



Anatomy of a Drawdown

2018 was the year of the reset; 2019 is looking better to me.

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Key takeaways

- A brief 20% drawdown in December triggered a familiar fight-or-flight response from investors, locking in losses in the process.
- Cash proved the best house in an expensive neighborhood in 2018, something we almost never see.
- With the S&P 500® down 20% and valuations down 30%, the market has priced in a lot of bad news and, in terms of the risk/reward balance, is now providing potentially better compensation for an uncertain future.

Loss aversion is an essential survival tool that is very much a part of the human condition. After all, our fight-or-flight response comes in handy should we happen to find ourselves face-to-face with a large bear in the woods. But when it comes to the financial markets, our tendency to want to “get out” whenever things go the wrong way can be detrimental to our financial health. This is why having a solid investment plan, sticking to it through thick and thin, and rebalancing on a regular basis is the way to go for most long-term investors.

When the stock market declines 5%, we tend to dismiss it as noise. When it falls 10%, we get a little nervous but explain it away as a “healthy correction” that hopefully will prove short-lived. But when that 10% turns into a 20% drop and the headlines start blaring “Bear Market!” it’s in our nature to want to sell when we should probably be considering the opposite (in the form of portfolio rebalancing).

I mention this because the S&P 500® just logged a 20% drawdown, as measured from the 2940 high on October 3 to the 2347 low on December 26. And true to form, investors sold \$83 billion worth of equity funds and ETFs in December (Exhibit 1). That's a record outflow, according to data from EPFR Global. That 20% drawdown lasted only a New York minute, and subsequently the S&P 500® rallied 10% in just a few weeks. In other words, investors locked in \$83 billion worth of losses. This is an unfortunate example of how market timing can cause many investors to underperform market indices over time.

So what caused the violent downturn in Q4?

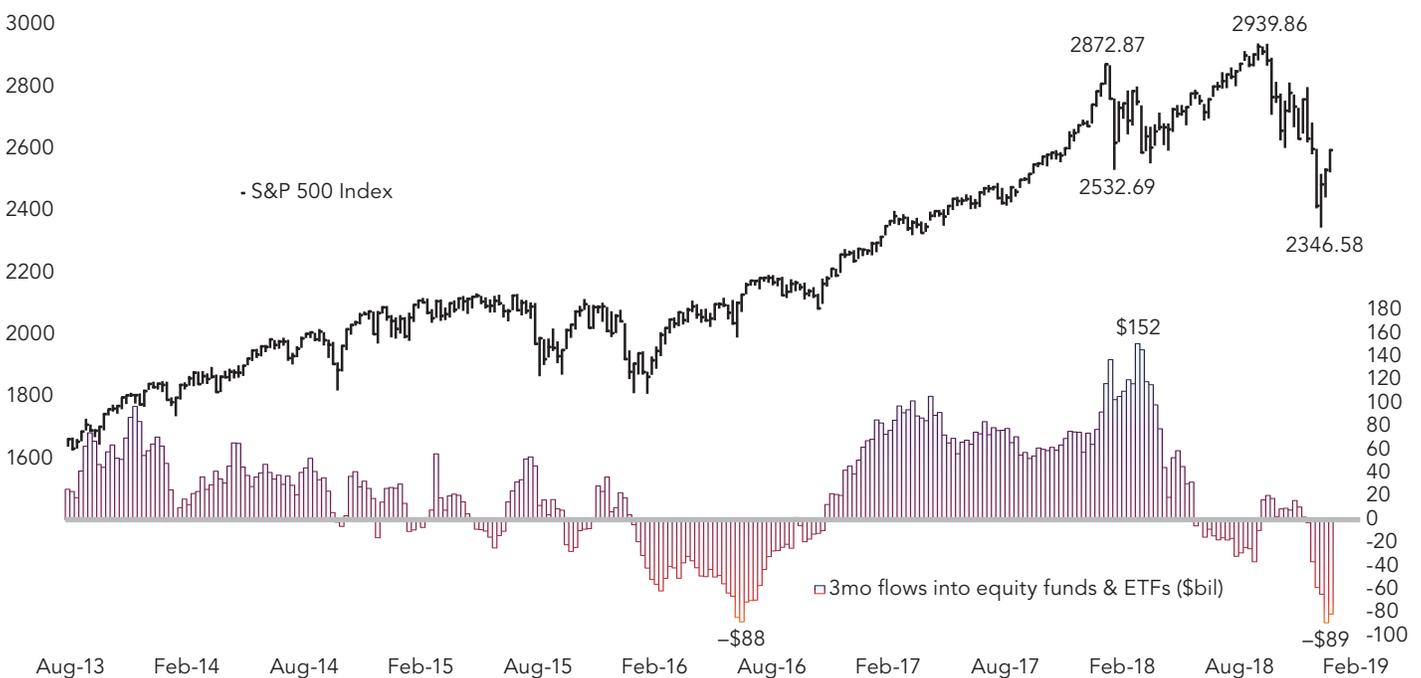
During the past three months, the stock market got hit by a trifecta of negative conditions. First, a (justified) valuation de-rating of the price-to-earnings, or P/E, ratio

on the basis of slowing earnings growth (driven partly by trade) and tightening financial conditions (due to actions by the U.S. Federal Reserve). The situation was made worse by the liquidation of crowded positions in the growth/momentum space, which in turn was further exacerbated by a lack of liquidity in the markets. In my view, the confluence of these three factors turned an otherwise sleepy 10% correction into a chaotic 20% drawdown.

My view at the beginning of 2018 was that the stock market would be stuck in a twilight zone for some time, unable to pull out until 2019. That part was right, but I did not see the 20% drawdown coming. I thought that the 10% retracements in late January and again in October would be all we would experience. But what was and is clear to me is that 2018's poor returns across all long-

EXHIBIT 1: Investors buying high, selling low?

Record Outflows amid 20% S&P 500 Drawdown



Sources: Fidelity Investments, Bloomberg Finance L.P., EPFR Global; weekly data as of Dec. 31, 2018.

term asset classes were a testament to the fact that, since the 2007–08 financial crisis, the era of quantitative easing (QE) has suppressed risk premiums and thereby elevated valuations and returns among long-term assets. Now that QE is in reverse (with the Fed raising rates and shrinking its balance sheet), risk premiums have come back down to earth for risk assets such as equities and credit—not so much for Treasuries, though, at least not yet.

2018 was interesting in other ways too. For one, cash was king, topping the leaderboard of the 20 asset classes that I track. You can see that in the chart below, my “periodic table of investment returns” (Exhibit 2). The fact that cash

was on top in 2018 is interesting for two reasons. First, the asset class returned only 1.7%, which is a pretty low hurdle for others to be unable to overcome. Second, this is the first time in 70 years that cash beat everything else: Hard to believe, but it’s true. If I narrow the universe of asset classes to just the eight majors—S&P 500, long-term Treasuries, high-yield debt, investment-grade bonds, TIPS, cash, gold, and commodities—we find only one other year when cash was king: 1981. That’s also interesting, because 1981 was the year when cash produced a stellar 14.7% return. So, that was a very high hurdle to overtake. Not so in 2018.

EXHIBIT 2: Cash was king in 2018

Annual Returns for 20 Major Asset Classes Ranked in Order of Performance (1984–2018)

| | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|---------------------------------|--|-------------------------|
| JPN | EUR | EAF | EAF | EM | EM | TIPS | EM | SV | EM | Com | LV | EMD | LV | LG | EM | REIT | REIT | Com | EM | REIT | EM | REIT | EM | LT | EM | SG | LT | EUR | SG | REIT | JPN | SV | EM | Cash | Cash | | |
| REIT | EAF | JPN | Gold | JPN | LG | IGB | SG | LV | EAF | JPN | SPX | REIT | SPX | EUR | JPN | SV | SV | Gold | SG | EM | JPN | EUR | Gold | IGB | HY | REIT | TIPS | EM | SC | LT | LG | SC | LG | LG | U.S. Large Cap Growth Stocks | | |
| LV | LG | EUR | EM | SV | SPX | Cash | EMD | SC | EUR | EAF | LG | LG | SV | SPX | SG | Com | HF | TIPS | SC | SV | Com | EM | EUR | Cash | Gold | SC | Gold | EMD | SV | SPX | REIT | LV | EUR | IGB | Investment-Grade Bonds | | |
| LT | SPX | LT | Com | EAF | LV | LT | HY | HY | SV | Cash | LT | SPX | LG | EAF | LG | LT | IGB | LT | SV | EUR | Gold | EAF | TIPS | Gold | LG | SV | REIT | SV | LG | LV | SPX | HY | EAF | Gold | Gold | | |
| IGB | SV | LV | JPN | LV | EUR | LG | SC | EMD | HF | EUR | SG | LV | EUR | LV | EAF | EMD | TIPS | EMD | EAF | EAF | EAF | Gold | LG | TIPS | EUR | Gold | EMD | EAF | LV | LG | EMD | SPX | JPN | LT | U.S. Long-Term Treasury | | |
| EM | LV | Gold | LG | SC | SG | Com | LG | REIT | SC | LG | SC | EUR | SC | LT | HF | HF | HY | IGB | EUR | SC | REIT | SV | EAF | EMD | SG | EM | IGB | REIT | SPX | TIPS | IGB | EM | SPX | HY | High-Yield Debt | | |
| TIPS | LT | REIT | Cash | SPX | TIPS | SPX | SV | EM | LV | SPX | EMD | SV | REIT | HF | EMD | TIPS | LT | REIT | REIT | LV | EMD | LV | LT | HF | EAF | LG | HY | LV | JPN | IGB | Cash | Com | SG | LV | U.S. Large Cap Value Stocks | | |
| Cash | TIPS | SPX | SPX | SG | LT | EUR | REIT | LT | REIT | REIT | TIPS | HF | HF | IGB | SC | IGB | Cash | HF | JPN | JPN | EUR | SC | Com | HY | REIT | JPN | LG | SC | EUR | SG | EAF | SG | SC | SPX | S&P 500 Index | | |
| HY | SG | HY | EMD | EUR | JPN | Gold | SPX | SPX | LT | HF | SV | Com | LT | Cash | SPX | LV | SC | Cash | LV | SG | LV | SPX | SG | SV | EMD | LV | SPX | SPX | EAF | EMD | LT | EMD | LV | REIT | Real Estate Investment Trusts | | |
| EMD | EMD | EMD | HY | REIT | SC | HY | LV | IGB | HY | HY | EUR | SC | SG | TIPS | Com | Cash | Gold | HY | LG | TIPS | LT | SG | IGB | JPN | SC | HY | LV | HY | HY | SC | SG | REIT | Gold | EMD | Emerging-Market Debt | | |
| EAF | SC | TIPS | EUR | HY | SV | EMD | LT | LG | EMD | Gold | HY | HY | HY | HY | EUR | SC | EMD | EM | HY | EMD | TIPS | HY | EMD | SC | SPX | SPX | Cash | LG | HF | SV | EUR | LG | EMD | Com | Commodities | | |
| SV | HY | IGB | IGB | EMD | IGB | EM | TIPS | SG | Gold | SV | IGB | SG | EMD | SG | LV | Gold | EM | JPN | SPX | HY | LG | EMD | SPX | LV | Com | Com | SG | SG | REIT | HY | HF | Gold | SV | TIPS | TIPS | | |
| SPX | EM | SV | LT | LG | EAF | LV | IGB | TIPS | SG | SC | REIT | EAF | IGB | Gold | Cash | HY | LV | SV | EMD | SPX | SPX | HF | Cash | SPX | SV | EMD | SC | TIPS | Cash | Cash | LV | TIPS | LT | HF | Hedge Funds | | |
| EUR | IGB | LG | TIPS | Com | REIT | REIT | EUR | Cash | JPN | LV | HF | EM | Cash | SC | TIPS | EUR | SG | LV | Com | Gold | SV | LG | HF | Com | LV | LT | SV | JPN | IGB | HF | SC | JPN | TIPS | SG | U.S. Small Cap Growth Stocks | | |
| LG | REIT | EM | LV | TIPS | Cash | SG | EAF | Com | TIPS | SG | EAF | Cash | TIPS | SV | HY | SPX | SPX | EAF | Gold | Com | SC | JPN | HY | REIT | HF | TIPS | HF | IGB | EM | Gold | HY | IGB | HY | SC | U.S. Small Cap Equity | | |
| SC | JPN | Cash | REIT | LT | EMD | SC | Cash | EUR | SPX | IGB | Com | IGB | EAF | JPN | IGB | EAF | EUR | EUR | HF | LT | SG | Cash | LV | LG | TIPS | EAF | Com | LT | EMD | EM | TIPS | HF | HF | JPN | Japan Equity | | |
| Com | Cash | SC | SV | IGB | HY | EAF | JPN | Gold | IGB | TIPS | Cash | TIPS | Com | EMD | SV | LG | LG | SC | TIPS | LG | Cash | IGB | SC | SG | JPN | IGB | EUR | HF | Com | JPN | SV | EAF | REIT | SV | U.S. Small Cap Value Stocks | | |
| SG | Gold | SG | SC | Cash | Gold | SV | Gold | EAF | Cash | EM | JPN | LT | EM | REIT | Gold | SG | Com | SPX | IGB | IGB | HY | LT | JPN | EAF | IGB | HF | EAF | Gold | LT | EAF | Gold | LT | IGB | EAF | Foreign Developed-Market Equity | | |
| Gold | Com | Com | SG | Gold | Com | JPN | Com | JPN | LG | LT | Gold | JPN | JPN | EM | REIT | JPN | EAF | LG | LT | HF | HF | TIPS | SV | EUR | Cash | EUR | JPN | Cash | TIPS | EUR | EM | Cash | Cash | EM | Emerging-Market Equity | | |
| | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | Developed Europe Equity |

'84 '85 '86 '87 '88 '89 '90 '91 '92 '93 '94 '95 '96 '97 '98 '99 '00 '01 '02 '03 '04 '05 '06 '07 '08 '09 '10 '11 '12 '13 '14 '15 '16 '17 '18

Past performance is no guarantee of future results. Diversification/asset allocation does not ensure a profit or guarantee against loss. It is not possible to invest directly in an index. All indices are unmanaged. Asset classes represented by: cash – Bloomberg Barclays 3-month Treasury Bellwether Index; U.S. large cap growth stocks – Russell 1000 Growth Index; investment-grade bonds – Bloomberg Barclays U.S. Aggregate Bond Index; gold – Handy & Harman gold price; U.S. long-term Treasury – Bloomberg Barclays U.S. Long-term Treasury Index; high-yield debt – Bloomberg Barclays High Yield Index; U.S. large cap value stocks – Russell 1000 Value Index; SPX – S&P 500 index; real estate investment trusts – MSCI US REIT Index; emerging-market debt – JPM EMBI Global Index; commodities – Bloomberg Commodity Index Total Return; TIPS (Treasury inflation-protected securities) – Bloomberg Barclays U.S. TIPS Index; hedge funds – HFRX® data; U.S. small cap growth stocks – Russell 2000® Growth Index; U.S. small cap equity – Russell 2000® Index; Japan equity – MSCI Japan Index; small cap value stocks – Russell 2000® Value Index; foreign developed-market equity – MSCI EAFE Index; emerging-market equity – MSCI Emerging Markets Index; developed Europe equity – MSCI Europe Index. Sources: MSCI, Bloomberg, Standard & Poor’s, Haver Analytics, HFRX®, Handy & Harman, Fidelity Investments, as of Dec. 31, 2018.

Corrections, common and uncommon

The value proposition for investing in stocks (as part of a diversified portfolio) is straightforward. The stock market historically has gone up more than it has gone down, and over the long term the S&P 500 has delivered a CAGR (compound annual growth rate) of around 10% nominal and 6.5% after inflation (based on Robert Shiller's data sets linking back to 1871).¹ At the same time, the historical odds of a 10% correction are four in ten, and the odds of a 20% "bear market" are one in five (Exhibit 3). In other words, the market goes through corrections all the time, yet still manages to deliver returns that, over the long run, are superior to a risk-free asset (i.e., cash or government bonds). It's simple math really, a reversion to the mean. No one should ever be surprised when stock prices correct, because that is what they have done at regular intervals ever since there was a stock market. But

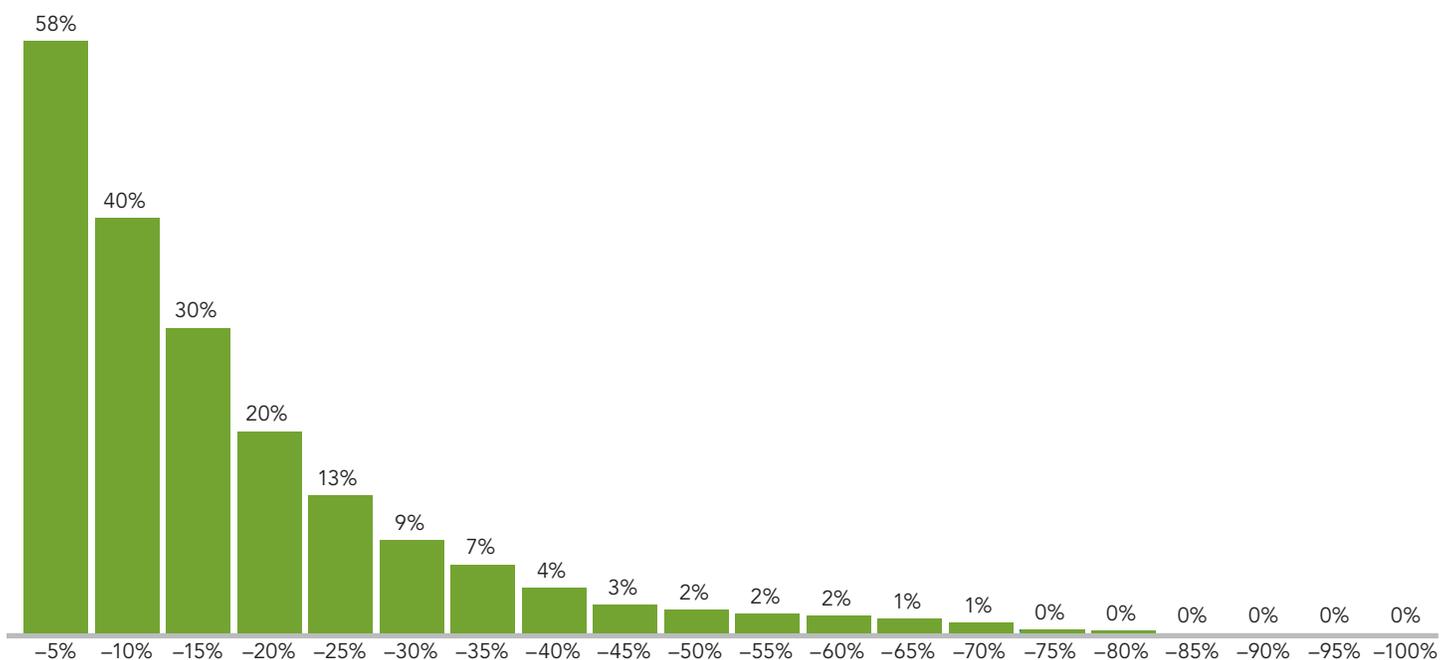
loss aversion is part of our human nature, and sometimes our emotions get the best of us. Investing should always remain on the left side—the logical side—of the brain.

Over the very long term—using daily data going back to 1900—the chart shows the stock market has been down 50% or more from its previous high only 2% of the time. It's something to keep in mind when deciding whether to buy or sell at the point when the market is down 20%, as it was only a few weeks ago.

But many investors have been conditioned by the 2007–08 financial crisis and the dot-com bubble back in 2000 that a 20% correction can quickly turn into a 50% meltdown from which it can take years to recover. But these episodes are the exception, not the rule. The "lost decade" of the 2000s falls into a small bucket of market regimes called "secular" bear markets. Other secular bears include the 1970s and 1930s. Secular bears can

EXHIBIT 3: Is now the time to sell? Or to buy?

Historical Odds of Declines of Various Depths from Previous Two-Year High (1900–2018)



Past performance is no guarantee of future results. Source: Bloomberg Finance, L.P.; daily data from 1900 through 2018.

last 10–15 years with little progress but elevated volatility. At the same time, such periods can be interspersed with secular bull markets or “super cycles” that last, on average, 18 years and historically have produced almost double the average return (18% per annum versus 10%) while exhibiting shorter and shallower corrections.

Whether we are currently in a secular bull market is unknowable in real time, but since its 2009 low the market so far sure has acted like we are in one. If that turns out to be the case, then December’s 20% “bear market” could prove to be short-lived, not unlike 1998, which saw a roughly 22% decline (using intraday values) reversed in only five months, or the 2011 correction, in which an almost 22% decline reversed in seven months.

Time will tell

We have a long year ahead, so let’s take a look at what’s next. For equities and credit, I think the valuation de-rating leaves risk assets on much better footing than a year ago. While the fundamentals remain uncertain, the much lower P/E ratio (30% lower than at the January peak) and wider credit spreads (high-yield spreads widened to 540 basis points in December) means that, in balancing the potential for gain against the potential for loss, investors are better-compensated for taking on risk: We definitely could not say the same a year ago.

We still have earnings and the Fed to contend with, as we always do, of course. On the earnings side, things have gone from great to good and down to fair in a hurry.

The third quarter was the high point, with Q3 earnings growing at a 24% rate, year over year. We are now getting into the Q4 earnings season and expectations are for 11% growth. But 2019’s Q1 and Q2 consensus earnings are now projected at only 2% to 4%, and the calendar-year 2019 estimate has been dropping steadily, from 12% a few months ago to around 7% today. At the rate that this growth estimate is falling, we may get only low single-digit growth in 2019.

Fortunately, against this weaker growth backdrop the Fed is now much more sensitive to downside surprises and has hinted that it may well be on hold for a while in terms of rate hikes—and perhaps even its balance sheet. That’s a step in the right direction, in my opinion, but for the markets the question is whether these measures are enough. Should the Fed be easing? I don’t think so, but this is where the debate is now going. It’s no longer a question of whether the Fed should hike two more times or four more times and over what period, but whether the Fed should be tightening at all, or even easing.

These are big unknowns that will take time to resolve. This suggests to me that the market is not going to break out any time soon. But “not breaking out” to new highs and “making new lows” are obviously not the same thing. In terms of the risk/reward ratio, though, one thing is clear in my mind: This most recent 20% drawdown priced in a lot of bad news and, with valuations brought back to earth, investors are getting better compensated to brace against an uncertain future.

Author

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Endnote

¹ Robert J. Shiller is a Yale economics professor and Nobel laureate, as well as the author of such books as *Irrational Exuberance* (2000), among others. He developed, alone or in partnership, the S&P/Case-Shiller Home Price Indices and the cyclically adjusted price-to-earnings ratio, also known as the CAPE or the Shiller P/E Ratio; his data series are available at <http://www.econ.yale.edu/~shiller/data.htm>.

Index definitions

Standard & Poor's 500 (S&P 500®) index is a market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance. **Russell 1000 Value Index** is a market capitalization-weighted index designed to measure the performance of the large-cap value segment of the U.S. equity market. It includes those Russell 1000 Index companies with lower price-to-book ratios and lower expected growth rates. **Russell 1000 Growth Index** is a market capitalization-weighted index designed to measure the performance of the large cap growth segment of the U.S. equity market. It includes those Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth rates. **Russell 2000 Index** is a market capitalization-weighted index designed to measure the performance of the small cap segment of the U.S. equity market. It includes approximately 2,000 of the smallest securities in the Russell 3000 Index. **Russell 2000 Value Index** is a market capitalization-weighted index designed to measure the performance of the small cap value segment of the U.S. equity market. It includes those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth rates. **Russell 2000 Growth Index** is a market capitalization-weighted index designed to measure the performance of the small cap growth segment of the U.S. equity market. It includes those Russell 2000 Index companies with higher price-to-book ratios and higher forecasted growth rates. **MSCI US REIT Index** is a free float-adjusted market capitalization-weighted index that comprises equity real estate investments. **MSCI EAFE Index** is a market capitalization-weighted index designed to measure the investable equity market performance for global investors in developed markets, excluding the U.S. & Canada. **MSCI Europe Index** is a market capitalization-weighted index that is designed to measure the investable equity market performance for global investors of the developed markets in Europe. **MSCI Japan Index** is a free float-adjusted market capitalization-weighted index designed to measure the performance of the large and mid cap segments of the Japanese market. **MSCI Emerging Markets Index** is a market capitalization-weighted index that is designed to measure the investable equity. **Bloomberg Barclays U.S. Aggregate Bond Index** is a broad-based, market value-weighted benchmark that measures the performance of the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. Sectors in the index include Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS. **Bloomberg Barclays U.S. 3 Month Treasury Bellwether Index** is a market value-weighted index of investment-grade fixed-rate public obligations of the U.S. Treasury with maturities of 3 months, excluding zero coupon strips. **Bloomberg Barclays U.S. Treasury Inflation Protected Securities (TIPS) Index (Series L)** is a market value-weighted index that measures the performance of inflation-protected public obligations of the U.S. Treasury that have at least one year remaining to maturity. **JPM (JPMorgan) EMBI (Emerging Market Bond Index) Global Index** tracks total returns for the U.S. dollar-denominated debt instruments issued by emerging-market sovereign and quasi-sovereign entities, such as Brady bonds, loans, and Eurobonds. **Bloomberg Commodity Index Total Return** measures the performance of the commodities market. It consists of exchange-traded futures contracts on physical commodities that are weighted to account for the economic significance and market liquidity of each commodity. **Bloomberg Barclays U.S. High Yield Index** is a market value-weighted index that covers the universe of dollar-denominated, fixed-rate, non-investment-grade debt. **Bloomberg Barclays Long-Term Treasury Index** is an unmanaged index of obligations of the U.S. Treasury that have a remaining maturity of 10 years or more.

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