A big market decline tests our abilities to make rational decisions in the face of uncertainty. GETTY

A number of market commentators have noted the historic nature of the recent market drop, which has taken us over 10% lower in major stock indexes in just a few days. My work as a performance psychologist for hedge funds and trading firms has never been busier. The uncertainty and potential economic and market risks associated with a coronavirus outbreak have investors running for the relative safety of investment grade fixed income and away from the very growth stocks that were recent market darlings.
1) A Knowledge Of Market History Can Be Valuable - History is far from a perfect predictor of the future, but it beats ignorance. In the last Forbes article, I highlighted a number of research services that track the markets daily and examine historical performance under similar circumstances. A common theme among these reports is that the stock market tends to rebound after extreme weakness, but that the path forward tends to be volatile, with plenty of shorter-term moves up and down. This can offer promise (and overexcitement) to nimble traders seeking movement and challenge (and risk aversion) to investors seeking stability. For example, I note from the Index Indicators site that, as of the close on Friday, February 28th, fewer than 5% of all stocks in the Standard and Poor’s 500 Index closed above their 5, 10, 20, and 50-day moving averages. That is evidence of very broad market weakness. Since 2006, when I started my database, there have been only nine daily occasions with such readings. Five of these occurred in October and November of 2008; two clustered in August of 2011. Returns were highly volatile going forward, reflecting a market VIX that averaged over 50 across the occasions. Six of the nine occasions saw daily closes over 6% higher in the following week. The 2008 and 2011 occasions ultimately saw us make lower lows in coming months. A simple mindset of doom and gloom or optimistic “buy the dip” is not supported by history. The real takeaway is that volatility is more sticky than directional movement—and we need to be prepared for that.

2) A Knowledge Of Market History Can Be Dangerous - Whenever your sample size is nine, with overlapping occasions, you have a small group of examples to draw conclusions from. It’s also not one that leads itself to robust statistical analysis. It is easy to see in history what we want to see. The smart investor or trader uses history to frame hypotheses, not to feed confirmation bias and become locked into conclusions. In the current market situation, an overreliance on market history may be especially misleading. The circumstances leading to the recent market weakness—a potential global pandemic—are not circumstances that have occurred during similar market declines. This is why the savvy investors I speak with are closely tracking case reports in Asia and Europe, consulting with experts in epidemiology, and paying attention to economic statistics around the globe. Finance professor Campbell Harvey makes the
exacerbating health and economic impacts. A history of past epidemics may be more enlightening than recent market history and suggests that such problems can take a while to play out.

3) How We Manage Ourselves Shapes How We Manage Risk - We know that stressful conditions introduce a fight or flight reaction of mind and body that can lead to make short-sighted, reactive decisions. The smartest money managers I work with a taking extra steps to maximize their energy and mindset, realizing that volatile market conditions can introduce unusual risk and opportunity. A common theme in our discussions is doubling down on slowing ourselves down when markets are speeding up. It’s the extra efforts at mindfulness that combat cognitive biases. We have declined around 10% in major stock market indexes in the U.S.; it’s not unusual to see greater declines than that during periods of recession. Many of these recessionary periods, however, have offered unusual investment and trading opportunity, punishing sound assets along with the shaky ones. In a world of continued falling interest rates, it’s hard to believe that companies with strong balance sheets and attractive yield won’t find interest among asset managers. When markets dropped meaningfully in 1973, 1987, 2000, and 2008, it took a while for bottoms to form. Ultimately, however, these declines led to unusual opportunity. Bottom line? It’s impossible to win the game if we don’t stay in the game. The best traders and investors I work with continually entertain market and economic scenarios and update these regularly, keeping enough powder dry to weather storms and pounce on opportunities.

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