Remembering Black Monday

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Amazingly enough, after the concern about another Black Monday, the 1987 drop's anniversary today hasn't generated much media attention. It's almost like it never happened.

As a long-term investor, you might argue that it *shouldn't* be remembered, that it was just another pullback that didn't mean anything in the long run. That makes sense, but those who were there certainly remember that it did mean something—something very scary—at the time.

Others might say that ignoring the anniversary implies a scary level of historical ignorance and complacency, that investors today are overlooking the many similarities between then and now. Not just similarities in the chart, but high valuations, slowing earnings growth, and the rising influence of automated trading models in the financial markets. Then it was portfolio insurance; now it's high-frequency trading.

Lessons from 1987

The truth, as usual, lies somewhere in between. Most of us live in the short term and have to react on that basis. But as investors, we succeed or fail in the long term. The best way to look at the anniversary of Black Monday is to consider what happened, why it happened the way it did, and what is similar (and different) about today.

What happened? October 19, 1987, marked the largest single-day drop in the history of the Dow Jones Industrial Average. The Dow declined 508 points, to 1,738.74, or 22.6 percent. We got a bear market in one day. (That's half the decline we saw earlier this year, all in a single day.)

Why did it happen? We don't actually know. Some have blamed it on automated program trading, portfolio insurance, and other technical factors. That might explain the speed of the decline, but the drop itself was hardly unprecedented. In 1962, for example, U.S. markets were down more than 22 percent, and although that took months to play out, there was at least one day when the market dropped more than 6 percent. Just as in 1987, we saw extreme volatility.

Sometimes, apparently, markets can become unhinged. It doesn't actually make much difference why drops like this happen. The fact of the matter is they do, and we have to be prepared for it. Note, though, that both the drops of 1962 and 1987 reversed reasonably quickly, with the market returning to new highs in less than a year.

What's different today? More recently, we have seen two flash crashes in the stock market. On May 6, 2010, the markets knocked almost 1,000 points off the Dow in minutes. On August 24, 2015, the Dow dropped roughly 1,100 points in the first five minutes of trading. In these cases, the bounce-backs were just as fast, and most of the damage was quickly undone. As technology has sped up, so have the crashes—and the recoveries.

It makes sense to ascribe these incidents to technology. In fact, we have seen similar problems lately in the currency and Treasury bond markets. Markets seem to have become more fragile with greater automation, making the possibility of a future technology-enabled drop very real.

Stay focused on fundamentals

At the same time, the markets' longer-term performance continues to be based on fundamentals. Sustained bear markets still coincide with recessions. Corporate earnings and economic fundamentals still determine how markets behave over time frames of a year or more. If short-term volatility rises, it has not affected longer-term results.

The real lesson of 1987 and its successor events is to pay attention to the fundamentals. After all, that's what will drive your portfolio's success over time, not shorter-term market action. If you understand the short term, you'll be better positioned to succeed in the long term. Knowing that future markets are likely to be more volatile, we are better positioned to stay focused on fundamentals. If we do that well enough, we may even be able to take advantage of the volatility.

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