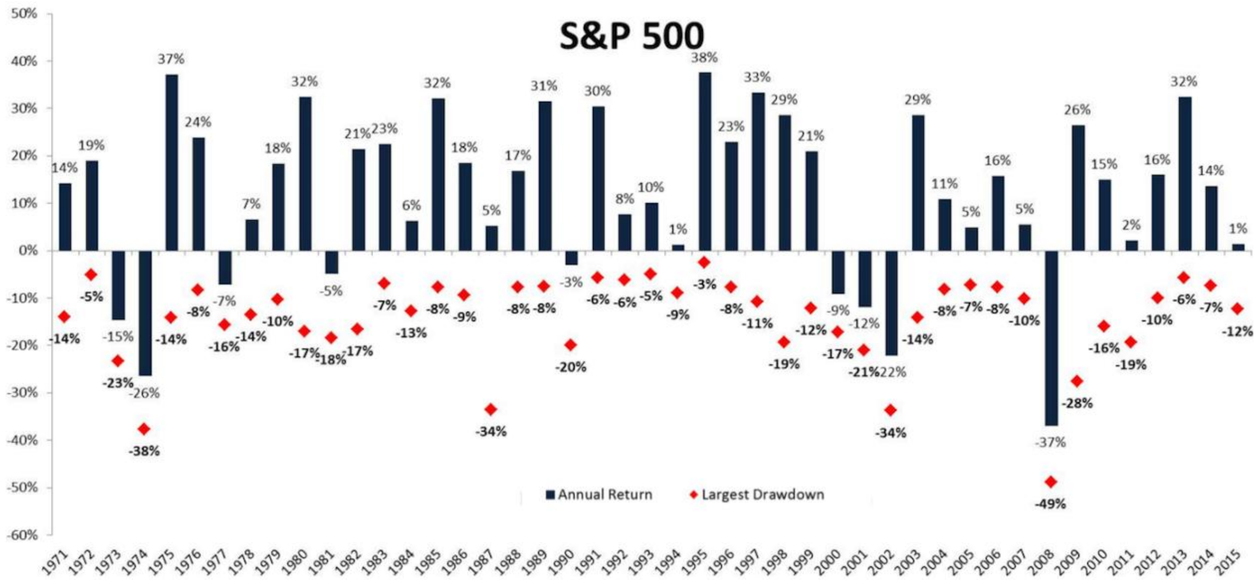
TEXAS FINANCIAL ADVISORY
BROOKLYNN CHANDLER WILLY & ASSOCIATES

A Rough Start to 2016

The first three weeks of the New Year delivered investors an 11% drawdown in the S&P 500, and many are justifiably concerned that stocks could continue to fall even further.

Drawdowns often strain the emotions of long-term investors because the fluctuations in equity prices tends to amplify loss aversion. As the decline worsens, many investors get to the point where they can no longer take the pain and simply throw in the towel.

I read an excellent report this week on the history of drawdowns, and it shed light into the frequency and true impact to investors over time. The chart below is an excerpt from the report, which shows the return and maximum drawdown for the S&P 500 every year since 1971.



Source: https://theirrelevantinvestor.wordpress.com/

The red diamonds indicate the largest drawdown for each year, and three interesting observations are worth noting:

1. **Drawdowns Happen Every Year**: There has not been a year since 1928 where stocks went up consistently through the year without some period of decline (the chart has been truncated to 1971 for readability purposes).
2. **The Average is Pretty High**: Since 1928, the average intra-year decline is 16.4%, so the current drawdown has yet to even reach the average.
3. **Big Drawdowns Are Common**: Declines exceeding double digits happened 64% of the time. Drawdowns of 20% or more have happened 23 times, or 26% of all years.

Admittedly, these numbers on their own probably don't instill much confidence in equity investing. However, drawdowns are short-lived, and the long-term returns from stocks more than justifies the exposure to these periods of weakness.

To prove my point, consider the following:

- A year with a 10% drawdown finished up 57% of the time.
- Five of the 23 years that saw a drawdown of more than 20% ended positive for the year.
- Approximately 36% of all years saw a double digit decline but still finished positive.

Stocks also represent the highest return of any major asset class over this time period for two reasons. First, economies tend to grow over time, and stocks reflect this growth.

Second, the powers of compounding amplify what may appear to be lackluster annual returns into incredibly attractive long-term returns. For example, an average annual return of 7% will double an investor's money in approximately 10 years!

Simply put, drawdowns are to be expected, but they just don't matter to long-term returns unless you let them by panic selling or trying to time market entry/exit points.

Implications for Investors

Equities are volatile investments, and emotions whipsaw stock prices quite regularly. In order to benefit from long-term equity returns, investors have no choice but to endure occasional declines.

Some believe that the answer lies in timing entry and exits – sell right before the drawdown occurs and then buy back once it is over. The reality is that timing markets is infinitely more damaging than tolerating "drawdown pain" because drawdowns are temporary, whereas mistakes from timing become permanent.

NOTE*: If this recent drawdown is too much to bear, go ask someone who sold the last time the S&P 500 dipped lower than the average of 16.4% how he/she feels these days. That drawdown occurred back in July 2011, and since then, the S&P 500 has surged.*

This current drawdown may feel worse than prior ones, but the reality is that every drawdown is painful. This one was just faster than others in the past, and it happened right around the time where our society measures the time it takes for the Earth to circle a huge ball of gas.

As we look back at drawdowns over the past 3-5 years, the pain and agony are now distant memories. The healing powers of hindsight help us forget what it was like when we were knee deep in it because the reasons for the drawdown become understood over time and rarely point to any major issues.

The bottom line is that staying invested when the stocks are seemingly dropping every other day is arduous, but the returns can more than make up for the volatility over time.

Sincerely,

Mike Sorrentino, CFA
Chief Strategist, Aviance Capital Management
mikeonmarkets.com

This commentary is not intended as investment advice or an investment recommendation. It is solely the opinion of our investment managers at the time of writing. Nothing in the commentary should be construed as a solicitation to buy or sell securities. Past performance is no indication of future performance. Liquid securities, such as those held within DIAS portfolios, can fall in value. Global Financial Private Capital is an SEC Registered Investment Adviser.