What, me worry? Market corrections are a good thing

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With tensions escalating in the Middle East and Ukraine and weakness in certain areas of the market, such as the small-cap arena, talk of a correction is heating up yet again. More and more prognosticators are saying a 10-per-cent to 20per-cent decline will hit stocks any day now - just as they did earlier this year in what turned out to be a false alarm.

Whether they're right this time or not (I have my doubts), sooner or later we will have a correction. And, given that it's been quite a while since we had one (the last official correction came in the spring and summer of 2011, though we came less than 0.1 percentage point away from one in 2012), it's a good time to consider how to respond to one. After all, the longer you go without experiencing a significant decline, the more daunting and dramatic one can feel when it does hit.

When looking for guidance, I always turn to the gurus - those rare investors who succeeded in the market over lengthy periods of time.

Back in 1996, in an interview with PBS's Frontline, mutual-fund legend Peter Lynch said no one he knew of could consistently predict when market declines would occur. "If you're in the market, you have to know there's going to be declines," he said. "And they're going to cap and every couple of years you're going to get a 10-per-cent correction. ... And a bear market is 2025-30-per-cent decline. They're gonna happen. When they're gonna start, no one knows. If you're not ready for that, you shouldn't be in the stock market.

I mean, stomach is the key organ here. It's not the brain. Do you have the stomach for these kind of declines?"

Then there's Warren Buffett. In their book, *The New Buffettology*, Mary Buffett and David Clark write, "Warren knows very well that if the bull market has not yet 'bubbled', these corrections and panics will be short-lived and present great buying opportunities."

I agree. Corrections aren't a time to flee - they're a time to buy.

Listen to other top strategists with strong track records - fund managers such as Donald Yacktman, David Herro, or Bill Nygren - and you won't hear them talking about how to forecast a correction or sidestep one. You hear them talk about value, long-term thinking, and discipline. In fact, sometimes you hear the gurus talk about how they hope to see a correction, both for a buying opportunity and as a way to knock excess positive sentiment out of the market.

In his book, *Winning on Wall Street*, the late, great Martin Zweig said that the lack of a market correction for some time was part of why he correctly called the 1987 market crash.

"What bothered me were the similarities to 1929, 1946, and 1962," Mr. Zweig wrote. "The familiar pattern was gross overvaluation in P/Es and yields along with straight-up price movement which lacks a major correction for years."

Walls of worry are good for bull markets. When sentiment gets too high, investors start piling on the bandwagon, which can lead to valuations getting far out of whack, which can lead to crashes. That's why Charles Schwab's Liz Ann Sonders - who worked for Mr. Zweig earlier in her career and today is one of the top strategists I know of - has said many times this year that she actually hopes we have a correction.

Still, most investors don't heed the gurus' advice. In January, as the U.S. market fell and correction talk increased, flows into domestic equity mutual funds fell sharply, according to the Investment Company Institute. In the week ending Jan. 15, a net of $4.2-billion (U.S.) flowed into such funds, according to ICI. The next week, that fell to $2.5-billion; the week after that it was $1.9-billion; and the next week flows were actually negative at -$1.6-billion. Then, almost as if on cue, the market unexpectedly reversed and left those who had bailed expecting a correction wishing they hadn't.

In the end, the discomfort of investing through corrections is the price you pay for reaping the long-term benefits of stocks, which have been the greatest investment vehicle of all time. It's hard, to be sure. We are emotional creatures, and when our money is involved, those emotions can get set off quickly and ferociously, often to our detriment.

Associated Graphic

Market declines can help correct the investors' irrational exuberance, preventing valuations from getting too far out of whack.

CARLO ALLEGRI/REUTERS