Investment Insights
Worried About a Market Downturn? Remember Your Goals.

Morningstar Investment Management LLC
January 2022

Dan Kemp
Global Chief Investment Officer

Marta Norton
Chief Investment Officer, Americas

Ryan O. Murphy
Head of Decision Sciences

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Key Takeaways

1. Investors should assess risk relative to their goals—and anything that might interfere with attaining those goals must be addressed. Market downturns obviously create friction in this sense.
2. Three key considerations if you're worried about a downturn: a) affirm your goals, b) check your portfolio suitability, and c) ensure portfolio robustness.
3. Having a robust portfolio rarely shows its benefits in a strong market, but it is critical in a down market. It is something Morningstar Investment Management takes seriously.

Resist a Short-Term Approach to Risk; Take the Long View Instead

Reviewing their financial positions for the year ahead has many investors worried, which is a natural reaction. Risk abounds in 2022—from inflation, to rising interest rates, to lofty valuations. How do we adjust our mindset to ride out the potential rough times to come? It helps to keep our goals in mind, remember to adopt the long view over the short one, and consider the wisdom of Warren Buffett:

"In the 20th century, the United States endured two world wars and other traumatic and expensive military conflicts; the Depression; a dozen or so recessions and financial panics; oil shocks; a flu epidemic; and the resignation of a disgraced president. Yet the Dow rose from 66 to 11,497."

Buffett has enjoyed a long record of success, and he didn't create such value by letting immediate concerns and fears alter his approach– nor should you.

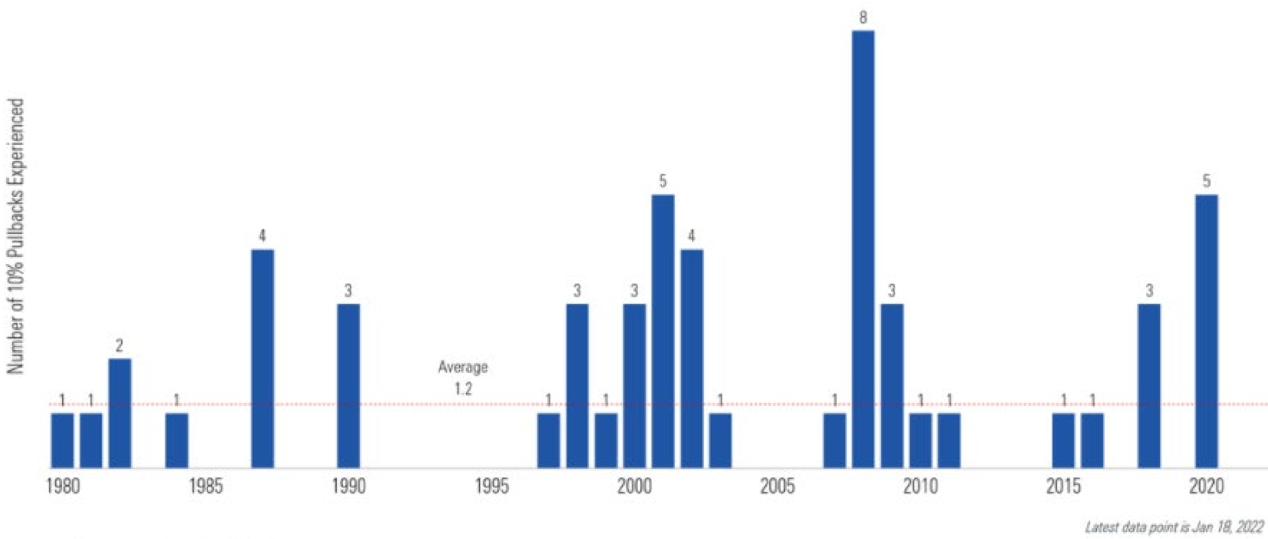
The future is unknowable, so the best we can do is to address it in terms of probability and preparation. In assessing probability, however, people are often driven by bias and emotion, emphasizing the positive at one moment and the negative at another. That narrow emphasis is likely to be reflected in the rapid changes in price of investments. Over-emphasis on optimism or pessimism leads to price volatility, which is part of being an investor, and enduring volatility is a price we pay for reaching our goals.

One must learn to ride out volatility and avoid giving in to pessimism about risk in the short term. After all, if we allow pessimism to drive us into selling during a downturn, we lock in a loss when we might otherwise have stayed the course and watched our fortunes reverse themselves.

That's not to say the fair value of an asset cannot drop. It can, and when that happens, previous valuation estimates no longer apply. That's why we pay close attention to the economic fundamentals of an asset and price it accordingly. That's investment rather than investor risk.

Do downturns occur? They do—and have done so repeatedly. In fact, we've seen the S&P 500 fall by 10% or more 54 times since 1980 alone.

Exhibit 1 Setbacks are common, perhaps even expected, with 10% pullbacks regularly occurring.



Source: Clearnomics, Standard & Poor's

Risk in the Small Versus Risk in the Large

That's why it's important for investors to reflect on their own experience with risk. One helpful way of doing so is to distinguish between risk in the small versus risk in the large. Risk in the small is how we react to volatility. This is a sensitive area that provokes emotions such as fear and greed, often to our own detriment. Risk in the large is all about long term goals and doing what it takes over time to avoid shortfalls. Most of us know that we must accept some investment risk to reach our desired financial goals.

This way of differentiating risk isn't new, but it can make a difference, as investors can be significantly better at managing risk in the large (goal attainment) than risk in the small (panicked selling amid volatility). Regarding the latter, the evidence overwhelmingly shows that people tend to act in downturns, mostly to their detriment, with outflows from their portfolio during bouts of volatility. Refocusing attention to think in terms of long-term investing, and to focus on overarching goals, can be a useful antidote to the bad behaviors investors can succumb to in the face of unavoidable volatility.

We don’t believe investors need to give in during periods of perceived risk; instead, we can address it and prepare for it. That’s where true downside protection comes in, starting with goals and working our way down to robustness.

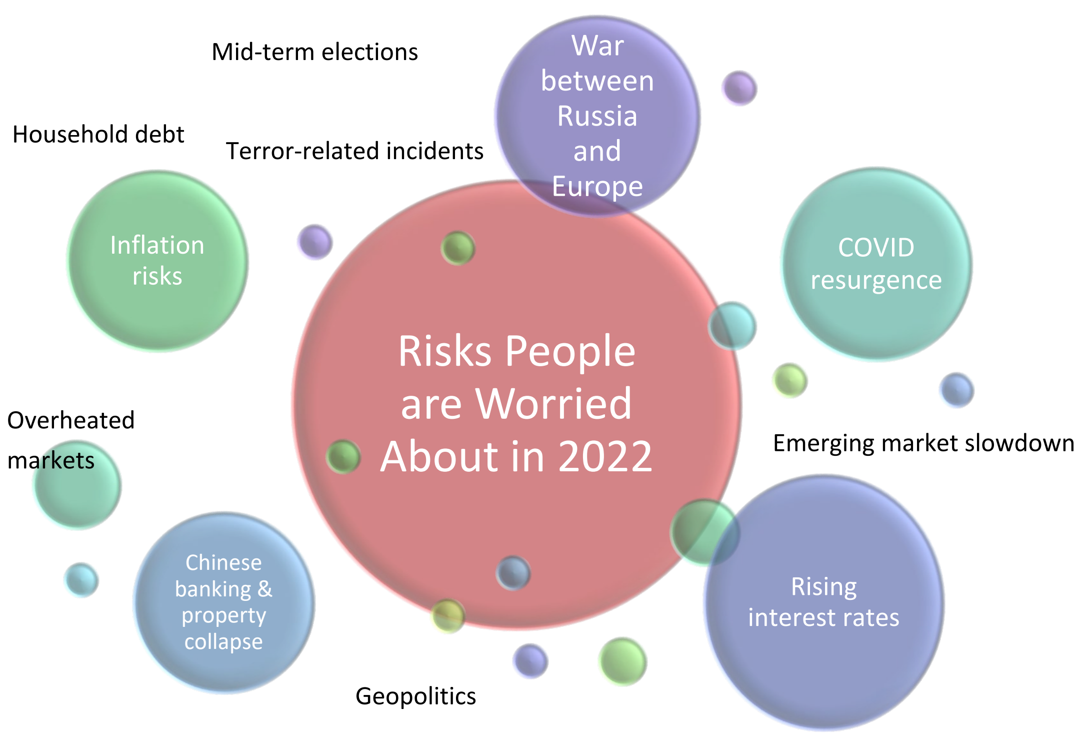
Our definition of investment risk (the ‘permanent loss of capital’) is likely the same as yours. We seek to understand risk across the full array of potential outcomes, ensuring that a portfolio has the ability to withstand or overcome adverse conditions.

Investing involves its fair share of adverse conditions, but people seldom talk about having a robust portfolio. Diversified, maybe, but not robust. To us, robustness can be considered in line with this quote from American author and professor John A. Shedd: " A ship in harbor is safe, but that is not what ships are built for."

We believe one of the best ways to control for risk is to buy fundamentally strong investments with attractive valuations. But of equal importance is having different risk and return drivers that can weather unpredictable storms to maximize the likelihood of achieving your goals. This can conceptually be applied in a multi-asset portfolio, or when combining multiple portfolios together (achieving more than the sum of the parts).

How Would the Average Investor Summarize the Key Risks in 2022?
Let's now get practical and apply this to the 2022 landscape. The below infographic presents a decent capture of the key event risks and fundamental risks investors face as we enter 2022. We will otherwise re-label them as the reasons most people are scared to invest.

Exhibit 2 A laundry list of risks as we enter 2022.



Source: Morningstar Investment Management

Of course, any one of these risks could materialize into a market setback, and no investment loss is good for an investor. This is especially the case for investors with shorter time horizons or those nearing retirement. (Sequencing risk means a big investment loss at the start of retirement and this can have a material impact on income levels from that point on.) But that doesn't mean we should run for cover every time new risks surface.

Investor behavior isn’t always rational, and people tend to approach markets with overconfidence and a vividness bias. This tends to really show itself at extremes, and especially in down markets.

Practical suggestions to alleviate anxiety about investment losses can be found in the field of decision sciences. Perhaps one of the easiest and most powerful ways is to simply reaffirm your goals before making any decisions. From a behavioral standpoint, people may be more successful when assessing risk in the large, and that reframing can act as a stabilizer.

Another is to look at your portfolio under the lens of robustness. If you take comfort that your portfolio can stand up to many different scenarios (think all-weather) then accepting some volatility is much more palatable and a pre-requisite for good returns.

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For More Information

Phone: + 1 877 626-3227
Email: ManagedPortfolios.US@morningstar.com
Online: www.mp.morningstar.com

22 West Washington Street
Chicago, IL 60602 USA