

Perspectives on Stock Market Corrections

Historically, stock market corrections of 10% or more are common during the first two years of new bull markets. Five of the last seven bull markets have experienced significant corrections as they have recovered from bear market lows. Despite such regularity, each correction manages to fray the nerves of even the most astute investors. The bull market correction of 2010 has been no exception.

By definition, bull markets originate from the lows of the bear markets that preceded them. The chart below details the market lows of the last five bear markets, the cumulative returns one and two years into each recovery, and the magnitude and length of each respective correction. From a practical standpoint, this analysis defines a correction as a decline of 10% or more, but less than the 20% typically associated with a bear market.

Historical Bull Market Corrections (% Price Return of the S&P 500)

Bear Market Bottom	% Return from Bottom After:		Corrections ≥ 10% Over Time Period	Length (# of days)
	1 Year	2 Years		
10/7/66	32.9%	41.7%	-9.9%	161
5/26/70	43.7%	59.7%	-13.9%	209
10/3/74	38.0%	67.0%	-13.6% -14.1%	29 63
8/12/82	58.3%	61.5%	-13.8%	288
10/9/02	33.7%	44.5%	-14.8%	104

Source: Investtools.com

In each case, the S&P 500 recovered handily off of the low, encountered a correction and ultimately moved higher as the bull market advanced. While each correction must be considered within its own economic and geopolitical context, the average correction has been a 13.4% decline with a range between 9.9% and 14.8%. On average, each ran its course within 142 days with the shortest lasting 29 days and the longest lasting 288 days. While the percentage declines have been within a fairly narrow range, the length in days has proven to be the larger variable. The period following the 1974 low was

particularly interesting as two sharp corrections of 13.6% and 14.8% occurred within nine months of each other. The lows of 1990 and 1987 are excluded, as their subsequent upswings did not experience interruptions large enough to be considered corrections.

With this historical precedent, why do investors panic in the face of such a regular occurrence? The primary reason is bull market corrections usually come within a year or two of the previous bear market trough. Such proximity triggers a number of psychological factors that threaten long-term goals. The field of behavioral finance formally addresses these factors:

Myopic loss aversion is the tendency for investors to shy away from stocks after a decline.¹ Investors focus only on the recent past and can make drastic decisions based on too short a time horizon. Corrections are relatively short-term phenomena and becoming myopic during one can be disastrous.

Frame dependence explains that decisions are often made according to the framework within which information is received.² For instance, when the market is going up investors are willing to take more risk, and when the market is going down the appetite for risk decreases. Risk tolerance should be based on long-term objectives because it affects asset allocation. After a correction or bear market, many feel a conservative asset allocation is warranted without realizing that an adjustment may jeopardize long-term goals.

Regret is the pain associated with not making the right decision.³ It is easy to regret not taking some action during a bear market that may (or may not) have avoided some of the loss. A correction naturally stokes this emotion and encourages action for action's sake, which is usually counterproductive.

These psychological factors (and others) have been present in one form or another during or after each of the previously discussed market corrections. 2010 has been no different as human psychology and stock market corrections tend to be relative constants. Noting these factors and not letting them influence decisions during future corrections are critical for long term success.

As 2010 began, we were expecting a pullback of some degree or another given these historical figures. Like many previous corrections, this one arrived just as investors were getting comfortable again with the stock market after a difficult bear market. What could have been a milder correction was exacerbated by the Eurozone's debt woes, which were not entirely surprising. In our 2nd quarter 2009 commentary, we examined the level of U.S. federal debt after a dizzying array of bailouts and stimulus packages. Then, in our 1st quarter 2010 commentary, we compared the U.S.'s debt position to Japan, the U.K. and the Eurozone - all of which were registering uncomfortable levels of debt to GDP. We acknowledged that sovereign (or government) debt was not a U.S.-centric issue, but a global one. This was painfully obvious by April of this year. As the correction unfolded, we made the strategic decision to stay the course. Experience has taught us that micro-managing short-term market swings is rarely successful.

How has the correction of 2010 stacked up to the past? One year off the bear market bottom of March 2009, the S&P 500 returned 68.6%. This was similar to the 58.3% return off of the 1982 low and somewhat stronger than historical norms. This year's correction has resulted in a 16.0% decline over 70 days from the April 23rd high to the July 2nd low. The decline has been slightly larger than the average historical correction, but not wildly outside the tracks. While it is too early to be certain this correction has run its course, it will likely be remembered as a correction in the context of a larger bull market rather than the beginning of a prolonged decline.

Moving forward, we expect the markets to remain volatile in the short-term as sovereign nations grapple with heavy debt loads and global economies continue to regain their footing. We remain optimistic as we look ahead and anticipate higher valuation levels over the not too distant future. As always, we continue to assess and reassess our current holdings and search for new opportunities to keep our clients properly positioned for the environment we see ahead.

As previously announced, we have moved offices. Our new location is approximately half a mile west of our previous address. Below is a picture of our new building, which was built in 1922. If you are in the neighborhood, feel free to drop by for a visit!



DARRELL & KING
INVESTMENT COUNSEL, LLC

410 White Gables Lane • Charlottesville, Virginia 22903
434-977-7010 PHONE • 434-977-6313 FAX • www.darrellandking.com

Endnotes:

¹*Beyond Greed and Fear: Understanding Behavioral Finance and the Psychology of Investing*, by Hersch Shefrin, Oxford University Press, 2002.

² Ibid

³ Ibid