Picking Your Battles

Seeking Protection Against Bears Instead of Corrections

Micah Wakefield, CAIA® | April 12, 2018 | Swan Blog

Recent global equity market sell-offs, like those seen in the first quarters of both 2016 and 2018, justifiably generate media attention and investor concern. But they also present an opportunity to evaluate risk.

While market drawdowns are inevitable and necessary for healthy markets, investors don't exactly jump for joy when one occurs. It's important, however, for investors to remember the differences between the two types of market downturns, corrections and bear markets, because in an industry too often focused on short term returns, corrections can cause short-sighted reactions that negatively impact long-term plans.

This post defines and compares the nature of corrections and bear markets, analyzes their impacts on investors, and considers which type of downturn is more important to seek protection against.

From Complacency to Panic

Prolonged bull markets with periods of low volatility can create risk complacency and even risk amnesia. Any subsequent market correction and/or spike in volatility often shakes investors out of their state of complacency and ignites fear of what they may have temporarily forgotten—markets can and will go down.

Because loss aversion is such a strong emotional driver, it is typical for many investors to transition quickly into a state of panic. Media coverage of market turmoil or daily losses for major indices can compound investor anxiety and drive nervous calls to advisors.

Corrections versus Bear Markets

Investing opens investors up to the possibility of losses—but mathematically speaking, not all losses are equal. Understanding the different kinds of losses between a correction and bear market may help investors better handle or prepare for them.

- Corrections come and go, with market losses and recoveries occurring within the span of weeks or months. As such, corrections are generally speaking a blip on the investment journey.
- Bear markets cause more significant losses that take much more recovery time. Unfortunately bear markets can be plan-altering and life-changing, both financially and emotionally, if portfolios and investors are unprepared.

In the past 20 years, the S&P 500 Index has experienced five corrections (not including the corrections occurring as part of the bear markets) and two bear markets.

Corrections are often defined as losses in market value exceeding 10% but less than 20% and happen from a market high*. Corrections have historically lasted from between a few weeks to a few months.

*Because the drawdown in 2011 did not happen from a market high, it is not included in our correction analysis.

Table A: Corrections in S&P 500 Total Return Index Over the Last 20 Years: 1998 - 2018

Start Date	End Date	Max Drawdown	Length of Fall	Length of Recovery
7/17/1998	11/23/1998	-19%	1.53 months	2.83 months
7/16/1999	11/16/1999	-12%	3.07 months	1.1 months
3/24/2000	9/1/2000	-11%	22 days	4.7 months
7/20/2015	4/18/2016	-13%	6.9 months	2.26 months
1/26/2018*	---	-10%	14 days	---

Source: Yahoo Finance, S&P 500 Total Return Index. *The recovery of this correction is still ongoing at the time of this posting.

Bear markets are defined as losses in market value of 20% or more and have historically lasted several months to several years. The losses experienced in bear markets are more intense and require longer recovery periods on average than corrections, as shown below.

Table B: Bear Markets in S&P 500 Total Return Index Over the Last 20 Years: 1998 – 2018

Start Date	End Date	Max Drawdown	Length of Fall	Length of Recovery
9/1/2000	10/23/2006	-47%	2.14 years	4.1 years
10/9/2007	4/2/2012	-55%	1.44 years	3.11 years

Source: Yahoo Finance, S&P 500 Total Return Index

Speed

The speed of the drawdown refers to how fast, measured in days, the markets fall from peak to trough. Over the past twenty years, the speed of the fall for corrections can be measured in a matter of days to a few months, while the bear markets took much longer, generally extending over a year.

While faster drawdowns impact emotions and media response, what is more important to investor outcomes is the magnitude or intensity of the drawdown and the length of the recovery.

Speed of Drawdown, 1998 – 2018

Source: Yahoo Finance, S&P 500 Total Return Index

Intensity

The intensity of the drawdown measures how much market value was lost. As defined earlier, corrections are market losses of between -10% and -19%. Over the last twenty years, the most intense correction delivered a 19% drawdown and the least intense corrections created a market value loss of about 12-13%. By comparison, the magnitude or intensity of losses during bear markets are often more difficult for investors to stomach. Although a bear market is defined as losses in value of more than 20%, the two in the past 20 years were more than -47%, more than double the losses caused by corrections. The intensity and effects of a bear market are unmatched, especially when we consider time of recovery.

Recovery

Recovery time refers to how long it takes for the market to recoup its losses and return to pre-fall levels. Mathematically speaking, the larger the loss, the larger the gain needed to recover. So if market corrections cause smaller losses by definition, one could reason they would require less recovery time.

It is important to note here, that recovery time depends on the intensity of the drawdown and the nature of the market after the drawdown ends and recovery begins, so recovery times are not always in direct correlation to the drawdown intensity.

The -13% drawdown of the 2015-2016 correction took about two months to recover while the -19% correction in 1998 took only about three months. The -11% drop in 2000, though, took almost five months to recover.

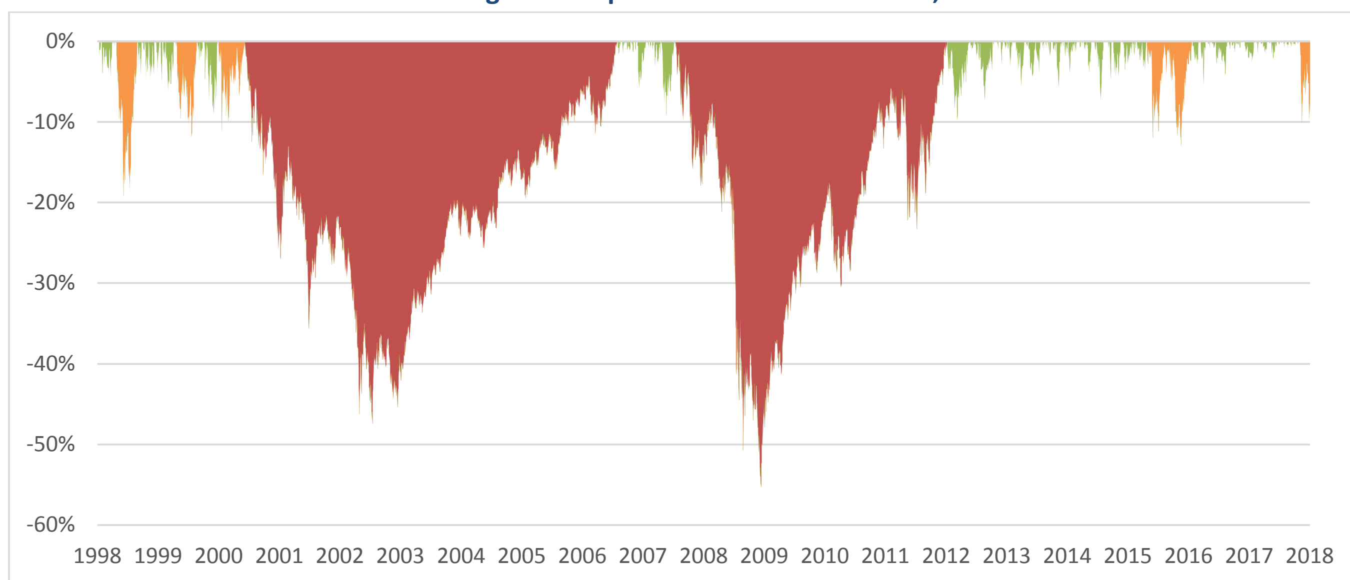
Despite the discrepancy between corrections' drawdowns and recovery times over the last 20 years, they all took less than half a year to recover. The recovery for the bear markets, however, required years of recovery time.

Duration

The duration of a drawdown includes the total length of time the market took to fall from a peak to the trough and the length of time to recover the losses back to the pre-drawdown level.

The graph below shows the depth and duration of losses of the corrections and bear markets.

Measuring Pain: Depth and Duration of Losses, 1998 - 2018



Source: Yahoo Finance, S&P 500 Total Return Index

The bear market during the Dot-com Bust of 2000-2002 may have created a smaller drawdown than the bear market during the Financial Crisis of 2008-09, but its duration was much longer.

Generally speaking, corrections take less time overall to fall and recover. Tables A and B above show average duration of corrections can be less than a year while bear markets can go beyond four years.

If on average it takes less than a year for investors to move on from a correction, are they worth all the fuss?

In contrast, a bear market generally takes years before recovery is realized—and sometimes longer for the investor to mentally and emotionally recover. That sort of recovery time can seriously wreck a long-term investment plan or delay goals like retirement start dates or college education funding.

Corrections: Practice Runs for Risk Management

Corrections may happen more often, but on average, they tend to be less intense and shorter in duration. *Generally, they do not derail investors from their financial goals.*

Bear markets, on the other hand, are much more disruptive for people hoping to achieve their goals, resulting in major losses that take years to recover from. For those near or in the retirement phase, these losses can be detrimental.

Corrections are often a wake-up call for investors to consider managing risk. But if investors and their portfolios are unable to withstand a 10% correction, are they prepared for the possibility of an actual bear market?

With the recent panic surrounding the February 2018 correction, it seems many may not be adequately prepared.

Don't Panic—Prepare

The current market and volatility regime we're in now suggests more uncomfortable downward moves may be ahead, which may make it harder for investors to hold on to a "buy-and-hold" strategy.

It's our philosophy to hedge market risk directly in order to limit losses during bear markets and help investors remain invested and on track with their investment goals. We understand you can't invest in risk assets and simultaneously protect against both smaller, short-term losses (corrections) and larger, longer-term losses (bear markets) and given the difference in the nature and impacts of corrections versus bear markets, we've chosen to seek protection from the latter. We believe in managing against potentially life-altering losses to portfolios rather than seeking protection from what are often bumps on the investment journey.

About the Author

Micah Wakefield, CAIA®, Director of Research and Product Development, helps oversee and review the core equity holdings for the strategies and assists with daily risk assessment and position review. He also leads research and development of strategies and products at Swan leveraging an extensive track record in portfolio management, trading, analysis, and business management.

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