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INSIGHTS

94 DAYS

At the time of writing, the S&P 500 is trading at 4441 – that's 2.3% below its all-time high of 4545. No doubt, news outlets are putting out headlines of stock market overvaluation, the fiscal deficit, high inflation, supply chain bottlenecks and a myriad other reason why this is the start of a bear market.

Put into context, a 5% stock market correction has happened on average roughly every 94 trading days since 1929. Frankly, the market has been overdue one of these corrections, touching a low of 4,348 earlier this week - it had been over 200 trading days since the last 5% correction. This is normal. Just like death and taxes are inevitable, investors cannot escape the maxim 'There is no free lunch on Wall Street', which is to say that for investors to enjoy higher returns, they must take on higher risks. That is one of the reasons stocks have historically out-performed bonds – they are riskier.

Risk and Diversification - Perspective

When defining risk as a reason stocks tend to outperform bonds, the word is used somewhat loosely - a more accurate distinction must be made between risk and volatility. If a stock goes from $50 to $100 but does so erratically (up 20%, down 20% etc.) the stock is volatile. However, the stock may not necessarily be risky. Instead, risk should be defined as the probability that an investor loses their money.

This leads to the first concept of diversification. There is always some small risk that a company could fail (new legislation, new technology etc.). As an example – if an investor invests all their funds into a single company, and that company has a 1% chance of failure, the client has a 1% chance of losing all their money. However, if an investor invests in a diversified portfolio of 20 stocks (5% allocation each), each with a 1% chance of failure, should one company fail, the investor will only lose 5% of their money. The chance of every stock failing and the investor losing all their money is miniscule. So, risk has been drastically reduced.

However, if all the stocks in the portfolio are companies which are driven by the same economic factors, they may all move up and down together through the economic cycle. This up and down movement is volatility. The companies' business models are sound, but the variability of their earnings fluctuate during economic cycles, which may in turn cause their stock prices to fluctuate.

The second concept of diversification applies to owning stocks (companies) in different economic sectors. By owning a portfolio of stocks in various sectors, as some sectors' earnings (and share prices) are negatively impacted at certain points in an economic cycle, companies

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in other sectors can benefit from that same point in the cycle, offsetting the negative stock price movements. As a result, the aggregate portfolio volatility falls overall.

Compensated for Risk

So, as we approach Q3 corporate earnings season in October, an increase in volatility is expected. However, this is just the volatility the investors are expected to endure for the benefits from the higher returns which stocks generate over time. Unless companies like JP Morgan, Apple or Google are expected to go out of business for some reason in the next few weeks (highly unlikely), this is just a bout of volatility, not an increase in risk. As such, investors should stay the course and get paid in the form of higher returns for investing in a more volatile asset class.

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