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MARKET INSIGHTS: PROTECTION IN A CORRECTION

A recession is unlikely this year, but investors may still want to plan for a stock market correction. High equity valuations are at risk of repricing lower in response to a variety of geopolitical risks, and a correction could occur even as U.S. employment grows, wages rise, and consumers spend.

We would be wise to recall that Peter Lynch, who delivered 29 percent annualized returns at Fidelity's Magellan fund from 1977 to 19901, warned that "Far more money has been lost by investors…trying to anticipate corrections than has been lost in corrections themselves." However, after 10 years of persistently higher valuations, investors may feel that an increasingly defensive portfolio at this time is less about market timing and more about thoughtful repositioning that acknowledges historically high-valuation levels and the rising uncertainties that threaten them. Such an approach may also reflect John Maynard Keynes' comment, "When the facts change, I change my mind. What do you do, sir?"

Should We Plan for a Correction?

Corrections are not unusual; in fact, they are a normal part of the investing environment. Investopedia reports that, between 1980 and 2018, there were 37 market corrections of 10 percent or more. The average of these S&P 500 corrections was 15.6 percent.2 By accepting the idea that corrections will occur, investors can then focus their attention on: a) ensuring portfolios account for potentially corrective environments, while being aligned with long-term goals and the ability to emotionally withstand price volatility (aka "risk tolerance"), and b) what could be the catalyst for the next corrective phase?

As we are currently in the midst of some market disruption related to the trade conflict between China and the U.S., this topic is certainly a focal point. Even if there is resolution by year end, trade negotiations will not provide a smooth trajectory to a Trump/Xi photo op, and the vagaries in negotiations will create volatility in the stock market. Trump has shown noticeable sensitivity to volatility in the U.S. stock market; this is not lost on the Chinese, and we should expect their negotiations to intentionally disrupt U.S. markets as a negotiating tactic. Even if such a tactic is not employed, the shifting expectations of the process of trade agreement success could easily produce a 10 percent correction in the S&P 500 this year.

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[1] Source: "Peter Lynch's Investing Career", https://www.investopedia.com/terms/p/peterlynch.asp.
[2] Source: "Real World Examples of a Correction", https://www.investopedia.com/terms/c/correction.asp.

Other potential catalysts for a U.S. correction abound globally: Relations with North Korea have deteriorated, as they have continued with missile tests, and the U.S. seized a North Korean cargo ship in Indonesia; Iran recently armed ships with missiles and fired one that landed close to the U.S. Embassy in Baghdad; Drones have attacked Saudi pumping stations and a weapons depot at a military airport; Yellow vests in France have dwindled in number but may increase in ferocity; Italy's spending plans are projected to breach European Union rules; With an inflation rate of 1,300,000 percent, Venezuela is redefining economic instability, while its neighbor, Argentina, recently raised rates three times in one week in an attempt to curb inflation. The U.S. remains the best house in a bad neighborhood, but the uncertainty surrounding us threatens business investment. Without increased capital expenditures to improve productivity, U.S. wage gains may also reduce corporate profitability at a time when tariffs could increase prices further.

Investor complacency about these geopolitical risks has so far resulted in only modest volatility around fully valued equity levels. At some point this year, though, any of these headlines could flare up and turn complacency into concern, easily translating into a "risk-off" correction. A more severe bear market is unlikely, as long as solid economic fundamentals of consumer spending and supportive fiscal, regulatory, and monetary policies remain; however, a correction seems reasonable to expect.

Protective Strategies

Investors who want some protection in a correction can shift their portfolios in many ways:

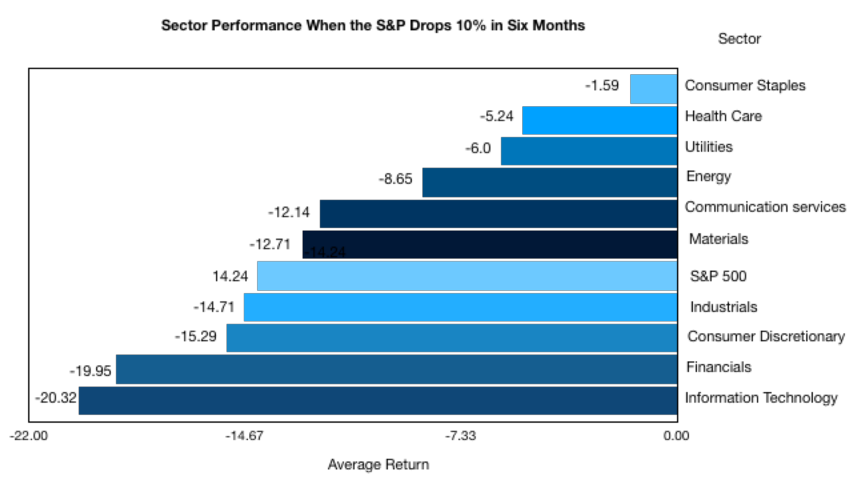
1. The most efficient approach shifts assets from equities to fixed income; this shift could be tactical (until the expected correction allows a reversal) or – for investors who are more fearful that we are marching toward economic slowdown – the move could be part of a longer-term, more conservative strategy. Either way, today's flat yield curve favors the lower volatility of shorter maturities. A short-duration fund yields more than inflation and should have relatively limited volatility.
2. A less stark approach to capture downside protection without reducing equity exposure is a shift to high dividend stocks. Income seeking investors may prefer this strategy. Historically, high dividend stocks have performed better in market downturns than those with lower dividends. The chart below compares the performance of stocks according to their quartile ranking of dividend payments; those in the highest quintiles of dividend yield provided measurably better protection than those with lower dividends. High dividend strategy funds may provide investors downside protection while potentially increasing income. It is important to recognize that, when markets recover, high dividend stocks may be less responsive on the upside as well.

Average Performance by Size of Dividend During Market Downturns

Market Downturn	Non-Dividend Payers (%)	Lowest Dividend Payers (%)	Quintile 2 (%)	Quintile 3 (%)	Quintile 4 (%)	Highest Dividend Payers (%)
> = 30%	-44.95	-38.11	-32.63	-32.03	-29.91	-32.37
25 to <30%	-39.76	-27.96	-26.60	-32.09	-28.99	-30.81
20 to <25%	-33.23	-24.50	-20.82	-20.78	-19.61	-21.45
15 to <20%	-26.63	-17.84	-14.53	-12.37	-11.39	-11.13
10 to <15%	-20.16	-13.51	-12.28	-11.24	-10.90	-11.02
All Drawdowns	-28.24	-20.24	-17.62	-17.06	-15.99	-16.68

Source: Kenneth R. French and CRSP, 1/1/1928 to 12/21/2018

3. Finally, a reallocation within equities, overweighting sectors that historically have provided better downside protection, may be favored by investors who want to balance fear of missing out with a defensive tilt. The chart below describes the average percent loss when the S&P 500 drops more than 10 percent over 6 months; it shows that, in downturns since 1988, utilities, healthcare, and consumer staples have experienced substantially less downside volatility than other S&P 500 sectors. Investors may want to allocate to these or other expectedly less volatile sectors.



Data since 1988. Source: Kensho

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