Reading Between the (Head)Lines

The media had a field day after Monday's 1,175 point drop in the Dow, with headlines declaring "The Biggest One-Day Drop in History!" While that statement is technically true, it is also fairly misleading, and likely only spurred growing concerns from your client base. But alas, we already know that the media is in the business of selling headlines, not in the business of providing sound investment advice. Nonetheless, it does provide a relevant and interesting discussion opportunity moving forward; and so today we will do our best to help you and your clients read between the (head)lines.

Let's start by putting the factual elements of the "biggest one-day point drop in history" statement into context. Yes, the Dow did in fact drop 1,175 points in one day, which was the biggest point drop in history. However, that 1,175 point drop translated to a 4.6% decline, which is nowhere near the biggest single-day decline on an percentage basis. That title still goes to another Monday, "Black Monday," when the Dow tumbled over 22% on October 19, 1987. The last time we saw a percentage decline in excess of 4.6% in a single day's session was in August of 2011. So even though Monday's move was not record-breaking, it was still significant.

In the image below, we have worked backwards in time to compile all of the historical largest point drop days for the Dow back to 1900. Prior to this Monday, September 29, 2008 held the trophy, with a Dow drop of 777 points. Before that, it was September 17, 2001, and so on and so forth back to the catastrophic drop of 14.66 points that occurred on December 14, 1914, a +20% decline at that time. All told, nine of the "worst" days below (including 12/14/1914 and "Black Monday") resulted in more dramatic percentage declines than Monday's session did.

We dug a little deeper into the data, and found that those who refused to be scared away on a big down day, and rather were enticed to purchase, could have significantly improved their returns over time. Consider the information outlined in the table below. Using data back to the beginning of 1900, we compared the average return of initiating investments in the Dow at close on the biggest point decline days in history versus all trading days. We looked out approximately one year (250 trading days), 6-months (125 trading days), three months (60 trading days) and two weeks (10-trading days). The results? Well, on a short term time horizon (two weeks and three months out), we find that our average return slips lower when we purchase after a significant point drop. This is to say, a day with a record point decline may not necessarily be an exact bottom, as evidenced today by another 1000 point drop. It takes time for the dust to settle after events like these. However, notice that when we look out to longer term holding periods (6 months and one year), the gutsy buyers are rewarded significantly for purchasing after these extreme down days. Specifically, the average return six months out increases by more than 1%, and jumps to about 1.5% when you look out one-year.