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Investment Insight – Potential Strategies during a Market Correction (Or Not)

"There will be recessions and there will be stock market declines. If you don't understand that's going to happen, then you're not ready and you won't do well in the markets"
-- Peter Lynch

There's no escaping the fact that we are in the midst of a market correction and the average stock is well off its highs. CNN's Fear and Greed Indicator[1], which measures investor sentiment, is hovering at extreme fear levels and the latest headlines are nerve racking for many investors. During such emotional times, it is easy to lose the objective perspective necessary to be successful over the long-term. Whatever ends up happening, many investors are wondering if they should stay put or take action. The reality is that whether investors choose to do something or not during the inevitable corrective phases of the stock market is likely to have a big impact on their future wealth. Below are some thoughts to consider.

Don't just do something, sit there

"The Stock Market is designed to transfer money from the Active to the Patient."
- Warren Buffett

During periods of heightened volatility, investors often feel an overpowering urge to be doing something. But is that really the best course of action? There have been numerous studies that show that activity and returns are inversely correlated for most investors. In other words, patient investors tend to outperform their impatient peers. We recently read about an illuminating finding by the large fund management company Fidelity that really drives this point home[2].

Fidelity has a massive number of retail clients around the world and therefore a good window on both investor behaviour and their long-term returns. The firm wanted to find out what sub-groups of its client base substantially outperformed the rest. What did their findings show? *Clients who forgot they had a Fidelity account outperformed all the rest of the subgroups.* By definition they had done precisely nothing and stayed the course. Their accounts had gained the greatest wealth. They avoided the self-defeating fate of many investors – buying high and selling low.

The huge temptation to sell this and trim that can be overwhelming as the hype around the latest scary headline reaches a fevered pitch. But more often than not, the most intelligent and rational decision is to simply do nothing during a market correction.

Don't just sit there, do something

"Mr. Market is kind of a drunken psycho. Some days he gets very enthused, some days he gets very depressed. And when he get really enthused... you sell to him, and if he gets depressed, you buy from him. There's no moral taint attached to that."
- Warren Buffett

Of course, that does not mean that *doing nothing* is the best strategy. It simply protects investors from emotional trading which tends to be counterproductive. For investors who are able to insulate themselves from the highly contagious psychology that swirls around the stock market, have a contrarian bent and the ability to make and act on sound business judgements in times of distress, *value can be added by doing something*.

Investors should keep in mind that a company's *intrinsic value* is set by its cash flows from existing assets, future growth and risk profile. On the other hand, *stock prices* are driven by market moods and momentum. Stock prices tend to fluctuate far more widely than underlying asset values which provides opportunities, because eventually underlying value and price *converge*. Corrections often represent a good opportunity for investors to either upgrade their portfolios and/or put money to work in better valued long-term opportunities. As a general and admittedly oversimplified guide, we list our best-to-worst potential *do something* alternatives during periodic corrections below.

- **Buy "Compounders"** – Buy the fast growing, high quality companies that you have always wanted to own and are run by strong operators and have favourable long-term prospects. These types of companies are responsible for the vast majority of the market's long term returns and occasionally get sold off in market corrections indiscriminately. While such Compounders rarely look *statistically cheap* during a correction, relative to lower quality companies, these companies still often trade at a substantial discount to their intrinsic value after consideration of their superior business models, leadership teams and growth prospects. In other words, such stocks can be *qualitatively cheap*. Buying such companies allows investors to potentially "double dip". Once on the gain as the stock price returns to a more sensible valuation and a second time as the underlying business value keeps compounding thereafter and the stock price follows along higher for the ride. *"We've really made the money out of high quality businesses. In some cases, we bought the whole business. And in some cases, we just bought a big block of stock. But when you analyze what happened, the big money's been made in the high quality businesses. And most of the other people who've made a lot of money have done so in high quality businesses." - Charlie Munger*.
- **Buy "Close the Discount" stocks** – Consider investing in average quality companies with share prices suffering from a negative short term event, offering a further discount due to the correction. Big gains can be had, particularly with cyclical stocks when bought during periods of extreme sector challenges. This provides investors with an opportunity to "single dip" as the valuation returns to more normal conditions in the future. However, once the correction is over and the stock has recovered, do not be tempted to hold on to them. They will not keep growing like Compounders and many such stocks will experience recurring round trips if held for the long term.
- **Buy steady blue chip stocks** – Often considered a relative safe haven during corrections, a decision to buy blue chip stocks is more about the psychology of safety than an analysis of the long-term business fundamentals. There's no doubt that many blue chip companies are high quality investments, but they tend to already dominate their respective industries and therefore have limited ability to grow. In other words, most of today's blue chips were yesterday's fast growing "Compounders", but are too mature today to grow fast. In addition, these well-known stocks are covered by an army of highly intelligent and motivated analysts, which usually limits potential opportunities for major mispricing. Extraordinary corrections and extreme panic like the 2008/2009 period are usually needed to push prices of blue chip stocks down to truly bargain levels. In other words, upside from valuation changes tends to be more modest and so is future compounding ability. Still, we believe buying blue chip stocks during a correction is better than the final alternative.

- **Raise cash** – Unfortunately, many people use (misuse?) a correction to sell stocks in order to raise cash. If a stock is overvalued, then selling makes sense. However, raising cash often occurs because investors belatedly realize that they do not have the stomach to handle the volatility that comes with owning stocks. The wrong time to realize this is during a correction because selling stocks to raise cash is quite often the equivalent of buying high and selling low. Alternatively, some investors may be fearful, extrapolate future prospects from today's unsettling headlines and feel the urge to sell to avoid further potential short term losses. Still others sell during a correction in hopes of buying back in at a lower price. Yet, very few actually do so. We believe investors should only own what allows them to emotionally withstand a temporary decline in stock price. Of course most investors understand that being invested in normal times or when the outlook is rosy and then cashing out during periodic corrections is a poor way to build wealth. Yet, when panic strikes and stock prices plunge, emotional trading can quickly unravel sensible long-term wealth building plans that were put in place when market conditions were calmer.

A final thought on stock market fluctuations

Warren Buffett and his business partner Charlie Munger believe that the passage of time is the friend of the investor and impatience is the enemy. When asked during a market decline about whether he was worried about a recent big drop in the stock price of Berkshire Hathaway, without hesitating Munger said: *"Zero. This is the third time Warren and I have seen our holdings in Berkshire Hathaway go down, top tick to bottom tick, by 50%. I think it's in the nature of long term shareholding of the normal vicissitudes, of worldly outcomes, of markets that the long-term holder has his quoted value of his stocks go down by say 50%. In fact you can argue that if you're not willing to react with equanimity to a market price decline of 50% two or three times a century you're not fit to be a common shareholder and you deserve the mediocre result you're going to get compared to the people who do have the temperament, who can be more philosophical about these market fluctuations."*

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1 http://money.cnn.com/data/fear-and-greed/

2 http://www.businessinsider.com/forgetful-investors-performed-best-2014-9