Planning Perspectives 3Q 2022

Integrity in Investing
Keeping a Good Long-Term View of Bad Short-Term News

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PROFESSIONAL FINANCIAL
Purposeful Wealth Management

"People try to get certainty in an uncertain world. We embrace uncertainty and account for it in robust portfolios."
– **Eduardo Repetto,** former CEO and CIO, Dimensional Fund Advisors

This is part of a series exploring integrity in professional wealth planning

Key takeaways:

- Market declines and recessions are always different, yet in some ways always the same.
- Bad quarters for bonds or stocks don't necessary mean bad years, or that bad years will follow.
- When years have big downturns in equities, but such downturns don't reliably predict a down year.
- Evidence shows that returns after major downturns tend to be strongly positive in following years.

In case you somehow missed the gloomy financial media's bad economic news of the "Worst First Half in Decades" reporting a traumatic market sell-off: U.S. equity markets had their worst six months of the year since 1970; U.S. bond markets had their worst since 1980.[1]

Official U.S. inflation hit its highest level since 1980. A major large stock index was -20.6%; an aggregate bond index was -10.4%; and the U.S. inflation index was 9.1% annualized.[2] Growth stock and investment grade bond indexes are about 50% lower. Don't ask about all the cryptocurrencies, SPACs or alternatives missing in action.

Two frequent questions related to planning decisions for investment goals are: "What comes next?" followed by "Is it different this time?" They make me recall my young children on long auto trips who persistently kept asking, "Are we there yet?" The unasked question of the child within us, hoping for some relief from the anxiety of so much bad news is, "Is it over yet?" And then the unspoken question: "Am I going to be all right?" For disciplined clients, that answer would be yes.

It's Always Different, Yet Always the Same

Although we know that market down cycles will occur, we never know when. Each one is triggered differently. When excessive market volatility leads to a decline, it's natural to wonder if today's challenges are so unique that the market will have trouble matching sellers with buyers. It's all a matter of price. Rather than speculate about what is unknowable, let's consider some turbulent past history.

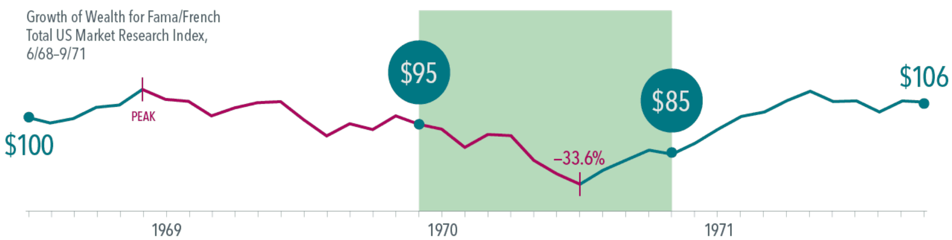
What can a century of economic cycles inform us about our possible investing experience? Dimensional's interactive exhibit looks at the circumstances around and behavior of a major U.S. stock index during previous economic downturns. What we see is how investors can be rewarded although economic activity has slowed due to recessions. These examples illustrate the forward-looking nature of markets, highlighting how market prices of that time reflected market participants' expectations for future market performance seeing far ahead of economic conditions and media reports of the immediate present.

If you find yourself questioning whether "this time is different," first ask yourself if your own financial circumstances have changed. Then a difference could matter for your planning. Otherwise, if markets here continue to remain open, most likely nothing should basically change

Exhibit 1: 1969 to 1970 Vietnam War Guns and Butter

High inflation and a big jump in unemployment punctuated the 11-month recession that began in December 1969. A volatile stock market eventually lost 33.6% over 19 months.

RECESSION					MARKET DOWNTURN	
Duration (Months)	Industrial Production	Inflation	Max Unemployment	Change in GDP	Duration (Months)	Return from Peak
11	–5.3%	4.5%	5.5%	–0.2%	19	–33.6%



Peak represents month-end stock market peak prior to market downturn associated with recession. Past performance is no guarantee of future results.

Source: Dimensional Fund Advisors, "Market Returns Through a Century of Recessions," (2022) www.dimensional.com.

about the way markets will work. Markets have rewarded disciplined investors with a long-term view.

Looking to the past offers insights that reinforce key principles for experiencing a successful outcome. Always during great economic uncertainty, whether in the era of the 1970s stagflation, the Dot Com Crash, the Great Recession, or the global pandemic, investors have wondered whether *this* time was different. While history doesn't repeat itself, it tends to rhyme. What we observe from the details in our exhibits, as well as from all the other periods you can select from the Dimensional website is:

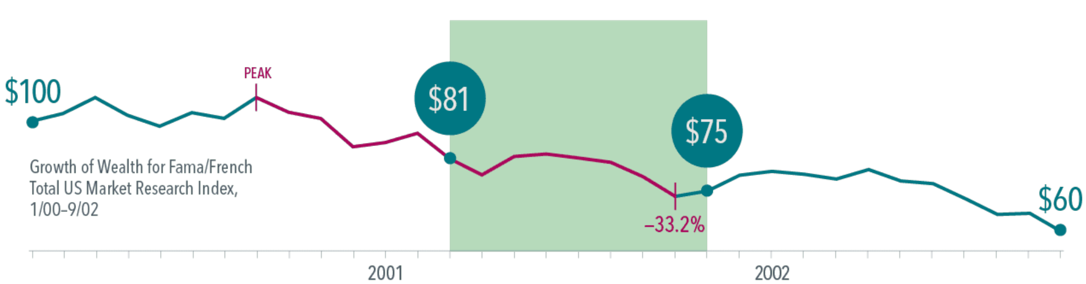
- Aggregate declines in market prices preceded the actual onset of an economic recession.
- The beginning point of the period preceding sustained price declines was never reliably predicted.
- Unlike more recent events, price decline and recovery usually total much longer than six months.
- For those "buying down" a market decline, prices can continue declining way beyond six months.
- After a sustained decline in market prices has bottomed, full market recovery can take years.
- Market prices turn upward sometimes months before a recession is declared over.
- The depth and duration of market declines have no consistent relationship to inflation.

While today's headlines about inflation, interest rates, and supply shortages are worrisome, markets continue to function much as they've done in the past as buyers and sellers trade to make a profit. In 2021, the average *daily* trading volume in equities was $775 billion. Each dollar traded reflects the expectations of buyers and sellers regarding

Exhibit 2: 2001 Tech Bust Following Boom

Many investors may not realize that the stock market had started a deep decline before the relatively mild recession in March 2001, which followed the tech boom.

RECESSION					MARKET DOWNTURN	
Duration (Months)	Industrial Production	Inflation	Max Unemployment	Change in GDP	Duration (Months)	Return from Peak
8	–3.0%	0.9%	5.3%	0.4%	13	–33.2%



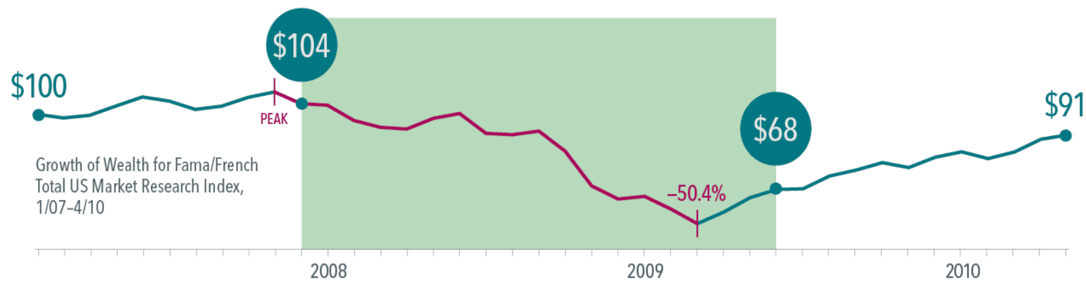
Peak represents month-end stock market peak prior to market downturn associated with recession. Past performance is no guarantee of future results.

Source: Dimensional Fund Advisors, "Market Returns Through a Century of Recessions," (2022) www.dimensional.com.

Exhibit 3: 2007 to 2009 Global Financial Crisis

During the Global Financial Crisis, the worst of the 50.4% stock market dive happened in the latter half of an 18-month recession that saw unemployment hit 9.4% and industrial production tumble 17%. But after falling for 16 months, the market started a nearly 11-year bull run

RECESSION					MARKET DOWNTURN	
Duration (Months)	Industrial Production	Inflation	Max Unemployment	Change in GDP	Duration (Months)	Return from Peak
18	–17.0%	1.8%	9.4%	–4.0%	16	–50.4%



Peak represents month-end stock market peak prior to market downturn associated with recession. Past performance is no guarantee of future results.

Source: Dimensional Fund Advisors, "Market Returns Through a Century of Recessions," (2022) www.dimensional.com.

company growth and profitability. Stock price incorporates their likely potential based on all the information out there that is known or knowable to traders.[1]

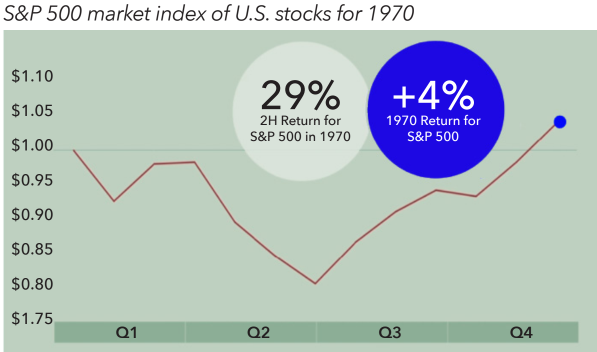
Markets consequently are forward-looking. *Unexpected* news and new information impacts prices. Optimistic news or negative comments that you saw on the internet or in a paper already have been incorporated into market prices. If your friend is texting you "to get out of the market" because they heard it was getting worse, other investors surely have heard the same thing from *their* friends.

Framing your performance view within the confines of a calendar quarter or year tends to create a "perceptual prison" when making investment evaluations and decisions. Price trends in charts leads to mental projections of price rises or declines, leading to unhealthy emotional responses: involuntary selling of holdings, refusal to rebalance, or in an advanced panic, moving most or all to cash based on "gut" feelings regarding "safety." (Those prone to such may consider keeping a supply of Prozac®.)

Exhibit 4 reframes *Exhibit 1* and changes the context into a single calendar year. During the first half of 1970, as we just saw in 2022, large U.S. stocks declined 20%. Media news was also scary, but without cell phone checks. Yet the second half of 1970 rose 29%—resulting in a positive 4.0 percent return for the entire year for anyone with access to a stock market index fund![3] This excerpt of history illustrates how little perceptions of past performance can tell us about the way markets will move. Professionals invest with the expectation that every day, there will be a positive return—not because they know what will happen next. The longer the time you stay invested, the more consistent your discipline, the more likely you will experience market returns aligned with your market expectations.[4]

Exhibit 4: A Rough Year? Calendar Year in 4 Quarters

S&P 500 market index of U.S. stocks for 1970



Past performance is no guarantee of future results. For illustrative purposes only. Index is not available for direct investment; therefore, its performance does not reflect the expenses associated with the management of an actual portfolio. US Stocks represented by the S&P 500 Index. S&P Dow Jones Indices LLC, a division of S&P Global. US Bonds represented by Bloomberg Aggregate US Bonds Index..

Keeping a Long View for Successful Planning

Even more disappointing than stocks, bond returns for 2022's first half have been the worst in decades. Many retirees desiring safety rely on government or investment grade bonds for their monthly income. While less risky than stocks, that does not equate to *stability of value*. High-grade bonds have protective covenants, and priority over stocks, but resale value of fixed income securities always has price risk. *Exhibit 5* looks at an index's fixed income returns by quarter back in 1980. That year recorded both the worst and best quarters for the index we used from its inception—negative 8.7% for the 1st quarter, and positive 18.8% for the 2nd quarter. The

Exhibit 5: Bad Bond Quarters Don't Mean Bad Bond Years

Bloomberg U.S. Aggregate Bond Index, January 1976 – June 2022

Past performance is no guarantee of future results. For illustrative purposes only. Index is not available for direct investment; therefore, its performance does not reflect the expenses associated with the management of an actual portfolio. US Stocks represented by the S&P 500 Index. S&P Dow Jones Indices LLC, a division of S&P Global. US Bonds represented by Bloomberg Aggregate US Bonds Index.

3rd quarter posted a -6.6% and finished with a 1.4% gain. Despite a frightful first half, however, the bond index surprising finished up 2.7% positive for the entire year!

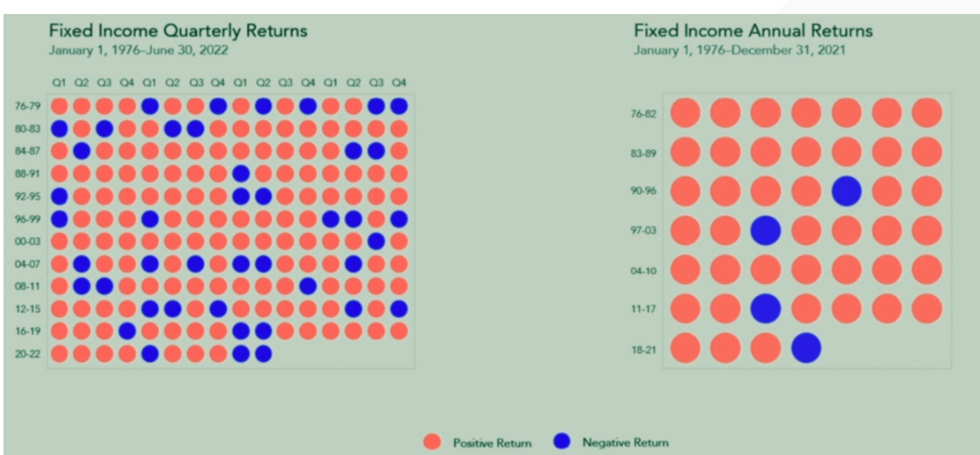
Our example reminds us that a long-term perspective for investing is essential even for fixed income. This is true even for those whose time horizon goals for retirement income needs is short. *Exhibit 6*, from January 1976 to June 30, 2022, 25% of the time (blue dots) quarterly returns of the Bloomberg US Aggregate Bond Index were negative. Negative bond returns occur more often than is commonly believed. But partly that is because only 4 or 9% of the calendar *years* during that same period using standard reporting by the financial media had negative returns.

Equity investing still requires a long-term perspective even though negative return quarters are not as frequent as you may think from daily and monthly media reporting. *Exhibit 7*, from January 1976 – June 30, 2022, only 29% of the time (blue dots) were quarterly returns of the S&P 500 Index negative. Surprising, only 8 or 17% of the calendar years during that same period resulted in negative returns.

Most clients for investment planning have allocations to both fixed income and to equities. *Exhibit 8* below shows that only 9% of the time (blue dots) when viewed quarterly both fixed income and equity returns were negative during a period covering nearly 50 years. So, while joint negative returns for both fixed income and equity is not a frequent occurrence, it is not uncommon. Certainly, it should not be a crisis for those with a systematic and diversified investing strategy. Depending on the equity/fixed allocation, viewing outcomes based on a calendar year will reduce the impression of the number of negative years by at least half.

Exhibit 6: Fixed Income Quarterly and Annual Periodic Returns

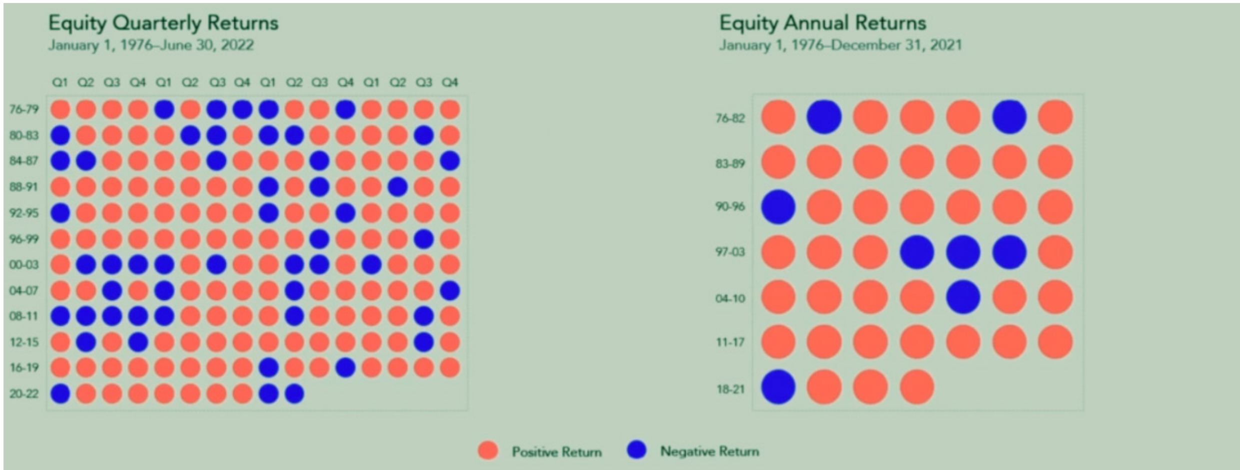
Bloomberg U.S. Aggregate Bond Index: January 1976 – June 2022



Past performance is no guarantee of future results. For illustrative purposes only. Index is not available for direct investment; therefore, its performance does not reflect the expenses associated with the management of an actual portfolio. US Stocks represented by the S&P 500 Index. S&P Dow Jones Indices LLC, a division of S&P Global. US Bonds represented by Bloomberg Aggregate US Bonds Index.

Exhibit 7: Equity Quarterly and Annual Periodic Returns

S&P 500 U.S. Stock Index: January 1976 – June 2022



Past performance is no guarantee of future results. For illustrative purposes only. Index is not available for direct investment; therefore, its performance does not reflect the expenses associated with the management of an actual portfolio. US Stocks represented by the S&P 500 Index. S&P Dow Jones Indices LLC, a division of S&P Global. US Bonds represented by Bloomberg Aggregate US Bonds Index.

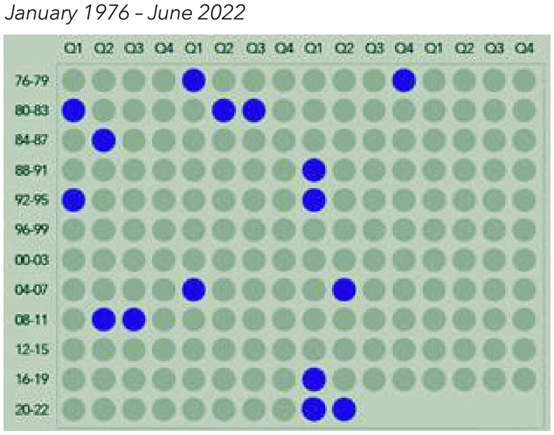
Don't Let Market Cycles Take You for a Ride

Security prices reflect a positive expected return looking forward. Otherwise, no sensible person would invest their hard-earned capital expecting to reduce their wealth. Markets represent capitalism at work. Data show the beneficial role of stocks in creating real wealth over time. Capital markets have substantially rewarded the risks of investing in most countries based on the evidence that we have.

But there's always risk and uncertainty in investing in stocks and bonds. Bear markets and recessions will occur from time to time, just as we have seen in 2022. While, historical gains of the last decade may not continue or be repeated, the growth of wealth over a future time period can be quite substantial. Consequently, planning how to capture the full and fair returns that the market can offer is a highly desirable objective.

Exhibit 8: Fixed Income and Equity Joint Quarterly Periodic Negative Returns

S&P 500 U.S. Stock & Bloomberg Aggregate Bond Index: January 1976 – June 2022



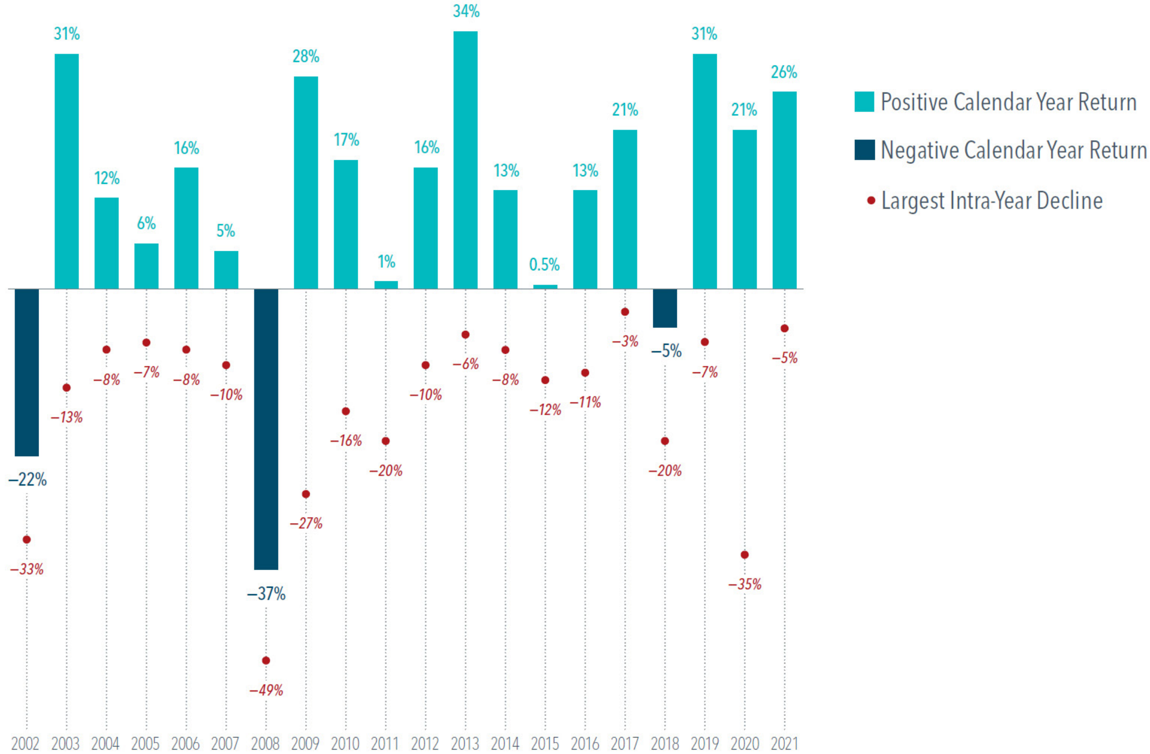
Past performance is no guarantee of future results. For illustrative purposes only. Index is not available for direct investment; therefore, its performance does not reflect the expenses associated with the management of an actual portfolio. US Stocks represented by the S&P 500 Index. S&P Dow Jones Indices LLC, a division of S&P Global. US Bonds represented by Bloomberg Aggregate US Bonds Index.

Frequently investors get the notion of investing in stocks but selling out of their positions when markets begin to decline—and then buying back in at a lower price, intending to enhance their investing outcomes. The temptation to "time" market declines rarely works well when investors try to repeat the technique, even assuming it worked the first time. **Missing out on even brief periods of strong returns can badly impact your investing outcomes.** If you had invested $1,000 at the beginning of 1997 in a mutual fund equivalent of the Russell 3000 Index of U.S. stocks and stayed invested, it would have grown to $10,367 in those 25 years. That return, on average, was 9.8% a year. That period's return included a tech collapse, 9/11, Great Recession and a "Lost Decade" for stocks. That result was close to the century-long record of returns.

Yet if you remained invested during the decline of the Great Recession and endured that decline until, fearing disaster, you suddenly chose to sell what in hindsight was on the worst day in November 2008, missing out on that index's best week of recovery ending November 28, 2008 before you decided to rebuy in fear of missing out, your future portfolio value would have been reduced to $8,652. Miss the best three months due to lockdown fears of the Global Pandemic in March of 2020, which ended June 22, and the total return falls to $7,308.[5] But for those who maintained their strategy through those market cycles, and particularly if they modestly kept investing

Exhibit 9: Do Downturns Lead to Down Years?

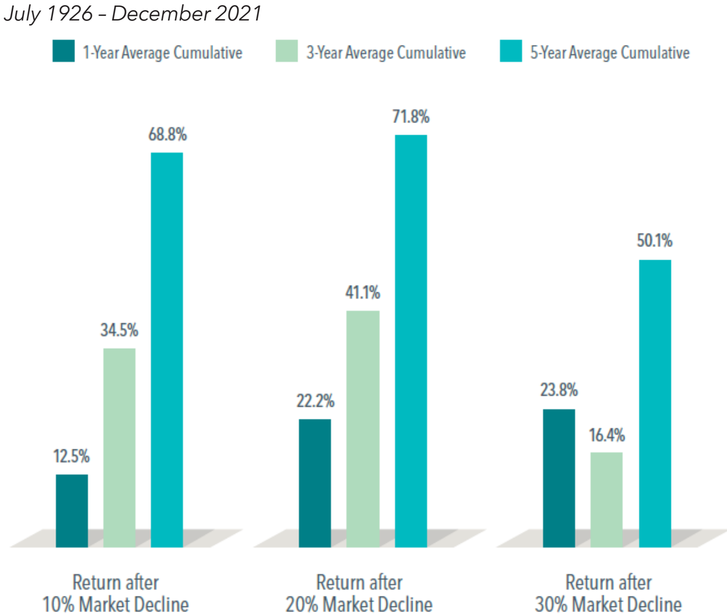
U.S. Market Intra-Year Declines vs. Calendar Year Returns January 2002 – December 2021



Past performance is no guarantee of future results. For illustrative purposes only. Index is not available for direct investment; therefore, its performance does not reflect the expenses associated with the management of an actual portfolio. In US dollars. Data is calculated off rounded daily returns. US Market is represented by the Russell 3000 Index. Largest Intra-Year Decline refers to the largest market decrease from peak to trough during the year. Investing risks include loss of principal and fluctuating value. There is no guarantee an investment strategy will be successful.

Exhibit 10: Average Returns after Downturns Have Been Positive

Fama/French Total US Market Research Index Returns + One-Month US Treasury Bills
July 1926 – December 2021



Past performance is no guarantee of future results. Short-term performance results should be considered in connection with longer-term performance results. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio.

Source: Ken French website. Market declines or downturns are defined as periods in which the cumulative return from a peak is –10%, –20%, or –30% or lower. Returns are calculated for the 1-, 3-, and 5-year look-ahead periods beginning the day after the respective downturn thresholds of –10%, –20%, or –30% are exceeded. The bar chart shows the average returns for the 1-, 3-, and 5-year periods following the 10%, 20%, and 30% thresholds. For the 10% threshold, there are 29 observations for 1-year look-ahead, 28 observations for 3-year look-ahead, and 27 observations for 5-year look-ahead. For the 20% threshold, there are 15 observations for 1-year look-ahead, 14 observations for 3-year look-ahead, and 13 observations for 5-year look-ahead. For the 30% threshold, there are 7 observations for 1-year look-ahead, 6 observations for 3-year look-ahead, and 6 observations for 5-year look-ahead. Peak is a new all-time high prior to a downturn. Data provided by Fama/French at mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html.

despite the bad news, the market returns that our clients experienced during that time seemed quite generous.

Exhibit 9 shows that substantial declines in U.S. equity returns by calendar year are a normal part of the investing experience. Recoveries from sharp declines have been positive, on average, but not every time—investing, after all, is always uncertain. But only in three of the past twenty years did a sharp loss remain a loss by the end of the calendar year.

Even then, the decline by the end of those years was not as low as they had been mid-year. The U.S. stock market *had positive returns in 17 of the past 20 calendar years,* despite some newsworthy dips in many of those years. Even in 2020, when a sharp 35% decline was associated with the coronavirus pandemic lockdowns, U.S. stocks ended the year with gains of 21%. Also, *notice how many returns ending negatively for the calendar year were high the following year, and with a single exception, returns more than enough to offset the prior year loss and reward with a substantial gain!*

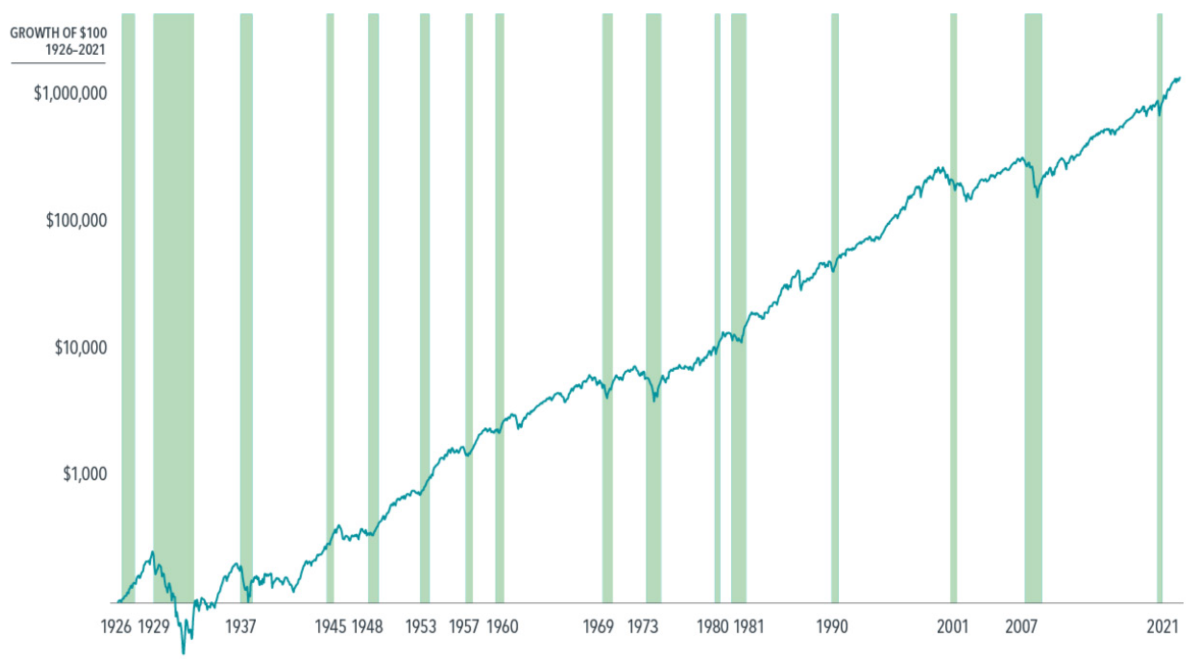
Historically, US equity returns following sharp downturns, have, on average, been positive. *Exhibit 10* summarizes what to expect from this notable market behavior. A market-weighted set of U.S. equities since 1926 tend to deliver positive returns over one-year, three-year, and five-year periods following steep declines. Averaging cumulative returns show the outcome to striking effect. Five years after market declines of 10%, 20%, and 30%, the cumulative returns **all** top 50%. Viewed in annualized terms across the longest, five-year period, returns after 10%, 20%, and 30% declines have been close to the historical annualized average over the entire period of 9.8%.[6] Notably, the broad market index returned 22.2% as the 1-year average cumulative for returns after 20% market declines—which is what happened this year. Staying fully invested with an informed, diversified portfolio strategy puts you in the best position to fully capture the market recovery when it unpredictably occurs.

Your Role as an Investor

Always expect uncertainty when you invest. Stock market outcomes will always be uncertain. Yet we notice that longer-term outcomes such as of the past 25 years or since 1976 are very much in line with a century of historical stock market returns since 1926. How can that be? The answer is that the financial markets do their job quite well in pricing risk and compensating those who willing to stay exposed to risk.

Exhibit 11: U.S. Equity Market Growth Through 100 Years after Recessions

Log scale, 1926 - 2021



Past performance, including hypothetical performance, is no guarantee of future results. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio.

Recessions shaded in green. Growth of wealth shows the growth of a hypothetical investment of $100 in the securities in the Fama/French US Total Market Research Index from July 1926 through December 2021. Stock returns represented by Fama/French Total US Market Research Index, provided by Ken French and available at mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html. This value-weighed US market index is constructed every month, using all issues listed on the NYSE, AMEX, or Nasdaq with available outstanding shares and valid prices for that month and the month before. Exclusions: American depositary receipts. Sources: CRSP for value-weighted US market return. Rebalancing: Monthly. Dividends: Reinvested in the paying company until the portfolio is rebalanced.

An investor's role is to provide the capital that makes capitalism work. The role of markets is to price shares of companies whose securities it processes each day through millions of trades between buyers and sellers. Trades embed vast amounts of news, expectations, and information into prices. The role of intermediaries like Dimensional Fund Advisors is to develop solutions and the role of CFP® professionals is to arrange financial structures. Reliably reaping the benefits of investing demands a long-term commitment to your wealth management strategy.

Exhibit 11 shows us that market returns often have been positive during business recessions. The progressive, upward trend year by year of the American economy is embedded in the aggregate of market prices of thousands of companies. There were a lot of negative surprises over the past 100 years—in business, government, politically, socially—but there were a lot of positive ones as well. The net result was a stock market return that seems very reasonable and sensible, even if you don't understand the sophisticated financial economics that underlie the outcome.

Uncertainty and realized returns are related. Investors are rewarded for bearing uncertainty, not avoiding it. Investing in stocks or bonds is always uncertain. That uncertainty will never go away. If it ever did, there would be no need for financial markets or investors. And so there will always be extended periods during which realized returns will be less than expected returns. So you earn that positive expected return simply by staying invested for the long-term.

Conclusion

We believe that generally maintaining your portfolio structure best positions you to fully capture the market benefits of an economic recovery when it occurs. If you change your portfolio, it should be a strategic, not a tactical choice. The only good reason for anyone to liquidate a stock portfolio—one that is systematically diversified, global and low-cost—is because you learned something about your personal risk preferences, or that your investment capacity has changed.

While volatile periods like the one we're experiencing can be intense, those who learn to embrace uncertainty with discipline tend to have both financial success and experience less stress. Reacting wrongly when the media reports bad news and market decline, can quickly undo years of investing progress. The investor's worst enemy, it often has been observed, is themselves. On several occasions in my long career, I watched helplessly as clients made choices to sell that took defeat from the jaws of victory.

Many investing questions are market timing questions in disguise. Research tells us that trying to profitably get in and out of markets is difficult, stressful, and costly. We don't have crystal balls. Rather than giving into the seductive allure of making predictions, embrace logic and evidence from decades of empirical research, the benefits of systematic diversification, and a transparent long-term approach.

Planning and investing with a trusted CFP® professional and their team, and staying in close contact with them in a turbulent time, is the ultimate in self-care and gaining peace of mind.

ENDNOTES

1. For instance, Evie Liu, "The S&P 500 Had Its Worst First Half Since 1970. What Comes Next." *Barron's* (June 30, 2022) https://www.barrons.com/articles/stock-market-sp500-1970-outlook-51656620380
2. S&P 500 index, Bloomberg Aggregate Bond Index and U.S Consumer Price Index, respectively.
3. Please note that the firm market index fund was not available until 1976 from Vanguard.
4. Of course, the classic problem is, how long will less informed investors whose money they manage allow them to keep it so that those expectations can be realized?
5. See Paul Byron Hill, "Planning During Big Bad Bear Markets," *Views from the Hill* (June 2022).
6. The average annualized returns for the five-year period after 10% declines were 9.54%; after 20% declines, 9.66%; and after 30% declines, 7.18%.