How Likely is a Market Downturn?

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Would you rather purchase ground beef that contains 15% fat or that is 85% lean? Of course they are the same, but for most people, 85% lean ground beef sounds more attractive. That is why packages of ground beef or hamburger patties are presented or “framed” to emphasize the high level of “good” in the product, ignoring the undesirable component. The framing effect is a cognitive bias that our mind uses to simplify issues and reach decisions quickly.

I was reminded of framing when looking at the popular table in our **Lifetime Investment Strategy Guide** that relates historical investment holding periods to the percentage of times the market suffered losses over the last 90 years. For example, if you look at annual calendar-year performance since 1926, the S&P 500 has had losses in 27% of the one-year holding periods. As you extend your holding period, the number of times you would have suffered a loss starts to go down. For example, if you look at all of the rolling five-year periods since the beginning of 1926 through 2015, (86 rolling five-year periods in total), the total return from investing in the S&P 500 was negative 14% percent of the time. By the way, reinvestment of dividends is important even over a five-year holding period. If you just look at the rolling five-year price gains or losses, the S&P 500 lost money around 27% of the time. On the other hand, if you purchased a long-term government bond portfolio at the beginning of the year and sold after five years (five-year holding period) you would have suffered a loss 7% of the time.

Time Frame and Losses (1926-2015)

Holding Period (Years)	Percentage of Holding Periods That Resulted in Losses				
	S&P 500	Small Stocks	Corporate Bonds	U.S. Gov't Bonds	T-Bills
1	27%	31%	21%	27%	1%
3	17%	18%	9%	11%	1%
5	14%	14%	3%	7%	0%
10	5%	2%	0%	1%	0%
20	0%	0%	0%	0%	0%

Source: Roger G. Ibbotson and Rex A. Sinquefield, "Stocks, Bonds, Bills and Inflation," 1982 ed., Institute of Charter Financial Analysts, Charlottesville, Va.; updated by Morningstar, "Stocks, Bonds, Bills and Inflation," Chicago.

The table has a number of goals. It helps to illustrate that longer investing time frames diminish the likelihood of suffering a loss over the complete investment time period. To gain from the greater total return potential of investing in stocks, you need to accept short-term volatility. Market downturns and runs can happen quickly and can be quite dramatic. Great discipline is required to keep fear and panic from overwhelming your decision-making process during a bear market. The potential impact of getting out of the market during bear markets was analyzed by Charles Rotblut in the May 2014 AAII Journal (“**The Danger of Getting Out of Stocks During Bear Markets**”). The only way to ensure that you will not suffer a short-term loss is to basically keep your money in cash such as U.S. Treasury bills. But then you risk not meeting your long-term financial goals.

Time Frame and Gains (1926-2015)

Holding Period (Years)	Percentage of Holding Periods That Resulted in Gains				
	S&P 500	Small Stocks	Corporate Bonds	U.S. Gov't Bonds	T-Bils
1	73%	69%	79%	73%	99%
3	83%	82%	91%	89%	99%
5	86%	86%	97%	93%	100%
10	95%	98%	100%	99%	100%
20	100%	100%	100%	100%	100%

Source: Roger G. Ibbotson and Rex A. Sinquefield, "Stocks, Bonds, Bills and Inflation," 1982 ed., Institute of Charter Financial Analysts, Charlottesville, Va.; updated by Morningstar, "Stocks, Bonds, Bills and Inflation," Chicago.

Now you may be wondering why I started this blog with a discussion regarding framing. As it turns out, individuals feel the pain of a loss much more than the joy of a gain, just as the undesirable prospect of 15% fatty beef sounds much worse than the benefit of 85% lean beef. The 14% possibility of a loss impacts most people more emotionally than the 86% past probability of a gain. Behavioral economists have tried to measure the loss-aversion tendency, and they estimate that most people demand around a 2–to-1 gain to overcome the risk of an immediate loss.

Long-Term Returns (1926-2015)

	S&P 500	Small Stocks	Long-Term Corporate Bonds	Long-Term U.S. Gov't Bonds	T-Bills
Average Annual Compound Rate of Return					
	10.0%	12.0%	6.0%	5.6%	5.2%
Growth: What $100 Invested Would Have Grown To					
	$538,988	$2,643,166	$18,853	$13,363	$9,590

Source: Roger G. Ibbotson and Rex A. Sinquefield, "Stocks, Bonds, Bills and Inflation," 1982 ed., Institute of Charter Financial Analysts, Charlottesville, Va.; updated by Morningstar, "Stocks, Bonds, Bills and Inflation," Chicago.

Stocks offer the greatest likelihood of beating inflation and maximizing your long-term wealth. But to achieve that benefit, you need to be able to deal with short-term volatility. Even if you are fully committed to stocks as part of your long-term strategy, you should keep some money in liquid assets, such as T-bills. Unexpected events may require that savings be used, and taking money out of the stock market at the wrong time can impair your long-term results.

We recently asked a sample of our members a simple question: As it pertains to your investments, what “keeps you up at night?” While many members were concerned about market volatility, low interest rates and the possibility of a bear market, a number of members responded that nothing was really keeping them up at night. The common pattern among investors not stressed about the market was the ability to maintain a long-term perspective because they had a long-term strategy to guide them. Some of the sample responses include:

- “I keep my portfolio at a level that does not present a problem. I am a long-term investor.”
- “I have a long-term view and rarely stay awake at night worrying about my portfolio. I am old enough to have lived through downturns, but my portfolio has always bounced back.”
- “The market will eventually settle and reward those with patience and ‘plan.’”
- “I have a four-year emergency fund for bad stock market years, so I do not have a problem sleeping at night.”

Another interesting answer focused on “understanding the differences between the psychological focuses of mainstream investors and the reasonable interpretations of the data….What can we do to avoid the risk of becoming part of the herd?” My recommendation to that member and all investors is to have a long-term strategy in place that can help guide you and give you a framework for your decisions. As we note in our **Lifetime Investment Strategy**, vague objectives such as “to do well” without any consideration regarding time frame do not help investors to make sound, informed decisions. With the right strategy for your investment horizon, the likelihood of a market decline becomes a risk you can better manage.