Corrections in Bull Markets

In recent months we have been managing our investments in a market correction. This has been a serious challenge for many of our less-experienced fellow investors. Indeed, I have received a number of emails from members about how to manage their portfolios in market corrections. Rather than reply just to them individually, it seemed to me that a discussion of how to manage corrections is of general interest, so I have conflated the questions for a general Educational Article on the issues involved.

The first issue that was raised by one my members was put this way:

A lot of so-called experts are calling this a bear market already and who could argue when you look at the charts?

There are many different definitions of a bear market. I am not sure that any of them are totally satisfactory. In making an assessment, I think we have to consider all of the evidence and make a judgement. This is not a judgement at a single point of time, but over a period – as events unfold.

In doing so, we must be careful of one of the more common cognitive bases that I described in Chapter 11 of my book *Think Like the Great Investors*: hindsight bias. A cognitive bias is when we think in what seems to be quite natural ways, but that thinking is a systematic deviation from rational judgement. In hindsight bias, we all naturally fall into the trap of thinking that at the time we knew things that were only really evident at a later time. In other words, we tend quite unconsciously, unless we are aware of this bias, to rewrite history in our minds. Unless we are alert to the bias, we don't even know we are doing it.

With bear markets, it can sometimes be quite difficult to identify that we are in something that is more than a mere correction, even a severe correction, until it is well advanced. So, the more obvious bear markets will have been preceded by many of the signs of rampant speculation and the initial fall from the high point will tend to have been quite severe.

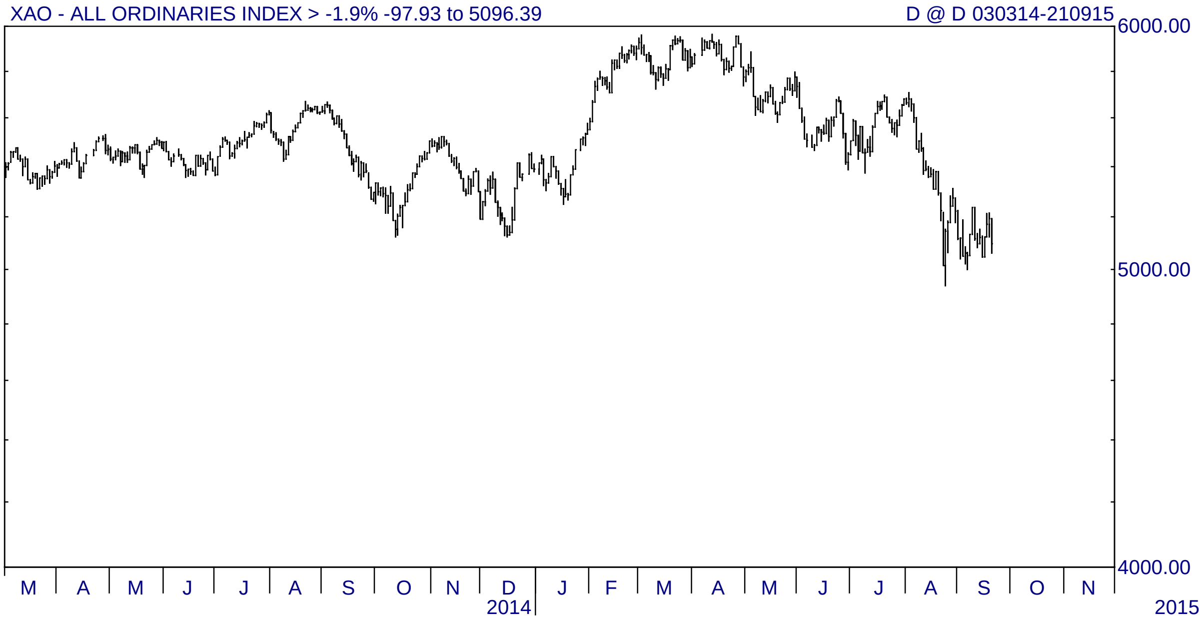
This time my analysis, which I constantly update on the members website, suggests that none of the usual signs of rampant speculation were present. Moreover, there was no really severe break in the trend. Below are the monthly and weekly charts I am looking at of the ASX All Ordinaries price index.

On them are marked the tentative trend channel lines, which will require minor repositioning once the correction is finished, assuming it does not turn into a bear market.

Monthly chart:

Weekly chart:

I am not seeing the signs of a speculative rush to the top. In fact, if we look at the daily chart, the top was a leisurely sideways affair that took three months to just roll over into the first decline in the correction:



Nor am I seeing a sharp fall from the top as happened in early 2008. Instead, I am seeing something more like the 2010 and 2011 experience, which turned out to be a two-stage severe correction. So far, this time we only have an incomplete severe correction – more severe than 2014, but still as far as I can see within the bull market from the 2009 low.

So, I am not seeing a bear market at this stage. I am simply seeing a fairly protracted correction in the bull market. However, this is where hindsight bias may come in. Right now, that is what I am seeing and that is the way I am managing my portfolio (more on that later). I would not be surprised if we have not seen the low of the correction yet. That said, anything is possible and what now looks only like a correction could become a bear market. Who knows? In that case there will be no shortage of the member's "so-called experts" who proclaim that it was obvious at the time. This will be hindsight bias writ large – they honestly believe they knew it would be a bear market back weeks or months ago. However, there was in my opinion no such evidence at the time, or even now as I write this in late September 2015.

My analysis is that we are in a correction in a bull market. As such, we should be long. I am 87% invested and have 13% in cash looking for buying opportunities over the next month or so as the corrections wears itself out. I love significant corrections and bear markets because they offer great opportunities to buy good stocks at cheap prices. I am looking to employ my 13% of capital (plus dividends declared but not received yet), probably before Christmas.

That is my strategy, but I am an investor. My mindset is that I am a part-owner of some great companies in a bull market. The major part of my return over the long term comes from dividends and franking credits and their reinvestment/compounding in the portfolio. I have stop-loss levels marked on my charts where my investment plan indicates that the uptrend I expect to happen has failed. Any business can run into trouble or suffer poor management. News is often in the price well before it is in the media. When my stops are violated I will sell without hesitation and wait for more opportunities to buy around the correction low. That is how I protect my capital – the first priority always.

I suspect that some of my members who have sent me questions do not have the mindset of a part-owner of a business. Not one of them has told me in their questions anything about the businesses of which they are a part-owner. All they have talked to me about in their questions is the share price. This is the mindset of a trader. A trader seeks to profit from movements in the price of shares. Their whole focus is properly on the share price, because that is the trading task. Important: in distinguishing the mindset of an investor from that of a trader, I am not making a value judgement about either activity. I am just trying to make clear that they are two quite different activities.

If a trader, then I would seriously question why they are still in this market correction. If their trades are behaving like the market index, I suggest that traders should have been on the sidelines since April/May. That or they should have been shorting declining stocks. Trading is not my game, but that is what I think they should be doing.

Why might they not be doing that? Why might they be agonising over falling prices of their stocks? I think it is a lack of:

1. A complete written and tested trading plan
2. Discipline to execute their stop-losses

Basically: inexperience. Everyone has to start somewhere and make lots of mistakes as the market teaches them – that tuition is called experience.

Now let me go back to some more of the questions from members to bring out more teaching about the craft of investing, rather than trading share prices.

I am struggling with the current drawdown… and yet you are still fully invested. How can you stand that much drawdown? My account is down around $90k since mid-May and I notice yours is down much more. How do you stand it?

First, let me correct the statement at the start of the question: I am not fully invested now and was not when this question was sent. As already stated I am only 87% invested, having sold down a couple of holdings to release cash for better opportunities that will emerge and being stopped out of two stocks.

Next, the question frames the member's drawdown (and mine) in dollar terms. This is another sign that the question is from a trader rather than an investor. Fair enough, but let me explain why I look at it quite differently as an investor:

The statement in the question that the member's account was down $90,000 since May is all the wrong way to look at it. With respect, this is a quite meaningless statement. Let me explain:

- If the member's capital was $100,000, then the portfolio is down 90% and something is very wrong with what the member is doing.
- If the member's capital is $1,000,000, then the portfolio is down only 9% and that may be seen as maybe not too bad.
- If the member's capital is $2,000,000, then the portfolio is down only 4.5% and that is pretty good.

The point I am making here is that, without looking it up, I don't know how much I am down in dollars. I just do not think that way. Investing is about return on capital and we should think all the time in percentages. The percentages I know and track closely.

So, although the member asking the question was concerned about the fall in the value of my portfolio in dollars, let me explain it the way I am seeing it:

- As of financial year 2014-15 my portfolio made a total return of 17.1%. Yes it was higher in April/May, but that is how it finished the year. There are always fluctuations within any year; that is the nature of investing. Investing is a craft of assuming risk, but managing it.
- So far in the financial year starting 1 July 2015, my portfolio's total return at last night's close (21 September 2015) is 1.59%. The market is down 5.13% (ASX All Ordinaries Total Return index). That does not include some dividends and franking credits I should earn in stocks that have yet to trade ex-dividend.
- The total return for the portfolio since purchase of the stocks I am holding is 25.7%. That is not an annual return – the holding periods vary greatly.

Sure, I would like to be doing better than that, but I am not overly concerned.

In conclusion on this question, I am not having any difficulty with the correction. I don't like it, but from 51 years of investing, I have seen much worse.

I review my stops regularly (I actually look at them every day). I think they are in the right place. If it turns out that the correction turns into a bear market (however defined), my stops will take me out. In the worst possible case, where all stop-losses were hit, my capital at risk last night was 12.44%. This would hurt, but I think the likelihood of all my holdings hitting their stops any time soon is remote.

The interesting thing is that there was already an answer to a very similar question on the website on the *Ask Colin* page on the Free Resources menu under *Drawdown*. This is an edited version of that answer:

Question

Last week (mid October 2005) I was looking at a large unrealised profit. This week I am looking at less than half that unrealised profit. How do you stay calm, when you see over 50% of your profits walk away?

My Response

This is an interesting question. The short answer is experience combined with rehearsal of your investment plan.

Experience is being there many times before. There is no real substitute for experience in any profession or in sport for example. If you have been there before, felt the emotions and dealt with them, taken action (or froze) and learned the lessons from the experience, you are better equipped to deal with the situation next time.

However, it is not possible to have experienced everything that could happen many times. Life is too short and some events are rare or unique. All athletes use rehearsal. They visualise all the possible situations that could occur and then visualise how they deal with them. They do this over and over again. Then when one of these things actually happens, they know instinctively what to do.

I had never lived through a 25% overnight fall in the market as happened in October 1987. Yet I was surprised how well I handled it. I think it was because I had rehearsed what it is like and what to do in a sudden drop in the market. I had previously had that unhappy experience in one stock, which I should have sold, but didn't, so I guess I had some experience. But essentially the key was that I had rehearsed what had to be done. I then sat there calmly and did what I had to do over the next two days.

Most people have trouble imagining alternative futures. It is a good skill to develop. Try to postulate all the things that could happen - likely or otherwise - and work out what you would do. Try to imagine it clearly and feel the emotions. Try to list the alternative options you have and weigh them up. Ask what is the best or worst you might expect. Then check out one stage worse that you think is possible.

You have arrived as an investor when you know instinctively what to do in any situation. Experience and rehearsal of your plan will get you there.

The other thing is to have a good investment plan that provides guidelines for decisions, of course. You need to have studied how it works over hundreds of previous situations. For example, my investment plan involves a sell stop which will always be somewhat below the absolute high of the trend. It will mean giving back a fair bit of the paper profit at the end in order to capture the meat of the trend. If you do not understand the implications of your investment plan, and have rehearsed it over and over, then these things will continue to be a challenge.

Your plan has to know whether you are a trader trying to capture most of every swing up in the market - in which case your recent experience is a failure of the trading plan. Or are you an investor intending to sit through the corrections and capture a big part of the bigger trend. In this case you must have rehearsed and internalised the sort of situation you have just experienced. The market was up 10% or so in a few months. You must know that cannot continue. Your plan must be the result of you thinking through what you will do in such a situation. Will you grab the profits and run or will you hold. If you hold, you must have rehearsed how it feels like and internalised the balance between the regret and the ultimate aim of your plan.

In addition to this guidance, I have for a month or so had the following advice on the members website (*Weekly Market Charts and Analysis*) for how to carry out what I have just described:

At this point, I am aware that less experienced members will be waiting for me to set out what I expect to happen. Let me repeat my assertion that I do not know how to predict the future with any accuracy or consistency and do not believe it is possible to do so. Moreover, trying to do so is futile and in fact can be quite dangerous to our investments. There is a better approach than prediction.

That approach is this:

1. *WRITE DOWN our analysis and assessment of the condition of the market.*

2. *WRITE DOWN our analysis and what strategy we will follow to take advantage of it.*
3. *Assess and WRITE DOWN our stop-loss for each stock we own. Our stop should be where we are wrong about what we expected to happen when we bought that stock. There are many ways to define what we expected to happen, so it will depend on the internal logic of our investment plan. Each of us will of necessity have a different plan, which is thought through to reflect our varying knowledge, experience, skills, personality etc. Simply trying to follow my plan is a sure way to fail – because nobody else is the same person as I am at this point.*
4. *If a stop is violated, sell without hesitation.*
5. *WRITE DOWN all the things that we can think of that MIGHT happen, no matter how unlikely. We should not limit ourselves by trying to think how likely they are; remember we cannot predict what WILL happen. It is better to have considered even the most unlikely events, than to try to limit our thinking here.*
6. *Then take each thing that might happen and WRITE DOWN what you will do if it were to happen. Mentally rehearse imagining it happening, feeling what it will be like. Then continue the mental rehearsal into what you have decided to do if it were to happen. Imagine and feel what it is like doing what you have to do. I do this all the time. Before the 1987 crash I had listed as my most remote possibility a 26% fall in one day (double the biggest one-day fall on Wall Street in 1929). When the market fell 25% on the day of the crash, I knew exactly what I had planned to do and carried it out methodically. I was amazed how absolutely calm I was in the crisis. That calmness came from the mental rehearsal process.*

I cannot do this for anyone else because I do not know their investment plan and have not made their life and investment journeys.

A final thought – I capitalised repeatedly above the words WRITE DOWN. This is very powerful. Those who are yet to have discovered the magic of having a written investment plan still imagine that they have it all in their head, so why write it down. I used to think like that. Now, I have a written investment plan and I also write down all my analysis. My investing returns have improved greatly from this. It is only when I started to write everything down that I found the gaps and logical errors in what I was doing.

So, today I have written at length at a difficult point in the markets. I DO NOT KNOW what is going to happen. However, I have a plan for all the possible scenarios that I can imagine. A key to better investing is not trying to predict what will happen, but knowing what we will do if each, even highly unlikely, eventualities unfold. Only by doing it will its hidden power be revealed to you and it has been to me over the years.

This has been a long article. I hope readers find it useful in building and improving their investing skills as they manage their portfolios through the current and any future market corrections.

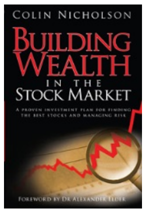
To read more of my work

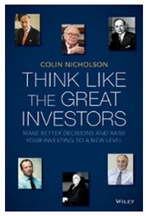
Previous Articles

All my previous articles for the free website are now on the *Educational Articles* page on the Free Resources menu. They are now listed alphabetically by title with a brief description of their contents.

Books

I have written two books, both of which are available for purchase from the ***Buy Books*** menu:





BUILDING WEALTH IN THE STOCK MARKET – A proven investment plan for finding the best stocks and managing risk

THINK LIKE THE GREAT INVESTORS – Make better decisions and raise your investing to a new level

Members Website

Follow my thinking on my own investments, disclosure of my portfolio as I go, weekly market scans, weekly market charts and analysis plus many more articles about investing and analysis

I am one of the very few investors who publishes their investment results each year, which I have done since 2000 – see the Investment Returns page on the About Colin menu on the website