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Steady as she goes

Keeping your calm in down markets

The Asteroid Field of 2022

After a nerve-wracking journey over the last two years, we entered 2022 with hopes of a smooth ride, only to find ourselves in another asteroid field of challenges such as stubbornly high inflation, hawkish central banks, geopolitical turmoil and lingering COVIDrelated supply-chain problems. This has led to a substantial correction in markets and questions about whether there will be another leg down.

This, however, is not a piece on whether markets will continue to sell-off. We do not pretend to know the very near-term direction of markets in these turbulent times. However, we do know that acknowledging what you know and do not know is critical to putting together a robust portfolio.

At Mercer, we believe that through thoughtful, fundamentals-driven decision-making, portfolios should perform better over the long-run. The remainder of this piece is dedicated to why Mercer embraces this medium-to long-term view and the dangers of trying to call near-term markets.

Mr. Spock and Dr. McCoy

Markets can be seen as two iconic Star Trek characters in one: the hyper-rational Mr. Spock and a more emotional Dr. McCoy[1]. Like Spock, they tend to incorporate new information at 'warp-speed'. Unfortunately, they often process this information in a more emotional McCoy-like manner, at least initially.

1. Markets usually process new information in the blink of an eye. By the time we read about a planned 50 basis point rate hike by the Federal Reserve or new lockdowns in China, there is a good chance that asset prices have already discounted this news to a large degree. This aligns with the old adage of 'buy the rumor, sell the news'.

2. The market tends to have kneejerk reactions. In the short run, it may appear to act like a pendulum that swings violently until it gradually returns to the center as uncertainty dissipates. Initial reactions to geopolitical events[2] or central bank hiking cycles are a good example – an initial sell-off is often reversed after only six months.[3]

Act in haste, repent at leisure

We are proponents of long-term investing. As such, we prefer to make fundamentalsdriven decisions regarding the positions in our portfolio. When we make tactical recommendations relative to our long-term portfolio, they are based on valuations being attractive relative to fundamentals rather than news-related fear and uncertainty.

Looking back at equity sell-offs over the last three decades helps us to put current events into perspective. Those sell-offs have varied from short-lived corrections to extended bear markets.

Figure 1. Equity Market reactions to major events

Event	Peak date	Cause	Peak to trough	Max down	Trough to previous peak
2022 Correction	Jan-22	Federal Reserve tightening, Ukraine conflict, China lockdowns	129 days[4]	-17.6%	?
COVID-19	Feb-20	Global lockdowns	33 days	-33.8%	140 days
Taper Tantrum 2.0	Sep-18	Federal Reserve tightening	95 days	-19.4%	109 days
Euro Sovereign Crisis	Apr-11	Risk of collapse of euro area	157 days	-18.6%	123 days
Global Financial Crisis	Oct-07	Risk of global financial failure	517 days	-55.3%	1 120 days
Dotcom Bubble & 9/11	Sep-00	Tech bubble & Middle Eastern instability	765 days	-47.4%	1 475 days
Asian Financial Crisis	Jul-98	Investors fleeing Asian securities	45 days	-19.2%	84 days
Early 90s Recession	Jul-90	Middle East instability, oil price spike	87 days	-19.2%	123 days

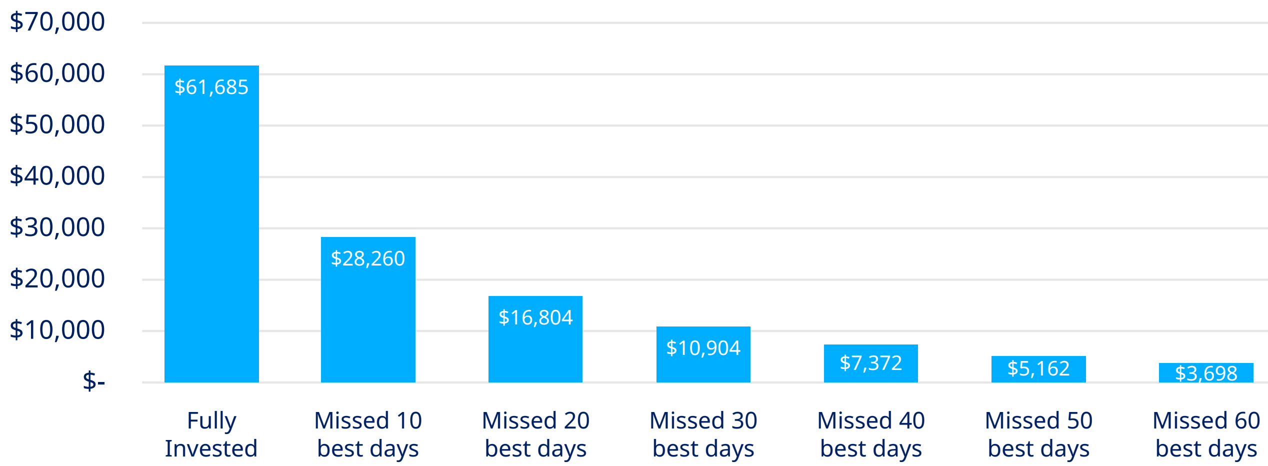
Source: S&P 500 Total Return Index in US dollar, Refinitiv, analysis at as May 17, 2022

When markets correct, we may be tempted to take risk off the table and avoid further turmoil. However, history tells us that corrections may develop over a matter of months, and equally, so may recoveries. This makes it difficult to know when the right re-entry point is. If this point is missed, assets may need to be bought back at a higher price.

At the height of the lockdowns in April 2020, did we know that policy responses would work their magic? Did we know that lockdowns would ease within a matter of weeks? Very few imagined that markets would rally so strongly and so quickly over the following four months. If you did not anticipate this, it was easy to miss the re-entry point as markets rebounded far in advance of the real economy.

Historically, market return distributions are heavily skewed by just a handful of trading days, which constitute the lion's share of a portfolio's long-term performance. Not being invested during the best 10 trading days over an entire 20-year period can cut cumulative portfolio performance in half[5].

Figure 2. Performance of a $10,000 investment between January 1, 2002 and December 31, 2021



Source: JP Morgan (USD)

Neither the beginning nor the end of a down market is glaringly obvious at the time6. It is hard to know when markets will crack, but it is equally hard to know when they will heal. It is therefore extremely risky to make drastic portfolio changes in the midst of a market correction, underlying our bias for building robustly diversified portfolios and considering valuations relative to fundamentals rather than the news.

Manage your portfolio like Captain Kirk steers the Enterprise

What made Captain Kirk a great leader? He struck a balance between Spock and McCoy. Just like Kirk, we too seek to strike a balance between the long-term and short-term. We view this as a sensible approach for portfolio management.

A robust long-term portfolio is positioned to profit from a diversified set of return drivers that do not all change at the same time. This does not mean that current events should be ignored. However, the focus should be on their impact from a forward-looking perspective, especially the potential to herald a regime change that could challenge current long-term portfolio biases.

Periods of market turmoil can also create opportunities after news flow-driven market movements have led to a material change in valuations that critically are not justified by long-term fundamentals. Rather than aggressively de-risking in the heat of the moment(um), we can see through the initial phase of the storm and then seek to take advantage of cheaper valuations of fundamentally sound assets to deploy some dry powder, irrespective of when we think markets will turn the corner. Arguably, the highestconviction call investors can make today is the expectation of higher volatility. This environment points to a strategic allocation to hedge funds which can capitalize on their skillset and unconstrained processes.

We do not know whether the market turbulences of spring 2022 are just a hiccup in the longest bull market in history or the beginning of a bear market that goes beyond just the medium term. Instead, we ground ourselves in to navigate through the asteroid field of 2022 and others that we may encounter in the future:

- **Have a diversified portfolio and follow your rebalancing policy**
- **Stick to your long-term investment strategy.7 Do not panic sell**
- **Consider making hedge funds part of your portfolio**
- **Be prepared to deploy dry powder when opportunities arise**
- **Evaluate whether events could herald regime changes. If yes, re-position your portfolio over time at the right price**

1. Spock and McCoy are characters from Star Trek: The Original Series. The former is an unemotional and extremely rational half-alien, the latter is a human being with all the emotions that come with it.
2. We demonstrate how geopolitical events have impacted financial markets over different time horizons here: Peering through the Fog
3. A more in-depth discussion on the historical impact of hiking cycles on financial markets can be found in Mercer's paper: The tortoise and the hare
4. This refers to the trough reached on May 12, 2022 but the market correction was still ongoing when this paper was published
5. See JP Morgan, '2019 Retirement Guide': https://am.jpmorgan.com/content/dam/jpm-amaem/ global/en/insights/retirement-insights/guide-to-retirement-us.pdf (slide 44). A valid counter question would be how avoiding the worst 10 trading days would have impacted long-term performance. However, avoiding the worst days requires the investor to actively time the market; being exposed to the best days merely requires one to stay invested in line with long-term benchmark allocations. Getting market timing wrong exposes the investor to the worst of all worlds when selling right after a drawdown and not getting back in on time – being in the market during the worst days and not during the best days as the best ten days often occurred shortly after the worst ten days.
6. The same applies to historical events in general. History tends to be written with some hindsight bias which makes it look like the course of events was obvious to people at the time it was unfolding. In reality, many people did not expect the events that we now know were the precursors to the two world wars to actually culminate in large wars. Reading unedited diaries from the time events were unfolding can offer us a less biased view of how these events were actually perceived and what was expected at the time.
7. Dynamic asset allocation tilts can of course be part of a long-term investment strategy. Dynamic tilts would be applied around the long-term strategic allocations and also be based around valuations relative to fundamentals rather than trying to time markets in the short run. More details on our current dynamic asset allocation view as at 2022Q2 can be found in our GDAA Mid-quarter update: Research - MercerInsight® Community

Reshaping the future.

About Mercer

At Mercer, we believe in building brighter futures.

Together, we're redefining the world of work, reshaping retirement and investment outcomes, and unlocking real health and wellbeing. We do this by meeting the needs of today and tomorrow. By understanding the data and applying it with a human touch. And by turning ideas into action to spark positive change.

For 75 years, we've been providing trusted advice and solutions to build healthier and more sustainable futures for our clients, colleagues and communities.

Welcome to a world where empathy and economics make a difference in people's lives.

Welcome to brighter.

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Continuously rethinking purpose and priorities drives HR transformation. Shaping the future of work requires improved strategies around investment and retirement, health and wellness benefits, talent and communications. We believe in the value of investing in the future to build resilience for your business and your employees.

Investments and retirement require sophisticated solutions. We approach these with a big-picture view that prioritizes long- term financial wellness. We offer research and advice on assessing risk and designing benefits programs while keeping in mind the need to optimize throughout changing times.

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