How to Beat the Market During This Massive Selloff -- Dow Set for 600 Point Decline at Open

By James Hickman Follow | 08/24/15 - 8:28 AM EDT

NEW YORK (TheStreet) - What a difference a couple of days make. Entering trading on Tuesday, the **S&P 500** was within 1.3% of its all time high, and had remained within 10% of its peak for 662 straight days -- the fourth-longest streak of tranquility, so-defined, since 1960.

Four trading days later, the index is down 6.3%, putting it 7.5% off its peak. The CBOE Volatility Index, also known as the VIX or "fear index," tracks at-the-money and close-to-the-money front month S&P 500 option premiums, or "insurance" against a market correction. The VIX reflects the broader market's perceived "tail risk," or risk of a major correction.

Asian markets tanked last night in what commentators in China are calling "black Monday" and European markets followed suit. The Dow Jones Industrial Average is set to open about 600 points lower and other U.S. indexes are also headed for a tumble.

The VIX was at 13 on Monday, the low end of the historical range and indicating low perceived market risk, but closed on Friday at 28.

What happened so suddenly? Meaningful downside volatility has been long overdue. Protracted periods of stability produce riskier behavior and inflated valuations. Such periods never end well for investors and the eventual catalyst is often surprising and small relative to the market value lost.

The airwaves and Internet are filled with authoritative opinions about what happens next. A word to the wise, no one has any idea what will happen next, which calls for action designed for a time horizon beyond the next few weeks or months.

What can be said with some conviction is over the next several years, returns from current levels of the S&P 500 Index are likely to be significantly less than long-term historical averages (see table below) and a substantial drawdown is likely at some point. Those longer-term returns will probably involve significantly more volatility than observed during the period of zero-bound interest rate policies. That said, in the coming months the combination of flight to relative safety in US markets and a continuation of historic lows in risk-free rates may push the stock market back toward new highs before the inevitable maximum drawdown. The risk/reward to hanging around for that possibility is not compelling.

Compounded Annual Total Returns for S&P 500 Index

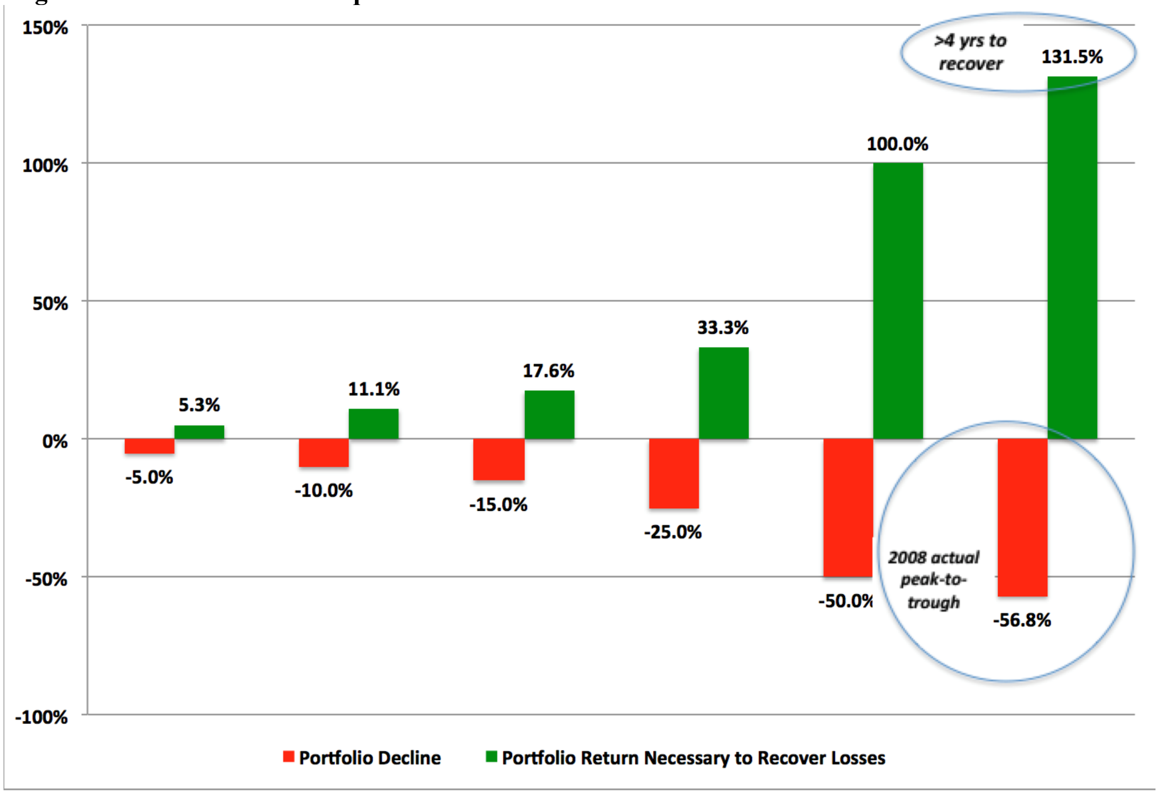
2010-present	11%
2000-present	2%
1990-present	7%
1980-present	8%
1950-present	8%

In the long-standing seesaw battle between fear and greed for control of market psychology, greed has dominated and fear does not tend to take hold until significant pain has already been absorbed.

That fact makes perfect sense, given that over almost any time frame, the market rises twice as often as it falls and the long-term net trajectory is upward. But the pernicious consequence of that historical reality is that investors' lack appreciation for the fact that loss avoidance is more important to long-term total market returns than upside participation, as demonstrated in the chart below.

Note the maximum draw during the U.S. financial crisis, -56.8%, required over 4 years to recover the losses, and compounded annual total returns from the point the maximum draw for that episode first reached 10% to the present have been just 4.4% for what is now nearly eight years.

Negative Portfolio Returns Require Greater Positive Returns to Recover Losses



Moving from basic math to actual market performance, the table and chart below show the value of avoiding market losses by examining monthly closes over the last decade for the S&P 500.

The graph of various upside and downside market capture combinations (capture being an investor's percentage participation in cumulative stock market gains and cumulative market declines, respectively) that would have produced actual total market returns (4.9% compounded for ten years ending August 2015) shows that if investors could have avoided just 10% of the cumulative declines for the S&P 500 index (the x-axis on chart) -- absorbing fully 90% of the declines -- that investor would have only needed to capture 65% of the market's cumulative increases to match total actual market performance, and done so with far less volatility than actually observed in the market.

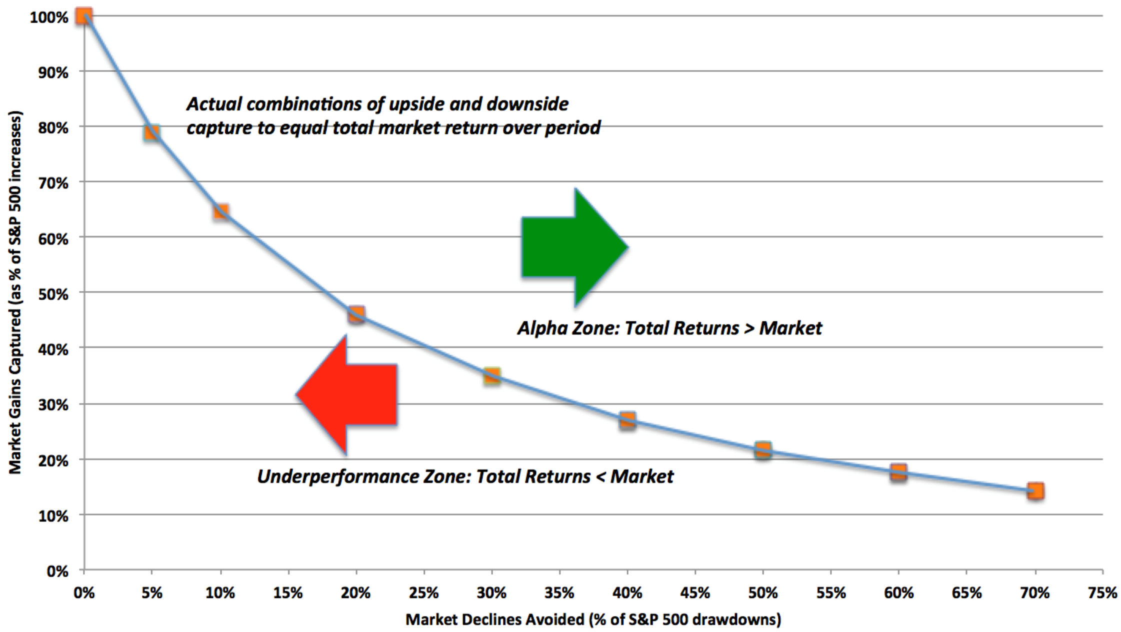
The impact of avoiding full participation in market declines is significantly less during periods when market declines are less frequent and of lower magnitude. In the last two years, the median monthly market decline has been -1.9% compared with -2.5% in the nearly four previous years, and the number of down months has dropped to 33% from 41% in the respective periods. With significantly fewer down months and shallower declines in the months that did decline, recent times have been tranquil indeed.

Ideally, one beats the market, and the non-linear relationship between combinations of downside and upside market capture -- avoiding losses has more impact than fully participating in gains -- demonstrates the most effective way to maximize total returns and more importantly, risk-adjusted total returns, is avoiding meaningful participation in the deepest market drawdowns.

To the extent that a combination of technical and fundamental market signals can help execute that objective, a rather large hole would be exposed in Wall Street's "buy-and-hold" mantra.

Loss Avoidance and Upside Capture Combinations Producing Market Performance
(10 Years Ending August 2015)

If Share of Mkt Declines Absorbed Limited to:	Share of Mkt Gains Needed to Match Total Market Return:	Market Losses Avoided:
30%	14%	70%
40%	18%	60%
50%	22%	50%
60%	27%	40%
70%	35%	30%
80%	46%	20%
90%	65%	10%
95%	79%	5%
100%	100%	0%



Source: Yahoo Finance (based on month-end closing S&P 500 Index values) and HVM calculations.

Does history give us any clues when we are poised to embark on a period of below-average returns marked by a serious drawdown? The answer is yes, although, as always, history is not always predictive of the future, and market "irrationality" can and often has outlasted one's investment time horizon.

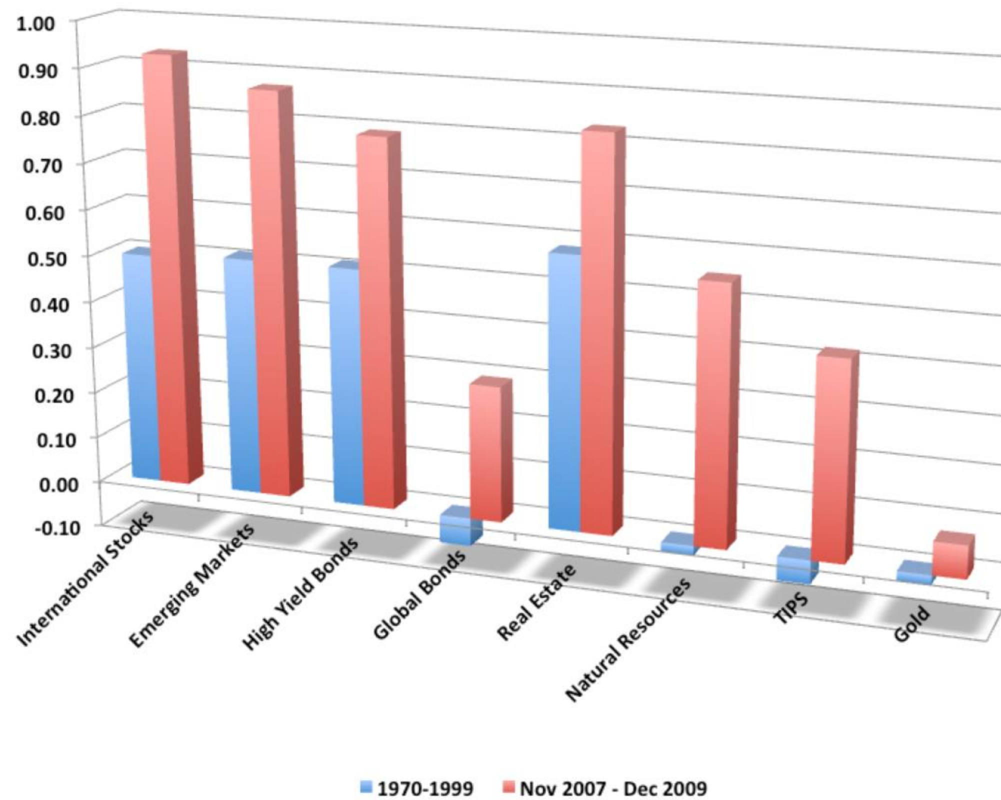
High levels of systemic risk and the likelihood of disappointing market returns and absorption of another significant market correction (in excess of 30%) are explored in detail here and here.

So, "buy-and-hold" is potentially flawed advice when systemic risk is known to be high for any investor seeking to maximize long-term total returns, but particularly for investors in the later stages of a carefully formulated retirement plan.

The risk of significant return shortfalls (the average return assumption for defined benefit pension plans was 7.68% at the end of 2014) can decimate retirement plans for those who do not have 30 years to recover (total market returns since 2000 are less than 2% per year, despite the 11% returns since 2010.)

Investors should also be wary of another Wall Street bromide - the notion that a "diversified portfolio" will cushion investors against a significant decline in any given asset class. This assertion is true in theory, but diversification has been a bit loosely defined in the past. The table below shows how correlations spiked among historically independent asset classes during the financial crisis, when the portfolio diversification many investors thought they had was needed most.

Rising Correlations Among Asset Classes During Periods of Market Stress



Source: William J Coker, Jr.

The near-term prospects of a suddenly skittish public equities market are impossible to predict. But we do know the market is trading at the fourth highest level of CAPE in history with the other three episodes observed just prior to massive corrections in 1929, the tech bubble and the financial crisis.

Moreover, this inflated valuation multiple is on U.S. profit margins that are roughly 50% above long-term averages (70% higher in the last several years) portending flat to declining earnings growth concurrent with multiple compression.

All this is happening amid a fifth straight year of decelerating global growth and a 15th year of compounded annual US GDP growth one-third lower than long-term averages.

The only market positives are the general tendency of global investors to seek refuge in the relative safe haven of U.S. markets and the fact, in our long-standing opinion, record-low interest rates are not going away for years.

But the cyclical bull market is long in the tooth and points to significantly below-average long-term total returns going forward, including the probability of another material drawdown at some point.

Investors should be thinking about moving capital into US fixed income and true alternative asset classes. Selling within 7.5% of the all-time high to lock in high recent returns makes good sense given the risky backdrop with which the market is only now beginning to come to terms.

This article is commentary by an independent contributor. At the time of publication, the author held TK positions in the stocks mentioned.