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Baird Trust Market Commentary

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Psychology of a Bear Market

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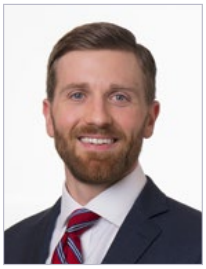

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In our June 15 piece titled *Our Thoughts on Market Volatility* we explained that, while unpleasant, bear markets are a common occurrence that investors must always be prepared for. Unfortunately, their timing is uncertain, and their severity is unknowable.

It is easy to look at past bear markets rationally. With the benefit of hindsight, they all look like great buying opportunities. Far removed from the emotion and fear that arise in the depths of a bear market, it is crystal clear that sticking to your investment plan was the correct choice. But it is impossible to fully recreate the psychology of a historical bear market after the fact. Human nature works hard to forget the pain.

Famed investor Howard Marks often discusses what he calls the pendulum of human psychology, or the mood swings of the market between fear and greed. He has said, "In the real world, things fluctuate from pretty good to not-so-hot. But in the markets, they go from flawless to hopeless." We see this time and time again in the stock market. Human emotions go into overdrive both on the upside and the downside.

During times of greed, investors fixate on capturing large investment gains without much thought to the downside risks. This was the case in 2021 with meme stocks, crypto, SPACs, innovation stocks, and money-losing technology companies. Many of these highly speculative "investments" have lost 50% to 90% of their value this year. On the opposite side of the pendulum, during times of fear investors fixate on risk and investment losses without any thought to the potential for positive surprises.

Today, the emotional pendulum is swiftly swinging in the direction of "fear". The S&P 500 is down more than 20% from its January high. Consumer sentiment is currently at the lowest level ever recorded, and investor sentiment is decidedly bearish. Interest rates are moving rapidly higher from very low levels. Inflation is at 40-year highs. It feels like nothing is going right, and the near future seems certain to keep getting worse.

As fear takes over, investors begin to worry and fixate on near-term unrealized losses. The natural response from our brain is to stop the losses at all costs. It is extremely difficult to watch stock prices fall and not experience a primal urge to sell simply to stop the pain. Even though most of us know this is a bad long-term decision, it often feels like it is the best short-term decision.

But when it comes to the stock market, investors must fight against their human nature. Emotion cannot be involved in making good investment decisions. As financial historian Peter Bernstein said, "The most important lesson an investor can learn is to be dispassionate when confronted by unexpected and unfavorable outcomes." Bear markets are certainly unfavorable outcomes, so our reaction to them *must* be rational rather than emotional.

A rational reaction is easier said than done when account balances are declining, the media trumpets the most negative

news stories, and feelings of fear are growing. During challenging times like these, our focus is on the underlying business results of each individual company in your portfolio rather than on its volatile stock price. What we find today is many business' results remain strong even though stock prices are weak. As long-term owners we know that a business' results over the next 5-10 years will determine investment success, not what the stock price does over the next 6 months. In the long run, if a business is successful, its stock price will ultimately reflect that success.

One of Warren Buffett's most famous quotes is to "be fearful when others are greedy and greedy when others are fearful." This essentially means to act in direct opposition to the broader investor psychology or sentiment. When things are going well and nobody sees any risks, proceed with caution. On the other hand, times like today, when fear reigns supreme, is the time to be more opportunistic.

Regardless of what lies ahead, we strongly believe the best path forward is to stick to your individual investment plan and our time-tested investment process. Our focus remains on the long-term compounding of your wealth, not the daily fluctuations in share prices. We understand today's market environment is difficult, but we believe, over time, it will become just another bear market we look back on with the benefit of hindsight.

Thank you for your continued trust in our team at Baird Trust. We truly appreciate the confidence you place in us as stewards of your financial assets.

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