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Three Ways to Help Mitigate Equity Market Declines

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Snapshot

- Equity-market drawdowns, or peak-to-trough losses, are more common than realized and do not necessarily signal further market troubles.
- Short-term performance swings are largely driven by fleeting market sentiment.
- We believe investors can prepare for and soften (but not eliminate) the impact of drawdowns through prudent diversification rather than emotional reactions.

After ringing in the decade on a high note, investors were caught off guard by the extreme volatility that ripped through capital markets in the first quarter of 2020. March brought a degree of turbulence not broached since the global financial crisis, with a sharp equity-market drawdown (peak-to-bottom decline) that overshadowed the similarly-shocking fourth-quarter 2018 decline. In the years leading up to these shocks, equity investors had been spoiled by prolonged market rallies, relatively muted pullbacks, and sustained periods of low volatility. The swiftness of the declines has served as a stark reminder of just how volatile equity markets can be—particularly the recent shift from above-average annual performance to bear-market territory (a drawdown of more than 20%) in a matter of months. While these sudden lows can feel painful in the moment, it is important to understand they are part and parcel of the risk an investor must bear to earn equity returns.

Significant market declines are fairly common and represent an inherent part of equity investing. While few investors like to see stock markets fall, there are approaches to investing that can help mitigate the impact of downturns, including:

- Reflecting regularly on whether your investment strategy is aligned with your investment goals (in that it may help you avoid incurring more risk than is necessary)
- Maintaining prudent diversification
- Refraining from reacting emotionally to short-term market movements

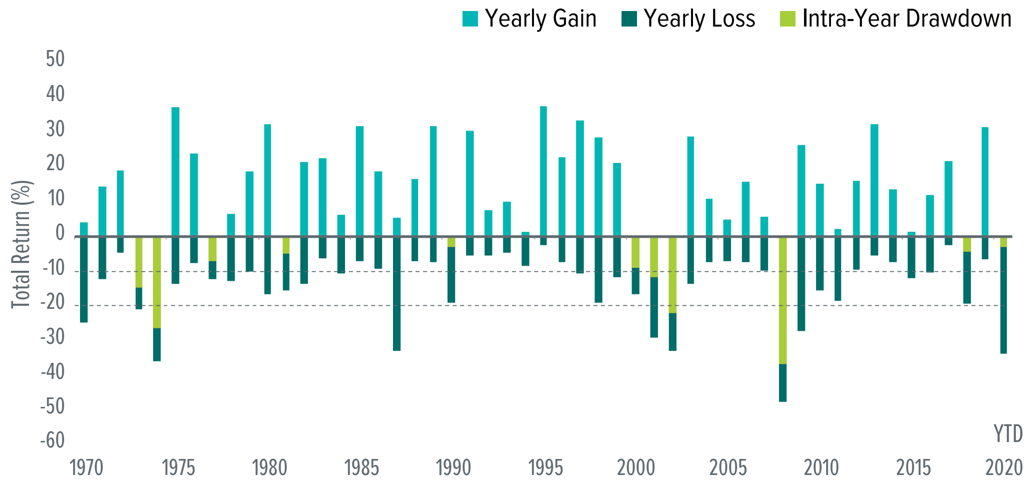
First-quarter 2020: A reality check

For a brief period at the start of 2020, market sentiment remained similar to that of 2019, 2017, and most of 2018 (before the aforementioned fourth-quarter 2018 drawdown, with low volatility and limited, infrequent pullbacks. Then came the COVID-19 pandemic, which crushed investor confidence as government-mandated lockdowns effectively paralyzed the global economy. U.S. large-cap stocks (as represented by the S&P 500 Index) fell approximately 34% in the 23 trading days between February 20 and

March 23. The quarter ended with a market drawdown that was larger than average (as measured by the S&P 500 Index, since March 1957, and its predecessor, the S&P 90 Index, since 1928), and the worst quarterly decline since the fourth quarter of 2008.

While notable, the magnitude of the drawdown in February and March of 2020 was not out of the ordinary. In fact, it was fairly in line with previous bear-market selloffs. This is illustrated in Exhibit 1, which captures market drawdowns and yearly returns for the last fifty years.

Exhibit 1: Substantial Declines are Fairly Common



Sources: Bloomberg, Standard & Poor's, J.P. Morgan, SEI. Returns represented by the S&P 500 Index. Drawdown periods are captured intra-year and calculated as total returns. As of 6/30/2020. Past performance is no guarantee of future results.

Exhibit 1 highlights the frequency of market corrections (declines of 10% to 20%) in the period between January 1, 1970, and June 30, 2020:

- The average intra-year drawdown measured almost 14%.
- There was a mid-year correction in 28 out of 50 years, or about 56% of the time.

Interestingly, these drops were hardly a marker for full-year results:

- Out of the 28 years in which corrections occurred, 18 (or 64%) still finished in positive territory.
- In the 28 years that experienced corrections, the market still managed to generate an average annual return of 5.7%.
- Despite these rather common corrections, the stock market has averaged 12% annual returns over the same period.

As for the early-2020 plummet that far exceeded the 20% bear-market threshold, that was a far less common occurrence. As illustrated in Exhibit 1, such dramatic drawdowns have occurred in only nine calendar years (including 2020) since 1970. An even wider historical lens would show just 22 calendar-year bear-market selloffs since the inception of the S&P 500 Index predecessor, the S&P 90 Index, more than 90 years ago.

We think it's critical to keep this historical perspective during periods of extreme market volatility—whether a more common correction or a less typical bear market. No matter the environment, doing so can help investors avoid making panic-driven investment decisions that may not align with their long-term goals. The past also serves as a reminder that it's unlikely one could predict the beginning or end of a drawdown—which we believe highlights the importance of maintaining a diverse portfolio of asset types.

Goal-setting and goal-revisiting

In short, from the outset of developing an investment plan at SEI, we work with our clients to set specific investment goals and then tailor asset allocations based on their associated risk tolerances and the return expectations necessary to achieve those goals. This approach is consistent with our goals-based investment philosophy: a blend of traditional investment theory and behavioral finance that involves managing investors' behavioral preferences while loosening the constraints of traditional assumptions with regard to optimal portfolio construction. SEI is a thought leader in the area of goals-based investing with a long-standing history of building strategic asset allocations for individuals, institutions and intermediaries; therefore, we recognize that there may not be a single portfolio suited to meet all of our clients' goals. We also recognize that traditional risk measures used to optimize portfolios (such as standard deviation) can fall short in providing a clear understanding of the above-all risk: not achieving investment goals.

Using a goals-based approach helps us to better align our investment solutions with the individual investment needs and risk views of our clients, and hopefully give them more confidence in their investment plans. While greater confidence rarely quells the distress that comes with large equity-market drawdowns, it can help investors to be better prepared for such turbulence—and, therefore, more likely to maintain perspective and stick with their investment strategies. Of course, an individual's investment objectives may change as the world and capital markets change. Therefore, we encourage all of our clients to periodically reestablish their goals to help avoid unnecessary risk-taking. As such, we revisit our asset-allocation methodologies and expectations to ensure that our investment solutions continue to align with our clients' needs.

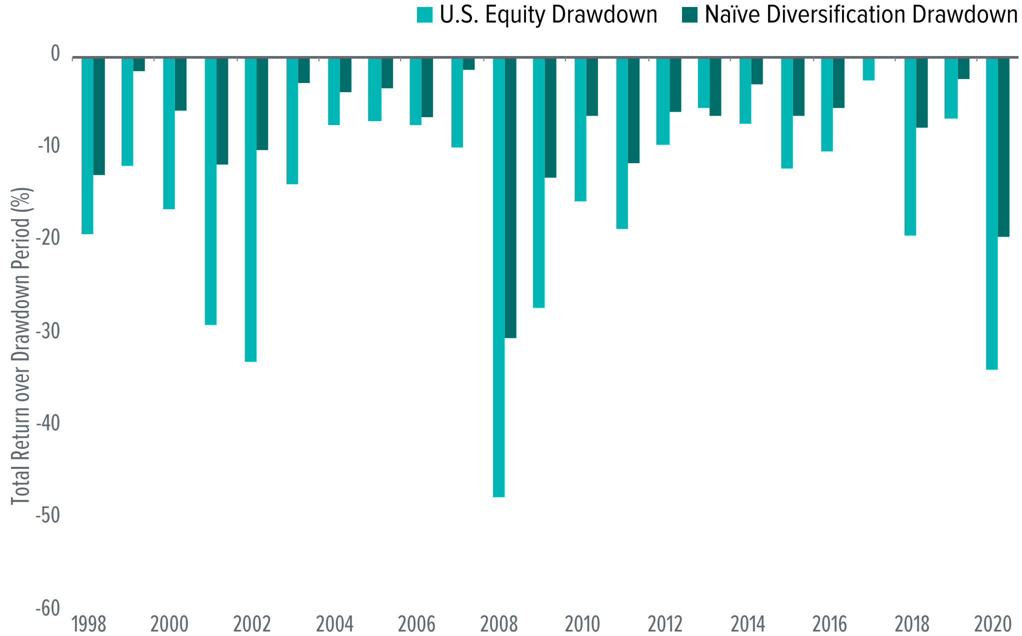
Diversification can dampen drawdowns

Consistently predicting when, how often, and with what magnitude market declines will occur is unachievable. However, we believe investors can prepare for and soften (but not eliminate) the impact of drawdowns through prudent diversification across an array of asset classes. Exhibit 2 demonstrates this point, comparing a hypothetical standalone portfolio of U.S. large-cap equities versus a naively diversified portfolio (meaning that each asset class is weighted equally) during each intra-year drawdown period since 2000.

We found that the single asset class (U.S. large-cap equities) portfolio underperformed the naively diversified portfolio in all but one of the years' drawdown periods—in 2013, when international equity markets were hit harder than their U.S. counterparts by the unusual events associated with the so-called taper tantrum (the term used to describe the market panic that occurred in reaction to the U.S. Federal Reserve slowly ending its bond-buying program). Even here, the performance difference was minimal.

This is not to suggest that investors should simply adopt a naïve diversification strategy. But the relative success of such a rudimentary approach to diversification does illustrate, in our view, the importance of maintaining exposure to a broad range of asset classes. At SEI, diversification within portfolios goes beyond a simple equal weighting of several security types: they are thoughtfully designed based on deep, skillful research in an effort to help investors meet a wide array of return objectives over varying time horizons.

Exhibit 2: Even Simple Diversification can Help Soften the Downside



Sources: Bloomberg, Standard & Poor's, MSCI, SEI. Returns are captured over intra-year max drawdown periods determined by SEI (see Exhibit 1). U.S. Equities are represented by the S&P 500 Index. Naive Diversification strategy is equal-weighted and composed of the following indexes: S&P 500 Index (U.S. large caps); Russell 2000 Index (U.S. small caps); MSCI EAFE Index (Net) (large- and mid-cap developed markets outside the U.S. and Canada); MSCI Emerging Markets Index (Net 2001-2020/Gross 1998-2000) (large- and mid-cap emerging markets); Bloomberg Barclays U.S. Aggregate Bond Index (investment-grade USD-denominated fixed-rate taxable bonds); Bloomberg Barclays U.S. Corporate High Yield Index (USD-denominated high-yield fixed-rate corporate bonds); Bloomberg Barclays Emerging Aggregate Index (USD-denominated debt from sovereign, quasi-sovereign, and coporate emerging-market issuers); Bloomberg Barclays U.S. Treasury Inflation Protection Notes Index (U.S. Treasury inflation-protected securities); Bloomberg Barclays U.S. Aggregate 1-3 Year Index (1-3 year USD-denominated debt from sovereign, quasi-sovereign, and coporate emerging-market issuers); and Bloomberg Commodities Index (commodity futures). All returns are total returns and in USD terms. As of 6/30/2020. Indexes are unmanaged and one cannot invest in an index. Past performance is no guarantee of future results.

Discipline amid heightened volatility

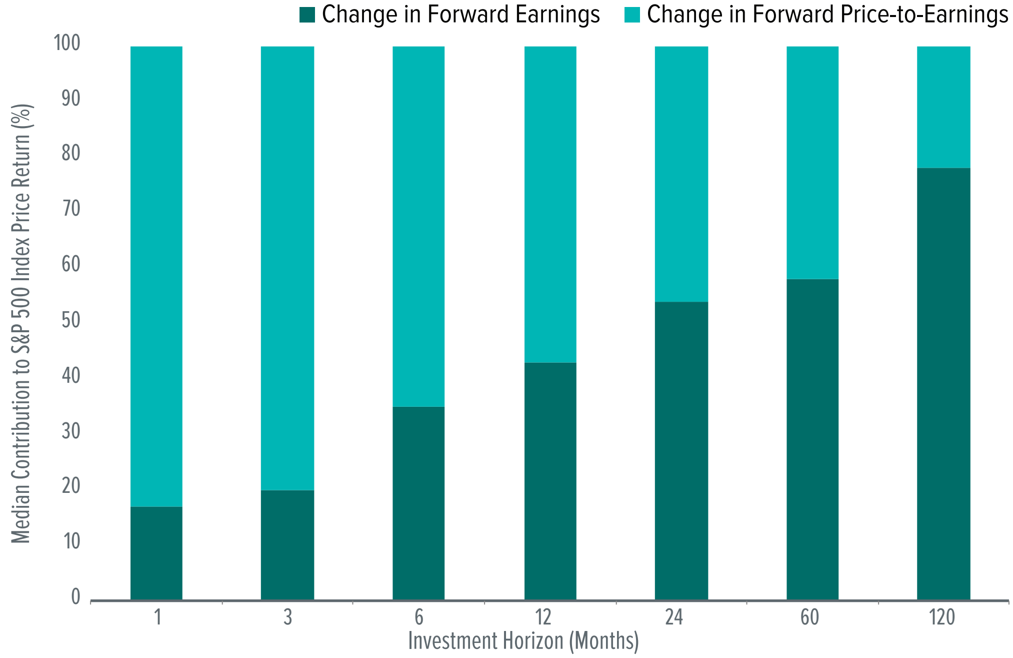
It's tough to sit back and resist the urge to tinker with your investment strategy in the midst of a significant market selloff—especially as news media and market pundits tend to focus on shorter-term market activity, dissecting every up and down. But such a short-term focus is rarely useful to investors who typically have longer-term goals with timeframes that are measured in years (and often decades), rather than months or quarters. We therefore think it's important to maintain a longer-term focus by taking comfort in the historical precedent that this downturn, too, shall pass—and by retaining an appropriate and well-diversified portfolio that can help investors do just that.

Equity markets are driven by underlying fundamentals and investor sentiment, with each having varying impacts on returns, depending on the time horizon. Market fundamentals ultimately boil down to aggregate corporate earnings, which can be expected to move in line with economic growth over time. Meanwhile, sentiment is oftentimes represented through valuations (that is, how much investors are willing to pay for each dollar of earnings).

Investors continuously change how much they value each dollar of earnings according to the long-term growth outlook. When sentiment is high, investors are typically willing to pay more (and stocks are considered "expensive"); and when sentiment is low, investors are willing to pay less (and stocks are considered "cheap"). However, unlike corporate earnings (which should ultimately align with economic growth over long time horizons), we believe the long-term impact of valuations on returns is a zero-sum game—meaning that any gains or losses tied to valuation changes should eventually be expected to reverse course. After all, investors will not continue to pay an ever-increasing amount for each dollar of earnings.

While sentiment and other factors can heavily affect equity markets in the short-run, corporate earnings—and ultimately economic growth—are the long-term fundamental drivers of aggregate returns. This is empirically illustrated in Exhibit 3, which compares the relationship between time horizon and the impact of earnings and valuations on equity-market returns.

Exhibit 3: Fundamentals Play Increasing Role over Longer Horizons



Sources: Credit Suisse, Standard & Poor's, SEI. Changes in Earnings derived from forward earnings-per-share and changes in Price-to-Earnings derived from forward price-to-earnings ratio. Median contribution to return from 1964 through 2019.

In Exhibit 3, we can see the extent to which investor sentiment drives market behavior over shorter periods of time. For example, over a one-month period, less than 20% of returns are attributable to corporate earnings. Even over periods of up to a full year, valuation changes drive well over half of returns. But fundamentals, rather than sentiment, begin to take the driver's seat as time horizon lengthens. The 10-year period is dominated by earnings, and this trend should only grow stronger as the horizon continues to extend. While it may not always be gratifying in the moment, one key to a successful investment experience is seeing past short-term, unpredictable noise—remembering that it takes time for equity-market fundamentals to fully play out.

SEI's view

Achieving investing goals does not come without risk. This means that weathering drawdowns is a natural component of equity investing. We believe this is perfectly acceptable as long as investors are taking prudent, well-thought-out risks.

Calculated risk-taking involves proactive (rather than reactive) decision-making—through sensible diversification—along with maintaining a strategic asset allocation consistent with both ability and willingness to take on risk. In our view, no matter where you stand on the risk spectrum, the key to a successful investment experience is refraining from emotional reactions to short-term market disruptions and keeping your mindset in line with your goals and objectives.

Important Information

This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice, nor should it be construed as a recommendation to purchase or sell a security, including futures contracts.

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Past performance does not guarantee future results. Index returns are for illustrative purposes only and do not represent actual portfolio performance. Index returns do not reflect any management fees, transaction costs or expenses. One cannot invest directly in an index.

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