THE STOCK MARKET GAME™

IN THE NEWS

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Mark It Correction

By Vincent Young

Recently CNN Business celebrated the bull market's 10th birthday and called it the" longest bull market in American history!"[1] A bull market means that stock prices are rising or predicted to rise and investors are optimistic about the health of their investments. It was named after the way bulls are said to gore their opponents with their horns and then thrust them up into the air as a finishing blow. Despite its gory roots, a bull market is positive news for businesses, their investors, and consumers.

What's Wrong?

In his YouTube video, Paddy Hirsch from Marketplace says that a "correction is something that happens after you get something wrong." The term "market correction" is used when the price of a stock drops 10% from its most recent high. For example, in 2018 when the S&P 500 Index dropped from its January 26 high of $2872.87 to $2581 on February 8, it was said to be in "correction." But what did the market do wrong? Why was it being corrected?

To figure it out, we have to start at the beginning.

When you first started The Stock Market Game™, your teacher may have told you that the goal was to invest your cash balance in stocks, bonds, or mutual funds that would help you grow your portfolio's total equity (the value of the investments and cash in your portfolio). This is the same goal people in the real world have when they invest their money. They want the price of the stock they bought to increase over time so they can sell it for more than they paid for it. This is how they earn money from the stock.

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Investors in the real world probably do the same things you do when deciding which companies are the best for your Stock Market Game portfolio. They might search the company's name online and read articles about the company. Hopefully, they read and listen to financial experts with different opinions about the company. Then they might research the company's financial health by reviewing its stock quote and visiting its investor relations website. They may also ask friends for their thoughts on the company.

Sometimes they invest in a stock just because everyone else is doing it.

Overvaluation

No one really knows why even a studious investor can get so caught up in the excitement and frenzy surrounding a company that all of the days of work and research are forgotten and a stock purchase is made on raw emotion and gut instinct. The continued willingness of investors to pay more for a stock pushes its price upwards. Sellers will keep raising their prices as long as there are buyers willing to pay it. This ongoing price increase can lead to overvaluation.

When a stock sells for a price that is higher than its PEG Ratio it is called an "overvaluation." The PEG Ratio or "price-earnings to growth" ratio is used to measure a stock's value. It includes the company's estimated earnings growth over the next five years.

The danger of an overvalued stock is that the investor is paying more for something worth much less. Forbes Magazine offers some advice[2] to help investors protect themselves from overvalued stocks. According to Forbes, if a stock is overvalued:

- its P/E ratio will be higher than its estimated growth rate
- there is a lack of interest for its products or services

- its P/E ratio is much higher than the P/E ratio of its competitors
- it is a "hot stock" that everyone seems to be talking about
- its executives begin selling their shares in the company

Correction

CNN Chief Business Correspondent Christine Romans says in her YouTube video that market corrections happen because the "markets aren't supposed to go straight up. A breather once in a while is important like a market reset." She also says that market corrections are a normal part of investing and points out between 2010 and 2017 the S&P 500 has had four corrections.

A market correction brings down a stock's price and keeps it from being overvalued. Lower stock prices give investors the chance to evaluate their portfolios and invest in companies that were previously too expensive.

There are many factors that may cause a market correction.

The correction that the S&P 500 Index experienced last February was caused by fears of high inflation due to an overheated economy which lead investors to sell off their stock which resulted in sharp price drops. An overheated economy means the economy has experienced a long period of unchecked growth that has caused high inflation. The Federal Reserve checks the economy and raises interest rates as a way to prevent overheating.

Bearable

The severe 10% price drop of a market correction can frighten many investors. They worry the correction will last longer than it should and eventually lead to a bear market. A bear market is a 20% drop in stock prices. It is the opposite of a bull market. Instead of rising stock prices, there are price drops. Investors are pessimistic about the health of their investments. It is negative news for businesses and their investors.

A bear market is the opposite of a bull market but it's named after the same gruesome act. The bear market is named after how bears are believed to attack and maim their victims by knocking them to the ground.

While investors should beware of the bear, the researchers at Charles Schwab have found out that only four of the 22 market corrections between 1974 and 2018 turned into bear markets (1980, 1987, 2000 and 2007)[3]. They suggest investors have a "Bear Market Emergency Kit." Some of the items they recommend for the kit are[4]

- Save enough money to last a year and change your spending habits
- Make a plan and set short term goals for the coming year and long term goals for the years to come
- Remind yourself that bull markets last longer than bear markets
- Diversify your investments with stocks, bonds, and mutual funds

For some a market correction is like eating your vegetables. It doesn't taste as good as a bag of potato chips or a candy bar but it provides them with needed vitamins to ensure a healthy body. A market correction fixes the problem of overvalued stocks by bringing their prices down so they better align with their company's PEG ratio.

Endnotes

1. Matt Egan, CNN Business, "The Bull Market Turns 10 Years Old," March 11, 2019. https://cnn.it/2YJ0PAN
2. Andy Swan, Forbes, "Five Powerful Ways To See If A Stock Is Overvalued," September 21, 2018. http://bit.ly/2UrxMCt
3. Schwab Center for Financial Research, "Market Correction: What Does It Mean?" December 14, 2018. http://bit.ly/2uFoHHU
4. Charles Schwab, "A Bear-Market Emergency Kit," November 16, 2018. http://bit.ly/2FXcYL9

To Think About

1. Turn your Stock Market Game portfolio into a Bear Market Emergency Kit. How much of your cash balance would you keep? What stocks, bonds, and mutual funds would you include? Remember to diversify your investments to protect yourself. Be sure to explain your decisions.
2. Compare Paddy Hirsch's video to Christine Romans'. Whose explanation of market correction did you like better? Why? Script your own market correction video. You can watch Paddy's video here: http://bit.ly/2VfFexZ and Christine's video here: http://bit.ly/2YMBIx6