Coronavirus Update: Putting the Volatility in Context

Such a sharp decline in the market as we have seen over the last several weeks proves, as one commentator put it, why IQ will only get you so far in investing. During times of panic, investing is more about temperament and psychology than it is about intellect. You need to be able to stay calm and not react when everyone is suddenly assuming that the worst-case scenario.

There is a particular phenomenon that describes what happens -- it's called "myopic loss aversion". This is the tendency to feel a much larger negative emotional response to a loss than the positive response we have to a gain of the same size. The market rises 20% and it is business as usual, but a 20% drop and anxiety and panic reach near-Apocalyptic levels. This is irrational, but it is just the way we are wired, and probably it has been beneficial for the survival of our species. But it makes being an investor particularly challenging.

What made the recent drawdown troubling was mainly its speed. A 20% drop is considered a "bear market," and the typical bear market develops over a period of around 150-250 days. In the recent sell-off from peak to trough the market fell nearly 20% in just 19 sessions.

But to keep this in perspective, this decline came on the back of an extremely strong year and the longest bull market in history. The S&P 500 returned close to 300% from the depths of the financial crisis in 2009 through 2019.

Another important point for context is to compare the current situation to the 2008 crisis. For many investors, Monday's 7% drop hearkened back to the dark days of the 2008-2009, but there are some important differences. In 2008 there was not just a bear market and a recession but a financial crisis. The decline in real estate prices caused a chain of events that rippled through the financial markets and triggered the collapse of a web of complex financial instruments that had become part of the foundation holding up the U.S. banking system. The system broke, and only a series of costly government interventions put everything back together again.

What makes the current sell-off different is the fairly straightforward explanation and the lack, so far, of breakdowns in the market structure. It has been a relatively orderly sell-off, and the system remains intact.

The coronavirus is still spreading in the U.S., though signs of containment in China and South Korea are promising. It is likely that we will not know the outcome of the epidemic in the U.S. for some time.

In a lifetime of investing, the stock market can generate amazing wealth, however, the cost of gaining it over the long run is avoiding the short-term panic caused by our tendency toward myopic loss aversion. Staying calm during times like this, as hard as it can be, is what will determine our long-term financial success.

The market is currently pricing in a recession, but whether that will actually come to pass is impossible to say at this point. Recessions on the average tend to last less than a year, and while market performance during recessions has varied, in the five years following a recession the market averages a 120% return. We may be in for continued volatility for a time, but we remain highly confident in the long-term resilience of the U.S. economy and the market.

Stay tuned as we continue to monitor the latest events.

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