46 PEAKS
INVESTMENT ADVISORY GROUP

What You Really Need to Know about Market Volatility

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Understanding stock market volatility is critical to long-term investment success. Investors who are not educated about, prepared for, or realistic about their tolerance for volatility, are more likely to make emotional, financial plan busting mistakes at some point along their investing journey. At 46 Peaks, we think the following five points are critical for investors to understand and to keep in mind whenever markets see a spike in volatility.

- First, always remember that there is no such thing as a truly "safe" investment. Investments with no volatility (like Savings Accounts, CD's, etc.) rarely offer returns more than inflation. Currently, yields are far below the level of inflation. So, while investors in these safe investments take comfort in their account values never declining, the true "value" of the accounts can suffer greatly from the wealth-eroding effects of inflation. To earn returns higher than inflation and so-called safe investments, investors must "pay the price" of enduring the "necessary evil" of occasional declines in the value of assets like stocks, bonds, real estate, etc.

- Historically, stocks have experienced modest declines of 5-10% about once each year. Declines between 10-20% occur less frequently but still often enough – about once every three years. In our opinion, the speed and frequency of declines less than 15%, and the speed with which markets typically recover from these declines, makes it impossible to successfully and consistently reduce risk around these events.

- Declines greater than 20-25% are rare, but occur about once every 7-10 years, and almost always occur during a recession. Bear markets associated with recessions can see declines of 50% (or more) and take several years. However, bear markets associated with recessions are typically slower to develop, last longer, and the magnitude and duration of these declines justifies risk reduction efforts.

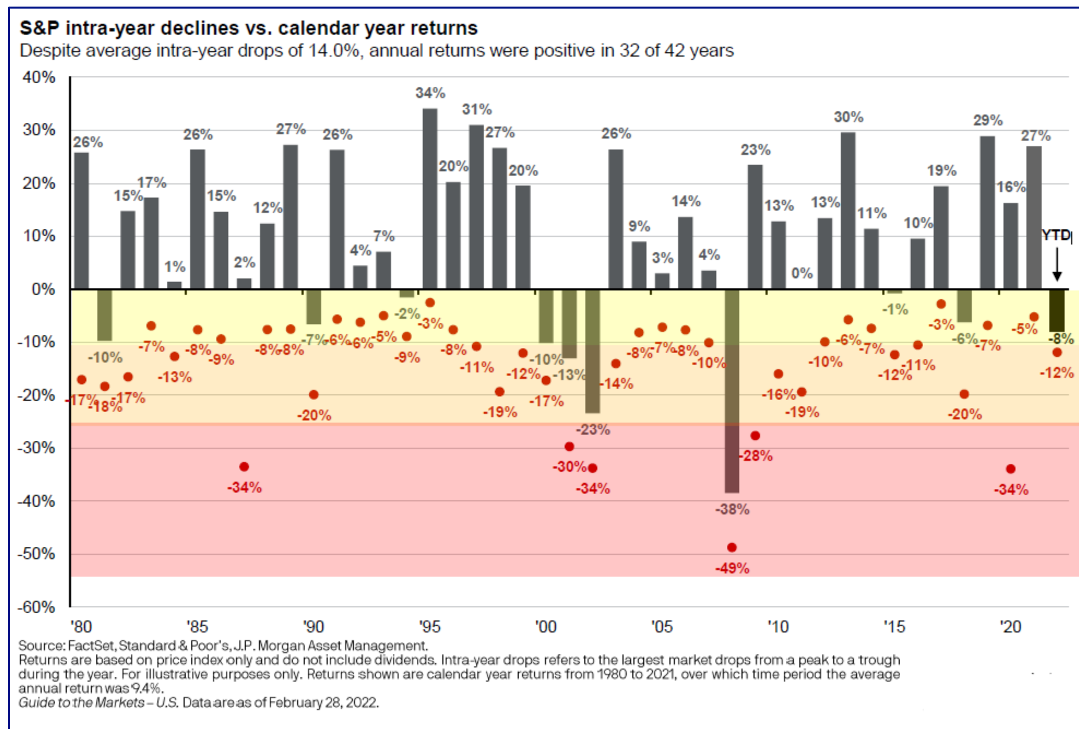
- One of the worst things an investor can do is to sell *after* a market decline, sit on the sidelines until after the market recovers, and miss a substantial portion of the market rebound. Thus, it is critical that all investors get educated about volatility, look in the mirror, and align their portfolio with their true tolerance for declines.

- An investor's exposure to market volatility should also reflect their time horizon and whether they are in accumulation (savings) mode or distribution (withdrawal) mode. Volatility can be an asset for savers – an opportunity to buy low. Conversely, a large drawdown can be troublesome for retirees in withdrawal mode.

The following pages are full of important charts and further insights into investing that are critical to investors, whether you are beginning your investing journey or already retired. We invite you to digest them and encourage you to save this document for future reference. Consider it a "Break Glass in Case of Emergency" type of resource for when volatility hits.

Stock Market Volatility – Modest Declines are Common. Large Declines, while Rare, occur Occasionally.

- This chart shows the calendar year returns (grey bars) and the largest intra-year decline (red dots) for each calendar year since 1980 (42 years).



- **Moderate declines are common**. Stocks experienced a maximum decline between 5-12% a little more than half the time - in 23 of 42 years.

- Years when stocks declined less than 5% were extremely rare – only twice in this period.

- More painful but not severe declines of 13-20% occurred 11 times – about 1 out of every 4 years.

- More extreme and stressful **declines greater than 20% occurred 6 times in 42 years**.

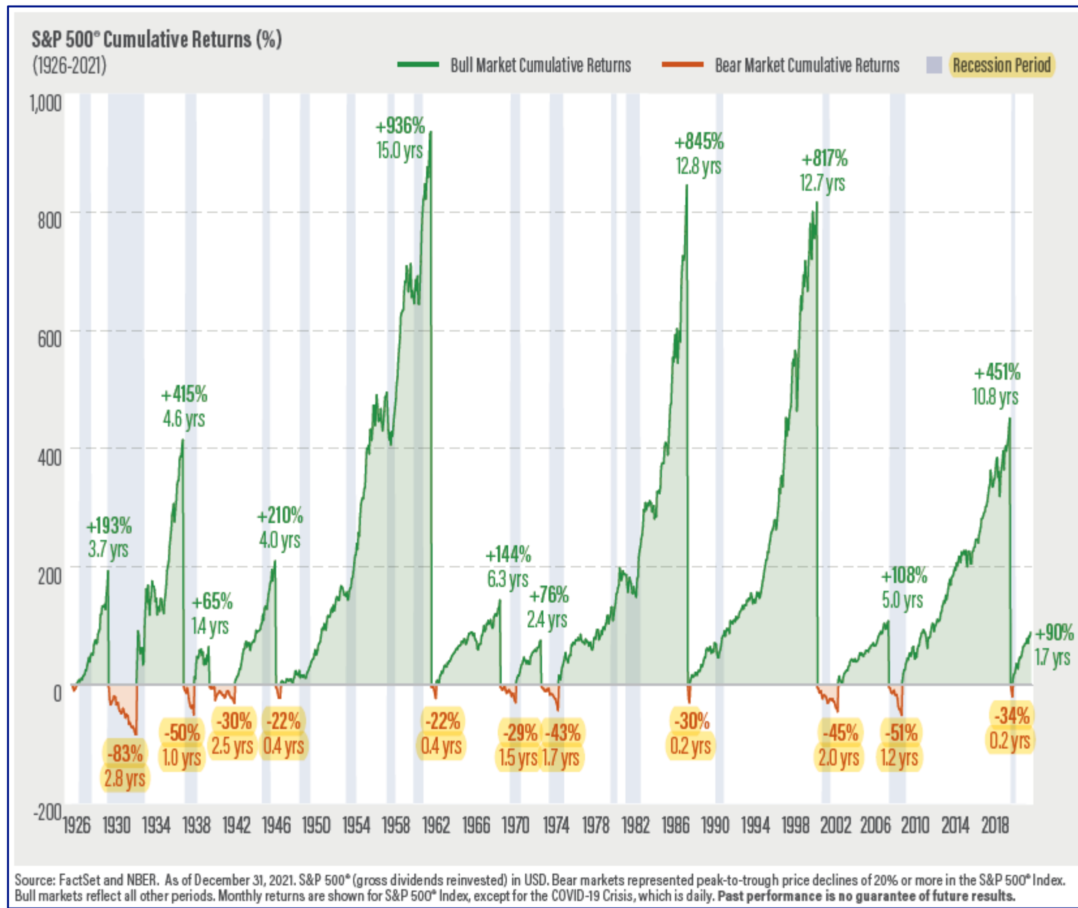
Key Takeaways

- Investors with any stock market exposure must understand that it's common for stocks to decline 5, 10, even 15%. Expect this.

- The boxer Mike Tyson once famously said – "*Everyone has a plan until they get punched in the face*."

- Only the bravest investors with long time horizons should be invested 100% in equities. Watching the hard-earned money in your portfolio decline 40-50% is not for the faint of heart and while you may think you can handle it theoretically, until you experience it, you will not know. Before you embark on an aggressive investing strategy, say out loud the real numbers that a fifty percent decline would mean. For example, "*I would be OK if my one-million-dollar portfolio declines to five hundred thousand. I would not panic and sell.*"

The Stock Market has Long Summers and Short Winters. But the Winters can be Brutal.



- For the past 95 years, Bear Markets in U.S. stocks (the red figures on the above chart) have averaged only 1.3 years. But **sometimes bear markets can last several years**. Watching your portfolio decline month after month, quarter after quarter, for 2-3 years, can demoralize even the most seasoned investors.

- Since WWII, we have had six bear markets with declines of 29% or more.

- In the post-WWII era, we have had **four bull markets of greater than 10 years**.

Key Takeaways

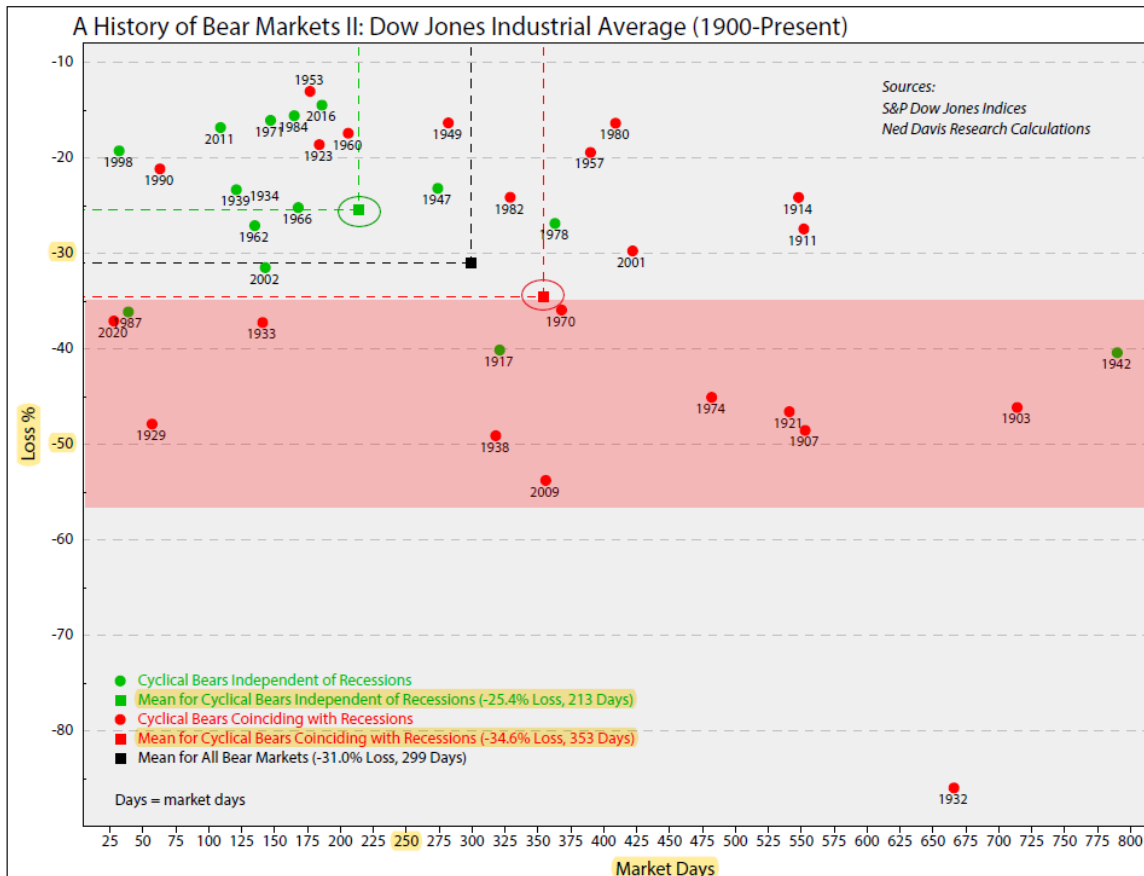
- It is critical for investors to understand their tolerance for enduring portfolio declines without losing sleep or selling after a large decline.

- Stocks usually go up, but there's always something in the current events to fret about. If your portfolio is aligned with your risk tolerance and your financial plan, don't worry so much. Bull markets can last a long time and endure through lots of negative headlines.

- Unless you are always aggressively invested with no "dry powder", bear markets can be viewed as opportunities to take advantage of lower prices.

A History of Bear Markets since 1900 reveals…It's Really All about Recessions.

- This is **one of our favorite graphs on this subject**. It charts bear markets associated with Recessions (Red Dots) and outside of Recessions (Green dots). The further to the right, the longer the duration of the bear market. The lower the dot, the greater the decline.



- Bear markets *without* a Recession have usually been **short and shallow** with an average decline of 25.4% decline over 213 days.

- Bear markets *with* a Recession have usually been **longer and deeper** than those without a Recession, with an average decline of 34.6% over 353 days.

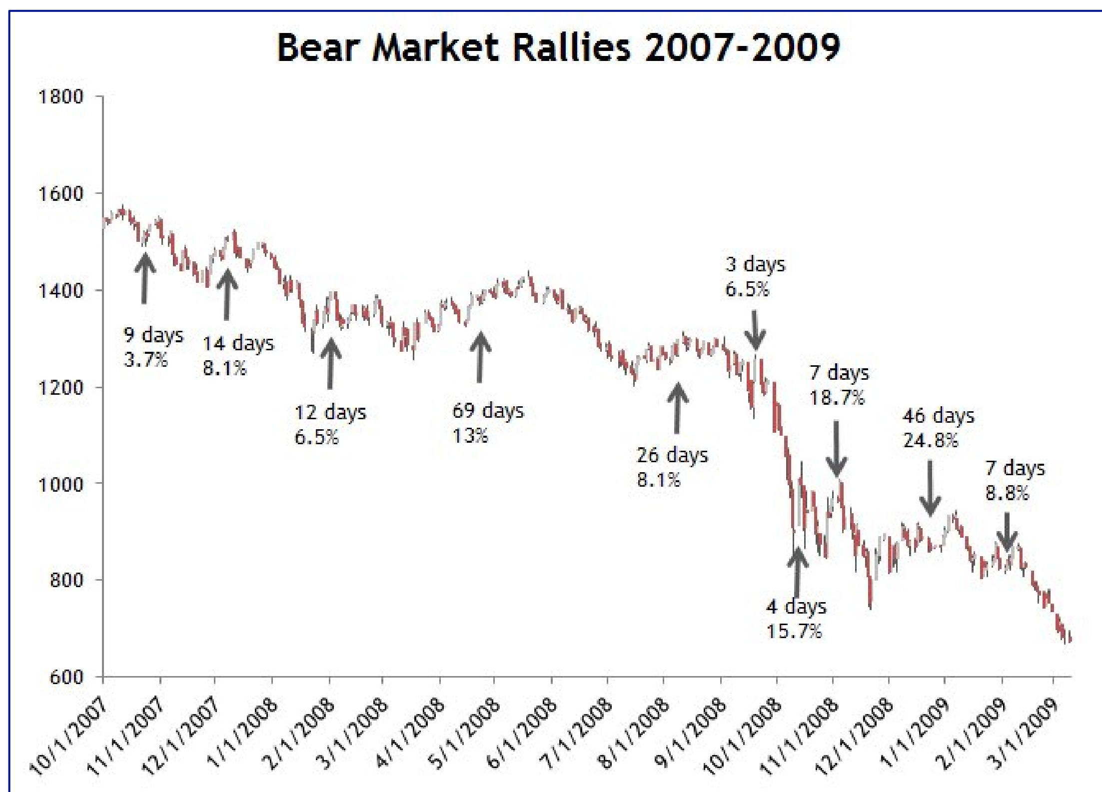
- Absent a Recession, there were only three bear markets with declines greater than 35% - 1987, 1917, and 1942. So, other than the hopefully-one-of-a-kind Crash of '87, there has not been a non-Recession bear market decline greater than 35% in 80 years.

Key Takeaways

- Investors should try to tune out all the short-term noise if a Recession seems like a distant possibility.

- However, monitoring for heightened Recession risk and reducing equity exposure when risks are high, may be a worthy pursuit to try to mitigate the largest, wealth-destroying drawdowns of Recession-linked bear markets. This is easier said than done. At 46 Peaks, we monitor dozens of variables to closely monitor short, intermediate, and long-term Recession risks.

Bear Markets have Upside Volatility too – They can be Very Challenging to Navigate.



- Most investors assume that large declines are the only key feature of bear markets and that **large short-term rallies must be associated with bull markets**. This is **not true**.

- For example, in the period from October 2007 (when a bear market began) to March 2009 when the bear market ended, the S&P 500 had **ten** short-term rallies, including rallies of 8.1% (14 days), 13% (69 days), 8.1% (26 days), 15.7% (4 days), 18.7% (7 days), 24.8% (46 days), and 8.8% (7 days), all before ultimately reaching its bottom.

- Since 1970, the S&P 500 has had 112 days on which it gained 3% or more. Of these, 103 (92%) occurred when the S&P500 was below its 200-day moving average (a condition associated with bear markets) and only nine times did it occur when the S&P 500 was above its 200-day moving average.

Key Takeaways

- You'll know you're really in a bear market when stocks go UP violently, as well as down.

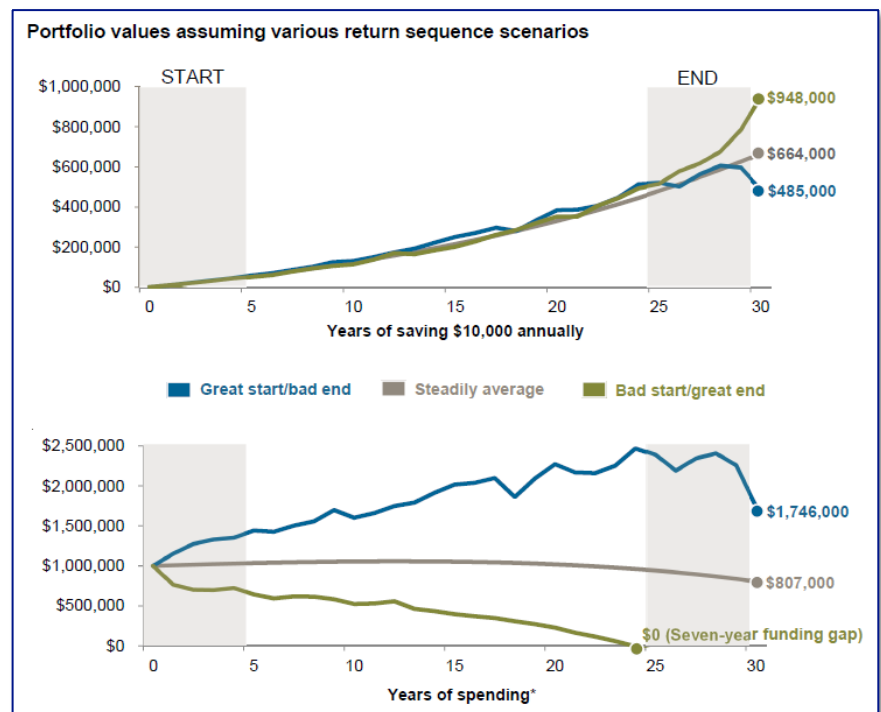
- These bear market rallies can be traps – many investors experience hope that the bear market is over, and a Fear of Missing Out (FOMO).

- When in a bear market, investors must remain patient and disciplined and not increase equity exposure prematurely.

Volatility and Drawdowns Matter A LOT for Retirement Investors

- Consider the hypothetical illustrations in the charts below in which someone saves or withdraws money from their portfolio over 30 years. The grey lines represent portfolio results with returns of exactly 5% each year. The green and the blue lines represent 5% *average* returns over the 30-year period, but with volatility. Importantly, the returns in the green and blue scenarios are experienced in reverse order. The sequence of returns for the green line represents a "bad start/great end" where returns are negative the first year and 3 of the first 5 years while positive each of the last five years. Conversely, the blue line represents the opposite - a "great start/bad end" sequence of returns with positive returns each of the first five years, and negative returns 3 of the last 5 years, ending with a 20% decline.

- During the saving and accumulation and investment period (top chart), the same investment ($10,000/year) and the same "average" return (5%) results in vastly different levels of wealth if you experience the good returns early or late in your investment program. For savers, it's best to experience poor returns early and good returns late (the green line).



- During retirement (the spending and withdrawal phase), the same withdrawals and the same "average" returns have life-changing differences depending on the sequence of those returns. In this example, the investor who began retirement with $1 million and was lucky enough to have a "great start/bad end" still had $1.7 million after 30 years. The unlucky investor who experiences a "bad start" to their retirement portfolio performance, runs out of money before the end of their 25th year of retirement.

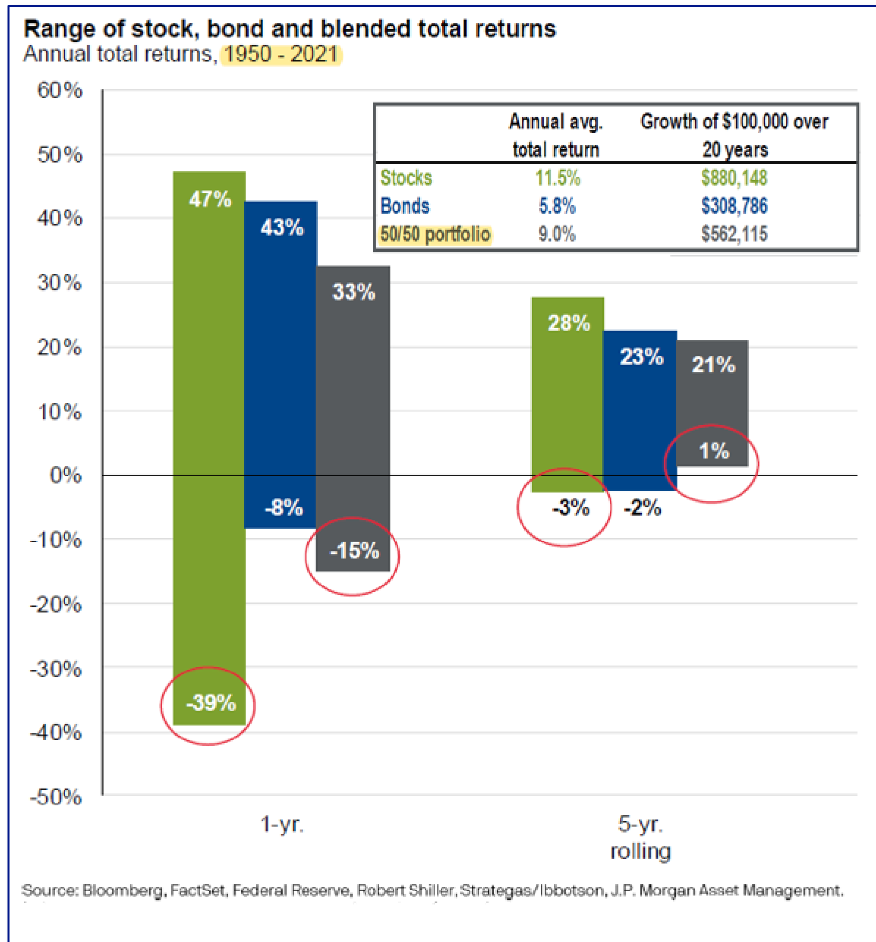
Key Takeaways

- Early in your lifetime, it's OK to be aggressive. While it's out of your control, market declines are opportunities to buy stocks cheap and compound gains for a long time.

- As you approach or enter retirement (and portfolio withdrawals), volatility becomes a mortal risk to your retirement plan. Significant portfolio declines early in retirement, coupled with portfolio withdrawals, could be fatal to your retirement plan.

- Investors must respect risk and coordinate their investments with their financial plan, including the significant risk of volatility early in retirement.

Diversification can Help, but it Can't Eliminate Negative Returns.



- **During the 71-year period beginning in 1950, the S&P500 declined…**
  - 39% during its worth 12-month period, and
  - 3% annualized over its worst 5-year period…
- **…While a diversified and balanced portfolio of 50% stocks and 50% bonds…**
  - Lost 15% during its worst 12-month period, and
  - Gained only 1% annualized over its worst 5-year period
- **Core Bonds are not always "safe". Since 1950…**
  - Core Bonds worst 1 year return was a decline of 8%,
  - While their largest short-term decline was 12.7% and their second largest decline was 10.2%.
  - In recent years, interest rate risk has increased as yields have decreased. Bonds are arguably less safe today than at any point in decades. **Core Bonds declined 6% in the first three months of 2022**.

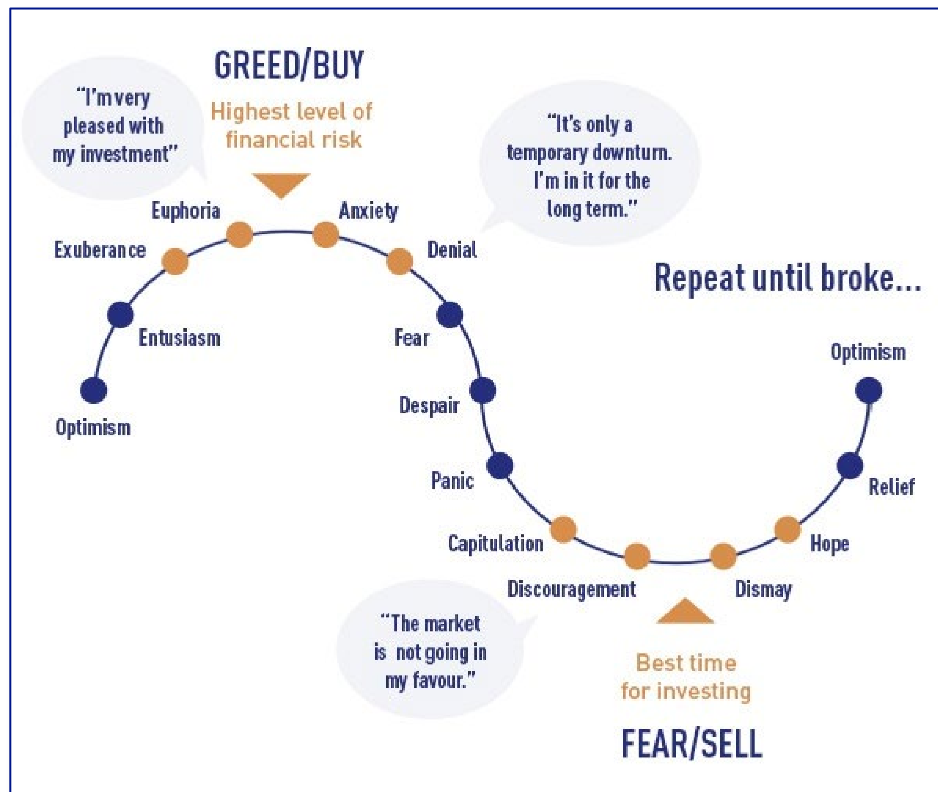
Key Takeaways

- Investors with aggressive portfolios must be able to tolerate 25-40% declines, and negative returns over multi-year periods.

- Even moderate investors with balanced portfolios must be able to tolerate 15% portfolio declines and minimal, possibly even negative returns over multi-year periods.

Emotions can be Public Enemy Number One for Investors. Its Critical to Manage them through Volatility

- This graphic depicts the **common emotions experienced by investors** throughout a market cycle.



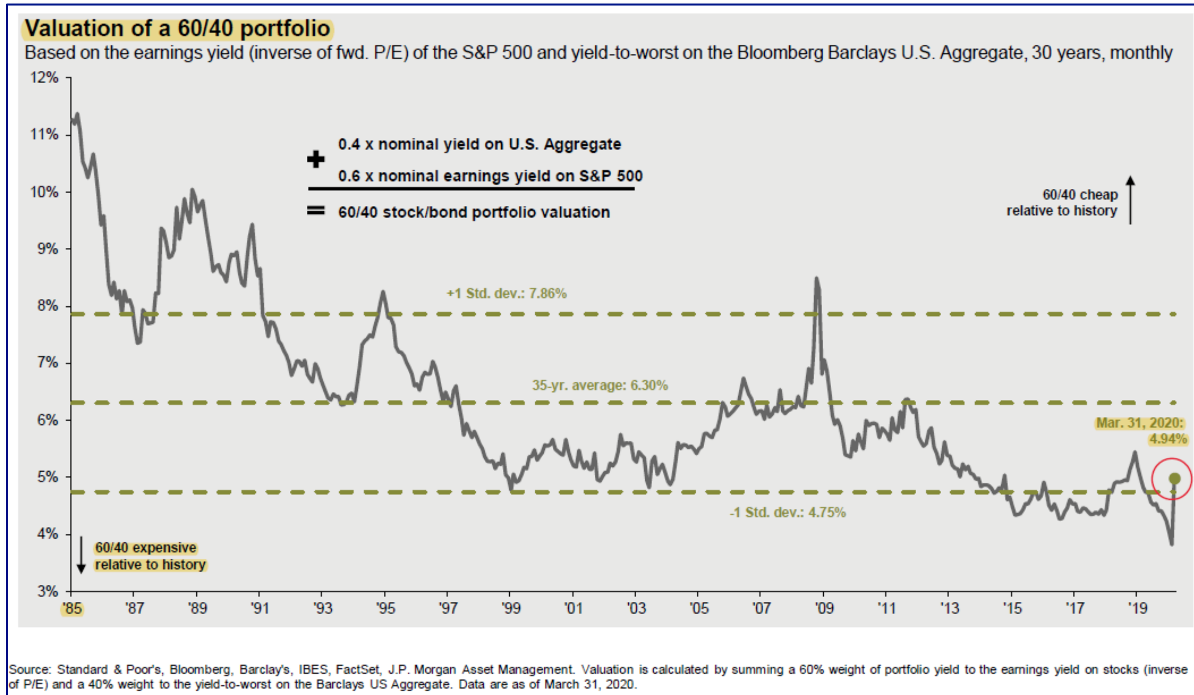
- Investors often want to increase their portfolio risk after stocks have gone up a lot – typically in the "Exuberance" or "Euphoria" parts of the cycle.
- Conversely, after large declines, investors decide they "*can't take it anymore*" and consider selling out during the times of "Capitulation" and "Discouragement".

Key Takeaways

- The next time you are feeling bullish and considering increasing your stock market exposure, look at this chart and ask yourself.."***Where do I think we are on this chart?***".
- Do the same during bear markets if you are feeling anxious and considering "getting out" or reducing your stock market exposure.
- During either what may be a peak or a valley, keep in mind Warren Buffet's words of wisdom – "***Be fearful when others are greedy, and greedy when others are fearful***." Don't be greedy *after* big gains.
- Again…make sure your portfolio's risk profile matches your tolerance for portfolio declines to avoid putting yourself in a position to undermine your financial plan by making bad investment decisions at the worst possible times.

Current (High) Stock Valuations and (Low) Bond Yields Mean its Not Getting Any Easier

- Returns of Core Stocks and Bonds have been strong the past few decades as interest rates have fallen (driving up Bond prices) and higher equity valuations have helped fuel stock prices. We think the chart below is **the most important chart in all of Finance today**. As illustrated via the grey line, the combined valuation of a 60% Equity and 40% Bond (60/40) Portfolio has rarely been higher. (On the chart, the lower the line, the more expensive the valuations.) In hindsight, the mid-80's were a great time to retire. Today, not so much.



Source: Standard & Poor's, Bloomberg, Barclay's, IBES, FactSet, J.P. Morgan Asset Management. Valuation is calculated by summing a 60% weight of portfolio yield to the earnings yield on stocks (inverse of P/E) and a 40% weight to the yield-to-worst on the Barclays US Aggregate. Data are as of March 31, 2020.

- Since valuations drive long-term returns, the long-term performance outlook for portfolios of Core Stocks and Bonds is significnantly lower than the returns experienced over the past few decades, and likely lower than most investors' expectations. These forward looking Long-Term Capital Market Assumptions (LTCMA) from JP Morgan forecast a long-term return of only 3.6% from a simple portfolio consisting of 60% U.S. Large Cap Stocks and 40% Core Bonds.

	Historical (1988-Today)		Forward-Looking (LTCMA, 2021)	
Portfolio	60/40	80/20	60/40	80/20
Return	9.4%	10.3%	3.6%	3.9%
Volatility	9.0%	11.7%	9.0%	11.9%
Sharpe Ratio	0.63	0.57	0.27	0.23

Source: Bloomberg, J.P. Morgan Asset Management Multi-Asset Solutions; data as of June 2021. Forecasts refer to our 2021 LTCMA projections. Portfolio consists of U.S. Large Cap and U.S. Aggregate Bonds.

Key Takeaways

- Financial Plans should adapt to save more, work longer, and reduce retirement spending expectations.
- In order to manage volatility and seek higher returns, investment programs should expand their opportunity set beyond Core Stocks and Core Bonds to include Alternative Strategies, Private Investments, and employ dynamic risk management techniques to attempt to mitigate drawdowns near and during retirement.

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