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WHAT TO DO IN A MARKET CORRECTION

Overview

A correction is technically defined as when the market declines by 10 percent from a recent peak. It's worth noting that corrections are a very normal part of the market life cycle. There has been at least one correction in each bull market of the last 40 years and a correction can occur in any asset class.[1]

Investors should understand that corrections are unavoidable and to be expected. In a normal market, it is not unusual to experience at least one correction a year. However, recognize that the market hasn't been very normal recently. There hasn't been a correction in the S&P 500 index since early 2016. Prior to that, there had been nine market corrections between 2010 and 2015.[2]

Whenever the market takes a precipitous drop, we often see emotional reactions such as fear, confusion, panic and loss of trust. Investors begin to second-guess their advisors. They make rash decisions. They might ask themselves:

- "Do I hold the right investments?"
- "Should I even be in the stock market at all?"
- "Should I just convert my entire portfolio to gold and bury it in the backyard?"

What goes up must come down. This too shall pass. Keep calm and carry on. These sayings apply to many aspects of life, but they are especially relevant to financial markets. By their very nature, securities markets rise and fall. We might not like it, but it's an unfortunate component of investing.

Emotional Rollercoaster

Emotional effects tend to occur when people get fearful or greedy. Investors can even accelerate the movement of the market based on one of those two emotions. However, there may not be anything inherently wrong with the market; the crowd is just acting based on feelings. It's important to be able to distinguish between how our investments are performing relative to our goals and how we feel about the market environment.

These are factors that generally cannot be controlled by investors or the entities in which they invest. That's why it's important to be guided by personal goals rather than chase performance. It's important to be able to distinguish between what is a temporary setback and what is a market fundamental.

External Factors

Securities markets also may be impacted by external factors. These can include rising oil prices, a change in the direction of interest rates, political fallout, bad news affecting a major market player or industry, a global crisis or even a severe natural disaster.

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Market Fundamentals

Corrections can occur when there are market fundamentals at play that affect the value of underlying investments. A classic example is the dot-com bubble of the early 2000s. At the time, investors began putting money into all types of tech companies — large, medium, small; growth, value and even start-up. They were seduced by the idea that tech companies were "the next big thing" and did not pay close attention to that market sector's fundamentals.

Many of these venture-capital-funded entities increased exponentially in value, peaking at nearly 80 times their earnings. At the time, that was more than three times the valuation of the rest of the equity market.[3]

An individual company's fundamentals are typically measured by components such as its balance sheet, income statement, overall management and cash flow. Many of the tech companies of this period did not have the company fundamentals to support this level of valuation. Eventually, when investors realized this fundamental flaw in the market, they ran for the exit, which caused the market to collapse.

What Action Should You Take?

One of the first things investors tend to want to do after a market correction is take action. Sometimes this is appropriate; other times it may not be. The first task is to determine the cause of the downturn. Today, the economy is demonstrating many favorable characteristics, such as low unemployment and benign inflation.

Market fundamentals are also positive. Since the last recession, companies have reduced debt, increased profits and improved their overall balance sheets. These are all clues that indicate the market itself is in good shape.

Therefore, a downturn could result from either disruptive news or simply the natural course of the market life cycle. Neither of these events is likely to be long term. As such, investors should check their emotions at the door and review their portfolio from a fundamental point of view.

Consider Your Risk

A diversified portfolio balances financial vehicles that carry more risk, like stocks, with others that carry less risk, such as annuities. The question is whether you should adjust your asset allocation to reduce your risk of loss.

Consider that an investor who is behind in his savings efforts may be willing to trade higher risks for greater rewards. On the other hand, an investor who has a more balanced allocation, such as 50 percent in stocks and the rest in more conservative assets, will likely experience less loss due to market volatility, but he may not be well positioned to meet his longer-term financial goals.

Stick to Your Plan

This is where working with a financial advisor is key. Having assessed an investor's objectives, timeline and tolerance for risk, an advisor should recommend a plan designed to meet those goals factoring in a variety of market conditions. It's safe to assume the market will always be changing, but an investor's plan for his or her money usually does not change very often, if at all. If the original asset allocation plan is sound, and a market correction is based on factors that are temporary or cyclical, sticking to the plan is often the best course of action.

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Portfolio Tips: Discuss With Your Advisor

In the event of a market downturn, there are steps you can take to help ride out the storm — whether you're caught in the middle of it or anticipate it on the horizon.

- To keep retirement savings on track, continue to invest automatically, even during periods of declining prices.
- Remember, investing when prices drop means new contributions will buy more shares.
- If you're not comfortable continuing to invest when prices are declining, consider using excess cash to pay down debt, as this will help reduce your liabilities while waiting for your assets to recover. Once they do, your overall net worth may well increase despite the market correction.
- Consider whether to rebalance your portfolio once the market has recovered.

"I will tell you how to become rich... Be fearful when others are greedy. Be greedy when others are fearful." - Warren Buffett [4]

Final Thoughts

Much like other aspects of financial planning, getting through a market correction is largely about sticking to fundamentals.

Try to avoid letting a market correction stoke your emotions. In the history of the securities markets, corrections are considered both normal and inevitable. In fact, they offer an opportunity to capitalize on low-priced investments.

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[1] Kimberly Amadeo. The Balance. Aug. 7, 2018. "Stock Market Corrections Versus Crashes And How to Protect Yourself." https://www.thebalance.com/stock-market-correction-3305863. Accessed Oct. 20, 2018.
[2] John Divine. U.S. News & World Report. Feb. 5, 2018. "3 Ways to Protect Yourself in a Stock Market Correction." https://money.usnews.com/investing/stock-market-news/articles/2018-02-05/stock-market-correction. Accessed Oct. 20, 2018.
[3] David Cogman and Alan Lau. McKinsey & Co. May 2016. "The 'tech bubble' puzzle." https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/the-tech-bubble-puzzle. Accessed Oct. 21, 2018.
[4] David Bakke. Investopedia. Nov. 30, 2016. "The Top 17 Investing Quotes of All Time." https://www.investopedia.com/financial-edge/0511/the-top-17-investing-quotes-of-all-time.aspx#ixzz5UU2IrnCi. Accessed Oct. 20, 2018.

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