Ultimate Innovation
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A Short History Of Market Crashes and Recoveries

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Market crashes are more common than most people think...so are the recoveries!

Steep stock market declines typically happen without warning and often on the heels of a long bull run. Bear markets often rattle investors, inducing most to panic-sell their portfolio holdings in an attempt to either curb losses or satisfy margin calls. But as history has shown, investors tend to lose more money from trying to time these market exit and re-entries than from the market crashes themselves.

"Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves." – Peter Lynch

The S&P 500 is officially in a bear market and the ASX 200 Index (ASX: XJO) has swiftly entered correction territory.

While nothing can ever fully prepare investors for a market crash, the aftermath of these severe corrections often produce some of the best returns for investors. Research by Michael Batnick on the performance of US stocks since 1900 shows that the average 10 year market return following a bear market is approximately 50% higher than the long term average return.

In this report, we review some of the severe market corrections and their subsequent recoveries.

1. The Tulip Craze (Netherlands - 1637)

What happened

Not exactly a stock market crash but there is no better place to start than the birthplace of the stock market itself - The Netherlands (formerly known as the Dutch Republic) and the tulip mania that gripped the nation.

In the early 1600s, the Dutch Republic was the most advanced economy in the world, reaping the benefits from the wildly successful Dutch East India Company - the first company to be listed on a stock market.

Eccentric Dutch upper classes became fascinated by tulip flowers, which they loved and cherished. Owning tulips became the fad to end all fads. For years, the price of tulips went only up and to the right, and the rare varieties commanded premium prices.

By 1636, the market for tulips was so hot that people no longer waited for the flower season to buy tulips. Instead, they bought futures contracts (a derivative contract that gave them the right to buy tulips at a pre-agreed price during the next flower season) and it wasn't long before trading in those futures contracts reached astronomical levels, with a typical contract changing hands at least 10 times a day.

Then in February 1637, buyers dried up and everything came down crashing.

How did the market recover

Tulip holders sought help from the government, but none of their measures were successful. Eventually, the storm ended up passing without causing any devastating damage to the Dutch economy. But more importantly, people learnt about the dangers of herd mentality in the financial world.

2. The Wall Street Crash (United States - 1929)

What happened

The decade starting from 1920 was commonly referred to as the “roaring twenties". The American economy was booming, driven largely by industrial, mining and financial innovation. Corporate profits were growing, wages were rising and a record number of people joined the labor force.

In the years prior to 1920, the U.S. government had issued “Liberty Bonds” to retail investors to raise money to finance World War I. Also, because these bonds were readily tradable, they introduced millions of people for the first time to the concept of securities trading.

But it was Charles Mitchel, President of National City Bank, who made the move that changed everything. To take advantage of the newly found households' appetite for new investment opportunities, he opened several stock brokerage offices, which for the first time, allowed individuals to buy and speculate in listed shares and corporate bonds.

Demand for stocks rose sharply as tails of instant wealth spread around the country. But normal gains weren’t sufficient and soon enough, Wall Street bankers invented margin accounts, which allowed individuals to borrow money and speculate on the stock market. This pushed the market frenzy into an overdrive.

By early 1929, vast capital from borrowed funds drove demand for shares, which in turn pushed prices up, further enticing people to borrow more money and speculate. In the 12 months leading to the 1929 crash, the US stock market went up by 50% with the main index, the Dow Jones Industrial Average peaking at 381.10 on the eve of the crash.

Then it all came down crumbling! It’s not quite clear what triggered the downturn but in late October 1929, buyers suddenly dried up and share prices began to tank. But that in itself wasn’t a big problem.

The problem was margin calls. On the eve of the crash, **90% of all stock market purchases were funded by borrowed money.** Therefore, when share prices began to fall, brokers started to make margin calls but most investors didn't have the cash to put up and that forced the brokers to fire sell people's shares, which triggered further stock market declines. Once the panic started, there was a stampede on the way out.

The losses were so great that many households and businesses went bankrupt. Banks, which had provided most of the loans for stock market speculations, also suffered heavy losses which ignited a "run on banks", further exacerbating their demise. In the end, over two thousand banks collapsed.

The combination of these factors plunged America into the decade long "Great Depression" which was felt throughout the world. By 1932, at the trough, the Dow Jones Industrial Average had fallen to a low of 41.20, an astounding 89% decline in less than three years!

How did the market recover

In 1932, a new US administration led by Franklin D. Roosevelt structured the "New Deal" in which the Government undertook massive public infrastructure projects to stimulate demand for labor, capital and inputs from the private sector. Sweeping financial reforms and regulations were also introduced to clamp down on market abuse and debt fueled rampant speculation.

Within eight years from the bottom in 1932, **about half of the companies** in the Dow Jones Industrial Average had fully recovered and achieved break-even from their lows. The best recovering stock was Dow Chemical Inc, which broke even by 1933, barely a year after - translating to a 233% gain for investors.

Taken as a group, it took an average of 12 years for the 28 companies that constituted the index in 1932 to break even. However, the index itself only return to 1929 peak in 1954, some 25 years later (mainly due to frequent changes that were implemented to the index)

Overall, the Great Depression stock market decline was followed by one of the best bull runs from around 1941 until 1956, in which the market compounded at a rate of 20.4% per annum.

3. Black Monday (United States - 1987)

What happened

On Monday, 19 October 1987, the Dow Jones Industrial Average plunged by nearly 22%. Black Monday, as the day is now known, marks the biggest single-day decline in stock market history. The remainder of the month wasn't much better. By November, 1987, most of the major stock market indexes had lost more than 20% of their value.

No single event caused the crash in 1987. Instead, a series of factors drove the sell-off, including a widening U.S. trade deficit, computerized trading, and tensions in the Middle East. The rise of program trading, which occurs when computers make automated trades, likely played the biggest role in this crash. The computers tended to produce more buy orders when prices were rising and more sell orders when prices fell. As those sell orders flooded the market on 19 October 1987, it rattled investors and caused them to panic-sell.

How did the market recover

Because the Black Monday crash was caused primarily by programmatic trading rather than an economic problem, the stock market recovered relatively quickly. The Dow started rebounding in November 1987, and recouped all its losses by September of 1989. In fact, five years post the crash, the markets were rising by about 15% a year.

4. Dot.com Bubble (United States - early 2000s)

What happened

As the name suggests, the market bubble was caused by the sharp increases in stock prices of internet-based companies. During the late 1990s, the technology dominated NASDAQ Composite Index had surged more than 5x from 1,000 points in 1995 to a peak of 5,048.62 points by March 2001.

Investors speculated that many internet companies, even those without any revenue or strong business fundamentals, would one day become extremely profitable. Consequently, vast amounts of money poured into the sector, driving up valuations of every internet company.

The bubble did burst when the Federal Reserve tightened its monetary policy in 2001, constraining the flow of capital into the market. The Nasdaq fell more than 20% in April 2001 and by October 2002, it hit its lowest point of 1,108.49 - down more than 80% from its peak. A lot of fundamentally weak businesses declared bankruptcy.

How did the market recover

It took the Nasdaq 15 years to recover from the dot com crash. However, peeling under the hood, businesses with strong fundamentals recovered much quickly. **Adobe Systems** (NASDAQ:ADBE) took only 6 years to recover from its lows, whereas **Amazon.com Inc** (NASDAQ:AMZN) took 10 years, **IBM** (NASDAQ:IBM) 9 years and financial software maker **Intuit Inc** (NASDAQ:INTU) 8 years to recover.

5. The Great Financial Crisis (United States - 2008 to 2009)

What happened

The GFC was caused by excesses within the US housing market and resulted in the world's largest bankruptcy when Lehman Brothers collapsed and brought many countries to the edge of insolvency.

The main driver was loose regulation and the financialization of the housing market which enticed banks and mortgage lenders to make subprime mortgage loans to people who could hardly afford the monthly repayments. As long as house prices continued rising and originators could bundle, package and sell these subprime mortgage backed securities to other financial institutions across the world, they didn't really care whether the underlying borrowers could repay their mortgages or not.

Before long, global financial markets were full of these toxic financial products that sorely depend on the continued rise of the US real estate market. Then, when the housing market stalled and defaults spiked, it sent a reverberating impact across the globe that took down some of the world's biggest financial institutions such as Northern Rock, Bear Stearns and ultimately Lehman Brothers.

During the next 1.3 years, the major US stock index, the S&P 500 declined by close to 52% and world economies went into a deep recession.

How did the market recover

Governments stepped in and bailed out most of the major banks around the world. The US engineered a US$700 billion bailout package to rid its banking system of the toxic subprime assets.

It took four years until March 2013 for the S&P 500 to fully recover from the GFC crash but it continued its upward trend for nearly another 8 years, though briefly interrupted by the start of the COVID pandemic in March 2020.

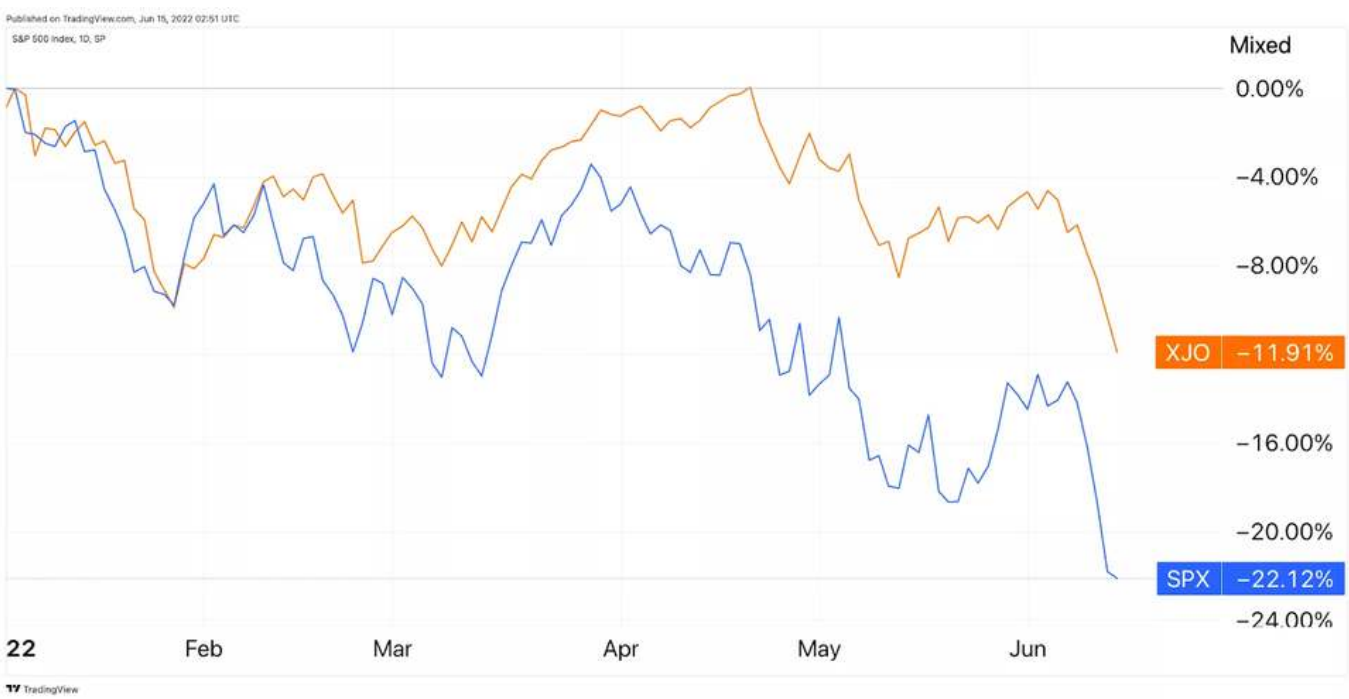
During this great bull run that ended in December 2021, the S&P 500 returned 16.4% per annum to investors, an almost 7x return from its low and the average time between new all-time highs was an incredible 13 days, the lowest ever in history.

Will financial markets always recover?

Mostly, at least based on historical trends. But there is the usual disclaimer: past performance is not indicative of future results.

The ASX is not yet in a bear market by definition. It would need to fall a further 9.6% to 6,018.7 points before following in the footsteps of the US market. If it were to reach this milestone, historical data from Bloomberg (between 1969 to 2018) suggests the average time to recover is 13 months.

However, investors that average down as stock prices decline capture the best returns going forward. Therefore, just keep buying.



Foolish Takeaway

Markets will always go through ups and downs, and as an investor, it's important to learn to comfortably live with that reality. Although it is extremely stressful to see your portfolio go down, panicking and selling will potentially harm your investment journey and most likely, you will miss out on the strong recovery that usually follows a bear market.

Therefore, we also urge our members to always have a well diversified portfolio across stocks, bonds, properties and regions, not to use debt or margin calls to invest and to have an emergency fund to help ride out steep market declines.

Above all, stick with your investment plan for the long term. The longer you remain invested, the more likely you are to make a gain.

Better days are coming. It's just a question of when!