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There is nothing new in Wall Street. There can't be because speculation is as old as the hills. Whatever happens in the stock market today has happened before and will happen again."

- Jesse Livermore

Growing macro concerns focused on inflation, rising interest rates leading to a potential economic slowdown, and the ongoing conflict in Ukraine have resulted in a massive selloff in risk assets. Not a complete surprise to any of our readers. And, also not a surprise, the cacophony of gloom and doom ("economic hurricane" says Jamie Dimon) has risen to epic proportion.

As we've written in the past, alleged experts who opine publicly on future economic results generally have an ignominious history of failure. Moreover, those errors are magnified as predictions help to form expectations that, when missed, cause negative reactions in the markets.

Instead, let's discuss the facts. You may recall the year 2021 delivered spectacular returns to equity investors. As did the year before, and the year before that. What is less known – despite this cacophony of perma-bear writers – is the US stock market typically declines by at least 10% every other year, 30% every 4 or 5 years, and 50%+ once every generation. Looking back over the past five years, the S&P 500 has corrected at least 10% in 2015, 2016, 2018, 2020, and yes, we've been going through another correction this year.

In 2002, Daniel Kahneman won the Nobel in economic science which was unusual given that Kahneman is a psychologist. The great theme behind Kahneman's work is human irrationality; specifically, his work on "cognitive biases" (unconscious errors of reasoning that distort our judgment) which lay the foundation for the "anchoring effect", which is our tendency to be influenced by irrelevant numbers that we happen to be exposed to.

The investment industry is fraught with irrelevant numbers. The bias, noise, and error that distort our analysis, our views, and our beliefs rarely seem like a big deal. They neither appear nor feel dangerous in the moment. They're not explosions, they're paper cuts. They're pinpricks. And therein lies the danger. Tiny wounds that cause damage so slowly as not to draw attention until it becomes severe.

The year 2021 was very much like a series of paper cuts. We all knew valuations were high. We collectively discussed them at great length. And yet, by ignoring the implied peril, many of us experienced a sensational swoon in our portfolio returns from the highs set in late November. Did we learn anything this time around?

Behavioral finance proposes seemingly contradictory ideas: When are we risk averse and thus overly cautious and when are we overconfident and excessively risk-seeking? Risk is counterintuitive – as an asset price depreciates, people begin to think it's riskier. Conversely, as an asset price appreciates, people think it's safer. And therefore, buying only perceived "safe" investments can actually make a portfolio riskier!

So here we are. The markets have gone through a period of excess and are now experiencing a correction. Excess leads to hubris which leads to greater excess, until conditions disappoint, and the excess becomes clear in hindsight. The realization and resulting reaction leads to excessive pessimism, thereby creating a buying opportunity for bargain-hunters. And the cycle begins anew.

As market volatility is largely driven by investor psychology, it reinforces the argument that market movements cannot be predicted. Similarly, as human beings largely drive investment decisions, we will continue to see these cycles recur time and again.

There is, however, one proven formula. Purchasing the best assets will provide investors with the best risk-adjusted return over a longer time frame, independent of market timing. Identifying businesses with excellent practices will increase the likelihood of a company generating materially higher profitability in future years. And that's a fact.