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The Reality of Stock Market Declines

1. No one can predict consistently when market declines will happen.
2. No one can predict how long a decline will last.
3. No one can consistently predict the exact right time to get in or out of the market.
4. Not having a plan to minimize the impact of market downturns guarantees your funds are vulnerable to loss.

At the most basic level, stock market prices are a function of supply and demand. Too much supply or too little demand and prices decline. Too much demand and not enough stock to satisfy that demand will push prices up.

But then it gets messy, because the factors that influence demand can defy logic. And markets can remain illogical on both the up and downside far longer than may make sense.

In a purely logical market, **FUNDAMENTAL** factors determine price. Fundamental factors are typically measurable, such as consumer purchasing power, earnings per share, cash flow ratios, PE ratios, debt to equity, product demand, book value and many more, both straightforward and esoteric measures of value.

TECHNICAL factors attempt to anticipate price changes based on historical patterns, human behavior and the tendency of trends to persist over different time periods. This may include moving averages, chart patterns, momentum, relative strength, incidental transactions such as the buying or selling behavior of “smart money,” behavioral factors of traders and investors, and more.

EMOTIONAL factors, such as market sentiment, are the most difficult to anticipate or predict, both in their timing, intensity and duration. Sentiment has been described as obstinate, biased and subjective. And it has the capacity to overrule logical decisions.

It would be nice to think that when investing on a long-term basis, fundamental factors are all that matter. Is the market or company growing and creating value? For the most part, this can work, but there’s still that pesky reality of market sentiment.

But the biggest threat to the market is the threat no one is expecting – the Black Swan. Black swans are those rare and unpredictable outlier events that have an extreme impact on financial markets, according to author and former options trader Nassim Nicholas Taleb in **The Black Swan: The Impact of the Highly Improbable**. Taleb coined the term Black Swan based on the European belief that black swans did not exist, until they were discovered to be quite common in southeast and southwest regions of Australia.

Financial markets are inevitably susceptible to the unexpected and the emotional response of investors to outlier events. Past performance may provide clues to the future based on past human behavior, but it cannot predict the future. Tomorrow is always unknown territory.

As investors, how can we make our peace with that uncertainty? One response may be to avoid financial markets altogether. But cash has its own risks, mainly the risk that you run out of money because your funds are not keeping up with the impact of inflation and taxes. Diversifying your sources of income can help, but in a severe market downturn most asset

classes become correlated and head the same direction. Which brings us back to active management.

Active management is the willingness to move to a defensive position when asset classes or the market begins to lose value, and back to a more aggressive investment stance when the market is trending up. To work, active management must be a very carefully designed, systematic approach that removes emotion from the decision as much as possible and accepts that not every buy or sell will be profitable.

The unpredictable, emotional nature of the financial markets assures there will never be the one right way to invest. But over time, minimizing the impact of market declines has the potential to reduce portfolio negative volatility, lower the risk of investing and produce competitive returns. We can't guarantee our investment approach will succeed, but it gives us the parameters to work with the uncertainty of investing over the long run. And time is often the most important element of investment success.

Past performance does not guarantee future success. Inherent in any investment or investment approach is the potential for loss as well as profit. There can be no assurance that active management or any other investment approach will prove successful.

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