BALLENTINE PARTNERS

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Stocks are awful. Stocks are awesome. At the same time.

It may seem illogical on its face, but it is almost always true. Nasty and painful drawdowns are not a bug of equity markets, they are a requisite feature.

Pete Chiappinelli, CFA, CAIA, Deputy Chief Investment Officer

"It is not logical.
But it is often true."

> Spock
> In second season of Star Trek
> September 15, 1967

I remember getting extremely irritated once when I read an innocuous newspaper quote from a thoughtful investor, academic, and well-regarded practitioner. I had studied under him at graduate school, followed his work for many years, read all his articles and his white papers, and saw him speak eloquently at industry conferences. And what he said, I'm sure to your ears, would not be anything particularly offensive or off-putting: "Despite equity markets having occasional painful drawdowns, equities tend to be very good assets to hold in the long term."

Why was I so irritated?

OK, bear with me, because I know I'm about to sound hyper-critical and "looking-for-a-fight" persnickety.

It was his use of the word, "despite." Why was I reacting so strongly? Because it undermined an important understanding of why equities, in the long term, exist as capital markets financing tools and why they are such awesome investments. It's not *despite* their shorter-term drawdowns. It's *because.*

This is no small distinction. It speaks to the heart of what we mean by risk and compensation for risk. His quote seemed to imply that if it weren't for those annoying and painful episodes, stocks would be great. I disagree. It is precisely *because* of these annoying and painful episodes that stocks NEED to pay you so well, ultimately. You get awesome returns from stocks not because they're nice guys --- those awesome returns are paying you back for all the headache and heartache they can put you through in the short term. You don't get one without the other.

Equities are awful. Equities are awesome. It may seem illogical, but this statement has to be true. The past decade is a perfect example. Please look at the charts below. The one on the left is showing the intra-year drawdowns of the S&P 500 from 2012 to 2022. Through this lens, stocks were awful this past decade. They suffered an official bear market -20% drawdown in 2018, followed by a gut-wrenching swoon of -34% in 2020, only to cap off the decade with another heart-attack inducing intra-year decline of -25% in 2022. In fact, of the past ten years, six of them put investors through *double-digit* intra-year declines. Pretty annoying and pretty painful if you were living through it.

Through a very different lens, however, the past decade for the S&P 500 has been awesome. This basket of stocks compounded your wealth at almost 13% annually for the full ten years. In other words, any money you had in this basket would have *tripled* over this time frame. The past ten years rank up there as one of the better decades on record. And that's pretty awesome.

How can this decade be both awful and awesome in the same breath? Easy. That's how it works.

Equities do well over time as <u>compensation</u> for drawdowns

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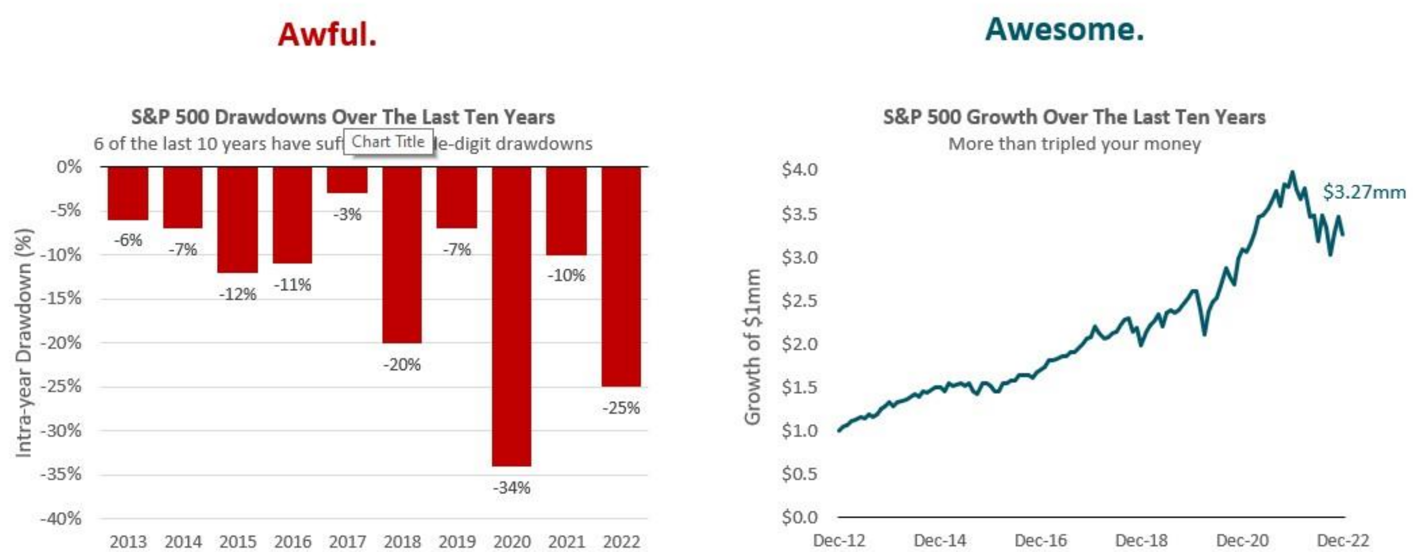
How can equities be awful and awesome at the same time? It may not seem logical, but it is true.



Source: Ballentine, J.P. Morgan Asset Management. U.S. equities represented by the S&P 500 index. Each drawdown represents a peak to trough collapse of price in a calendar year. Any investment can result in total loss. Past performance is not necessarily indicative of future performance.

Let's be clear. We are not just talking about the awful *volatility* of equities. That is just one small component of risk. Equities are awful not just because they can go down, but because they can go down at precisely the time you don't want them to, as Ben Inker, a former colleague of mine, used to remind us all. Drawdowns don't happen in a vacuum. Often, when stocks go down, it's associated with a recession, that is, it's happening exactly when you might be losing your job, your health benefits, your ability to pay for your kids' college tuitions, your self-confidence, and your sense of purpose in life. Financially, losing your job during a down market means you may need to tap into your investment account at exactly the moment when you should not be doing so. For almost anybody at any stage in life, as we learned so painfully in 2022, stocks can go down just as inflation is rising - in fact, stocks went down *because* of rising inflation - so you are hit with wealth destruction AND rising costs. Elsewhere, stock market declines can trigger the drying up of venture capital and private equity financing, so other parts of your investment portfolio and business dealings are dragged down in concert.

In other words, it's not just that stocks go down that can make them awful, it's that usually a lot of other awful things are simultaneously happening in one's personal, professional and portfolio's life that are compounding the problem. It's not a double whammy. It's a triple, quadruple, quintuple, etc. whammy.

That's a pretty bleak picture I'm painting for stocks, I know. But that's the point. In order for you to feel compensated for all that pain, stocks better make it up to you, and how! And that is exactly what stocks do, better than most asset classes. They are powerful wealth-builders and wealth compounders. Over time, cash and bonds cannot hold a candle to the awesomeness of stocks. But it is worth reminding ourselves once in a while that the awful periods of stocks - like the really nasty drawdowns of 2018, 2020, and 2022 - are not a bug of the equity markets, they are a requisite *feature.*

Pete Chiappinelli, CFA, CAIA, Deputy Chief Investment Officer

Pete is Deputy Chief Investment Officer at the firm. He is focused primarily on Asset Allocation in setting strategic direction for client portfolios. Pete has 30 years of experience in research, investment strategy, and thought leadership regarding the management of multi-asset class portfolios, inclusive of equities, fixed income, and alternatives. His work has been featured in leading financial publications such as *The Wall Street Journal*, *The New York Times*, *Barron's*, and others in Canada, Europe, and Asia. His market commentaries have been featured at major industry conferences, in TV documentaries on capital markets history, and on social media outlets. Prior to joining Ballentine Partners in 2022, he was a Senior Portfolio Strategist on GMO's Asset Allocation team. Prior to that, he was an Institutional Portfolio Manager at a specialized unit within Fidelity Investments and was the Managing Director of Institutional Investment Strategy & Research at Putnam Investments. He is a graduate of Carleton College and holds his MBA from The Wharton School at the University of Pennsylvania. Pete holds the Chartered Financial Analyst (CFA) designation, is a member of the CFA Institute and CFA Society Boston, and he holds the CFA Institute Certificate in ESG Investing. He also holds the Chartered Alternative Investment Analyst (CAIA) designation and was the founding President of CAIA Boston. Pete lives in Hingham, MA with his wife, Cheryl, and enjoys travel, cooking (definitely not a "foodie" but a "foodie wannabe"), sourdough breadmaking, and conjuring up ways to embarrass his three children.