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Markets have posted impressive gains recently, leaving many investors wondering if a correction is (over) due. As adherents of Modern Portfolio Theory (MPT) we believe in efficient markets, where stock prices reflect all known information at all times. The corollary to this then is that stocks are correctly priced -and therefore suitably priced for expected future returns.

MPT however is a hypothesis which best explains stocks behaviour over the long term. Over shorter periods however, stock prices are often influenced by market sentiment, recent news and emotional trading. This leads to temporary mis-pricing of securities, and the opportunity for investors to capitalize by buying securities below their intrinsic value.

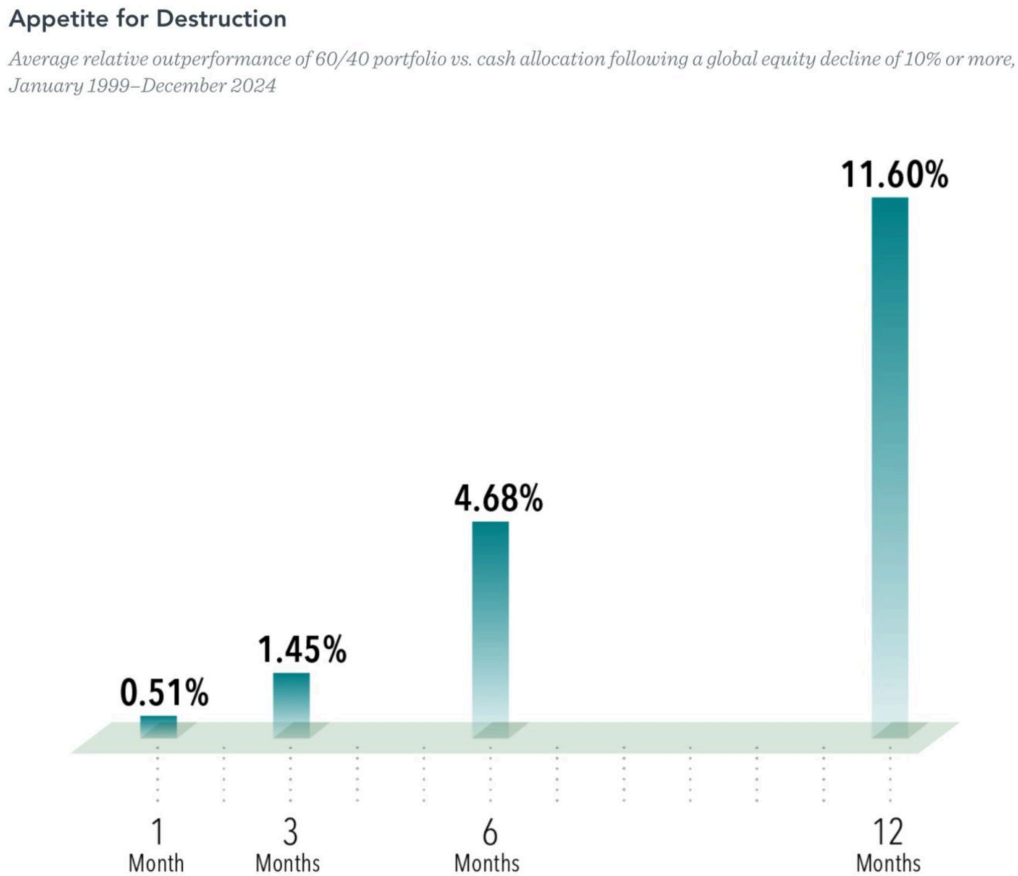
Sentiment (emotion) encompasses fear of missing out (FOMO) and fear of loss (FOL), and are merely alternate ways of describing fear and greed. Both are drivers of market performance and contribute to irrational investment decisions that are detrimental to investor’s returns over time.

At some point markets will adjust, lower, and when stocks decline investors are often tempted to move into cash in order to avoid further losses. That’s only natural, as the appetite for risk moves directionally with market returns. Lower markets mean less willingness to stay in risk assets (stocks). History tells us that’s probably the wrong move. A balanced asset allocation of 60% stocks and 40% bonds has on average outpaced cash in periods following three-month market declines. Investors sitting on the sidelines have invariably missed opportunities when markets rebound.[1]

The best course of action is to stay disciplined and stay invested. History provides solid guidance as to the what the future holds.

Thanks for reading!

Martin
1-519-546-5088



Source: 1. Dimensional Fund Advisors (Graph)

MARTIN WEILER, FINANCIAL ADVISOR
FIRST CAPITAL FINANCIAL / WORLDSOURCE FINANCIAL MANAGEMENT INC
50 CORESLAB DR. DUNDAS, ON L9H 0B2
P: 519-829-1331 F: 833-869-8042
MARTIN@FCFCORP.CA