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Dealing with Market Volatility

An evaluation of historical market pull-backs and how to approach future downturns with a long-term perspective.

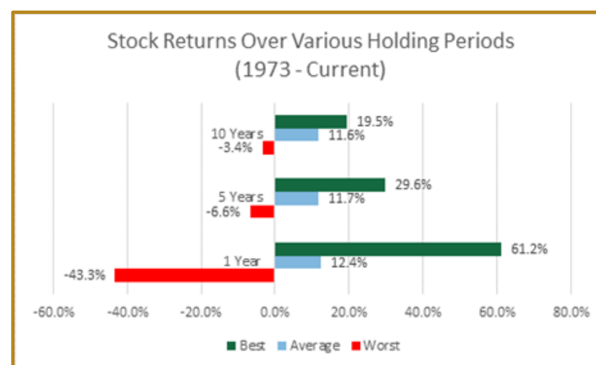
While a roller coaster metaphor may be a bit cliché to describe market volatility, it is difficult to watch a market drop without conjuring up memories from a childhood favorite: the Demon Drop.

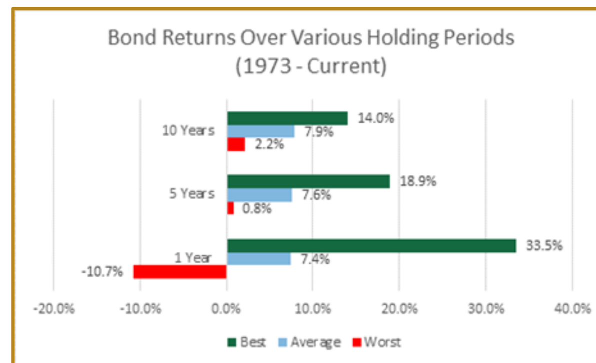
Amongst the most popular amusement park rides in the mid-80's, the Demon Drop boasted one of the highest freefall experiences in the country. And even though you knew it was coming, a certain fear would take hold of you during the ascent and 60ft free fall drop. Similar emotions can be felt during a market sell-off; even though we can analyze and attribute the reasons for a downturn, we suddenly begin to feel like our feet are dangling from that 60ft drop again.

In the market, just like at the fairground, drops are inevitable. The key is to have the right safety harness, or investment team, to carry you through them calmly and strategically. Over the past 50 years, there have been many periods of extreme volatility. The S&P 500 has experienced several pullbacks, recessions, and bear markets caused by the economy, geopolitical events, inflation, and financial and health crises. In fact, the longest period of decline lasted about 2.5 years and the steepest decline was nearly -60%. However, in each instance of market decline, stocks have recovered, the freefall stops, and you are eventually able to catch your breath.

The Long-Term Approach

The key to remaining calm in periods of extreme volatility is to maintain a long-term perspective and avoid emotional decision making, both of which require certain preparations. By planning for short-term needs with liquid and stable assets, a portfolio has the durability to handle the twists and turns of the market. Both stocks and bonds can be quite volatile in any given year, but as the holding period of a security increases, the volatility diminishes.





Source: Chilton Trust, FactSet. **Past performance is no guarantee of future results.**
Stock returns represent monthly total returns of the S&P 500 Index from January 1971 – August 2022.
Bond returns represent monthly total returns of the Bloomberg Barclays U.S. Aggregate Bond Index from January 1971 – August 2022.

Taking a long-term approach has proven to result in great returns for investors even with several severe market sell-offs since the 1970s.

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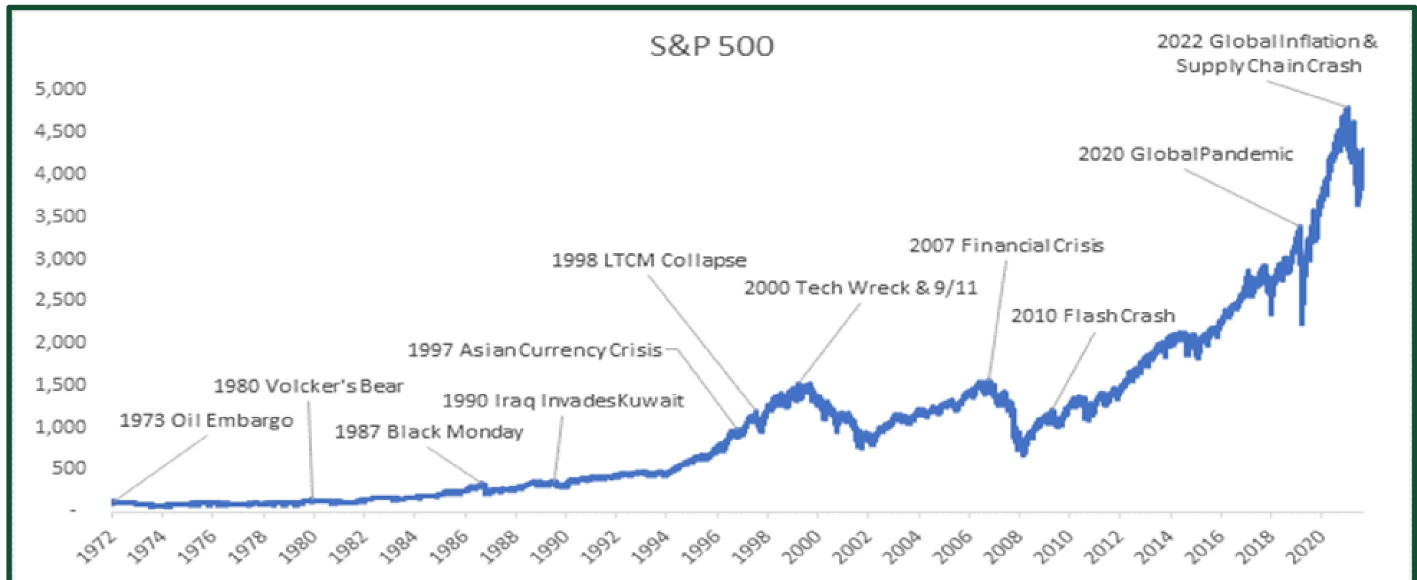
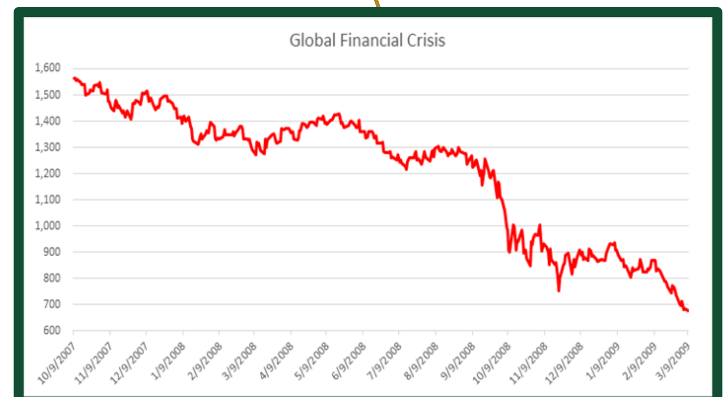
When looking at the S&P 500's performance over a long span of time, one can barely make out the peaks and troughs of market volatility, despite their severity at the time.



Source: Chilton Trust, FactSet. **Past performance is no guarantee of future results.**
Chart represents daily index price performance of the S&P 500 Index from January 1971 – August 2022.

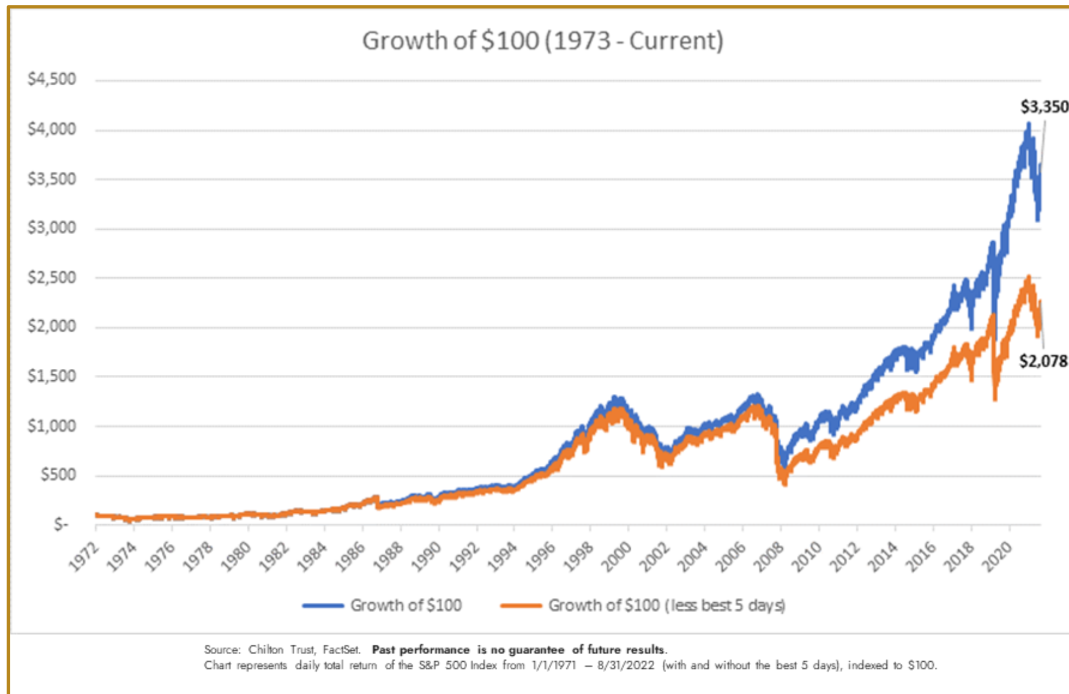
The Global Financial Crisis was one of the most severe market events in recent times. In fact, the trajectory of the S&P's performance from the October '07 to March '09 demonstrates a tale of doom and gloom. The stretch saw a market correction of -56.8% over 560 calendar days. However, when viewed with a long-term perspective, the catastrophic movement was mirrored by a recovery that gained back 26.6% after just one month, 68.6% after one year and 102.6% after 3 years. This proves the point that despite the occurrence of significant downturns, the stock market is still the best place for individuals to generate and compound wealth over time.



Source: Chilton Trust, FactSet. **Past performance is no guarantee of future results.**
Chart represents daily index price performance of the S&P 500 Index from 10/9/2007 – 3/9/2009.

Ultimately, portfolios with low turnover and investors that exhibit an ownership mentality of durable businesses are best situated to ensure that losses from market corrections are mitigated.

In contrast, investors with less patience, who decided to jump off the ride during these downturns have suffered significantly. Charting the growth of $100 from 1973 to 2022, you can see the discrepancies of investors who did and did not trust their "safety harnesses" during the freefall. By missing just the 5 best days of performance in the past 50 years, investors lacking the confidence and trust to remain committed in these tougher times resulted in capturing only two-thirds of the total return versus those investors who were fully invested during the same period.



The Importance of Asset Allocation

Even in a year where stocks and bonds have experienced negative returns broadly, a thoughtful allocation strategy will provide benefits to investors. However, the success of an allocation strategy is predicated on the construction of the portfolio. Asset classes should be selected based on the investor's goals and serve as resources for specific purposes – from liquidity to preservation and long-term growth. With an investor's goals as the primary driver in the portfolio construction process, uncertainty in portfolio outcomes can be greatly reduced, or even eliminated. Having the flexibility to invest in anything without the compulsion to be invested in everything provides investors with an optimal asset allocation.

Model portfolios and risk tolerance "buckets" are the antithesis of smart portfolio construction and often lead to wide variability in portfolio outcomes from their intended goals. Since Harry Markowitz developed the concept of Modern Portfolio Theory in 1952 – the notion that a diversified portfolio of lowly-correlated assets would produce an optimal "risk-adjusted" outcome, institutions have grossly misapplied the concept of diversification. This misapplication has led to shocking results for investors when portfolio outcomes are vastly different than projected results of model allocations.

This growing trend among institutions using model portfolios to create scale and ease compliance burdens is concerning as these one-size-fits-most portfolio models fail to deliver in periods of heightened volatility.

But why does this matter in the conversation of market volatility? Well, this result tends to be further exacerbated in periods of extreme downturns when asset correlations migrate towards being perfectly and positively correlated. In other words, everything falls in unison due to mass "risk-off" selling pressure.

To prepare for market volatility, proper allocation once again takes center stage. In order to ride out difficult market periods, investors should have enough cash or low volatility fixed income securities in their portfolios to cover their expenses. This prevents the risk of selling out of equity positions at an inopportune time. Fortunately, these extreme periods don't tend to last long and while market volatility can't be avoided, it can be used to create opportunity in a well-managed and personalized portfolio.

Ultimately, a portfolio with optimal allocation and high-quality holdings will preserve the integrity of the investor's goals over time.

Being able to construct high-quality and high-conviction portfolios that combine market inputs and expectations with an individual's unique goals and objectives increases the likelihood of successful outcomes regardless of market conditions.

Also known as goals-based investing, this approach takes a bottom's up view of asset allocation by only including those asset classes that add greater certainty to an investor's attainment of their stated goals.

This is done through matching cash flows with need, aligning bond maturities with known liabilities, or selectively adding assets that reduce volatility or enhance returns within the investor's stated objectives.

High Quality Investments and Conviction Matters

While much ink has been spilled within the active vs. passive investing debate, it comes to a head during periods of extreme market volatility. Owning the entire market via a passive index strategy will capture 100% of the ups and downs. Alternatively, an active strategy that selectively owns high-quality companies can limit losses through market cycles by avoiding companies that are dependent on debt, have inconsistent revenue streams, or exhibit limited pricing power, as these are often the companies which are hit hardest during periods of economic weakness. During historic market events, such as the Dot Com bubble in the early 2000s, the Savings and Loan Crisis of the 1980s, or the Energy Crisis of the 1970s, many low-quality debt-laden companies with poor revenue streams filed for bankruptcy and dragged down market returns.

When evaluating fundamentals, we often look for companies with the following traits:

- Pricing power;
- Stable margins;
- Solid revenue growth;
- High return on invested capital;
- Have a strong track record of prudent capital allocation;
- Have proven to generate free cash flow consistently over time; and/or
- Benefit from high barriers to entry

A key to a successful long-term investing strategy is owning quality companies; this becomes much more apparent during times of market volatility. When a portfolio is comprised of high-quality, durable companies, even the most drastic market events can create opportunity for an investor.

> "The true investor welcomes volatility.... A wildly fluctuating market means that irrationally low prices will periodically be attached to solid business."
> – Warren Buffet

An investor who can seize opportunity for discounted names can wisely position themselves during a downturn and capture significant gains once those valuations eventually normalize.

There have been extreme moments of market volatility in the past and this trend will certainly continue – likely with even greater velocity. There is no utopian market future in which downside risk disappears; it is as inevitable as that 60ft freefall on the Demon Drop. Unlike your time at the amusement park, you can't merely close your eyes and wait for it to be over. However, smartly constructing a customized portfolio based upon your needs will provide peace of mind in the perils of uncertainty. The benefits of personalized results far outweigh the efficiencies of model portfolios at standard big banks and provide you with the flexibility needed to carry you through a market downturn. The solution to handling market volatility is not merely "riding it out;" it is about having faith in the strength of the companies you own and the execution of your wealth management team. Bearing the brunt of the worry, supporting your needs during moments of pressure, and working hard to make sure you land well – these are the safety harnesses that keep you safe for the freefall. This is a role that Chilton Trust understands, appreciates, and does not take lightly. Ultimately, these responsibilities are central to our core principals as we act on behalf of our clients.

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For further insight on transfer planning and strategy, contact one of our experienced wealth advisors or explore our content library here.

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