The Investing Opportunities of 10 Percent Corrections

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The day you plant the seed is not the day you eat the fruit. Be patient, and do not give up.

– Fabienne Fredrickson

When a stock or equity index trades down more than 10 percent from its last high, we say that it is undergoing a correction. A decline of 20 percent or more is called a bear market. Over the past 50 years, the market has seen 26 correction periods, but only six bear markets. Downside market volatility is unnerving for investors who pay close attention to such short-term movements, and negative performance is always frightening. But the good news is that 10 percent corrections are a long-term investor's best friend.

Our economy and stock market have moved steadily higher over the past 100 years, giving investors infrequent opportunities to put new money to work during corrections, so long-term investors must take advantage of these periods of opportunity when stocks are “on sale.” Adding money to investments during these temporary downturns has been a great way to enhance the long-term returns on a portfolio. Given that the market was recently at an all-time high again in September, you could say that adding money to a stock portfolio during a 10 percent correction has never turned out to be wrong. That contribution could turn out to be early, perhaps, but never wrong.

Looking at the past 50 years of stock market history, let’s say that a new investor began investing in September 1968 and invested $1,000 in the S&P 500 at the end of each month after that. This new investor faithfully made his contributions to his account for the next 50 years, spending only the dividends that the account paid out. The brave new investor would not know it yet, but over the next 50 years the equity market would see 26 corrections of 10 percent or more. And he would not know that those periods are ideal opportunities to make additional investments to boost long-term returns.

Our new investor was faithful and smart, but also had a strong stomach and added an additional $1,000 to his investment account at the end of each month after a 10 percent or worse correction occurred in the S&P 500 index. This decision was difficult each of the 26 times that he gritted his teeth and bought, especially when market pundits, financial news outlets and his friends and neighbors told him that he was crazy. In each correction, naysayers would continually tell him that the market was due for a great fall, and to save his money. But he took advantage of each correction and added more money anyway.

If the investor had not contributed extra money to the account after every market correction, the investor would still have done very well, due to a steadily growing economy and positive stock market returns during that long period. After 50 years of adding $1,000 each month, the investor had contributed $600,000 to his account over that long period, and the account grew to be worth $7.3 million now.

But factoring in the contributions made during market corrections, the account grew to $7.8 million. That is the power of 10 percent corrections. Twenty-six extra contributions of $1,000 each during very scary market shocks grew to an extra $500,000 in the account at retirement. While it may be difficult to buck the trend and go against conventional wisdom, the payoff for being brave while others are fearful is considerable.

While the financial media may focus on financial market volatility and scary downdrafts in the stock market, there is great opportunity in going against the grain when fear trumps reason and patience. Remember, investing is not gambling. By buying stocks, an investor is buying a stake in a U.S. economy that has grown steadily for 240 years, with only brief and temporary interruptions in that growth. It has never been good in the long run to bet against the American economic horse, and it will not pay off in the future either.

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