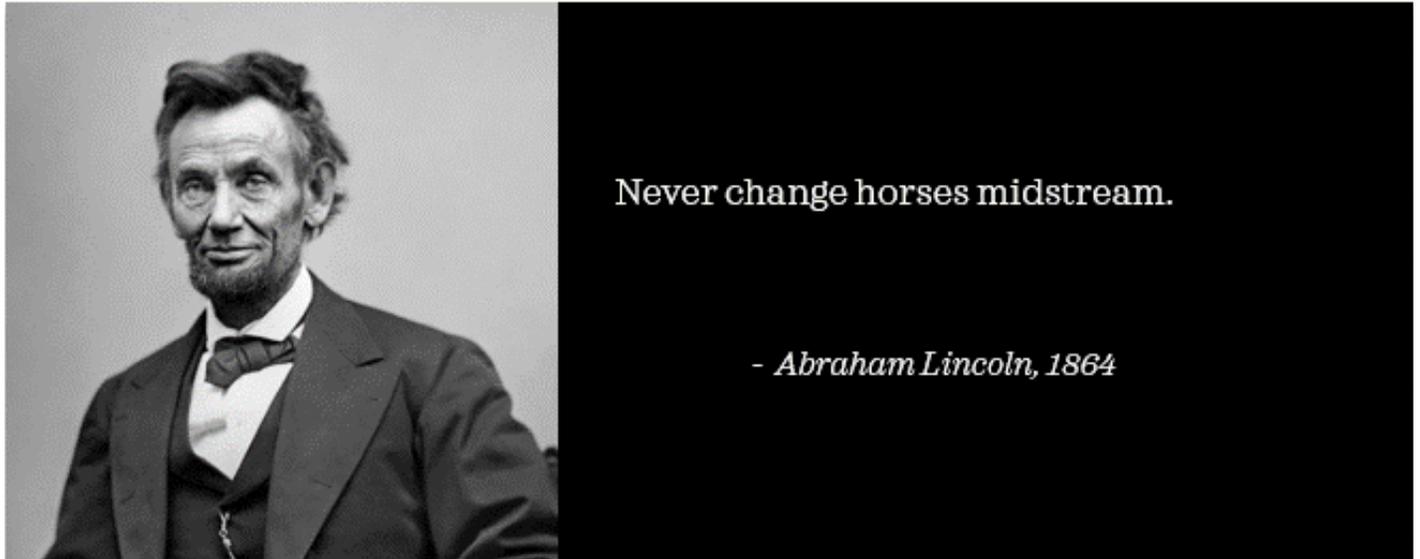


Changing Horses Mid-Stream: Resist the Temptation

Pete Chiappinelli, CFA, CAIA, Deputy Chief Investment Officer

When stock markets suffer a painful drawdown, panic, doubt, and self-preservation instincts to de-risk often kick in. History suggests that it is wiser to stick to your original plan.



Honest Abe had sage advice for his political party in 1864, as they contemplated removing him, the incumbent, from the Republican ticket in the midst of the Civil War. He was obviously against such a move. True, his words were a bit self-serving, but the reason this aphorism has become part of the American lexicon is that it spoke more broadly to the importance of planning, strategy, and follow-through.

All plans, all strategies - political, business, investing, etc. - at some point encounter setbacks and turbulence. That is guaranteed. What is also guaranteed is that human emotion and panic kicks in at these stressful periods. Second-guessing. The cancerous creep of doubt. Cold sweats. Middle of the night heart palpitations. Fear of further loss. And, of course, the strong desire to make the pain go away.

For many investors, this has been the story of 2022 in the capital markets. The last few months have seen a rapid and painful repricing of global equity markets. Here in the U.S., as the financial press and blogosphere has pointed out *ad nauseum*, this has been the worst start to a calendar year since 1939 (as measured by U.S large-cap stocks). Seeing headlines like this as well as seeing one's own accounts decline in value, can trigger all the emotions mentioned above. Forget *ad nauseam*. How about just plain nausea.

Many, we suppose, have been tempted to "get out" or at a minimum dramatically reduce exposure to the equity markets after suffering some uncomfortable losses. Many have been tempted to throw out the very plan and strategy that they - alone, or in consultation with an advisory team like ours - had so carefully devised. Many have been tempted to change horses mid-stream.

But is this wise? Is this prudent? And what can history tell us? Remember, despite the headlines, corrections like we are experiencing are nothing new. Also remember that the projections, modeling, and stress-testing that went into the original investment strategy did so with the full knowledge that markets can be volatile, sometimes painfully so. Since 1980, the average intra-year drawdown for a given calendar year from peak to trough was -14%. The last decade for U.S. stocks was one of the best ever, yet in 7 of those 10 calendar years, the market suffered intra-year double-digit drawdowns.

The reason we tend to forget this is that most of the time, markets find a base and then recover. Not every time, but enough times so that in the long term, equities have been a great wealth-creator. Some argue, rightfully, that the entire reason why equities offer such attractive long-term returns is *because of*, not despite, these drawdowns. In academic and quantitative circles, it is called the “equity risk premium”, but in plain-speak, it is the bribe the market must offer you as an enticement to take risks. Long-term returns are *awe-some* precisely because short-term drawdowns can be *aw-ful*.

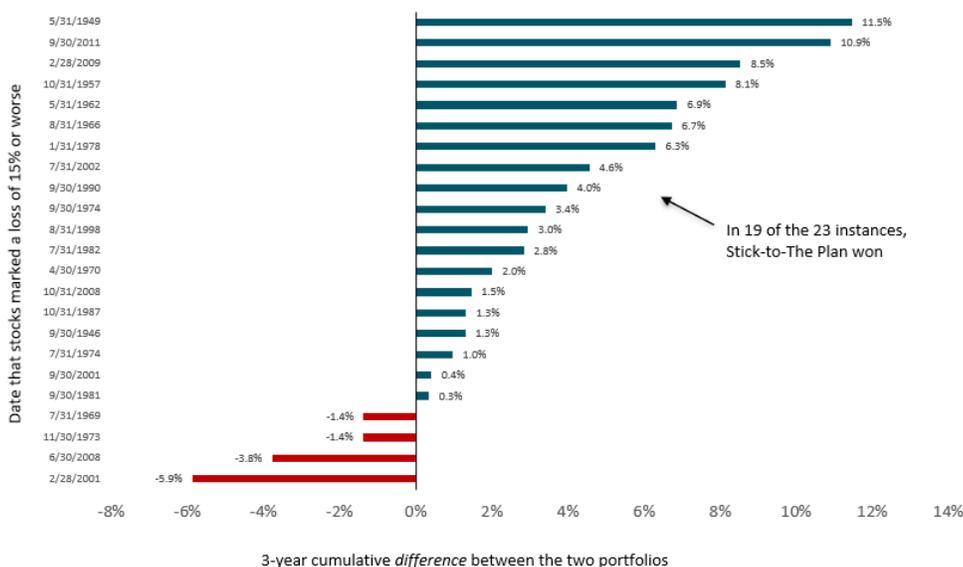
History can also help us conduct a what-if analysis. What if an investor, after suffering a dramatic loss, changed horses? Now, we wanted to be somewhat realistic, in that we know most investors, certainly those working with prudent advisors, would never go from 60% equities to 0% equities. That’s a form of radical market-timing and not very common. Instead, we modeled out a more likely response to market turbulence wherein an investor changes horses by moving to 40% equities. Make no mistake: this would be a substantial move, but one that more closely aligns with actual behaviors.

In broad strokes, then, we modeled out two investors. One “sticks” with a strategic mix of 60% U.S. stocks and 40% U.S. bonds throughout. The other investor, however, “changes horses” in the panic of a market shock and shifts to a 40%/60% mix. From 1945 onwards, we identified over 23 instances, on a month-end basis, where the U.S. stock market suffered a painful (if not normal) 15% or worse decline. This was the trigger for the shift from 60/40 to 40/60 in our analysis. We then compare the performance *differential* over the ensuing three years between the two portfolios. The results below speak to Mr. Lincoln’s sage advice.

Stick-To-The-Plan Beat Change-Horses 83% of the Time

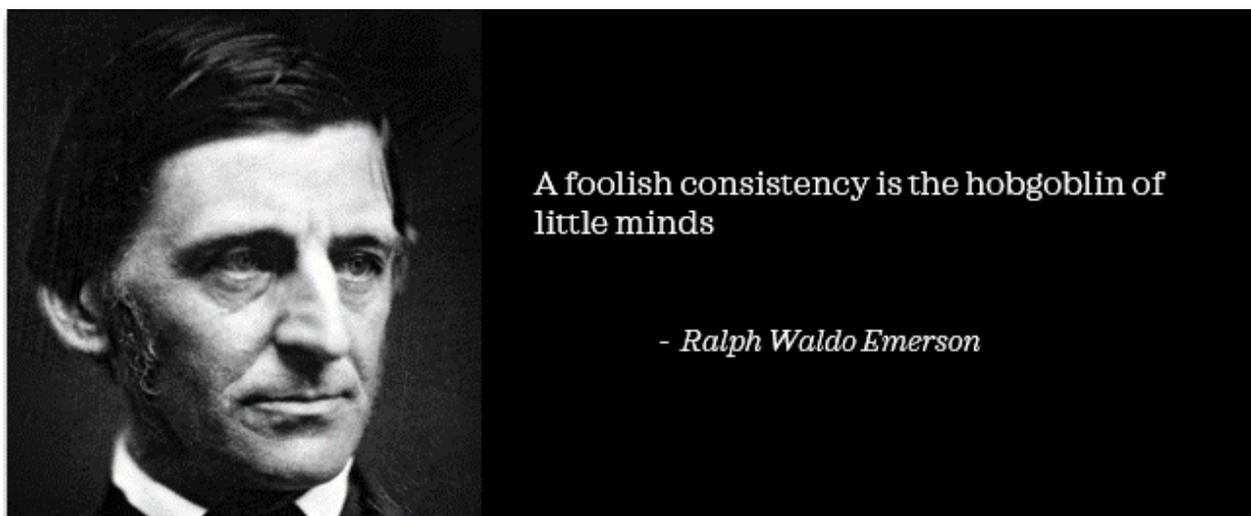
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Historical Instances of Large Drawdowns Since 1945: Stick-To-The-Plan* vs. Change-Horses**
Cumulative Performance *Differential* 3 Years After The Drawdown



Source: Ballentine, Ibbotson, S&P. *The Stick-To-The-Plan portfolio is a mix of 60% U.S. stocks and 40% U.S. bonds, rebalanced monthly, and held throughout, even after the 15% (or worse) drawdown. The Change-Horses portfolio is established after a 15% (or worse) drawdown and is a mix of 40% stocks and 60% bonds going forward, rebalanced monthly.

Take a look at the first example on the chart, the top blue line, when the market suffered a large loss in the period ending May 31, 1949. After that drawdown, we tracked the 3-year difference in performance between the Stick-To-The-Plan portfolio and the Change-Horses. The Stick-To-The-Plan outperformed by 11.5%. As you see, in 19 historical examples, or 83% of the time, sticking to the plan would have resulted in better outcomes. Frankly, this analysis understates the results, as we have not even considered the effects of taxes. If the investor had embedded capital gains, making large de-risking moves can trigger taxes on those gains, payable that year. Market downturns are the exact wrong time to create negative cash flows, as it compounds the pain. The main point is that history has shown that sticking to the plan tends to result in better results in the longer term.



But does Mr. Lincoln's advice mean "do absolutely nothing"? Absolutely not. In fact, Lincoln, himself, made many changes during the War, firing Generals and promoting new ones throughout. And as a contemporary poet/philosopher Ralph Waldo Emerson famously reminded us above, we must remain open to making changes, at times. How to reconcile these seemingly opposing thoughts? Easy. We must stick to the plan but remain flexible and opportunistic *within* those plans.

Investing is no different. We here at Ballentine have been making small shifts throughout 2022. This is not a change in strategy or changing horses, it is a case of making reasonable and modest trades, cognizant of the end goals. Past trades in the last few months have included a modest trim of our U.S. overweight to add to our European equity position, which was trading at an extremely attractive valuation discount, relative to its history. We added a modest new position to high yield municipal bonds to take advantage of their now higher yields and the much higher tax-equivalent yields of muni bonds today, more broadly. As for taxes and our focus on after-tax returns, we have judiciously taken advantage of the recent downturn to harvest tax losses for our clients where they exist, importantly *replacing* the equity exposure, not reducing it (i.e., keeping the strategy intact, but tweaking the tactics). More trades are possible as we navigate these turbulent streams.

Time will tell whether these modest adjustments play out well. Further, the overall strategy itself may still suffer additional losses as 2022 and beyond unfolds. The study above certainly includes episodes with horrific losses beyond those initial drawdowns. The point is that sticking with a strategic mix of diversified assets, supplemented with modest shifts as opportunities or risks present themselves, is not borne out of a foolish and stubborn consistency; it is a prudent manner of portfolio management, borne of patience, long-horizon thinking, tax awareness, and frankly, humble acknowledgement that massive, horse-changing deviations from the plan are not only difficult to time, but usually ill-advised.

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.

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