

Staying Safe in the Markets Now That the 10% Correction Is Out of the Way

By [James Hickman](#) Follow | 08/25/15 - 03:05 PM EDT
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1



NEW YORK ([TheStreet](#)) -- Staying safe in the markets over the next trading period might require a history lesson. Here are several.

Barron's published a famous cover story on the absurdity of tech valuations in [March 2000](#). The article cogently articulated the alarming, though already publicly available facts about tech company cash deficits the market was ignoring -- and continued to ignore -- the very facts that would later burst the bubble.

In the three trading days that followed publication, the S&P 500 reached what turned out to be the peak close of the tech bubble. The article ran around trading day 105 of a stretch during which the S&P 500 Index closed within 10% of its peak. The streak ended at 123 days, before beginning a new streak a month later lasting another 97 days and including a new intraday peak six months after the *Barron's* story. It was just over two years after the September 2000 intraday peak of the tech bubble, and 30 months after the first observation of a maximum drawdown greater than 10% that the S&P 500 hit the nadir of the tech bubble collapse down 49% from peak. The subsequent ten-year compounded annual total return from the point at which the 10% maximum drawdown threshold was reached was -1%.

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In testimony provided to the Joint Economic Committee of the U.S. Congress on March 28, 2007, Federal Reserve Chairman [Ben Bernanke stated](#), "At this juncture, however, the impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained. In particular, mortgages to prime borrowers and fixed-rate mortgages to all classes of borrowers continue to perform well, with low rates of delinquency." Those words were spoken on day 97 of a tranquility period that would last 293 days. Two years later the S&P 500 index troughed at 57% below peak, and the subsequent nearly-eight-year compounded annual total return for the index from the point at which the 10% maximum drawdown threshold was reached has been 4.4%, including a 9% compounded annual total return from the trough of that period to present.

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This history illustrates that corrections do not play out in smooth, straight lines, and are sometimes triggered by relatively minor catalysts. The corrections have everything to do with the market finally and reluctantly coming to terms with the broken narratives that had driven inflated values.

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Wall Street is animated by a structural long bias, also manifested in the financial media. The optimistic drumbeat plays no small part in the path of all corrections. Central bank and fiscal policy as well as legislation can also play a big role.

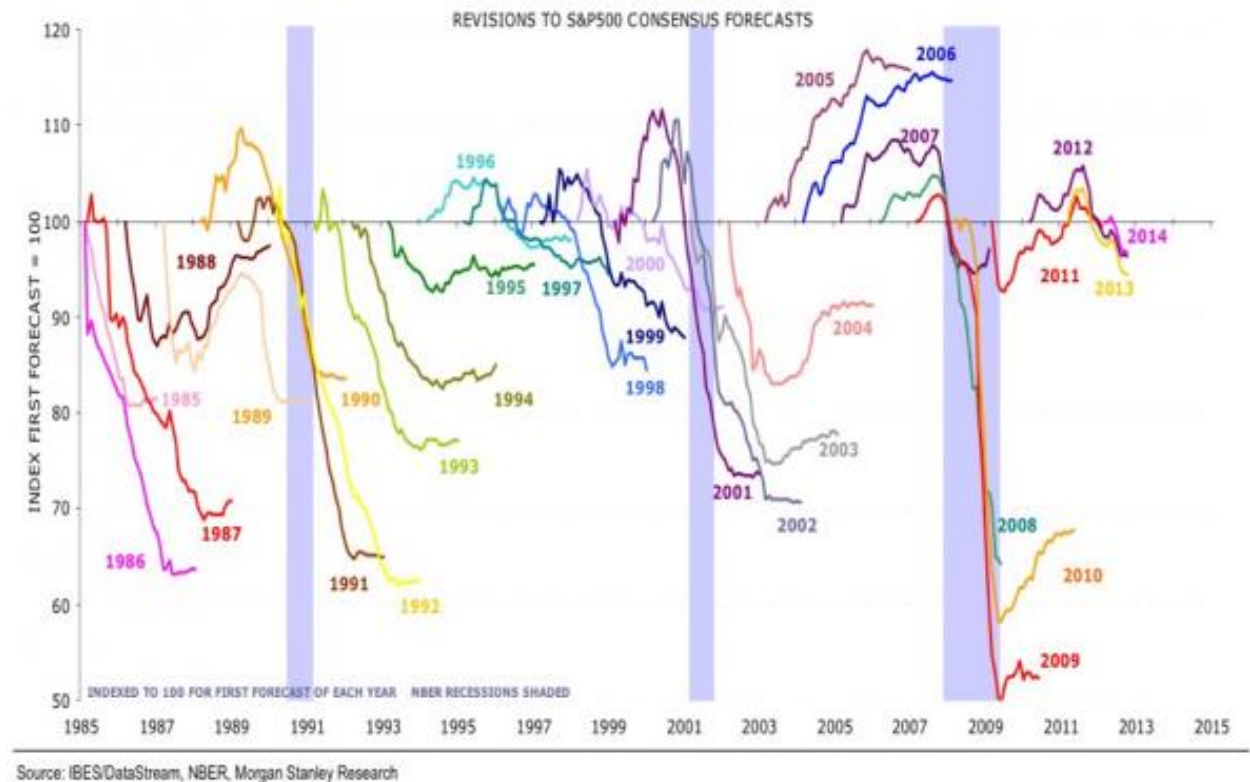
Why the long bias? Rising stocks are better for trading commissions and investment banking fees. In fairness, the market does rise two thirds of the time and shows a clear upward long-term trajectory, so in order to be right, an investor should be bullish two thirds of the time. But what about the other third, when 50% drawdowns sometimes occur?

Investors should understand money managers are usually paid on relative performance to a benchmark -- not on how much money they make *or lose* for investors in actual dollars, but how much they make or lose *relative* to that benchmark. As such, the bonus gets paid even if significant investor losses are incurred, provided the losses are less steep than the benchmark. There is generally more career risk for an asset manager who is wrong by being too cautious and lagging benchmark and peer group upside than generating catastrophic losses for clients that are essentially in line with the benchmark and peer group declines.

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The long bias is even more pronounced among sell-side analysts, driven mostly by investment banking or the money management side of the house, reflected in the persistent dominance of buy- over sell-recommendations, consistently optimistic forecasts of GDP growth and corporate earnings (see Chart below) and repeated advice to investors to "buy-and-hold" and "dollar-cost-average into market declines."

Wall Street's Optimism Bias Reflected in Historical Trends in Earnings Forecasts



Morgan Stanley

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Anyone tuning in to the financial news networks in the last 24 hours heard many of the same old bromides trotted out at the first sign of correction -- "nothing has really changed in the last 24 hours ... no one saw this coming ... the U.S. economy remains fundamentally sound ... the market is only trading at 15 times next year's earnings."

These are the siren songs of the Wall Street establishment when fear seems to be gaining ground on the animal spirits. The market's perception of risk can change in a New York minute and the incorporation of that revision into asset prices occurs just as quickly. The 20% drop in the S&P 500 known as "Black Monday" occurred less than two months after the market hit a new peak.

Make no mistake, the last several days have been historic in terms of how quickly declines of this magnitude have been absorbed. Since 1950, there have only been seven distinct episodes of a 9% or greater drop in the S&P 500 in only three trading days. But the magnitude of [declines from peak values are not historic at all](#). CAPE [dropped from 26.5 to 24.5](#) times corporate earnings that are bolstered by profit margins still 70% above normal. But the list of *historic* factors worthy of investor consideration is indeed long, and all portend significant further downside for markets:

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- [Middling job creation, a severe labor supply overhang, apathetic labor participation rates and mid-1990s real wages.](#)
- An economic recovery that is not only the weakest since WWII, but [the 12th worst 6-year period of US economic growth out of the last 80 years.](#)
- U.S. GDP and gross world product growth each into [a 15th year of significantly lower levels than long-term trends](#), sovereign debt levels for the largest world economies already portending protracted downward pressure on production growth and rising, while global economic deceleration is not beginning with the slowdown in China but into a fifth year.
- In the U.S., [waning productivity](#), anemic economic internals reflected in [money velocity](#) and [net business closures](#), and [poor demographic trends](#).

The two biggest market corrections since the crash of 1929 were each precipitated by protracted periods of tranquility supported by flawed narratives encouraging risky investor behavior. The first instance of a market close below 90% of peak value does not necessarily signal the start of a steady downward trend, but except for the unprecedented period of the 1990s (supported by historic windfalls), it has tended to mark the point from which incremental market returns have been significantly below long-term averages for multiple years during which a substantial correction occurs.

The immediate rebound in public equities provides [an excellent opportunity](#) for investors to adjust asset allocations to account for the poor risk/reward balance in public equities from current levels.

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This article is commentary by an independent contributor. At the time of publication, the author held no positions in the stocks mentioned.