

## Surviving the Next Downturn: A Reprise

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In January 2018, Ballentine Partners published “*Surviving the Next Downturn: A Mental Primer*”. The article predicted the inevitability (but not the timing) of the next severe market decline and documented the history of past market selloffs and subsequent recoveries. It also offered some guidance for investors who find the roller-coaster of short-term stock market volatility difficult to handle. The article was first published after a period of strong market performance and expectations for continued economic expansion. Now that the sharp fall in equity prices has occurred, we are re-publishing this article in order to provide some historical context around our current predicament.

The monumental health crisis that triggered the current stock market meltdown resulted in the S&P 500 falling much more rapidly than in prior circumstances (except for the crash of 1929 and October 19, 1987 when the Dow Jones Industrial Average dropped nearly 23 percent in a single day). Perhaps the rebound will be similarly quick, as the spread of the coronavirus is brought under control and the global economy recovers. If so, it would eclipse the average time for bear markets to recover to their old highs of 16 months by a wide margin.

While stock market history rarely repeats itself, it often rhymes. So in this uncertain time, it is useful to compare our current situation with similar episodes in the past. We hope you agree.

## Surviving the Next Downturn: A Mental Primer

Bruce D. Simon, CFA, CPWA<sup>®</sup>, Managing Director & Director of Research

### A Reminder: Stocks Sometimes Do Go Down

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As of this writing (January 10), the broadest index of global stock market performance (MSCI ACWI) has gone more than 400 days without a pullback of 5% or more, the longest such streak in 30 years. It is no surprise, then, that experienced investors are riding the rally with one foot on the gas and a hand on the parking brake. The only thing we can say with certainty is that this streak will end, but the question is when. In the meantime, enjoy the ride.

First off, let's be clear: Ballentine Partners does not foresee nor expect a significant downturn in the near term. US economic momentum is solid, business and consumer confidence is high, interest rates are low, and growth outside the US is accelerating.

What we do know is that a downturn *will* happen at some point in the future. It may be triggered by weakening economic growth, some geopolitical crisis, or something else that no one could have foreseen. We can make informed judgments based upon sound economic forecasts, but economists are notorious for identifying a recession long after the equity markets have already reacted. And their record is less than stellar. The old adage that "economists have predicted nine of the last four recessions" is certainly relevant today.

With those caveats in mind, let's review the history of past downturns and subsequent recoveries to identify some common threads in order to better prepare for what might be coming.

### Recession Warning Signals Not Apparent

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Since the daily record of the S&P 500 Stock Index began

in 1926, the US stock market has experienced 14 bear markets, defined as a peak-to-trough decline of 20% or more<sup>1</sup>. On average, these bear market declines lasted 16 months and fell 41% before recovering. In only two of those instances was the market decline NOT preceded or accompanied by an economic recession. *An impending recession is by far the most likely catalyst for a severe market decline.*

Is it possible to anticipate a recession before the stock market responds? Economists and strategists point to a number of leading indicators that are often present before the economy officially enters a recession. These include:

- ◆ Spiking energy prices
- ◆ Accelerating wage inflation
- ◆ Inverted yield curve (10-year treasury bonds yielding less than 2-year notes)
- ◆ Slowing economic momentum (as measured by the Purchasing Manager's Index, or PMI)
- ◆ Weakening trends in building permits, foreshadowing a decline in the housing market

<sup>1</sup> This methodology counts bear markets as peak-to-trough declines of 20% or more. A new bear market can begin after the prior one has risen at least 20% from its trough.

- ◆ Overconfidence among corporate managements leading to overbuilding and excess supply
- ◆ Aggressive Fed tightening that pushes up interest rates

While oil prices have doubled from their lows of early 2016, they remain at less than half of their previous peak. Wage inflation continues to remain muted in spite of near

forward price/earnings ratios for the S&P 500 and subsequent one-year performance is nearly nonexistent, at 0.10. Over a five year measurement period, the correlation jumps to 0.42, a significant increase but still far from a perfect indicator. In other words, stocks can remain overvalued for long periods of time, as long as underlying

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record low unemployment. The yield curve has flattened quite a bit over the last few months, but it is still far away from an actual inversion. Economic indicators such as the PMI remain quite strong, as do most housing measures. Importantly, the sluggish growth that has characterized the economic recovery of the last eight years has instilled a sense of caution among corporations, as measured by the modest growth in capital expenditures. Perhaps the one factor of greatest concern is the plan for the Fed to “normalize” interest rates, which may result in three or four rate hikes in 2018, on top of the three in 2017. On balance, however, we would argue that most of these early warning signals remain benign.

Over the past several months, we have been highlighting the high valuations present in the US stock market as a potential danger sign for long-term investors. But valuation is absent from the list above because it has proven to be a poor predictor of a bear market. According to JP Morgan Asset Management, the correlation between

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fundamentals remain supportive. *Overvaluation may extend the degree of the decline, but it tells us nothing about when the decline might begin.*

### Time is on Your Side

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Now that we have demonstrated that the onset of a severe market decline is nearly impossible to predict, let's focus on some of the redeeming aspects of a falling stock market.

Although bear markets last an average of 16 months, one should not assume that there will be plenty of time to exit. For one, the magnitude of the decline is rarely apparent when the market first begins to falter. This was certainly the case in the last great decline, when stocks began to weaken in October 2007 but didn't bottom until March 2009. And there have been plenty of times when the market fell dramatically in a compressed time period. Seasoned investors may remember Black Monday (October 19, 1987) when the Dow Jones Industrial Average dropped 508 points (22.6%) in a single day. *Especially* seasoned investors may even recall October 1929 when the DJIA lost nearly a quarter of its value in two days. *In other words, market crashes can take on many different forms.*

A key point to remember: even in the worst stock market crashes, long-term investors have always gotten their money back. It will be painful while it lasts, but investors that exercised patience were eventually made whole. After the brutal 48% decline in the S&P 500 during the Great

Recession, investors who held on had fully recovered their losses within seven years and have gone on to significant gains since then.

Ballentine Partners analyzed the performance of the S&P 500<sup>2</sup> back to 1926 to understand the frequency and magnitude of past market weakness. The results are shown below.

<b>Decline</b>	<b>No. of Occurrences since 1926</b>	<b>Average Days Between Occurrences</b>	<b>Average Peak-to-Trough Decline</b>	<b>Average No. of Days to Low</b>	<b>Average No. of Days to Breakeven</b>
<b>5% or More</b>	<b>134</b>	<b>242</b>	<b>-12%</b>	<b>83</b>	<b>132</b>
<b>10% or More</b>	<b>45</b>	<b>722</b>	<b>-22%</b>	<b>203</b>	<b>337</b>
<b>20% or More</b>	<b>14</b>	<b>2194</b>	<b>-41%</b>	<b>478</b>	<b>923</b>

Our analysis reveals that pullbacks of 5% or more have occurred 134 times since 1926, or an average about once every 234 days. On average, these pullbacks lasted 83 days and fully recovered to breakeven in 132 days. In other words, staying the course and holding onto your stocks is usually the best approach, as long as you don't need the money right away. Declines of 10% or more are on average recovered within a year. Even the long breakeven period of 923 days for drops of 20% or more is significantly skewed by the Great Depression, when it took 22 years to get back to even. Excluding that event reduces the average time to breakeven to 520 days. Time heals most wounds from stock market selloffs.

During a severe market decline, one should keep in mind the difference between price volatility and permanent impairment of capital. While some companies will go bankrupt in a recession, most large multinational companies may only experience a temporary decline in earnings. In contrast, investors in lower-rated fixed income securities may never receive their full principal back in a stressed economic environment. That impairment is permanent, while a decline in the value of broad-based equity portfolios has historically been recovered.

<sup>2</sup> Price change only.

## Taking Action

The allure of selling out near the top and buying back in near the bottom is extremely powerful. Advisors that raise cash in advance of an expected downturn are in effect making a market timing call. In an environment of rising stock prices and very low cash yields, this decision could have a huge opportunity cost. In addition, you have to be

right twice: when to get out, and when to get back in. Assuming the market's short-term movements are somewhat unpredictable, your odds of success are 1 in 4, and that ignores the tax cost of realizing gains.

Add to that the common occurrence of a sharp rise just before the crash (some call this a "melt-up") and the opportunity cost of getting out too early can be especially painful. As a result, this is a strategy that we don't advocate.

That is not to say that "staying the course" is always the right approach. Making modest adjustments in tactical allocations based upon an economic environment that is likely to persist for a reasonable period of time (say 24 to 36 months) is a way to mitigate risk without making an outsized bet.

There are other means of lowering equity risk exposure than outright selling of stocks, typically involving some type of derivative strategy utilizing options or futures. These strategies are akin to buying a level of insurance on your portfolio. As with any insurance, the premium payment will rise and fall with market conditions, and the cost is a drag on investment returns if the insurance is not

needed. These strategies typically entail a degree of complexity, and must be carefully monitored to ensure that the strategy is achieving the desired result. On balance, they are typically more tax-efficient than outright sales.

Another point: falling stocks also create the opportunity to realize losses on securities purchased at higher prices, and

weakness, including years with actual losses. Focusing on the return relative to expectations rather than the peak value would help prepare for the inevitable declines from the top.

Another useful technique is to stay focused on the total portfolio return, rather than the performance of a

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provide a better entry point for buying. At the same time, portfolios can be rebalanced by trimming overvalued asset classes and adding to underperforming ones. *Prudent portfolio management can soften the after-tax impact of the decline and position for the next upturn.*

### The Mental Game

In our view, the key to surviving the next downturn is proper mental preparation. For example, a common behavioral tendency of human nature is for investors to measure their results “anchored” to the high water mark of their portfolio. They view a loss as any decline from the highest value the portfolio has achieved. But what if the investor compared their portfolio’s recent run of strong performance to the long-term expectation for the risk level assumed? For example, a balanced portfolio with an expected return of 6% that has been producing 10% or 11% for the past several years is probably due for some

particular security or segment of the market. By focusing on the total portfolio, knowing that you are doing much better than the stock market itself can be comforting.

Ultimately, the best preparation for the next downturn is the awareness of its inevitability, and diversifying one’s portfolio to ensure that the near-term damage can be withstood. The right allocation depends on the time horizon of the investor, and his or her ability to survive the market’s short-term gyrations without undue stress. The confidence in knowing that equity prices have always recovered to new highs is comforting, as long as you have the financial resources and the intestinal fortitude to ride it out. At Ballentine Partners, our role is to ensure that your investment strategy is properly calibrated for your family’s unique circumstances. Stock market declines are rarely fun, but the pain can be managed with the proper preparation.

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Bruce is a Managing Director and Director of Research at the firm. Bruce rejoined Ballentine Partners in June 2016 after more than 5 years as Chief Investment Officer of City National Rochdale, LLC, in Los Angeles. City National Rochdale, a wholly owned subsidiary of City National Bank, serves family clients across the United States with a staff of nearly 100 investment professionals. Before moving to Los Angeles, Bruce served as Chief Investment Officer of Ballentine in our Waltham office for three years. Prior to that, Bruce spent four years with Morgan Stanley Private Wealth Management in New York and eight years with Glenmede in Philadelphia as Chief Investment Officer and Portfolio Manager. In addition to working directly with a number of family clients, Bruce serves on Ballentine's Investment Management Committee, which is responsible for the oversight of all of the investment activities for the firm. Bruce received an MBA with a concentration in Applied Economics from George Washington University and a BS degree in Business Administration from Penn State University. Bruce holds the Chartered Financial Analyst (CFA) and the Certified Private Wealth Advisor (CPWA®) designations. He lives with his wife in Palm Beach Gardens, Florida.

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