STATERA
ASSET MANAGEMENT

Commentary: November 2017

TIME CAN MEND

To date, the U.S. equity market has recovered from all major and minor downturns. Even so, a time will come again when we are in the middle of an extended downturn. That presents a conundrum: How do we prepare otherwise risk-tolerant individuals to remain in markets that have treated them badly? We think the answer includes regular reminders about past market volatility as well as the illustration of the idea that the achievement of long-term gains may well require enduring stretches of heightened market volatility and extended declines. In this month's commentary, we seek to revisit the worst of what we've experienced over the past few decades. Our intention is to remind readers about past market tumult and those subsequent recoveries. The upshot is that our investment time horizon is an important consideration when estimating our tolerance for market risk.

Bang on Your Buck

We find that when people speak of market volatility, they generally do not mean the daily ups and downs. They understand that these may be seen as the normal digestion of divergent money flows amidst a wide range of investment opinions. Rather, what people typically have in mind when they think of market volatility are the worst of times. They think of troublesome downturns that range in severity from that experienced at the beginning of 2016 to the Tech Bubble of 2000-2001 and the Financial Crisis of 2007-2008.

Frankly, it's not a bad start when establishing an idea of one's tolerance for market risk to evaluate the equity market at its meanest. After all, such periods are those most likely to cause an equity investor to throw in the towel. But it would be a mistake to end with our eyes fixated on the downturns. An overriding fear of large interim losses can cause us to overlook the significance of our investment time horizon.

While the emotional upheaval that parallels market tumult is understandable, we should acknowledge the long-term benefit of remaining in the market. Hopefully obvious there is the context of time. It's true that the domestic equity market has recovered from every major and minor downturn in history. Still, those recoveries sometimes required a lengthy passage of time.

In Figure 1 we show total return data that include the effects of reinvested dividends[1]. Clear in the chart is the magnitude of historical market declines and the eventuality of each recovery. We can see that it took

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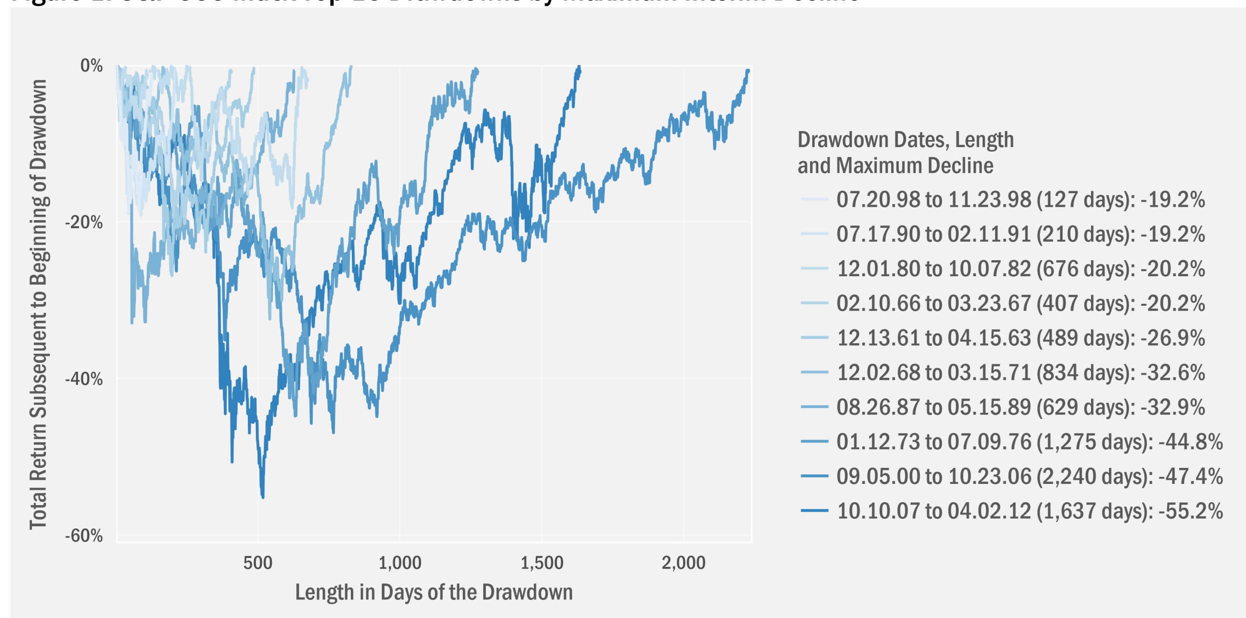
[1] The primary effect will be that the actual recovery from the downturn will have occurred before the index itself achieves a level higher than when the downturn began, as those dividends augmented longer-term performance more than is expressed by the index price level.

more than 6 years to recover to breakeven from the Tech Bubble[2]. It took about 4.5 years for the S&P 500 to recover from the Financial Crisis. For many, those periods may have been too long to endure. Others, however, saw those drawdowns as part and parcel to obtaining a reasonable long-term return.

Figure 1: S&P 500 Index Top 10 Drawdowns by Maximum Interim Decline

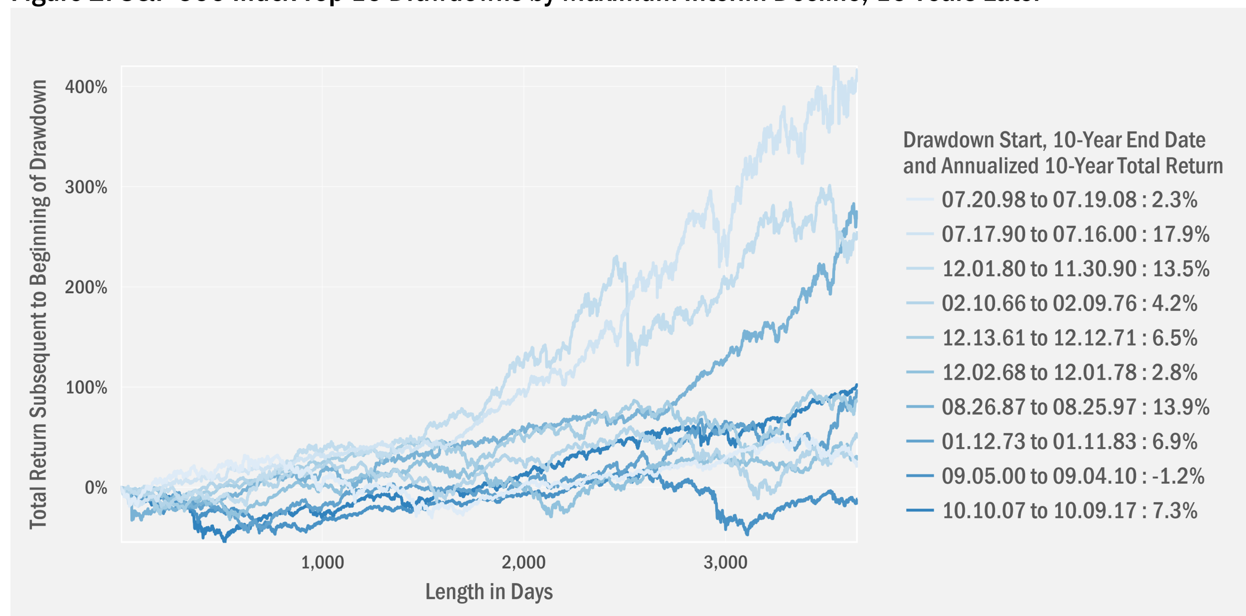


From 10.31.57 to 10.31.17. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all the invested capital. One cannot directly invest in an index. Index performance reflects the reinvestment of dividends, but does not reflect the expenses associated with the management of an actual portfolio. Please see additional important information regarding indexes at the end of this report. Drawdown may be measured as the maximum loss from a prior peak value and/or the length of time the portfolio requires to return to breakeven after a prior peak.
SOURCE: SRCM using data from Bloomberg

We generally desire something more than breakeven for our patience though. Happily, patience historically has found reward in the fullness of time. For each of the drawdowns shown in Figure 1, we chart the 10-year total returns subsequent to the start of the drawdown in Figure 2. In each case but one, the 10-year total returns were positive. The exception was the downturn beginning with the bursting of the Tech Bubble and converging with the Financial Crisis. It took a few more months in 2010 to recover to breakeven from the peak in 2000 on a total-return basis.

[2] Fodder for a later commentary, we will note that not all stocks took the same beating during the Tech Bubble. In fact, while the broader market, as measured by the Russell 3000 Index, was down more than 35% from the end of 1999 through the end of 2002, small-cap Value stocks, as measured by the Russell 2000 Value Index, actually rose close to 24%. A rare mixed outcome for sure, and the Financial Crises left few boats unsunk, but worth a review as part of our broader understanding of market history.

Figure 2: S&P 500 Index Top 10 Drawdowns by Maximum Interim Decline; 10 Years Later



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SOURCE: SRCM using data from Bloomberg

Aspirations in Balance

In a way, managing investment expectations is every bit as much a challenge as managing investment portfolios. We meet the expectation challenge by keeping a keen eye on the empirical evidence discussed above. When we balance our concerns about volatility with a healthy long-term view, we may be in a better position to stay the course and potentially be rewarded for our patience.

There is, of course, no simple method to achieving that balance, in our view. That's why we revisit these topics regularly, hoping to spark discussions about what levels of market risk readers may find comfortable in the context of their long-term plans. To that end, we offer the reminder that discussions with advisors may provide opportunities to discern what level of market risk is right for the moment and to devise plans to reevaluate an acceptable balance over time.

Important Information

Investing involves risks including the possible loss of principal. Past performance is not indicative of future results.

One cannot invest directly in an index. Index performance does not reflect the expenses associated with the management of an actual portfolio.

The S&P 500 Index represents 500 U.S. companies and captures approximately 80% coverage of available market capitalization.

The Russell 3000 Index represents approximately 98% of the investable U.S. equity market.

The Russell 2000 Index tracks the performance of U.S. small-capitalization stocks and is comprised of the smallest 2000 companies in the Russell 3000 Index. The Russell 2000 Value Index measures the performance of those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values.

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