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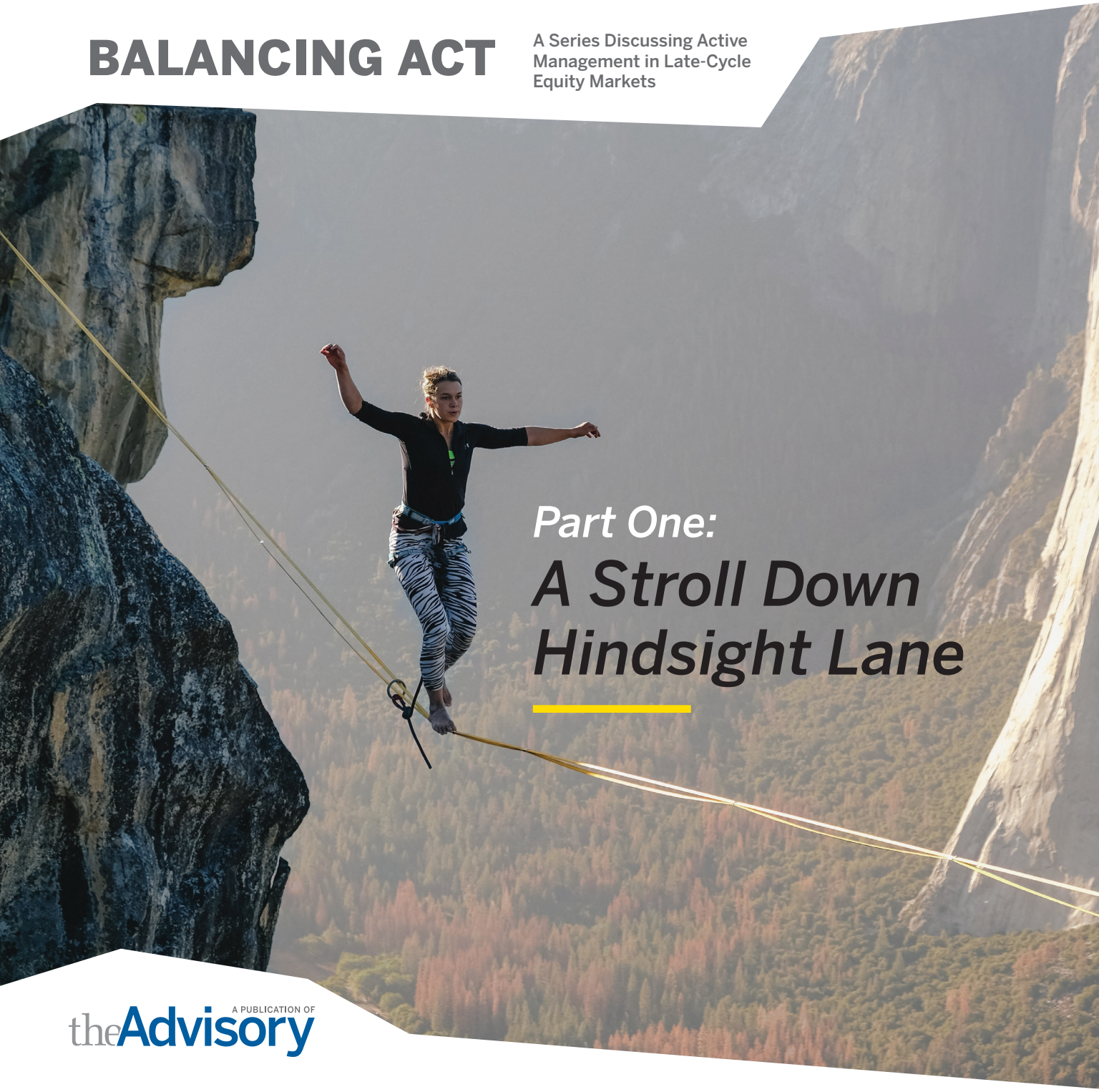
BALANCING ACT

A Series Discussing Active Management in Late-Cycle Equity Markets



Part One:
A Stroll Down Hindsight Lane

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The bull market in U.S. stocks is now almost nine years old—the second-longest period on record without a 20% decline in the S&P 500® Index. Returns have been strong and remarkably consistent during this period. From its low point on March 9, 2009, the Index has advanced more than 250% through Sept. 30, 2017, and in seven out of nine calendar years between 2009 and 2016, it earned double-digit returns.

Many investors are worried about the age of the bull market, how much longer it can last and what might happen to their investments in a downturn. We can understand these concerns about a market reversal. As of early November, the S&P 500 Index was trading at roughly 20 times earnings, well above its historical average. The bull market has indeed lasted for some time now, and the current geopolitical environment offers plenty of potential scenarios that could shock the market.

But we can't emphasize strongly enough that it is largely impossible to predict the near-term path of the stock market. Skewing one's portfolio heavily toward a strong bullish or strong bearish belief is speculation, pure and simple. ***We believe that investing in equities should be a balancing act, not an exercise in placing bets on one side of the scale or the other.*** *At any given time, we need to weigh the risk and opportunity we see in the economy, in the stock market and in individual companies—all in an effort to balance the possible positive and negative outcomes of every investment we make.*

Perhaps the risk of a downturn is elevated after a nine-year bull market, but that doesn't mean it makes sense to blindly reduce or eliminate exposure to equities. One's timing needs to be nearly perfect in order to justify a decision to temporarily pull out of the stock market, and then re-enter at a later date. As such, we believe strongly in maintaining consistent, permanent allocation to equities as a core mechanism for generating long-term returns.

We also believe that active, selective management of equity portfolios is a powerful tool for directing capital to companies that, in our view, offer a favorable mix of upside potential and downside risk. And if history is any indication, being selective in the stock market often generates particularly strong benefits during time periods when the market or the economy falters.

In this series of articles, members of our research teams will share their perspectives on this philosophy. We will hear equity research analysts talk about risk and opportunity within the sectors they cover, and portfolio managers discuss the dangers of relying too heavily on traditional valuation metrics. We will also talk about tools we use to better understand how our portfolios might behave in a downturn. The common thread in each of these pieces: To the extent that an "aging bull market" conundrum exists, we have no interest in trying to address it through market timing. We believe in a consistent approach to investing at all stages of the market cycle, in which we embrace the value we hope to create through active, selective equity investment.

In this article: Head of Asset Allocation Research Taylor Graff looks at the folly of market timing, the role that the economy has played in determining the length and severity of downturns historically, and how active management has fared during periods of economic weakness.

Part One:

A Stroll Down Hindsight Lane

In the rear-view mirror, market downturns and recessions often seem like they could have been easily predicted. But timing the market turns out to be far more difficult without the benefit of hindsight.

TAYLOR GRAFF, CFA
Head of Asset Allocation Research

Ultimately, fundamentals drive stock performance. Over shorter periods of time, this relationship is not very reliable, as stock prices are also affected by a tremendous amount of market noise—announcements from the Fed, political angst or exuberance, fears of war, hope of peace, and a host of other factors. But in the end, a company's market value is determined by its potential for future growth and profitability.

In the equity strategies that our firm manages, we focus on fundamental research of individual companies to assess their long-term prospects, and we avoid making decisions that require guessing about short-term market movements. When clients ask us about timing the market—for example, about potentially exiting the market to avoid a market correction—there is almost no situation in which we would recommend doing so. As we will discuss in this article, one needs to be highly precise about two market-timing decisions—when to exit, and when to re-enter—in order to truly benefit. In our experience, it is extremely difficult, if not impossible, to do so effectively.

Even if investors discard the notion of broadly timing the market, they still may have questions about staying invested in actively managed strategies during what they perceive as a risky market. Are there any signals amidst the noise that can offer them comfort? Well, we believe that broader economic fundamentals are important for long-term stock valuations—these fundamentals determine the overall environment in which corporations operate. While one can't predict a recession with any more accuracy than a market correction, we have learned two things from the last 50 years of market history: Market corrections were mild unless they coincided with a recession; and, active managers generated meaningful alpha during recessionary periods. These facts suggest that if the economy and markets do turn sour and we experience a major market correction, actively managed strategies may in fact weather the storm better than indexes due to their focus on robust, healthy businesses.

THE FOLLY OF MARKET TIMING

At the risk of stating the obvious, it would be great if we could time market corrections! Get out of the market when it peaks, get back in when it bottoms out, preserve your capital—that's an ideal scenario.

The problem is that it is impossible to time market corrections effectively, at least in our experience. We think about the market and individual stocks in terms of probabilities—we develop a likely range of upside and downside scenarios over a period of years, and try to make decisions that position us relatively well across all of those scenarios. However, trying to avoid a market correction is a very different exercise. It involves two very distinct and momentous decisions—when do you exit, and when do you re-enter?

The data suggests that unless you are highly accurate about both of those decisions, you are unlikely to get much benefit from your market timing attempt. We looked at all of the market corrections in the S&P 500 Index from 1968 to the present, and calculated how well an investor would have fared by exiting the market at various points before and after the market's peaks, and then re-entering the market at various points before and after its troughs.

We found that unless investors timed it perfectly on both ends—or at minimum, timed at least one of the decisions perfectly—in most cases they would still bear

the brunt of the losses from the downturn. Just being three months off for each decision meant that investors on average would have experienced 90% or more of the average downturn (see chart on page 5), and in many cases would have missed out on positive returns.

If you see this data as a challenge to simply "do better," be forewarned: The broad investing herd **and** noted financial experts repeatedly try—and fail—to time the market. The chart on page 5 also shows how the investing public has invariably entered and exited the market at the worst possible times (as measured by monthly net equity mutual fund flows); additionally, otherwise brilliant economists and market experts often put a stake in the ground regarding the market's future path, only to be proven sorely mistaken. Finally, note that taxes and transaction costs are additional hurdles that market timers must overcome.

IT'S THE ECONOMY

In short, precise market timing is impossible, in our view. However, we still want to be attuned to information that can help us understand the probability of a downturn. Additionally, we are always looking for data that may offer clues about the potential length and severity of the next downturn.

One factor that seems to be quite relevant is the health of the economy when a downturn occurs. Specifically, we know from history that downturns tend to be longer and more severe if they occur during an economic recession, and milder and shorter in the absence of a recession. This is obviously relevant when we consider our clients' overall exposure to risk assets, and it is also important for our equity research analysts and portfolio managers as they think about the prospects of the individual stocks in their portfolios.

If you see market timing as a challenge, be forewarned: Both the public *and* noted financial experts repeatedly try—and fail—to time the market.

A STROLL DOWN HINDSIGHT LANE

One reason market timing is so hard: You have to be *really accurate* for it to pay off.

We looked at all of the meaningful S&P 500 Index downturns since 1968. Consider:

If you...	...then you avoided...
timed the typical downturn perfectly—out at the top, back in at the bottom	100% of the typical downturn
were just three months early exiting, and three months late re-entering	10% of the typical downturn
were just three months late exiting, and three months early re-entering	1% of the typical downturn

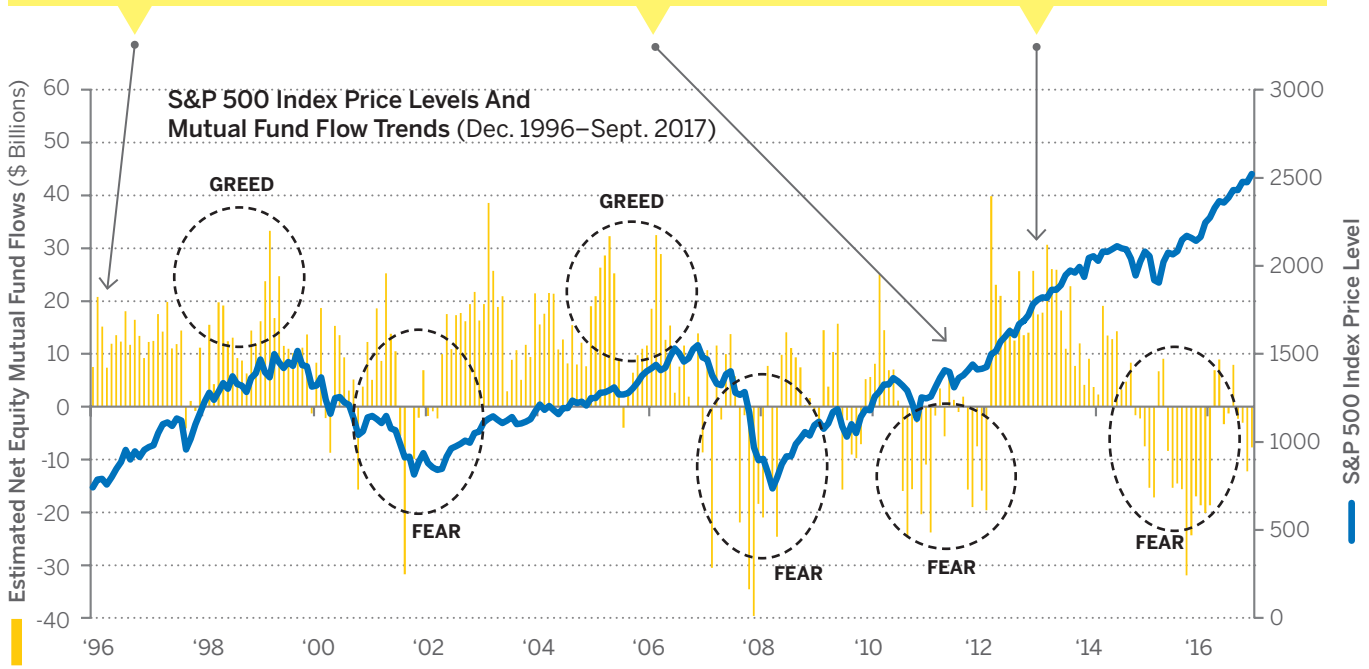
And both the herd and industry experts have proven to be *really inaccurate* with market timing decisions.

Investors have invariably poured money into the market as it was peaking (marked as "greed" in the chart), and pulled money out right before notable upswings (marked as "fear"). Moreover, leading experts have repeatedly made infamously inaccurate calls about the stock market's near-term prospects (apologies to the few experts who are singled out here, among the many we could have chosen).

Dec. 5, 1996: Alan Greenspan suggests that "irrational exuberance" may have produced a stock-market bubble. The market races ahead for almost four more years, and never again falls back to where it sat on the day of Greenspan's speech.

Oct. 26, 2012: Jeremy Grantham says he thinks it's a good year to "keep your head down" with regard to the stock market. The S&P 500 Index advances more than 35%, almost without interruption, over the next two years.

July 15, 2014: Janet Yellen states that "equity valuations of smaller firms as well as social media and biotech firms appear to be stretched." All three of these segments of the market have performed admirably in the three-plus years since her statement.



Sources: Bloomberg for S&P 500 Index data, Morningstar for U.S. equity mutual fund net inflow/outflow data. Morningstar estimates monthly net mutual fund flows by computing the change in the assets of each fund in its universe that is not explained by performance. Source for Alan Greenspan and Janet Yellen citations: Federal Reserve public statements. Source for Jeremy Grantham citation: 10/26/12 Bloomberg Businessweek interview, "Charlie Rose Talks to Jeremy Grantham."

WHAT DRIVES EQUITY MARKET DRAWDOWNS?

Since 1968, downturns in the equity market that did not coincide with recessions were generally short and shallow. Downturns during recessions (highlighted in yellow below) were generally longer and more severe.

Start Date for Downturn in S&P 500 Index	Length of Correction (Months)	Percentage Drop	Time to Recover to Previous Peak (Months)
11/29/68*	**18**	**-36.1**	**21**
04/28/71	7	-13.9	2
01/11/73*	**21**	**-48.2**	**83**
09/21/76	18	-19.4	17
09/12/78	2	-13.6	9
10/5/79	1	-10.1	3
02/13/80	1	-13.7	4
11/28/80*	**21**	**-27.1**	**3**
10/10/83	10	-14.4	6
08/25/87	3	-33.5	20
10/9/89	4	-10.2	4
07/16/90*	**3**	**-19.9**	**4**
07/17/98	2	-19.3	3
03/24/00*	**31**	**-49.1**	**56**
11/27/02	3	-14.7	2
10/9/07*	**17**	**-56.8**	**49**
04/23/10	2	-16.0	4
04/29/11	5	-19.4	5
05/21/15	9	-14.2	5
Averages			
Overall	9	-23.7	16
Recession*	17	-38.7	34
No Recession	5	-16.4	6

Source: Bloomberg. Recession and expansion periods are defined by the National Bureau of Economic Research.

The table above offers a glimpse of each of the notable S&P 500 Index downturns from 1968 to the present. Downturns that overlapped recessions are highlighted in yellow. The average downturn during recessionary periods lasted 17 months, resulted in a 38% drop in market value, and required a 34-month period before the Index recovered to its prior peak. The average downturn in non-recessionary periods lasted only five months, resulted in a 16% drop in value, and required only six months of recovery time before the Index bounced back. **Recessions appear to play a notable role in both the length and severity of downturns.**

As we mentioned earlier, we don't believe that it's any easier to predict a recession than it is to predict a market correction, and we don't build plans or base decisions on predictions of this nature. But there has been an undeniable relationship between recessions and the severity of downturns over time, so we can at least use that knowledge as a filter to assess the potential significance of incoming data.

THE VALUE OF ACTIVE MANAGEMENT

As we proceed further in this series, we will move into discussions that focus more on individual stock selection, and on the value that active management can produce for investors—particularly during periods when the stock market or the economy is potentially poised for a reversal. To close this article, we offer some introductory evidence to support the notion that managers tend to earn their stripes during periods of economic weakness. The table at right summarizes the results of a 2011 study by Robert Kosowski, who found that managers indeed tended to struggle during economic expansions but produced meaningful value during recessionary periods.

This data makes sense intuitively. During periods when the economy is strong and the market is running, people tend to be more confident and more willing to speculate on riskier companies. Additionally, the ongoing popularization of passive investing may be contributing to a lack of selectivity in markets; index funds essentially ignore the intrinsic value or current price of any given stock, and as capital shifts to index funds, those funds may provide support for all stocks.

But when the economy weakens, when broad-market confidence fades—that is when we believe it is most important to be selective about the companies we choose to own. As we said at the start of this article, fundamentals ultimately drive stock performance. In the absence of other exogenous factors to buoy a company's stock price, the only thing left is that company's foundation—the health of its balance sheet, the strength of its business model, and its ability to generate earnings and cash flow.

PERFORMANCE WHEN IT COUNTS

Actively managed equity funds generated meaningful value during recessionary periods in the latter half of the 20th century.

Average Annual Four-Factor Alpha For Equity Funds, 1962–2005

	Recession Periods	Expansion Periods
All Growth Funds	3.87%	-1.27%
Aggressive Growth Funds	0.82%	-1.63%
Growth Funds	3.21%	-1.22%
Growth & Income Funds	3.27%	-1.21%
Balanced & Income Funds	5.48%	-1.69%
All Equity Funds	4.08%	-1.33%

Source: "Do Mutual Funds Perform When It Matters Most? U.S. Mutual Fund Performance and Risk in Recessions and Expansions," Kosowski, Quarterly Journal of Finance, Vol. 1, No. 3, 2011.
Four-factor alpha is a measure of equity performance. It seeks to isolate a stock or portfolio's idiosyncratic return vs. a benchmark, by accounting for market capitalization, book-to-market ratio, momentum and volatility. Recession and expansion periods defined by the National Bureau of Economic Research. Results based on all listed U.S. equity funds during the period, covered by the Center of Research in Security Prices (CRSP) survivor-bias free mutual fund files. Fund categories constructed by the author based on each fund's investment objective.

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