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Rush Hour and Short Cuts: How to Navigate Market Corrections

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Would you rather be stuck in rush-hour traffic or rebalance your portfolio?

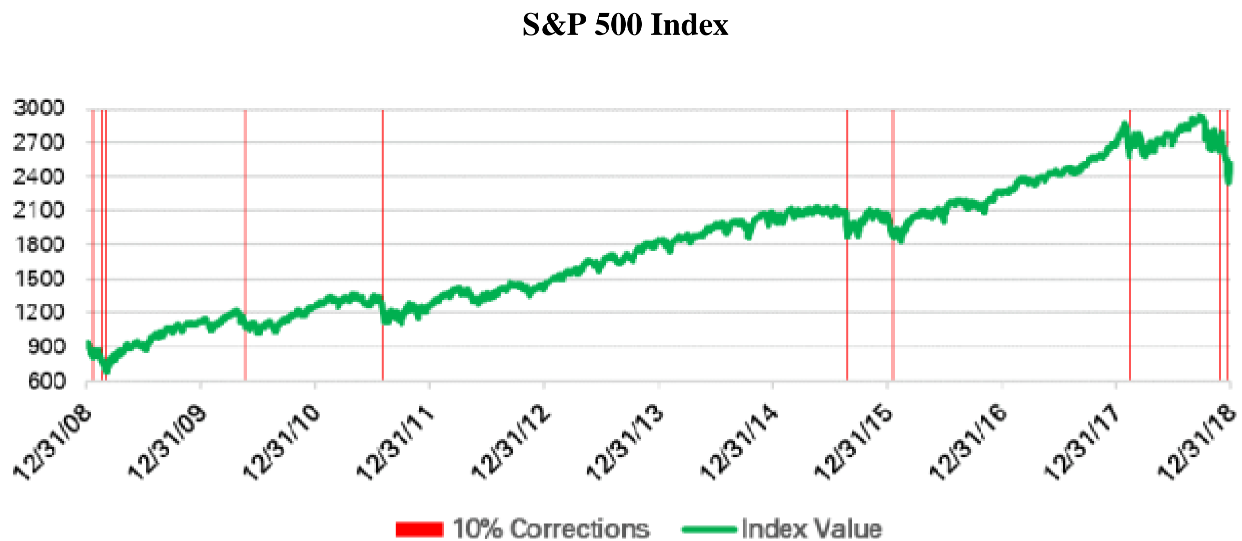
It's an odd question, no doubt. But odder still is the fact that 31% of investors would prefer to sit in gridlock than rebalance their portfolios.

Why is this response so disappointing? Because systematic rebalancing is one of the few opportunities for a nearly "free lunch" that the markets offer.

Year-end 2018 was a great time to rebalance. The US stock market declined 13% in the quarter, while international markets fell 11% — and 14% for the year. Rebalancing back into equities after such a significant decline gave investors an opportunity to buy at lower prices, which should lead to higher risk-adjusted returns over time.

Even though the fourth quarter correction in 2018 may seem significant, the reality is that corrections of this magnitude are surprisingly common. In just the last 10 years, there have been

10 instances when the S&P 500 fell at least 10% from a recent peak. An investor who was steadfast through these declines generated a 10.7% annual return, excluding dividends — a handsome reward indeed.



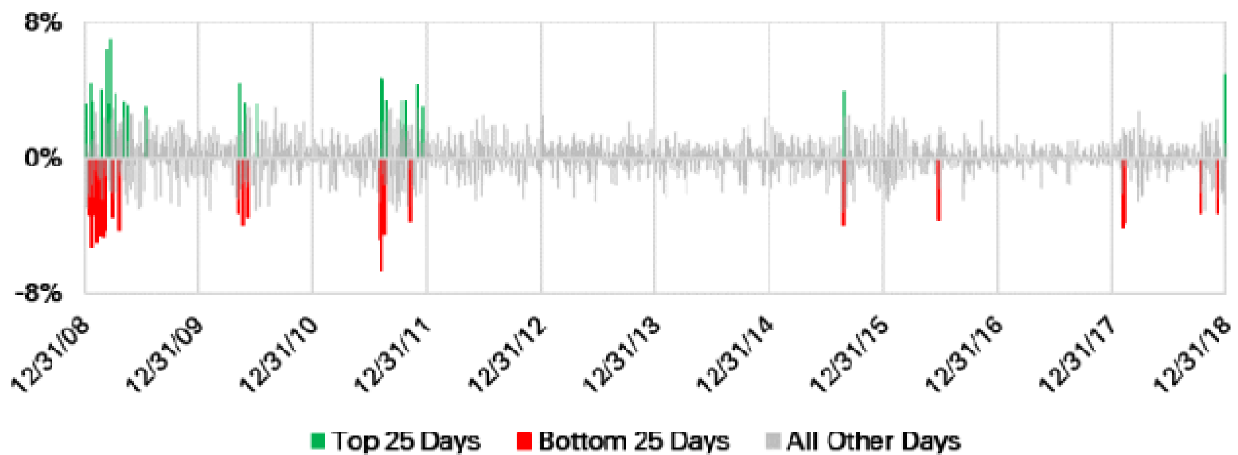
Source: High Pointe Capital Management

Even though holding steady through market ups and downs, save for periodic rebalancing to buy underperforming assets, makes intuitive sense, evidence shows that most investors actually do the opposite. They buy assets that recently outperformed and sell those that have disappointed. This reactive behavior costs them dearly. Geoffrey C. Friesen and Travis Sapp found that investors sabotage themselves to the tune of 1.56% per year by buying shares in mutual funds that outperformed in the past and selling shares of those that underperformed.

Why is it so hard to time the market? A look at the daily performance of the S&P 500 Index offers some clues. In the graph below, we highlight the 25 best performance days in green and the 25 worst in red. These were the days most likely to send naive investors into fits of euphoria or panic. Oddly, these best and worst days tend to cluster in narrow bands. What does that mean? Banner days are not far removed from dismal ones, and vice versa. So, an investor looking to time the market would have had to seesaw between optimism and pessimism over a short time frame.

We venture to guess that few such investors exist.

S&P 500 Daily Returns



Source: High Pointe Capital Management

In *Thinking, Fast and Slow*, Nobel laureate Daniel Kahneman explores how human beings make decisions and offers insights into why investors might make choices that are harmful to their portfolios. According to Kahneman, the human brain has two working models. The first, which he calls System 1 thinking, makes snap decisions based on intuition, short cuts, and emotion. System 2 thinking, by contrast, is slower and more analytical and logical. Market-timing decisions by naive investors tend to correspond to System 1 thinking.

Kahneman's framework can also explain why some quantitative investors have had better luck timing individual stocks rather than the broad market. Known as momentum investing, this form of timing requires detailed analysis of historical data — that's System 2 thinking rather than emotional or instinctual reactions.

There is one more point to be made about market declines like that experienced in the fourth quarter of 2018: Events of this kind are opportune times to harvest tax losses, especially those of the short-term variety, and thus ease the tax burden.

So, while 2018 was indeed a difficult year for investors all around, it also reaffirmed certain conventional principles of good investing: Have an asset allocation policy that doesn't keep you up at night, rebalance back to the target asset allocation after market declines, and be on the lookout for opportunities to harvest tax losses.

And the next time you're stuck in rush-hour traffic, tune out the "noise" about the daily ups and downs of the stock market and remember there are no short cuts in investing.

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