BALLENTINE PARTNERS

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How to Tolerate a Stock Market Correction

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Nobody likes watching the evaporation of their hard-earned capital during a stock market decline. When the market falls day after day, investor confidence is tested, the outlook darkens, and pessimism abounds. Memories of the March 2020 crash (when the S&P 500 fell about 34%) and the 2008-09 collapse (when the decline approached 50%) are still fresh for some people, urging them to stop the bleeding by selling stocks.

Fanning the flames are the professional investor talking heads on television proclaiming the start of a major crash, usually motivated by a large financial incentive to convince viewers to follow their advice. A noted investment manager and longtime equity market skeptic recently made headlines when he called for a dramatic collapse in the S&P 500, calling the current environment "the fourth superbubble of the last hundred years". He joins a number of other bearish investors that have called for a dramatic stock market crash. They may ultimately be vindicated but getting the timing right is exceptionally difficult. When Fed chairman Alan Greenspan made his famous "irrationally exuberant" stock market call in 1996, the S&P 500 went on to four consecutive years of 20%+ gains before the market crash beginning in 2000 as the technology bubble burst in dramatic fashion.

Stock market corrections (declines of 10% or more) are part of the cost of admission for participating in the substantial returns that equity investors have enjoyed over long time periods. In fact, the volatility created by market declines are what creates the opportunities for attractive returns in the future. If the stock market ticked up every day by a predictable amount (like a high-quality bond held to maturity), the return would approximate a US treasury bond: predictable, but uninspiring. It is the volatility and the uncertainty of future returns that creates the opportunity for outsized gains.

For long-term investors, market weakness can create opportunities. Investors may be able to harvest tax losses during a correction, thereby shielding future gains from capital gains taxes. Losses can reduce the tax cost of rebalancing the portfolio from highly appreciated asset classes or funds to those with better future prospects. Lower stock market values improve the probability of success for establishing Grantor Retained Annuity Trusts (GRATs) allowing wealthy investors to pass assets to beneficiaries free of estate tax. Conversion from a traditional to a ROTH IRA is more attractive because the tax liability is lower. Investors with immediate cash needs may be forced to sell into a falling market, while long-term investors can capitalize on the buying opportunities that these panicked sellers create.

We acknowledge that stocks will face an uphill climb this year as the Fed reduces its monetary support. But even after five 25 basis point hikes in the federal funds rate, the new level will be far lower than its long-term

average. Despite these headwinds, we still expect the US economy to grow in real terms by 4% or so, nearly double the rate of the prior decade. As the Omicron spike wanes, supply chain bottlenecks should begin to diminish. Coupled with a shift in spending away from goods and back toward services, we believe inflation will begin to ease in the second half of 2022, providing some opportunity for the Fed to ease off the brake pedal.

What could go wrong? Plenty. The Fed could tighten too aggressively, raising rates too fast and driving the US economy into a recession. Fed policy generally works with a lag, so inflation expectations could become more anchored and more difficult to bring down once the impact of higher rates is felt. A new, more dangerous COVID variant could emerge, setting back the timetable for a return to normal. And let's not ignore the threat of a Russian invasion in Ukraine that could set off a major military exchange and a spike in energy prices that will only exacerbate the inflation problem.

The truth is that not even professional investors have a crystal ball. We make probability-based projections after analyzing current data and applying the knowledge gained by our past experiences, but we recognize the limitations of this approach. As long as your portfolio is broadly diversified and geared for the appropriate level of risk for your personal circumstances, the best strategy is to stick to your investment plan. That means continuing to add equity exposure if you are below your long-term target and staying the course if you are not. Unless your portfolio was severely overexposed to equities relative to your target allocation, chances are the recent decline has taken care of this situation without your having to do anything at all.

Market corrections are upsetting, but really the only thing that matters is how much your portfolio is worth when you need to draw on it. In the interim, the best thing to do is to grit your teeth and focus on the opportunities it provides for higher returns for long-term, patient investors.

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Bruce is a Partner and Director of Research at the firm. Bruce rejoined Ballentine Partners in June 2016 after more than five years as Chief Investment Officer of City National Rochdale, LLC, in Los Angeles. City National Rochdale, a wholly owned subsidiary of City National Bank, serves family clients across the United States with a staff of nearly 100 investment professionals. Before moving to Los Angeles, Bruce served as Chief Investment Officer of Ballentine in our Waltham office for three years. Prior to that, Bruce spent four years with Morgan Stanley Private Wealth Management in New York and eight years with Glenmede in Philadelphia as Chief Investment Officer and Portfolio Manager. In addition to working directly with a number of family clients, Bruce serves on Ballentine's Investment Management Committee, which is responsible for the oversight of all of the investment activities for the firm. Bruce received an MBA with a concentration in Applied Economics from George Washington University and a BS degree in Business Administration from Penn State University. Bruce holds the Chartered Financial Analyst (CFA) and the Certified Private Wealth Advisor (CPWA®) designations. He lives with his wife in Durham, NC.