Understanding market downturns

For prepared investors, market downturns can represent great opportunity

Nearly everywhere you turn, from friends and colleagues to cable news shows, you can find someone with a strong opinion about the financial markets. People will often use specific terms such as correction or bear market to render judgments about the direction of markets, especially when market performance is choppy or trending down.

Is it worth getting concerned when markets stop or even reverse their upward advance?

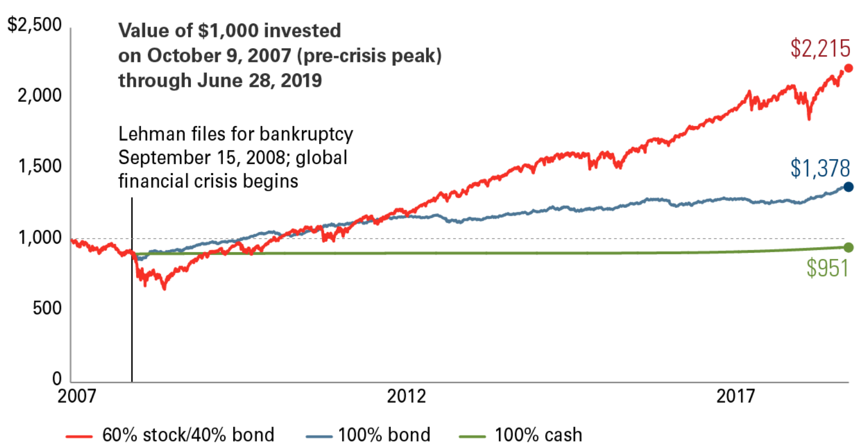
To answer that, it's important to realize that downturns are not rare events: Typical investors, in all markets, endure many of them during their lifetimes.

Even knowing this, it can be unsettling to witness the decline of your portfolio during one of these events. After all, that account balance is more than a number—it represents very important personal goals, such as the ability to retire comfortably or to provide a quality education for family members. When market conditions place those goals in jeopardy, you may feel compelled to do something, such as sell most or all of your investments. You may assume that converting to cash will give you a better long-term result than staying invested.

But such action would shut you out of the strong recoveries that have historically followed market downturns. The answer is to come up with a game plan before the next market pullback, so you're well-positioned to try to take advantage of the opportunities that follow. What's more, you'll probably know what to expect as markets cycle through their phases, so you can tune out messages that don't help your strategy.

It's worth noting that not all financial declines are the same in length or severity—for example, historically speaking, the global financial crisis and Great Recession of 2008–2009 was an extreme anomaly. As challenging as that event was, it was followed by the longest stock market recovery in U.S. history.[1]

Riding out a rough period



Since 1980 there have been:

12 Corrections
Declines of 10% or more

8 Bear markets
Declines of 20% or more, at least two months long

5 Recessions
Declines in economic conditions for two or more successive quarters (refers to declines in the broad economy rather than the financial markets, though the two can be linked).

Source: Vanguard.

Sources: Vanguard calculations, using data from FactSet. All data as of June 28, 2019.

Notes: This is a hypothetical illustration. Balanced portfolio is represented by 60% S&P 500 Index and 40% Bloomberg Barclays U.S. Aggregate Bond Index; bonds are represented by Bloomberg Barclays U.S. Aggregate Bond Index; and cash is represented by Bloomberg Barclays U.S. 3-Month Treasury Bellwether Index.
Past performance is no guarantee of future results. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

1 Lu Wang, "The Bull Market Almost No One Saw Coming," Bloomberg Businessweek, December 15, 2019, https://www.bloomberg.com/news/articles/2019-12-15/the-bull-market-almost-no-one-saw-coming, accessed on December 19, 2019.

Best defense: Making a plan and sticking to it

We can develop a plan now that prepares you and your portfolio for financial system shocks, whenever they happen to occur. That means focusing on the factors of your investing strategy we can control (including things such as asset allocation and costs) and not worrying about those things out of our control, such as downturns in the markets and economy.

In the meantime, remember that bearish market conditions—while inevitable—don't last forever. As a savvy investor, you can ignore short-term pullbacks of the market (and any commentary that might cause you to veer off course) and remain committed to achieving your long-term vision.

Downturns come and go. The results of a well-designed and faithfully followed plan, on the other hand, can serve you the rest of your life.

In coming up with the best plan for you, it is helpful for you to think about the following:

- How do you feel about risk? Are you OK with a greater amount of up-and-down movement in your portfolio if it means potentially higher returns? Or, alternatively, would you rather have more stability in your portfolio even if it means forgoing higher returns?
- Where are you along your investing journey? Depending on how close you are to retirement or other financial goals, we can adjust your portfolio's risk profile to a level appropriate for your personal risk-comfort level and investing objectives.

Notes: All investing is subject to risk, including the possible loss of the money you invest.

Mid and small-capitalization stocks historically have been more volatile than large-cap stocks.

Investments in bonds are subject to credit, interest rate, and inflation risk. High-yield bonds present higher credit risk than other types of bonds.

Be aware that fluctuations in the financial markets and other factors may cause declines in the value of your account. There is no guarantee that any particular asset allocation or mix of funds will meet your investment objectives or provide you with a given level of income.

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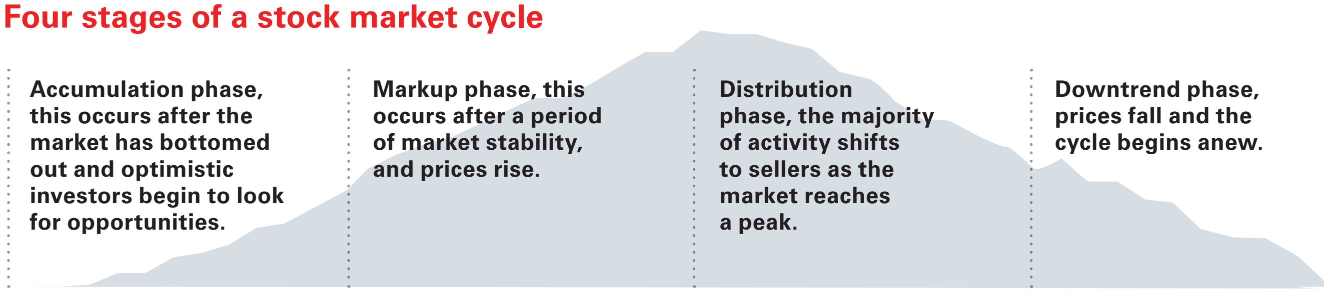
Remember: Recoveries have rewarded patience

If you've ever taken an economics course, you might remember this basic principle: Economies and financial markets, such as the stock and bond markets, move in cycles. That is, you can count on markets to experience lows, when prices fall, and peaks, when prices reach their highest. While no one has perfected the science of knowing exactly when those lows and highs will occur, you know the financial markets (and most global economies) will eventually come back around.

Four stages of a stock market cycle



Source: Vanguard.

This underscores the importance of maintaining a diversified, properly balanced portfolio (versus a highly concentrated, nondiversified one), which can more effectively withstand the shock of a market downturn. Perhaps more important, the inevitability of market cycles illustrates why reactive selling amid a downturn is harmful in the long run.

Taking the long view

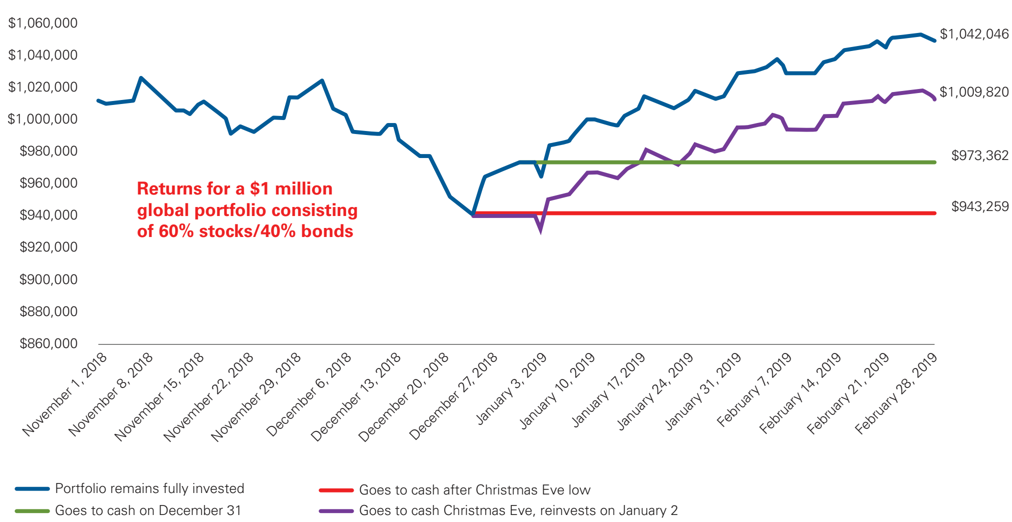
When the financial markets are in turmoil and account balances start to fall, there can be a strong temptation to ask your financial advisor to "do something" to stem any perceived losses. Yet it is often the case that staying the course—or doing nothing—proves to be the better path.

Here is one recent example: A hypothetical 60% stock/40% bond portfolio that stood at $1 million on the morning of November 1, 2018, would have lost 5.7% of its value by Christmas Eve. Yet selling the portfolio at that time and fleeing the markets, even if briefly, would have cost an investor tens of thousands of dollars in two months, versus the alternative of staying invested.

When faced with a similar situation, consider how you might feel if markets rebounded and you could have recouped all your money, and more. That's why it's best to stick to the long-term plan you and your advisor have built. Any changes should be made because of changes in your life, not changes in the markets. If you have questions about making portfolio moves, remember to talk to your financial advisor before acting.

Staying the course can pay off; abandoning course can be costly

The global stock market drop in late 2018 offered a lesson in investor behavior



Sources: Vanguard calculations, based on data from FactSet, as of February 28, 2019.

Notes: U.S. stocks represented by CRSP US Total Market Index. U.S. bonds represented by Bloomberg Barclays U.S. Aggregate Float Adjusted Index. Global stocks represented by FTSE Global All Cap ex US Index. Global bonds represented by Bloomberg Barclays Global Aggregate ex-USD Float Adjusted RIC Capped Index.
The performance of an index is not an exact representation of any particular investment, as you cannot directly invest in an index.

Make successful investing easy—make a plan

Just as you buy a health insurance plan to cover you and your family against sickness and injury, it's smart to create a contingency plan for your portfolio for when the markets slide.

With a plan in place, it's easier to tune out the noise that seems to amplify itself during times of financial stress (for instance, the one-size-fits-all advice of stock-picking gurus on financial news programs). Think of a plan as being like a suit of armor against impulsive decisions that could threaten your goals. A plan can be as simple as riding out any market downturns, without making any changes. It might call for selling certain depreciated assets in order to rebalance your portfolio in a tax-advantaged manner. Or perhaps it involves adjusting your asset allocation at regular intervals, so you experience less volatility and less disruption to your income if you're retired and drawing down your investment.

You and your advisor can figure out together what type of proactive plan may work the best in your circumstances. Market downturns—or even just the thought of them—can cause lots of concern. And they certainly can make an ugly dent in the portfolio you worked so hard to build. The good news is with patience and a little planning, you can breathe easier knowing that better market conditions will eventually reappear.

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Smart things to do (that many won't) in a down market

One of the most unsettling aspects of market downturns is the fact they are out of your control.

Markets move based on numerous variables that no one person can meaningfully control or even fully monitor. And when stock prices falter, the resulting steady drumbeat of negative news reports can drive many people to flee the markets out of fear (and miss out on potential gains as financial markets regain their strength). But when others are pessimistic, you can reframe the situation as one of opportunity. Namely, you have the power to follow these suggested actions—which historically have resulted in success weathering market lows.

Tune out the noise

It's OK to not check your portfolio balance when the market is falling. Turning off the financial news might be smart if it keeps you from making mistakes based on emotional decisions.

Revisit your asset allocation

If you happen to be near retirement or in retirement, or if you simply lose sleep over downturns, you may need to reevaluate your risk tolerance. Your financial advisor can help you figure out the balance of stocks and bonds best suited to your comfort level with risk and other personal circumstances.

Control what you can: Costs

Expenses eat returns, and their bite is particularly painful during market corrections. An advisor can explain options for removing high-cost investments from your portfolio in ways that minimize the taxes due from their sale.

Set realistic expectations

U.S. stock and bond markets have posted remarkable returns in the past few decades. Statistically speaking, it would be prudent to expect lower returns in the future. Your advisor can work with you to develop a plan that still achieves your goals despite potential headwinds of lower returns.

Stay diversified

Downturns offer case studies in how different asset-class and sector exposures can help to insulate your portfolio. Speaking with your advisor about risk tolerance, as mentioned above, helps him or her to better understand your investing style and what's most important to you. With this greater insight, your advisor can suggest diversification options for your portfolio that blunt the impact of downturns while putting you on track to achieve your financial objectives.

All investing is subject to risk, including the possible loss of the money you invest.

Diversification does not ensure a profit or protect against a loss. Be aware that fluctuations in the financial markets and other factors may cause declines in the value of your account. There is no guarantee that any particular asset allocation or mix of funds will meet your investment objectives or provide you with a given level of income.

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