## The Black Swan Paradigm: Painful but Temporary

There is no sugar-coating it: the first quarter of 2020 ushered in the most challenging societal test many Americans have ever faced. Largely unforeseen, fast-moving, and lethal, the Coronavirus pandemic has upstaged economic and political concerns. At this unprecedented time, our first priority is maintaining our health, protecting our loved ones, and dealing with challenges no one could have anticipated just a few weeks ago. With many Americans addressing loss on so many fronts, our focus on financial topics is best put into proper perspective. The situation evolves by the hour and the impact on world financial markets is nothing if not extreme, and sometimes it's hard to know where to look for the next sign of progress or set-back. Whiplash, anyone?

With markets clinging to the 24-hour news cycle and valuations in flux, we thought it best to focus on the lessons of history…something timely, no matter what the market conditions are when you may be reading this. By leaning on history, we see parallels and patterns which can help us maintain a steady constitution in the midst of turmoil.

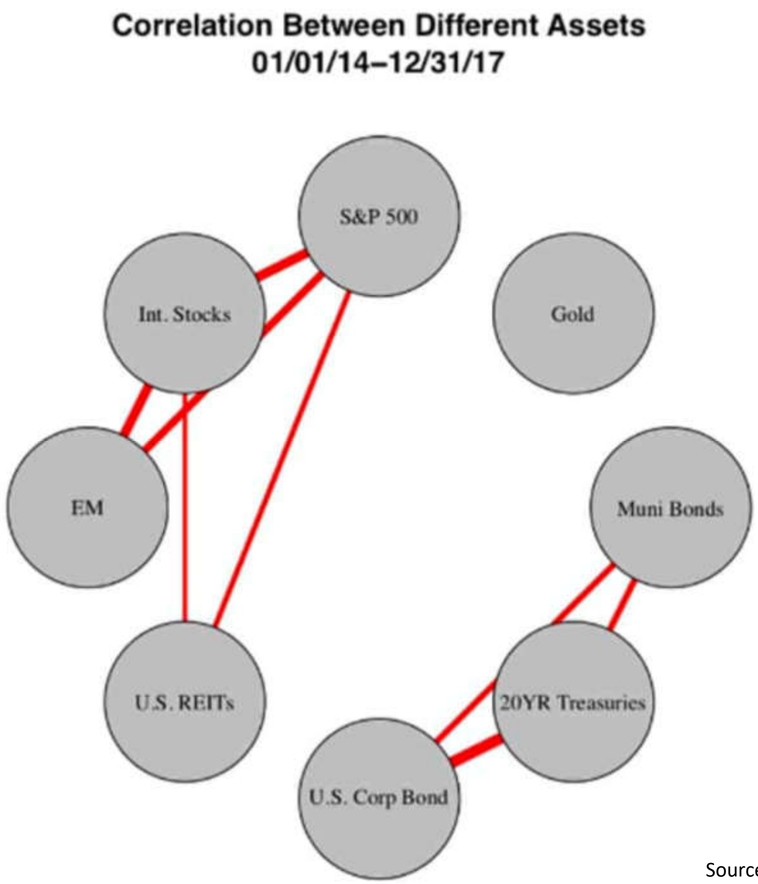
**History Lesson #1: Bear markets are a bull market in the making** (a bear market is defined as a decline of 20% or more in the stock market). The U.S. entered a bear market in March, ending an eleven year steady climb in equities. There have now been 26 bear markets since the Great Depression, lasting an average of 10 months. The causes have been varied and the impact painful, but a consistent theme should give us heart: often, the year following a bear market has been outstanding for investors. A survey of bear markets over the past 30 years shows that in most cases, serious downdrafts in the market were followed by even larger upticks in the market within one year. If history is any indicator, we might expect significant returns in the coming year or so, assuming that social distancing and stay-at-home recommendations succeed so that economic activity can resume at a normal pace.

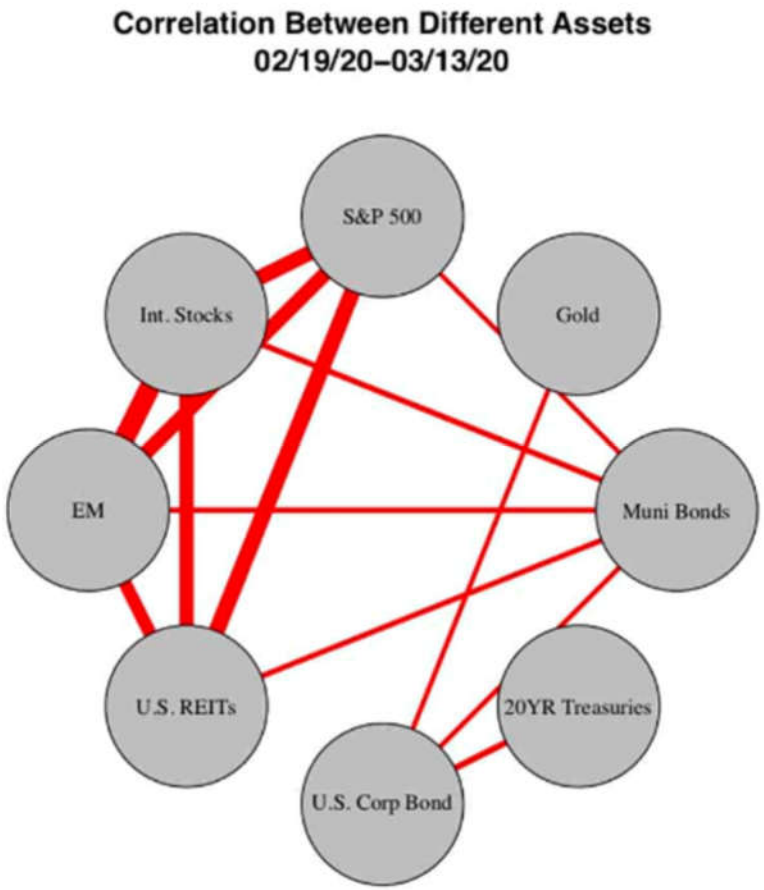
| Dates of S&P's biggest declines | Black Monday 8/25/87-12/4/87 | Gulf War 7/16/90-10/11/90 | Asia Monetary Crisis 7/17/98-8/31/98 | Tech Bubble 3/27/00-10/9/02 | Financial Crisis 10/9/07-3/9/09 | US Credit Downgrade 3/10/11-10/3/11 | Trade War 10/3/18-12/24/18 |
|---|---|---|---|---|---|---|---|
| U.S. stocks | -33.5% | -19.9% | -19.3% | -49.0% | -56.8% | -19.0% | -19.6% |
| Next 12 months | +21.4% | +29.1% | +37.9% | +33.7% | +68.6% | +32.0% | +37.1% |

Source: Morningstar as of 2/28/20. Returns are principal only not including dividends. U.S. stocks represented by the S&P 500 Index. Past performance does not guarantee or indicate future results. Index performance is for illustrative purposes only. You can't invest directly in an index.

**History Lesson #2: Successful investing is not so much about market timing.** ***It's about time in the market.*** To use a gambling analogy, trying to time your way to outperforming the market is a bit like betting against the house. You may win from time to time and sometimes you will win big, but if you gamble long enough, the house always wins. An entire financial media industry has been built around convincing people that moving in and out of stocks, bonds, and commodities during times of panic (or euphoria) can be a winning strategy. The reality is that very few investors have managed to win consistently with that strategy. Need some convincing that timing is a tough game? This should do it: over the past 20 years, 24 of the 25 worst trading days in the stock market were within one month of the 25 best trading days in the market. If you sell and don't manage to get back into the market *at just the right time*, you miss those 25 best days. "The market climbs a wall of worry," as the saying goes, but worry might very well get you nowhere. As the graph below demonstrates, ignoring the noise of volatility and staying the course, long-term investors bet with the house, and win.

**History Lesson #3: In a panic, nothing makes much sense, but panic doesn't last.** Diversification is the safest path to long-term financial reward. When normal market conditions prevail, the benefits of diversification are clear: stock and bond returns are inversely correlated, while commodity and alternative investment strategies are minimally correlated with the return of traditional investments. But when broad market panic sets in, diversification provides little shelter. It's a bit like a boat when everyone moves to one side: even the strong and nimble will go overboard. In a market panic, investors race to liquidate whatever they can, at the same time, without regard to asset class. In recent weeks, there were days when almost all asset classes were in the red: stocks, high yield bonds, investment grade corporate bonds, gold, industrial metals and agricultural commodities. But history teaches us that correlations eventually return to a more normal pattern. So while we saw negative returns in stocks, corporate bonds, and commodities during Q1 2020, we should not expect this unusual correlation breakdown to persist. In the long-run, diversification is vitally important.




Source: Ycharts (OfDollarsandData.com)

The take-away: having perspective matters a lot when making decisions and history is a great teacher. Bear markets come and go, as do bull markets, but in the end, markets don't settle down. **Markets settle up**. If you stay invested and maintain a diversified portfolio, you will be well-positioned when the market starts its time-tested eventual march upward.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