AI-01818 Ten Truths about the Stock Market

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This document, titled "**10 truths about the stock market**," offers a comprehensive **mental framework for investors**. It emphasizes that the **long game in the stock market is generally positive**, despite the **short-term volatility and potential for significant declines**. The text clarifies that **average annual returns are rarely seen in a given year** and highlights the **asymmetric upside potential of stocks**. Furthermore, it asserts that **earnings are the primary driver of stock prices** and cautions that **valuations offer little insight into short-term movements**. Finally, the document notes that **uncertainty is constant**, **unforeseen risks are the most destabilizing**, and the **stock market constantly evolves** through company turnover, which is **not entirely synonymous with the broader economy**.

Here are the 10 truths about the stock market, as presented in the sources:

1. **The long game is undefeated** [1]
   The stock market has a history of overcoming various challenges, including world wars, economic depressions, recessions, financial panics, oil shocks, and epidemics [1]. As Warren Buffett stated, the stock market news will be good over the long term [1]. Historically, since 1926, there has never been a 20-year period where the stock market failed to generate a positive return [2]. The odds of achieving positive returns significantly improve as your investment time horizon lengthens [3].
2. **You can get smoked in the short-term** [3]
   While the S&P 500 typically generates positive annual returns, it also experiences an average intra-year drawdown (decline from its high) of 14% during those years [3]. Bear markets can occur rapidly, like the S&P 500's

34% drop in just over a month in early 2020, or they can be slow and painful, such as the 57% decline over more than a year from 2007 to 2009 [4]. Investing for long-term returns necessitates the ability to withstand considerable intermediate volatility [4].

3. **Don’t ever expect average** [5]
   Although the stock market may generate approximately 10% annual returns on average over the long run, it rarely delivers this "average" return in any single year [5]. The annual returns of the S&P 500 since 1926 show a "chaotic mess of dots," illustrating the difficulty in predicting next year's returns, even with perfect economic foresight [5]. Despite this volatility, most annual returns are positive, indicating that stocks generally trend upward [6].
4. **Stocks offer asymmetric upside** [6]
   A stock's potential downside is limited to 100% (it can only go to zero), but there is no limit to how many times its value can multiply on the upside [6]. For example, the S&P 500 increased by more than six times from its low in March 2009 [6]. This asymmetric upside is an inherent feature of stock investing, though not guaranteed [6].
5. **Earnings drive stock prices** [7]
   Ultimately, any long-term movement in a stock's price can be attributed to the underlying company's earnings, expectations for future earnings, and the level of uncertainty surrounding those expectations [7]. News related to the economy or policy changes impacts markets to the extent that it is anticipated to influence corporate earnings. Earnings (profits) are the fundamental reason for investing in companies [7, 8].
6. **Valuations won’t tell you much about next year** [8]
   While various valuation methods can help estimate whether a stock or the overall market is cheap or expensive, they offer very little insight into where prices will be in the next 12 months [8]. Over short periods, assets considered expensive can become even more expensive, and those deemed cheap can become even cheaper [8]. Additionally, prices can remain cheap or expensive for extended durations, and some argue that valuations do not necessarily revert to a mean [9].
7. **There will always be something to worry about** [9]
   Investing in stocks inherently involves risk, which is why the potential returns

are relatively high [9]. Even under the most favorable market conditions, there will invariably be factors that deter highly risk-averse individuals from participating in the market [10].

8. **8. The most destabilizing risks are the ones people aren't talking about** [10]
   Surveys of market participants typically identify common risks, but these frequently cited risks are usually already factored into market prices [10]. It is the risks that are not widely discussed or are of little concern to most market participants that tend to severely disrupt markets when they eventually materialize [11].
9. **There's a lot of turnover in the stock market** [11]
   Just as most businesses do not last indefinitely, most individual stocks are not permanent components of the stock market [11]. Major indices, such as the S&P 500, experience significant turnover, with struggling businesses being removed and new, growing companies being added [11]. The inclusion of new and often unexpected companies has been a primary driver of the S&P 500's returns over the last decade [12].
10. **The stock market is and isn't the economy** [12]
   While the performance of the U.S. stock market is closely related to the trajectory of the U.S. economy, they are not the same entity [12]. The economy encompasses all business activities in the U.S., whereas the stock market reflects the performance of predominantly large companies [12]. These large companies typically benefit from lower-cost financing and economies of scale, allowing them to source goods and labor more cheaply [12]. Furthermore, many of these larger companies conduct significant business overseas, where growth prospects may sometimes exceed those in the U.S. [13].

Here are 22 items of protocol or guidance derived from the "10 truths about the stock market":

1. **Acknowledge the stock market's proven resilience over the long term**, having historically overcome major challenges such as world wars, economic depressions, recessions, financial panics, oil shocks, and epidemics [1, 2].
2. **Maintain a long-term investment horizon**, understanding that since 1926, there has never been a 20-year period where the stock market failed to

generate a positive return, and the odds of positive returns improve significantly over longer periods [2, 3].

3. **Prepare for significant short-term volatility**, as the S&P 500 typically experiences an average intra-year drawdown of 14% from its highs, even during years with positive annual returns [3].
4. **Be ready for the possibility of both rapid bear markets** (e.g., a 34% drop in just over a month) **and painfully slow, prolonged declines** (e.g., a 57% decline over more than a year) [4].
5. **Cultivate the mental fortitude to stomach considerable intermediate volatility**, as this is essential for achieving long-term investment returns [4].
6. **Disregard the expectation of consistently receiving the historical "average" annual return** (around 10%) in any single year, as the market rarely delivers this exact average [5].
7. **Recognize the inherent difficulty in predicting next year's stock market returns** due to their chaotic nature, even with perfect economic foresight [5].
8. **Take comfort in the fact that, despite volatility, most annual returns for stocks are positive**, indicating an overall upward trend [6].
9. **Understand that while a stock's downside is limited to 100% (it can only go to zero), its potential for gains is theoretically unlimited**, allowing for significant multiplication of value over time [6].
10. **Recognize that this asymmetric upside, while not guaranteed, is a fundamental characteristic of stock investing**, as demonstrated by instances like the S&P 500 increasing more than six times from its March 2009 low [6].
11. **Prioritize analysis of a company's earnings**, expected future earnings, and the certainty surrounding those expectations, as these are the ultimate drivers of long-term stock price movements [7].
12. **Understand that news related to the economy or policy primarily impacts markets to the extent that it is anticipated to influence corporate earnings** (profits) [7].
13. **Use valuation methods cautiously for short-term (next 12 months) price predictions**, as they offer very little reliable insight into where prices are

headed within this timeframe [8].

14. **Accept that in the short term, assets considered "expensive" can become even more expensive, and those deemed "cheap" can become even cheaper** [8].
15. **Be aware that periods of high or low valuations can persist for extended durations**, and some theories suggest valuations do not necessarily revert to a mean [9].
16. **Accept that risk is inherent in stock investing**, which is the fundamental reason why the potential returns are relatively high [9].
17. **Understand that even during the most favorable market conditions, there will invariably be factors creating uncertainty** that may keep highly risk-averse individuals out of the market [10].
18. **Be wary of commonly cited risks**, as these are often already factored into market prices and therefore less likely to cause significant unexpected disruption [10].
19. **Focus on identifying and considering less discussed or widely ignored risks**, as these are typically the ones that cause significant market disruptions when they eventually materialize [11].
20. **Recognize that individual stocks and businesses are not permanent fixtures in the market**; major indices like the S&P 500 constantly experience turnover, with struggling businesses being removed and new, growing companies being added [11].
21. **Understand that the addition of new and often unexpected companies to major indices has been a significant driver of overall stock market returns** over the past decade [12].
22. **Differentiate between the U.S. stock market and the broader U.S. economy**, recognizing that while closely related, they are not identical entities [12]. The stock market primarily reflects large companies, many of which have global operations and competitive advantages (e.g., lower financing costs, economies of scale) that may lead their performance to diverge from the overall U.S. economy [13].

Here are the 10 truths about the stock market, without explanation, as presented in the sources [1-10]:

1. **The long game is undefeated** [1]
2. **You can get smoked in the short-term** [2]
3. **Don't ever expect average** [3]
4. **Stocks offer asymmetric upside** [4]
5. **Earnings drive stock prices** [5]
6. **Valuations won't tell you much about next year** [6]
7. **There will always be something to worry about** [7]
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2. **Maintain a long-term investment horizon**.
3. **Prepare for significant short-term volatility**.
4. **Be ready for the possibility of both rapid bear markets and painfully slow, prolonged declines**.
5. **Cultivate the mental fortitude to stomach considerable intermediate volatility**.
6. **Disregard the expectation of consistently receiving the historical "average" annual return** (around 10%) in any single year.
7. **Recognize the inherent difficulty in predicting next year's stock market returns**.
8. **Take comfort in the fact that, despite volatility, most annual returns for stocks are positive**.
9. **Understand that while a stock's downside is limited to 100%, its potential for gains is theoretically unlimited**.

10. **Recognize that this asymmetric upside, while not guaranteed, is a fundamental characteristic of stock investing**.
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