Laurentian Bank Securities
ECONOMIC RESEARCH AND STRATEGY

Should you withdraw from the market after October's contraction?

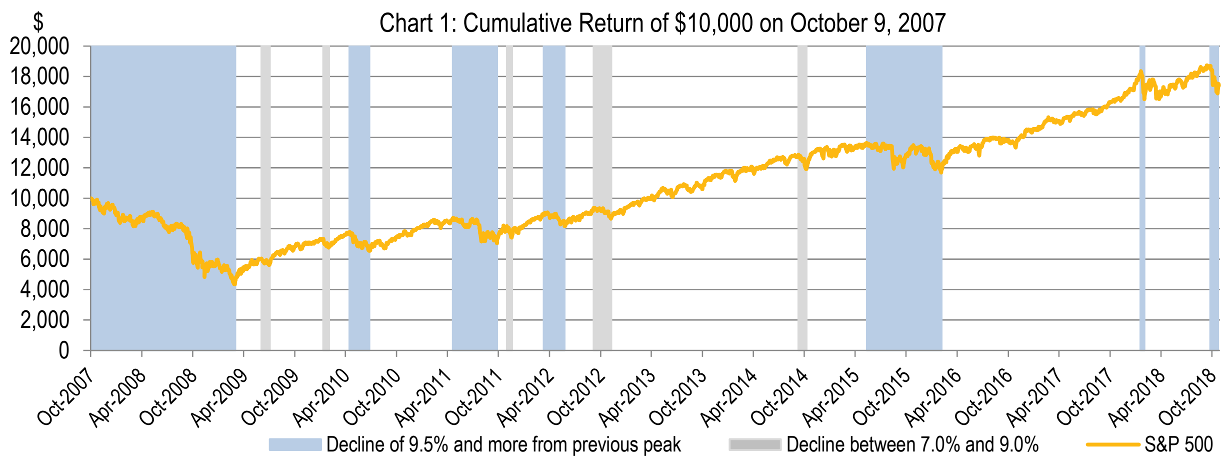
After the upset in the financial markets in October, many investors are wondering, with reason, whether it is time to cash in their chips and claim the gains they have accrued in the last few years. No one likes facing the loss of their hard-earned savings. And with just about twice as much volatility in 2018 as in 2017, not to mention current geopolitical tensions, it is getting harder and harder to see the future in a positive light. But at the risk of sounding like a Pollyanna, and bearing in mind the stark uncertainty about financial and economic prospects, it is important to remember a few statistics. In brief, (1) it is more profitable to remain invested for the long term and (2) market contractions and corrections are generally good entry points.

The benefit of staying invested for the long term

Imagine an independent investor who invested $10,000 on October 9, 2007, possibly one the worst times in the last 20 years to buy into the financial markets, because it was the peak of the US stock market before the Great Recession of 2008-2009: $10,000 invested in the S&P 500 composite index on that date would hypothetically have lost 57% of its value, dropping to $4,322 by the nadir on March 9, 2009, in the middle of a severe recession. After this kind of fiasco, it might seem wise to salvage what you can and cash out. But when is the best time to leave the market and when is the best time to return? "Market timing" is so notoriously difficult, is it worth the effort?

If this investor had decided to remain invested for the entire subsequent period – that is, for just over nine years – the return on their investment *since October 9, 2007,* would have been 75%, and the value of the original $10,000 would have been $17,496 at the close of the markets on November 5, 2018 (see Chart 1). That is equal to an annualized return of 5%, despite the financial crisis of 2008-2009. Furthermore, this yield only considers the increase in market value of the equity. If we add in reinvested dividends, the total return on the investment amounts to 122% (7% annualized).

Chart 1: Cumulative Return of $10,000 on October 9, 2007



Sources: Thomson Reuters and LBS Economic Research and Strategy.

Market contractions are common and offer good investment opportunities

On the other hand, exiting the market completely after a correction may be a losing strategy. In fact, the most profitable strategy in our simplified example would have been to invest *after* the long market pullback from 2008 to 2009. The S&P 500 composite index delivered a cumulative return of 305% from its lowest level, on March 9, 2009, to this November 5. That is an impressive annualized return of 15% (17% including dividends).

Staying in the market despite corrections and taking advantage of them to increase your exposure to stock markets is definitely an investment strategy that yields an attractive return. One of its advantages is that contractions occur more frequently than you might think. For example, since the peak on October 7, 2007, we have experienced no fewer than seven contractions of 9.5% or more on the S&P 500, including the one in October 2018 (blue bars in Chart 1). Add to those five contractions of between 7.0% and 9.0% (grey bars in Chart 1).

The return on a hypothetical investment of $1,000 after each of these pullbacks has always been high, despite subsequent market setbacks. For example, investing on July 2, 2010, following a 16% drop that began in April 2010, would have generated an annualized return of 12.0%. Even the long 14.2% contraction between May 2015 and February 2016 would have offered an annualized return of 15.1% to those who took advantage of the market's low point (see Table 1). Since 2009, this strategy has actually offered an average annualized return of 12.2%, again, not including returns associated with dividends.

Table 1: Reinvesting following a contraction is lucrative

Trough Date	Total Return (%)	Annualized Return (%)	Value today of $1,000
March 9, 2009	302.5	14.9	4,025
July 10, 2009	209.7	12.4	3,097
July 2, 2010	166.3	12.0	2,663
October 10, 2011	127.9	11.8	2,477
June 1, 2012	113.1	12.0	2,131
February 11, 2016	48.9	15.1	1,489
February 8, 2018	5.5	7.3	1,055
Average		12.2	

Sources: Thomson Reuters and LBS Economic Research and Strategy.

The importance of a balanced portfolio

Finally, we should mention that in a balanced portfolio, the impact of corrections on the stock market is proportional to the percentage held in shares. Most of the time, when the market adjusts (even though this did not happen during the last correction), bonds offer positive returns stemming from a decrease in interest rates, partly offsetting market losses. Finally, geographic diversification also usually reduces losses. For example, stock market corrections are often accompanied by an increase in the value of the US dollar, which serves as a safe-haven currency for investors looking to avoid risk. If the portfolio is partly comprised of stocks and bonds on US markets, the appreciation of the US dollar will absorb part of its losses.

Conclusion

Of course, our reinvestment scenario relies on the (admittedly unrealistic) assumption that it is possible to consistently identify when the markets hit bottom after each decline, but the advice would be the same even if we could not manage to identify these low ebbs in the market: investing when markets are down usually delivers very interesting returns in the longer term. So, should you get out of the market after a correction? Not if you have your sights set on the long term. In general, it is even more beneficial to increase your exposure. And, if you have a balanced portfolio that relies on asset diversification, the vagaries of the stock markets should be more tolerable and should encourage holding investments for the long term.

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