So What About Friday's Market Drop?
By Dave Stieh, CFP

August 23, 2015

It can be entertaining for a long-term investor when short-term investors are looking for any excuse to sell. They're convinced that the market is going to go down before they can get out, and so they jump on any bad news that comes along.

And, of course, this past Friday was a great time to see this in action. With all the economic drama playing out in the world, there were plenty of opportunities to panic. The Greek Prime Minister has resigned! Sell! China devalued its currency a few days ago by 2%! Head for the hills! Chinese stocks are tanking yet again! Get out of US stocks before it's too late! The Fed might raise short-term interest rates from zero to very nearly zero! It's the end of the world!

Of course, a prudent investor might wonder whether a change in governance in a country whose GDP is a little less than half the market capitalization of Apple is really going to move the needle on the value of U.S. stocks—especially now that Greece seems to have gotten the bailout it needs to stay in the Eurozone. Chinese speculators are of course feeling pain as the Shanghai Index goes into free-fall, but most U.S. investors are prohibited from investing in this market anyhow. If the market value of PetroChina, China Petroleum & Chemical and China Merchants Bank are less valuable today than they were a week or a month ago, does that mean that one should abandon U.S. stocks? Does it mean that American blue chips are somehow less valuable?

What makes this dynamic entertaining—and sometimes scary—is the enhanced volatility around very little actual movement and very low volume, which increases volatility. You see the market jump higher and faster, lower and faster, but generally returning to the starting point as people realize a day or two later that the panic was an overreaction, and so was the false exuberance of realizing that the world isn't going to come to an end just because we're paying less at the gas pump than we were last year. Despite all the market volatility over the past nine months, and despite the drop on Friday, the S&P 500 is only down about 4% for the year, and was in positive territory as recently as August 19.

If you would like to read a more rational picture of our current economic situation, check out this analysis by a long-term trader who now refers to himself as a "reformed broker" in Fortune magazine: http://fortune.com/2015/08/20/american-economy-worries/ He talks about the "terrible news" that it hasn't been this cheap to fill your gas tank in over a decade, and business that rely on energy to manufacture their goods are now forced to figure out what to do with the excess capital they're not spending on fuel.

And that is not all! American corporations are struggling under the burden of enormous piles of cash they don't have a use for. They may have no choice but to return some of that money back to shareholders in the form of record dividends. Of course, you read about the risk to corporate profit margins. It seems that unemployment is so low that wages for American workers are going up, and that could raise consumption and demand for products and services.

Meanwhile, contributions to 401(k) and other retirement plans are up dramatically, housing starts and the construction sector are booming, America's biggest global economic competitor (China) is reeling, and the Federal Reserve might decide that it no longer has to keep short-term interest rates low because the emergency is over and the economy has recovered. The author apologizes (tongue in cheek) for bringing us all this terrible news, but hey, we can always sell our stocks and get out until conditions improve.

Right?

We would not be surprised if the U.S. stock market suffered a 10% or even a 20% short-term decline, this year, or perhaps next year. But what can you do with that information? Nobody can predict whether Friday was a signal that the market will take a pause, or if Monday will bring us another wave of short-term euphoria measured mostly in sighs of relief. And if you don't know when to sell in this jittery market, how will you know when to buy back?

Our clients don't have to play that game and understand that their exposure to stocks is a factor of what is necessary to hedge against inflation for their unique goals and objectives, and is normally less than half of the portfolio. The remainder is very well diversified in bonds and a significant allocation to assets that are not correlated to the stock market at all (alternatives). This provides for lower volatility and, thus a "smoother ride" than the traditional stocks, bonds and cash portfolio. A nice position to be in times of high downside market volatility.

These short-term swings provide entertainment, but very little useful information for a prudent, well diversified investor. If you aren't entertained by watching people sell in a panic and then panic-buy their way back in when they realize things aren't as dire as the headlines made them out to be, then you should probably watch a movie instead.