Is It Time to Sell?

While 2008 is now eight years behind us, to some investors, the recent surge in volatility feels a bit like déjà vu. They wonder whether recent market declines are the start of a bear market—and whether it’s time to head for the sidelines.

Volatility and risk are words often used interchangeably, but they actually mean different things. Volatility captures the choppiness of a return pattern. Experienced investors know no asset price ever moves in a straight line, and measures of volatility describe the roughness of that ride. Risk, on the other hand, represents the probability of sustained capital loss. Higher returns are generally associated with risk, and investment management firms like Bernstein constantly focus on finding the most efficient trade-off between the two.

At times like these, it is important for clients to understand this distinction as it relates to their ultimate goals and the journey from here to there. We believe the current increase in volatility is not accompanied by an increase in risk. In our view, current conditions appear consistent with a transient mid-cycle correction, rather than a prolonged recession or credit crisis that will lead to an extended bear market like in 2008.

In the long run, the stock market and the economy tend to be tightly linked. However, at times, market signals and economic fundamentals can disconnect. We see that happening now. Our research has not uncovered evidence that disruptions in the energy market and weakness in China will bring about a global recession. We still expect the economy to grow, albeit at a slow pace.

In our view, the US consumer is strong, job growth is accelerating, and conditions in Europe and Japan are steady. Weaker growth in China is not a new development—it’s been happening for years. On the other hand, the Chinese government’s heavy-handed, but ineffective policy measures are noteworthy. While these missteps have clearly shaken investors’ confidence, keep in mind that China’s stock market does not reflect what is happening in the broader economy.

As for oil, the downdraft in prices has a silver lining. While it creates near-term pressure in some parts of the economy, low fuel prices are an enormous benefit to consumers. On balance, we see today’s uncertainty contributing to greater volatility, but not greater risk. For that reason, we do not believe it is prudent to move away from long-term strategic allocations at this point, and we do not recommend selling equities.

In the rest of this note, we examine what a taxable investor would need to believe for exiting the market to be a good decision long term.
BELIEF #1: YOU’LL COME OUT AHEAD AFTER HAVING SOLD...(AND HAVING PAID TAXABLE GAINS)
An independent study found that taxable equity investors gave up nearly half their returns over a 10-year span due to taxes.¹

The odds of a costly tax bite look particularly high right now. That’s because most equity strategies have depleted the capital loss carryforwards they accrued since the market’s drop in 2008 and 2009. In fact, given that the US stock market has almost tripled from its low of March 9, 2009, many of the stocks bought some years ago are now held at large gains. So any decision to sell now in order to avoid a steeper drop would need to consider the potential taxes owed in order to be profitable.

That sets up a daunting challenge. Consider that for market timing to succeed, an investor needs to exit and then reenter the market at a lower price. Otherwise, you risk buying at a higher price than you sold—a buy high/sell low strategy that has historically failed.

While buying the dips is hard enough, taxes raise the bar that investors must overcome in order to profit from timing their moves. Specifically, the more taxes you pay upon exit, the lower your reentry price has to be in order for the strategy to be profitable. In short, taxes make the hurdle for selling equities that much higher.

BELIEF #2: YOU’LL KNOW WHEN TO GET BACK IN
Stock markets have their ups and downs: Sell-offs seem to pop up out of nowhere, and so do recoveries. Even if you get the sell decision right, long-term investors also need to buy back in at some point. The decision to exit the market will only benefit the investor who can successfully time the reentry.

That may not be as easy as it sounds. For instance, in the 78 months that have passed since the 2009 market recovery began, the S&P 500 has gained a total of 186.83%. But the market’s upward climb has been punctuated by a series of pullbacks (Display 1).

In fact, there have been about 14 different dips in which the broad market, as represented by the S&P 500, retreated by 5% or more. On average, when the market stumbles, it has taken about 29 trading days to find a bottom—and about 32 trading days to reclaim the prior peak.

As this pattern shows, recoveries tend to happen in quick, unexpected surges. And the surges are not marked by an “all-clear” sign either. More accurately, the market often rallies despite investor concerns. The investors who sell during periods of market stress often feel the pain of loss twice: First, they lock in their losses; then, they miss out on the market’s eventual recovery—which can also prove very costly.

Consider Display 2, which charts the growth of $1 million in two portfolios from January 2005 through December 2015, assuming a withdrawal of $50,000 per year. In one case, the investor maintains a portfolio 80% in global stocks and 20% in bonds. In the second instance, the investor begins with 80/20, but panics after a 30% loss in the account and switches out of stocks and into cash. He remains in cash for a while, before returning to 80/20 thereafter. How would these two investors compare?

The steady 80/20 investor would have suffered a wrenching downturn of 46%, but would have still wound up with $1,110,000 at the end of the time period, after her spending outlays. However, the market timer who jumped into cash in November 2008 (the dotted orange line in the display) and returned to the 80/20 mix in April 2012 would have been left with only $630,000. This market timer would have experienced a 38% drawdown (most of the drop experienced by the steady 80/20 investor) and also would have seen his portfolio shrink by a third.

**BELIEF #3: MARKETS ARE EFFICIENT EVEN WHEN CRUMBLING**

In challenging market conditions, emotions can easily lead to poor investment decisions. During broad-based sell-offs, as
in the three quadrants where active managers tend to shine—and where investing in the index disappoints. In the meantime, nimble managers can also ease clients’ pain by tilting their portfolios away from riskier stocks, as Bernstein has done in our accounts with Dynamic Asset Allocation (DAA).2

**Patience and Perspective**

In challenging markets, our emotions tell us to pull out of the markets. Yet, history shows that investments made in these moments of distress are usually the most rewarding. By selling, investors miss an opportunity to sow the seeds of long-term success that occur when potential is much higher than normal.

Today, panicked sellers are unsettled by a number of concerns, including China and oil, in particular. Here’s our perspective on those issues, and why we don’t believe they’ll lead to a broad, sustained slide that warrants selling out of equities:

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2For more information on Dynamic Asset Allocation, please see “Conviction and Consistency,” January 2016, and “Storm Tracking,” July 2015.
China: When it comes to China, we find it useful to separate the economy from the currency and the markets. In our view, nothing has changed materially in China’s economy over the past few months. China’s growth rate has slowed as it transitions from a manufacturing-led to a consumption-led economy, but that’s an inevitable and necessary transition. We believe that the current preoccupation with industrial data emphasizes the wrong metric. Today, more than half of China’s growth is driven by consumption. So consumption data, in our opinion, represents a better indicator—and for now, most mass-market consumer indicators remain strong.

The Chinese government seems to be feeling its way when it comes to currency measures. The Bank of China is moving from managing its currency against the US dollar to managing it against a trade-weighted basket, which is likely to lead to more renminbi weakness this year, in our view. The sharp devaluation at the start of the year was unexpected, though, and is clearly contributing to investors’ unease.

A poorly designed circuit-breaker mechanism in China’s stock market—removed because it was exaggerating volatility—also exacerbated investors’ concerns. Keep in mind that the Chinese stock market is sentiment driven, rather than a reflection of fundamentals. Taken together, we believe that these policy missteps have heightened anxiety in the short term, but the long-term picture for China remains the same. As China undergoes this transition, our job is to identify those companies that are successfully adapting to change—and there are many of them. As active managers, we are constantly looking to harness this volatility to benefit our clients.

Oil: We fully expect oil prices to rise over time, as low prices lead companies to cut back production, and inadequate supply fails to meet the demand. However, we cannot predict when these adjustments will begin to occur. If oil prices stay in the $30 range, there will be some pain in the energy sector, including bankruptcies among smaller players.

That’s why we are not yet prepared to make a bet on energy in our core portfolios. Instead, we are finding other, indirect ways to take advantage of oil’s decline. For instance, we’re favoring companies that could benefit from an eventual rise in oil prices but survive until then, with solid management, a healthy balance sheet, and robust cash flows even at low oil prices.

What about the impact of oil’s slide on the broader US economy? It would take a very significant global slowdown—akin to a depression—for oil demand to contract enough that oil prices would remain where they are now. Also, consider that much of the pain in the US oil patch has already been factored into GDP when it comes to capital investment. Further, lower energy prices can stimulate key sectors of the economy. Take the auto sector, for example. Car production and sales have reached record levels in part because consumers are spending their windfall from the “oil dividend.”

Overcoming Anxiety, Embracing Opportunity

In the meantime, what should investors do? We recommend clients remain invested at their strategic allocations, which are rooted in planning and supported by DAA. Both seek the most efficient trade-off between risk and return, using a methodology guided by risk-based principles that fully consider challenging market conditions. Together, they form a powerful anchor against volatility.

Also know that our portfolio managers are using these periodic pullbacks as an opportunity to add to high-conviction positions. Conversely, big rallies offer our investment professionals the chance to trim exposure to companies they like, but whose price may be getting overheated.

It can be hard to stay committed to a long-term strategy in today’s market, but history strongly suggests that it’s the best course of action. Difficult markets come with the territory—a good strategy takes them into account. ■
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