Investment Fundamentals

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Stock Market Correction

- A stock market correction is when the value of an index declines 10% or more from its most-recent high.
- On average, a correction in the U.S. stock market occurs about every two years, and generally takes three months to recover.
- Despite the panic they tend to cause, stock market corrections are necessary for the health of the overall market.

The word “correction” is defined by Merriam Webster as "the act of making something (such as an error or bad condition) accurate or better.” In the context of the stock market, a “correction” occurs when an index or individual stock drops 10% from its most-recent high. Essentially, corrections are price declines that stop an upward trend.

In August 2015, for example, the Dow Jones Industrial Average, the S&P 500 Index and the NASDAQ Composite Index all fell over 10% from their respective highs in the wake of China’s slowing economy and concerns about the timing, speed and size of potential Federal Reserve interest rate hikes — qualifying as the first U.S. stock market correction since 2011. Investors watched in horror as their portfolios tumbled.

Given this, it’s understandable that a stock market correction would cause some panic among investors. But still, why would the word “correction” — which has such a positive connotation — be associated with something that causes investments to lose value?

The simple answer is that it’s because a bull market (one in which prices are generally rising) can result in stock prices rising faster than justified by underlying company earnings.

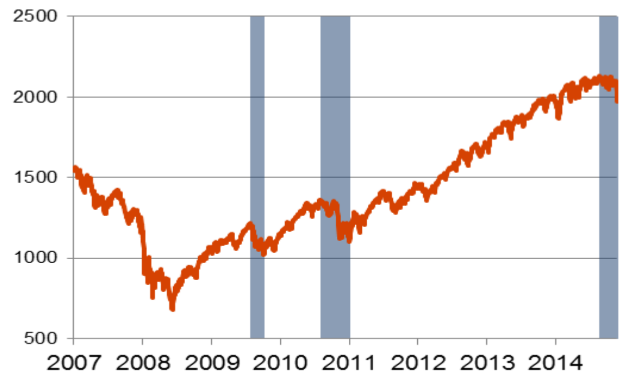
The banality and virtues of stock market corrections

Despite the alarm often triggered by stock market corrections, they aren’t typically tied to major economic crises and are actually quite common. On average, U.S. stock market corrections occur about every two years. It’s a good thing, too, because they are necessary for the health of the market.

Without the occasional pullback, stocks become overpriced or inflated, and a bull market swells to a bubble that eventually bursts — resulting in a sudden decline across broad sections of the market (known as a stock market crash). And a crash is far more likely than a correction to lead to a bear market (which is when equity prices decline 20% from a recent high).

The correction that occurred in August 2015 was unusual in that it had been four years since the last one occurred — double the average timespan between corrections (Exhibit 1).

Exhibit 1: Stock Market Correction? It’s about time.



Source: SEI, S&P 500 Index as of 8/24/15. Shaded areas represent corrections within the current bull market.

Despite the panic the recent pullback caused, it was actually just what the market needed — because a correction can be viewed as a defence against more-profound trouble. Plus, savvy investors can treat the relatively cheap stock prices caused by a correction as a buying opportunity.

What to do in a stock market correction

What should you do if markets contract by 10% from recent highs? Just wait. U.S. corrections generally last around three months and, despite their regularity, the average annual return for the S&P 500 Index over the last 50 years has been 9.84% (as of 8/28/2015)[1]. So there’s a good chance investment losses suffered in a correction will be recuperated in the long run. And if you overreact by selling your investments, you could miss out on gains when the market bounces back. Remember, a correction is just “the act of making something better.”

[1]Source: Professor Aswath Damoradan, NYU Stern School, http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html

Index Definitions:

S&P 500 Index: The S&P 500 Index is an unmanaged, market-capitalization weighted index that consists of the 500 largest publicly traded U.S. companies and is considered representative of the broad U.S. stock market

Dow Jones Industrial Average: The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and NASDAQ.

NASDAQ Composite Index: The NASDAQ Composite Index is an unmanaged, market-capitalization weighted index that consists of all securities listed on the NASDAQ exchange. It is often used to gauge performance of global technology stocks.