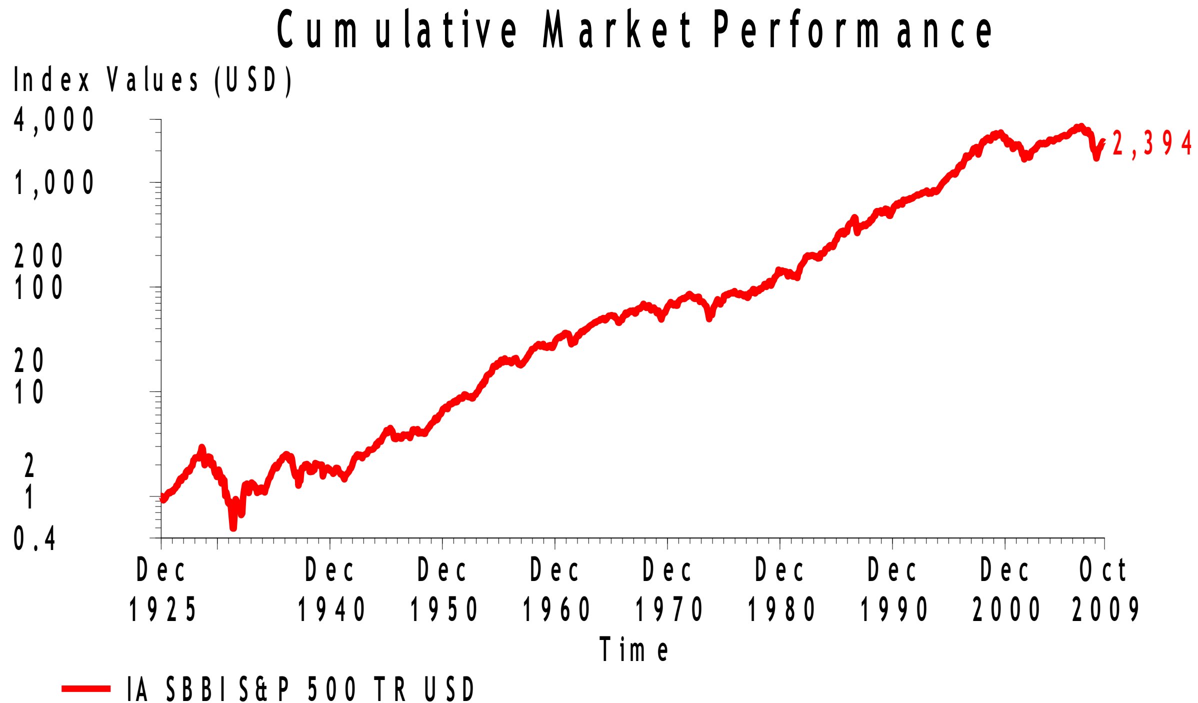
Routinely "Under Water"

Investors, fondly recalling the October 2007 high in the U.S. stock market, are undoubtedly anxious to see a full recovery of their capital. This is understandable. The promise of equities is clear - they offer the potential for growth as corporate profits increase over time in response to growing revenues and improved productivity. As illustrated below, $1.00 invested in U.S. large cap stocks on January 1, 1926 was worth $2,394 at the end of October 2009, after factoring in the reinvestment of dividends.



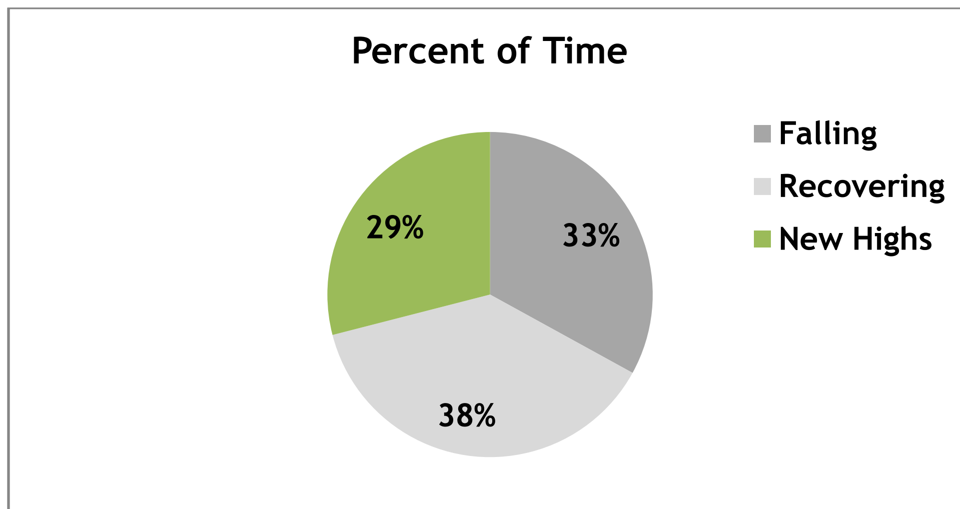
It is this ascending graph, featured in endless sales presentations during the last bull market, which enticed so many investors. "Stocks for the long-run" is the common mantra.

Unfortunately, this graph obscures a harsher reality. Over this almost 84-year history, U.S. large cap stocks experienced 105 periods where a drawdown occurred (i.e. where the value fell below its prior peak as measured at month-end) – about once every 10 months. And although the average decline from peak to trough was just -6.9%, there

were eight periods where the decline was greater than -20% (see Table I at the end of the Commentary). The mother of all declines was the 83% plunge in the Great Depression followed by the recent 51% drawdown just endured from October 2007 through February 2009.

The average time from peak to trough was just three months, although this ranged from as little as a month to the 34 month decline at the outset of the Great Depression. Recoveries took longer – four months on average. The deeper the decline, however, the longer the recovery. Where the decline was in excess of -20%, it took an average of three and half years to recover.

As a result, investors spend the vast majority of the time with the value of their stock holdings below their prior high. In fact, as illustrated in the following chart, since 1926 investors in U.S. large cap stocks spent 33% of the time watching the values of their stock portfolio fall, 38% of the time watching them recover and only 29% of the time watching them hit new highs.

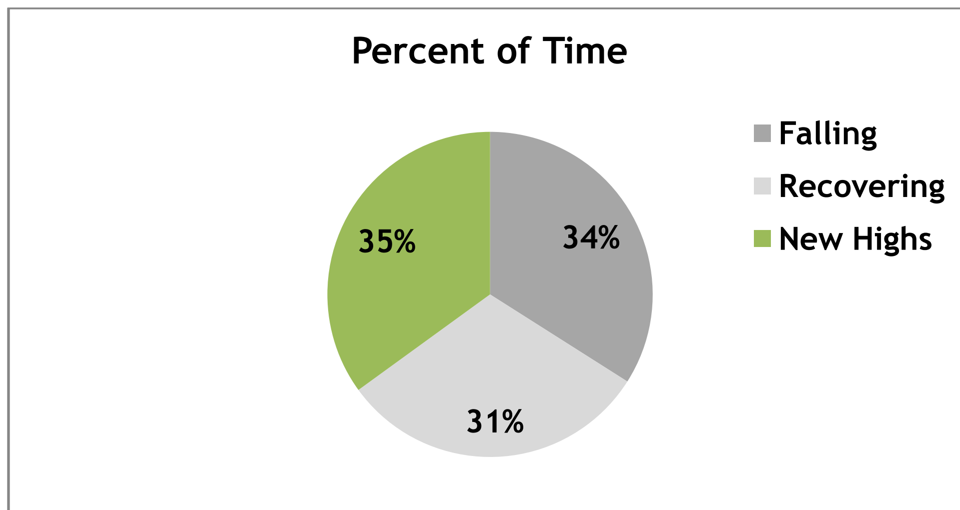


Source: Tacita Capital. Based on month-end values with dividend reinvestment.

What about adding bonds? Surely, a balanced approach will yield more inspiring results. Unfortunately, this is true only to a degree. In fact, a balanced investor with a portfolio comprised of 35% intermediate-term U.S. government bonds and 65% large-cap U.S. stocks endured 120 periods of drawdown, nearly 15% more than the stock only investor. The average decline period was the same – three months.

Where a balanced investor wins out is that their average decline was less: –4.4% versus -6.9% for the "stock only" investor. The ferocious bear markets were all buffered to a degree by the bond allocation (see Table II at the end of the Commentary). Also, the average recovery period was faster by a month.

However, on the measure of month-end portfolio experience, there was not much of a difference. As illustrated below, balanced investors spent 34% of the time watching their portfolios fall in value, 31% watching them recover and only 35% enjoying new highs.



Source: Tacita Capital. Based on month-end values with dividend and interest reinvestment.

Investors need to be aware that when measured against the previous high, their portfolio will be spending the majority of the time "under water." Also, the greater the decline, the longer the period of submergence. Understanding the inevitability of this disheartening experience may make it a little easier to bear. A wiser approach is to take a longer-term view and compare today's value against prior lows as well as prior highs. Markets are cyclical; performance comparisons need to recognize this reality.

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Table I – Worst “Stock Only” Drawdowns

Peak Date	Trough Date	Recovery Date	Decline (%)	Decline Duration	Recovery Duration*
Aug-29	Jun-32	Jan-45	-83.41	34	151
Oct-07	Feb-09	n/a	-50.95	16	n/a
Aug-00	Sep-02	Oct-06	-44.73	25	49
Dec-72	Sep-74	Jun-76	-42.63	21	21
Aug-87	Nov-87	May-89	-29.53	3	18
Nov-68	Jun-70	Mar-71	-29.25	19	9
Dec-61	Jun-62	Apr-63	-22.28	6	10
May-46	Nov-46	Oct-49	-21.76	6	35
	Average			**16**	**42**

*Recovery duration includes the first month exceeding the prior high.

Table II – Worst Balanced Portfolio Drawdowns

Peak Date	Trough Date	Recovery Date	Decline (%)	Decline Duration	Recovery Duration*
Aug-29	May-32	Aug-36	-64.74	33	51
Feb-37	Mar-38	Feb-43	-33.76	13	59
Oct-07	Feb-09	n/a	-30.79	16	n/a
Dec-72	Sep-74	Jan-76	-27.44	21	16
Aug-00	Sep-02	Nov-04	-23.45	25	26
Aug-87	Nov-87	Apr-89	-20.65	3	17
Nov-68	Jun-70	Jan-71	-18.71	19	7
May-46	Nov-46	Sep-49	-14.59	6	34
	Average			**17**	**30**

*Recovery duration includes the first month exceeding the prior high.

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