Laurus
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"Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves."

-- Peter Lynch

A recent blog post by Sam Altman, CEO of Y Combinator, turned the phrase "the days are long but the decades are short". Now, being admittedly sardonic, Sam is 30 years old and his blog was about passing along life lessons which, given his age, seemed somewhat less than poignant. However, the phrase seemed appropriate to preface a discussion of recent market events.

Many investors, including some professionals, get caught up in the inflamed controversy of economic events. The recent devaluation of the Chinese yuan would be one. The continual "Fed watch" for the expected interest rate increase would be another. Bubble fears over excessive housing prices in Toronto and Vancouver and the lack of frontrunners in the upcoming Canadian or US elections could also be included.

China's "Black Monday" resulted in an historic 1,000 point decline at the opening of the Dow as fears about the health of world's second largest economy spiralled into a full-blown panic that the contagion would spread.

Or, at least that's what journalists would have you believe.

In fact, most industry experts expected Chinese stocks to fall after a speculative "feeding frenzy" that took their market to ridiculous levels of valuation. Similarly, many felt a correction of some magnitude would be healthy for a US market that had risen over 200% since the Great Recession. The August correction has been much faster than ideal, exacerbated by margin calls and algorithmic trading. Though painful, the pullback has brought valuations back in line with historical norms.

The question investors must really ask beyond the hyperbole, is whether this correction is actually the beginning of a longer term "bear" market. While Canada's economy is largely driven by the state of commodity prices, our largest trading partner to the south is experiencing a resurgence in growth. Public companies (excluding energy) have shown gains in earnings for the most recent quarter.

The American economy continues to accelerate at a modest pace. The jobless rate has fallen, more cars and homes are being sold, and consumer confidence is on the rise. And the major cause of recessions – tightening of credit – is non-existent.

Those with pessimistic outlooks continue to focus on China, the potential Fed rate hike, and the prospect for economic stress in Europe. And of course the television gurus keep pointing to stock charts and talking about long term trend lines being broken.

Experience tells us that when markets have risen the most is precisely the time investors typically increase risk by buying stocks while the sell side analysts are enthusiastically increasing earnings expectations. Conversely, when something scary happens (like a 1,000 point drop in the Dow) and markets teeter, the street begins to revise earnings downward, and investors overreact and sell at lower prices.

So, returning to Altman's comment, when the market pulls back our client's portfolio values over an extended period, our days are very long. But a period of investor selling at lower prices eventually solves the problem of high valuations – simplistic perhaps, but generally true.

The decades do go by quickly – rising market prices help us forget all those troublesome day-to-day crisis issues that sell newspapers: the flash crash in 2010, the debt ceiling scare in 2013, the S&P downgrade of US government debt in 2011, or the Greek near collapse earlier this year, just to name a few in recent history.

The coming months will likely remain more volatile than normal until current events are digested. Historically, when market growth exceeds underlying fundamentals, corrections occur. The last major correction in 2011 resulted in the SP500 pulling back 17% over a two week period, followed by a choppy eight week period, then rising almost 100% from there. The pattern today is similar to 2011 – from August 17th, the SP500 fell 11.2% through August 25th.

As we've preached many, many times in the past, volatility is not risk. Risk is the possibility of permanent loss of capital, and that seldom occurs when you own well managed businesses with a sustainable competitive advantage for very long periods of time.

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