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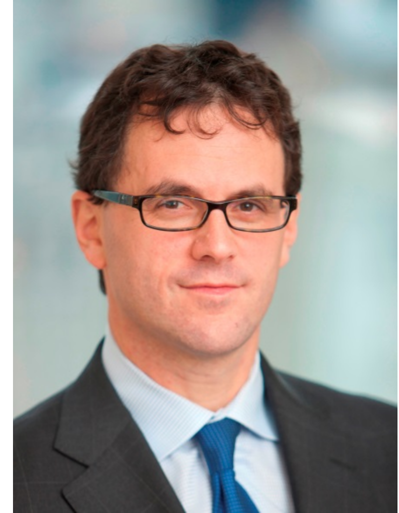

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Headline: Largest One Day Drop Ever!
PMA: So What!

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With its 666 point decline on Friday, February 2nd, and then it's 1,175 point drop on Monday, the Dow Jones Industrial Average reminded us that, yes, markets do go down, sometimes dramatically so. The delivery of this reminder may have been painful, but it's a reminder that we all probably needed. Even though the past eight years have made it easy to get used to, markets do not simply go up in a straight line.

But why did the market drop like this at this point in time? Was it a rational reaction to the rise in interest rates and expected inflation? But if so, why wasn't this already priced into the market? Why did the market appear to be shocked by this? Or, if it wasn't rational, was it proof of one of the tenets of behavioral finance – that markets are often a reflection of the irrationality of human beings? Or, was it a rational re-pricing of the market in response to new data? Or was it some mysterious confluence of algorithms and hedge funds and computer problems?

The truth is we don't know the answer to these questions. And it may take some time before we have the answers. In the meantime, to keep things in perspective, here are some key points to consider:

1. As we've said before, the percentage drop in the market is what's important, not the point drop. The press was ablaze with stories about how the 1,175 point drop on Monday, February 5 was the largest in history. To which the appropriate reply is: so what? A 1,175 point drop is larger than the 508 point drop that occurred in October of 1987. But the 1,175 point drop relative to the opening of the market at 25,500 represented a 4.6% decline. The 508 point drop in 1987 represented a 22% decline.

2. Long-term returns are the only returns that matter. Let's not forget that even with this drop of 1,800 points over two days, the Dow is still up 3.6% over the last 3 months and 20% over the last year (as of Tuesday, February 06, 2018). Even as this letter is being written, the Dow has ended up 473 points higher on February 6. An investor who got out of the market a year ago, on the theory that he knew when a correction was coming, would have missed the 1,175 point drop on Monday but would also have missed the 4,000 point gain during the past year.

3. Ultimately, financial markets are a reflection of the underlying economy and the strength of corporate earnings. The economy is the master, and the financial markets are like the dog on the leash. There is some pull in the leash, but ultimately the returns in the markets cannot stray too far from the master. By almost every measure the economy is doing well – consumer confidence, unemployment, earnings, etc. The rise in interest rates is not something to dismiss, but it is a reflection of the strength of the economy, not the weakness.

4. However, we must stress, in light of the last point, that just as a great company can be a lousy investment if its price gets too high, so too can a great economy deliver mediocre returns in financial markets if the collective prices of all the companies in the economy get too high. Current market valuations are the key to future returns, which leads to the most asked question among market participants: is the market overvalued? And, if so, what will be future returns going forward?

As investment advisors, one of our goals is to try to set realistic expectations among clients about future returns in the stock market and future returns in their portfolio. As far back as 2013, after four solid years of returns in the markets, we had been cautioning clients to expect modest, single digit returns in the markets and – in the case of many of our clients – modest, single digit returns in their balanced portfolios of stocks and bonds, a consequence of high stock prices and low-bond yields. The S&P 500 had returned 26.5%, in 2009, 15.1%, in 2010, 2.1% in 2011, and 16% in 2012, which meant an average return over those past four years of 14.6%. At the end of 2012, we thought future returns going forward would be more modest.

We are, in a way, happy to say that the market (as represented by the S&P 500) over the next five years from 2013 through 2017 exceeded our expectations , returning 32.4% in 2013, 13.7% in 2014, 1.4% in 2015, 12% in 2016, and 21.8% in 2017, for a five-year annualized return of 15.8%. Except for 2015, not exactly the single-digit returns we had believed most likely.

Over the last 9 years, then, from the end of 2008 through 2017, the S&P 500 has returned an annualized return of 15.3%. Although we do not agree with Alan Greenspan's opinion that stocks are in a bubble (see our inserts), they are not cheap, either. Fully aware of our past efforts, we nonetheless reiterate our belief that stocks going forward will return somewhere in the neighborhood of 7%, on average.

After 9 years of an average return of 15.3% in the S&P 500, a modest return of 7% is something for which investors should be grateful. More importantly, if the gyrations of the past week have made you more nervous than past market volatility, now may be the time to review your risk tolerance and the asset allocation of your portfolio, and we encourage you to contact us and schedule a time to meet. As we age, and as the circumstances in our lives change, so does our appetite for risk.