Episode #240: How to Use Stock Market Turmoil to Your Advantage

Video Transcription

Hi, my name is Tim Devlin. I want to welcome you to this week's episode of "Money Script Monday." Now, over the past two years, we've had a string of totally abnormal events, including a world pandemic, the ensuing reopening, and now the Ukraine and Russia conflict.

So with that, it's brought a lot of market volatility in the form of a crash during the pandemic. And then more recently, we've seen the S&P 500 move into correction territory, and the NASDAQ move into a full-on bear market.

Today, what I want to talk about is how we can use these times of stock market turmoil to our advantage and use this as an opportunity, not to panic, but to buy great assets that may be trading below their fair value.

As we go through this day, I want to cover, first, the major cause. So we'll talk about these waves of inflation. Two, the effect, the diversions of fundamentals between the underlying businesses, the companies themselves, and their stock price. And then three, what's that potential opportunity for you going forward?

So, first, let's start with these inflation waves. Now, as we all know, we had a pandemic in 2020. It was a crazy time and what resulted from that is everybody was forced to stay home combined with the government providing stimulus in the form of checks and support to the U.S. consumers.

Well, what happened was that U.S. consumers couldn't go out of their homes. They were forced to be locked down. So, what ended up happening is all of that stimulus went to be purchased on goods.

People went and shopped online, and that drove up the demand for goods just as the world's supply chain was shutting down from the coronavirus. So that's the first wave of inflation that we experienced. This massive increase in good usage or consumption.

Now, the second thing that occurred was the reopening. Eventually, we were able to go back out and spend money on restaurants, travel, concerts, whatever it may be. We were able to go and spend money on services and not goods. And this came about in the form of the reopening. And this was like our second wave of inflation.

Now, third, the more recent one is due to the Russia and Ukraine conflict. And this has been taken in the form of commodities. If you've tried to fill up your gas tank over the past few months, you know you're paying a lot more than you were six months ago, a year ago. It's gone up at an astronomical amount, and you see that across the board in the form of commodities. So, these have been the main drivers of inflation.

What ends up happening is the federal reserve eventually is forced to step in, and they're going to say, "We don't want inflation out of control, it's not good for the U.S. consumer. It's not good for our economy." And so the result of that is they start to raise interest rates. They're trying to slow that growth and cool inflation. And so what's not good for stocks in your portfolio is inflation. That's like kryptonite.

So with the federal reserve saying, we're going to raise interest rates and try to kill these different forms of inflation, their end goal is to try to control that. Now, the effect of the rising interest rates and the rising inflationary environment is a lot of stock market volatility. And so, as I mentioned at the start, we've seen the S&P 500 move into correction territory. The NASDAQ index has moved into a bear market.

What ends up happening is you end up having this divergence of fundamentals. So, in other words, the core business itself can be improved. They can be increasing revenues, earnings, etc., but the stock price may not reflect that. And so, I want to walk you through this chart here.

Now, on this axis here, we have the value of those shares, the value of the stock price as you would be able to buy it. And on the bottom here, we have time.

Over time, business grows and what you'll notice is this orange line here represents the intrinsic value of the company. In other words, the theoretical value of how much this business is worth is based on its earnings potential. Now that's an important factor. This is the theoretical value of what that company should be worth.

But every day, we have the stock market that quotes that business and says, how much is somebody willing to buy or sell that business today? And during times of market turmoil, this may not match the intrinsic value of the company.

People get panicked, and people get scared. And what ends up happening is you enter this zone of pessimism, where the price of the stock falls far below the intrinsic value of the company. And this is a good thing for people that can purchase stocks.

And that brings me to the third thing here, the potential opportunity. First, we talked about these inflation waves. That's the big cause. The effect has been this divergence of fundamentals where businesses are improving, but their stock prices are coming down. They're not reflecting those improvements.

So, the potential opportunity for investors is those with cash on the sidelines or people that may have been a little bit more conservatively positioned and have the capacity to increase their exposure to the stock market have a major opportunity.

What you can see on this chart here is the percent drawdown of the S&P 500. So, in other words, how far are we from the peak? If the S&P 500 was at, let's say 100%, and it moved to 80%, we're 20% drawdown, for example.

So, what you can see here is different ranges ranging from 0% to 9.99%. In other words, we're near all-time highs or just a few percent off. Negative 10% to -19.9%, this is the correction territory. And then -20% to -29.9%, this is where we enter that bear market category, and then so on and so forth up to a -50% drawdown.

The next thing we measured is how many days within the stock market fall into these ranges. So, in other words, how many observable events do we have? And then we wanted to say was based on these drawdowns, so in other words, how much have we come off those highs?

What does that forward return look like on average for investors? And what you'll notice here is that the worse the drawdown, in other words, the farther we are off the highs, the higher the forward average one-year return.

So, investors can put more cash to work. They can reposition from a little bit more conservative to a more aggressive portfolio allocation. This represents opportunity. This represents greater future potential returns on average.

I think the second important thing to think about here is not only are the future returns often more positive, but we've always seen recoveries within the market historically. And I think that's an important thing to remember too.

Whenever we're going through these turbulent times, we want to look at these drawdowns not as times to sell and panic, but rather to be opportunistic. Buy great companies that are trading below their intrinsic value, represents a great opportunity to buy these shares at a discount, and take advantage.

With that, I want to encourage you to talk with your financial advisor and look at your allocation. See if maybe you can put a little bit of extra cash to work if it makes sense for your plan and your goals.

See if we can move from a little bit more conservative to potentially more aggressive if it makes sense for your plan and your goals. And your advisor's going to help you figure this out. They're going to help you determine what makes sense for your plan and ultimately help you achieve your goals going forward.

So, with that, I want to thank you for joining me in this week's "Money Script Monday."