Uncommon Sense

The Permanent Challenge of Temporary Declines

Investment markets were kind to investors in the year 2021. Despite continued uncertainty around how the ongoing pandemic would impact society and the world's economies, markets worldwide gave investors above-average returns.

More significantly, there were almost no periods of significant declines. To the dismay of the financial media, the world's premier stock market index, the S&P 500, saw a maximum decline of only 5% throughout the whole year.

While this was a welcome respite from the normal market rhythm, there's a danger that investors will forget the important lessons learnt from past declines.

With higher inflation now a reality in the developed world, fresh concerns about geopolitical conflict, and upcoming midterm elections in the US, the possible triggers for market volatility are many.

Now only a month old, 2022 has already set itself apart. The market has still not surpassed the mark it reached on 3 January, and at the time of writing is 6% below that point.

To prepare you for the probability of more and deeper declines during the coming year, we outline below a few points you should keep in mind when others are losing theirs.

What You Should Know

A market correction is defined as a 10% drawdown from a previous market high. While it may sound like a significant number, these events occur far more frequently than most investors believe. Indeed, they come around as often as your birthday, with years like 2021 being the exception. Over the last few decades, the average annual decline is -14%, with about three in four of these years still ending with a positive return.

Every five years (on average), we can expect a decline of about one-third, as we experienced in 2020. We know that the stock market does not move in a straight line, but rather fluctuates around a generally upward trend. We call this "volatility".

Unfortunately, we cannot consistently predict ahead of time when these fluctuations will occur or when they will reverse. To be a successful long term investor is to accept the above with humility.

How You Should React

When a threat appears, it's natural to want to run away. It's how we're wired. However, a market decline is not a lion. It's a (mostly) harmless phenomenon that can only harm you if you react the wrong way.

Market declines will happen consistently over the course of your life, and your mindset when they occur is a choice that will determine your financial future. We recommend that you confront them with confidence rather than fear, mindful of the opportunities they provide.

Importantly, you have the luxury of being a long-term player in a system where everyone's playing a different game. Contrary to the day-trader, what happens in the next 30 days is unimportant to your 30-year plans. If you're in it for the long run, the odds are stacked in your favour. You're guaranteed to win.

We know that stock markets provide positive returns about three in every four years. The negative year earns you the other three. It's the price of admission for profiting from the collective ingenuity of the hundreds of companies working for you while you sleep. We encourage you to see the temporary declines are the reason for the stock market's permanent returns. You can't have one without the other.

Time Heals

The stock market is a device for transferring money from the impatient to the patient. As you exercise the patience you'll need to repeat many times in the future, be encouraged that you are busy earning future returns. If you're still saving, declines are your best friend, allowing you to buy more units of shares at knockdown prices.

Success in life requires the practice of rationality under uncertainty, and to be successful long term investors, we must decide to act on a plan rather than react to market movements. We are here for you as we continue to work on your plan together.

While we don't know where the market will be in 6 months, we're pretty confident where it will be in 10 years: much higher. Time is the enemy of market declines, and we've got plenty of it.