The Long View

March 2020

CAPITAL GROUP℠

Investing through adversity

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Investing through adversity

"I think the most important thing is to keep a long-term orientation. Trying to figure out what the market's going to do today or even next week is an impossible task and one that I don't think is helpful to creating long-term wealth."

TIM ARMOUR
PORTFOLIO MANAGER

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After an extended bull run in global equities, markets have recently experienced the biggest shock since the global financial crisis on mounting concerns the coronavirus outbreak will stunt economic growth and weigh on corporate profits. The turmoil served as a reminder that markets can and will change, and that a measured, long-term approach to investing is paramount in today's environment.

The reaction of financial markets to the coronavirus outbreak is not the first bout of volatility during the extended bull run since 2008. Markets also saw a significant correction during 2018. Although swift declines can be unsettling, they have long been part of the investment environment.

Referencing the pullback in 2018, portfolio manager Tim Armour recalls "The correction was overdue, the pullback didn't leave me overly concerned. Markets do better over the long term when they experience corrections periodically; they can't go up all the time."

More recent volatility associated with the unknown impact from the coronavirus comes as markets were already nervous about a slowdown in Chinese economic growth; heightened trade tensions between the US and China; political uncertainty in Europe; and the approaching US presidential election in 2020.

In short, we are living in incredibly disruptive times – politically, economically and socially. As investors, it is our job to find companies that will prosper over the longer term no matter which way the macro winds are blowing.

Volatility also reinforces the value of diversification, and the role of bonds, Mike Gitlin, head of fixed income, says. "Investors need to stay balanced in their equity and fixed income weightings in their portfolios, especially during times like this. It's important that investors focus on the four primary roles of fixed income in a balanced portfolio: diversification from equities, income, inflation protection and capital preservation."

Some core bond strategies may not provide the diversification from equities that investors expect, and that could be a problem. "That said, market corrections may present opportunities for investors to upgrade their bond portfolios to what we refer to as true core: that means reallocating to bond funds that offer the potential for both solid income and diversification from equities," Mike says.

Tim says the most important thing to do during periods of volatility may be one of the hardest. "You have to contain your emotions. It's not easy to do on the way up, and it's not easy to do on the way down, but it is the key to creating wealth over time. Sticking with the fundamentals, employing good asset allocation and maintaining a balanced portfolio with a long-term horizon is the best approach."

Key Takeaways

- **Markets periodically experience corrections that are part of the investment environment.**
- **Volatility can provide opportunities for investors to upgrade their portfolios.**
- **History shows that staying invested through periods of volatility has rewarded long-term investors.**

Bull vs. Bear: Long-term gain beats short-term pain

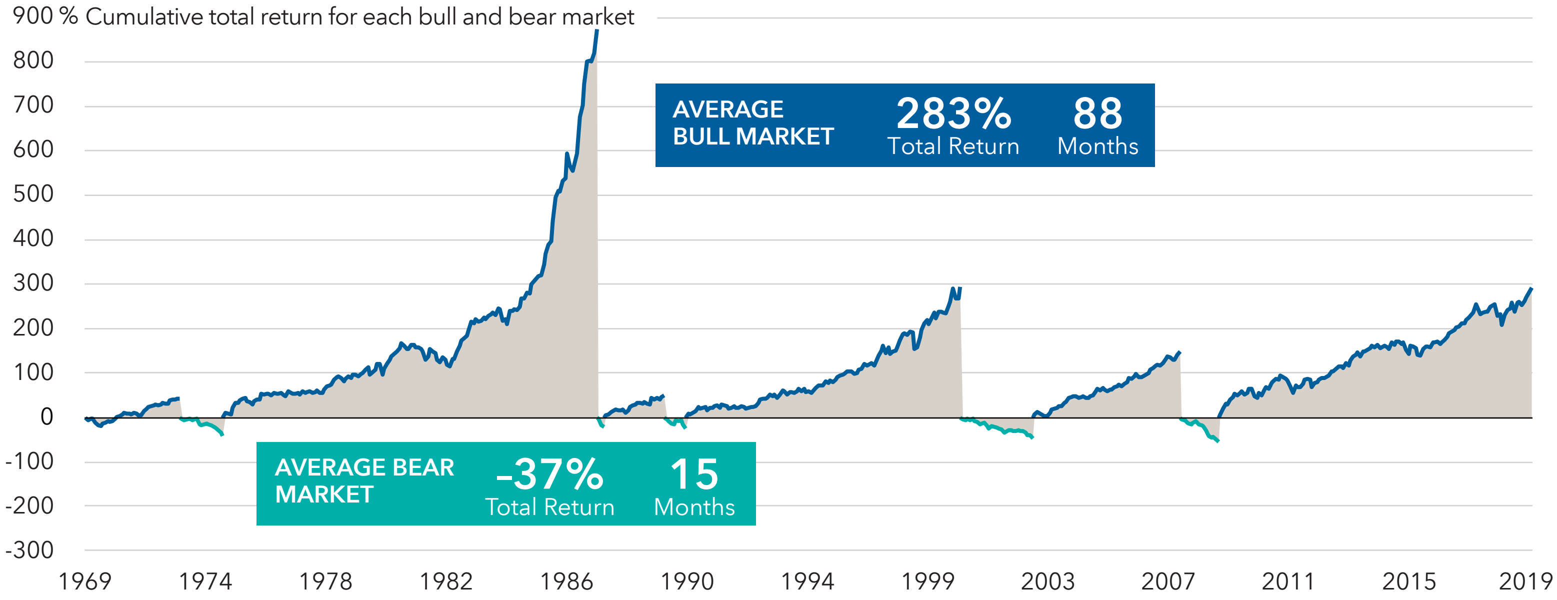
The downside looks less daunting with a long-term perspective

"None of us can predict what the market is going to do in the short term. But what we can do is identify good companies that we think are growing and will be better and bigger companies 10 years from now. If we get that right, through all sorts of market cycles, we are going to do well for our investors."

TIM ARMOUR

PORTFOLIO MANAGER

Declines can be painful, but missing the upside could be worse



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Data to 31 December 2019. MSCI World (net dividends reinvested) in USD. Bear markets represent peak-to-trough price declines of 20% or more in the MSCI World Index. Bull markets reflect all other periods. SOURCES: Capital Group, MSCI

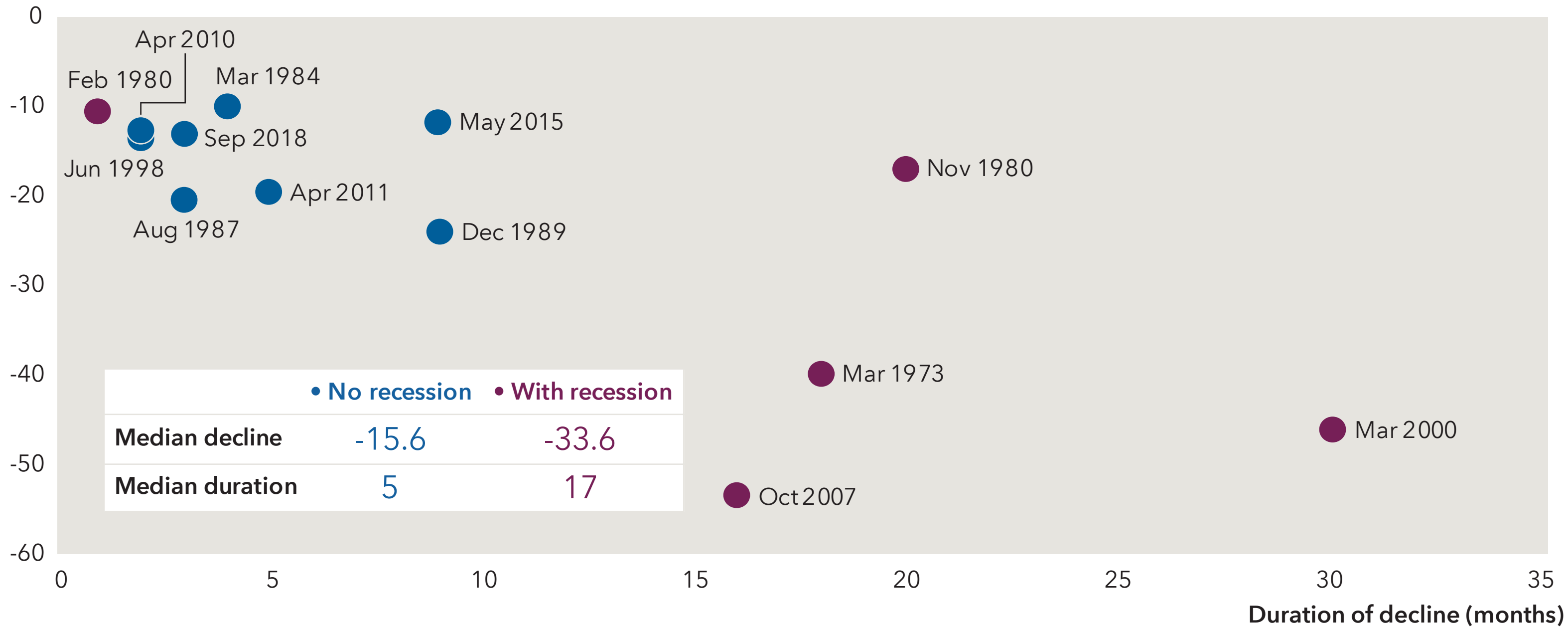
Swift and dramatic change can take a toll on investors. When markets falter, some may be inclined to reduce their exposure to equities. Yet history shows that periods of turmoil and steep market declines have subsequently proven to be among the best times to invest. Recent volatility may have caused some investors to panic and head for the exits, but a long-term focus can help put bear markets into perspective. Since 1970 there have been five periods of 20% or greater declines in the MSCI World Index. And while the average 37% decline of these cycles can be painful to endure, missing out on part of the average bull market's 283% return could be even worse. The much shorter duration of bear markets (15 months on average), is also a reason why trying to time investment decisions can be difficult and is usually ill-advised. Rather than indiscriminate selling, investors who are nervous about heightened volatility may want to consider objective-based funds with the flexibility to invest in a broad investment universe and a history of resilience during downturns. Investors should also re-examine their bond exposure for excess risk, as diversification from equities is one of the primary roles of fixed income in a balanced portfolio. Recent history, and the long-term record, show how rapidly the market can turn. The volatility of returns of world equity markets dating back about 50 years indicates that investors may be doing real damage to their long-term finances by trying to time the market.

Why are some declines steeper? It's the economy

Some of the most severe declines are associated with recessions

Short, and not that sharp: Since the 1970s, two thirds of market declines have lasted less than 10 months

Declines of more than 10% - duration and depth in MSCI World (%)



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Data as at 31 December 2019. MSCI World (gross dividends reinvested) in USD. Please see back cover for additional information.
SOURCES: Capital Group, MSCI

Every decline is different. A look back at stock markets in the past 50 years (it's too early to include the falls of early 2020) shows that retreats have varied widely in intensity and length. But many declines during that period share a common pattern. In fact, two thirds of the declines since 1970 lasted less than 10 months. One important factor in determining whether a decline is major or minor is what's happening in the economy at the time. The median decline in the MSCI World during retreats associated with a recession is 18.1% greater than those not associated with a recession, while the duration of the decline is substantially longer. The reason? Earnings fall much more dramatically around major pullbacks than around minor bear markets. Those declines in the lower centre of the chart are among the most serious and have all been associated with a recession.

In relatively recent times, the financial crisis and the tech bust have both had significant impacts on investor sentiment. Market crises are traumatic and costly. But ultimately, the markets have not only survived, but thrived. For more than a century, stock markets have endured wars, recessions, assassinations, bubbles and busts. And each time they have come back. Through it all, the markets have demonstrated a remarkable strength and resiliency in the face of challenges.

Some sectors have provided a measure of protection

Security selection and diversification can play a role when markets retreat

"Recent volatility serves as a reminder that markets can and will change, so we'll continue to take a measured, long-term approach, with capital preservation very important in security selection and portfolio construction. I believe that in this environment, our ability to add value will come primarily through security selection backed by fundamental research."

HILDA APPLBAUM

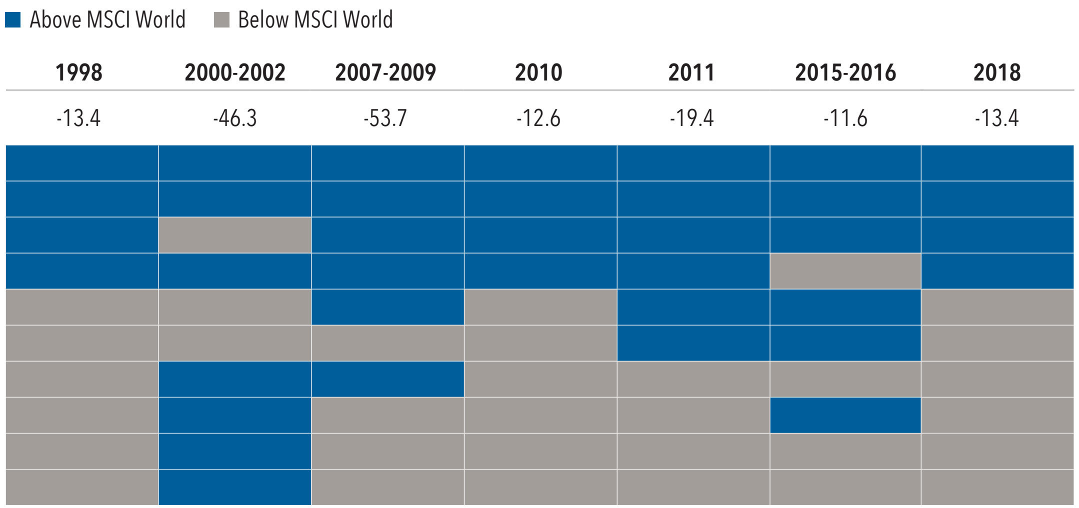
PORTFOLIO MANAGER

Index return doesn't tell the whole story – some sectors have outpaced the market

SECTOR SCORECARD

Through seven declines, some sectors have finished above the overall market

SECTOR	MSCI World ABOVE	MSCI World BELOW
CONSUMER STAPLES	7	0
UTILITIES	7	0
COMMUNICATION SERVICES	6	1
HEALTH CARE	6	1
INFORMATION TECHNOLOGY	3	4
CONSUMER DISCRETIONARY	2	5
ENERGY	2	5
INDUSTRIALS	2	5
FINANCIALS	1	6
MATERIALS	1	6



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Data as at 31 December 2019. MSCI World (net dividends reinvested) in USD. Communication Services was Telecommunication Services prior to GICS sector changes in 2018. SOURCE: MSCI

During the financial crisis that jolted the markets a decade ago, there was nowhere to hide. From its peak in October 2007, to its low in February 2009, the MSCI World Index dropped 53.7%. Every sector in the index suffered a serious setback, with the financials sector losing 72% of its value. But some sectors held up better than others. Consumer staples, for example, retreated about 33%, while health care dropped 35%. Small comfort, but still relative outperformance.

One of the consequences of the market's decline during the financial crisis was that many investors questioned the value of diversification. During periods of instability, however, it's important to maintain perspective, balance and flexibility. A portfolio that has the ability to nimbly explore evolving opportunity sets, using both allocation and security selection, can add value by investing in the right stocks and bonds based on a fundamental, valuation-based approach.

The benefits of diversification may have been lacking in 2008 and early 2009, but generally the principle remains fundamentally sound. Diversification through a strategic allocation to stocks and bonds around the world remains the hallmark of a portfolio that can help investors pursue their objectives in the long run. Such a portfolio can also help investors maintain a long-term perspective and place short-term drivers of the market into perspective.

Buffers: Bonds have provided resilience when equities declined

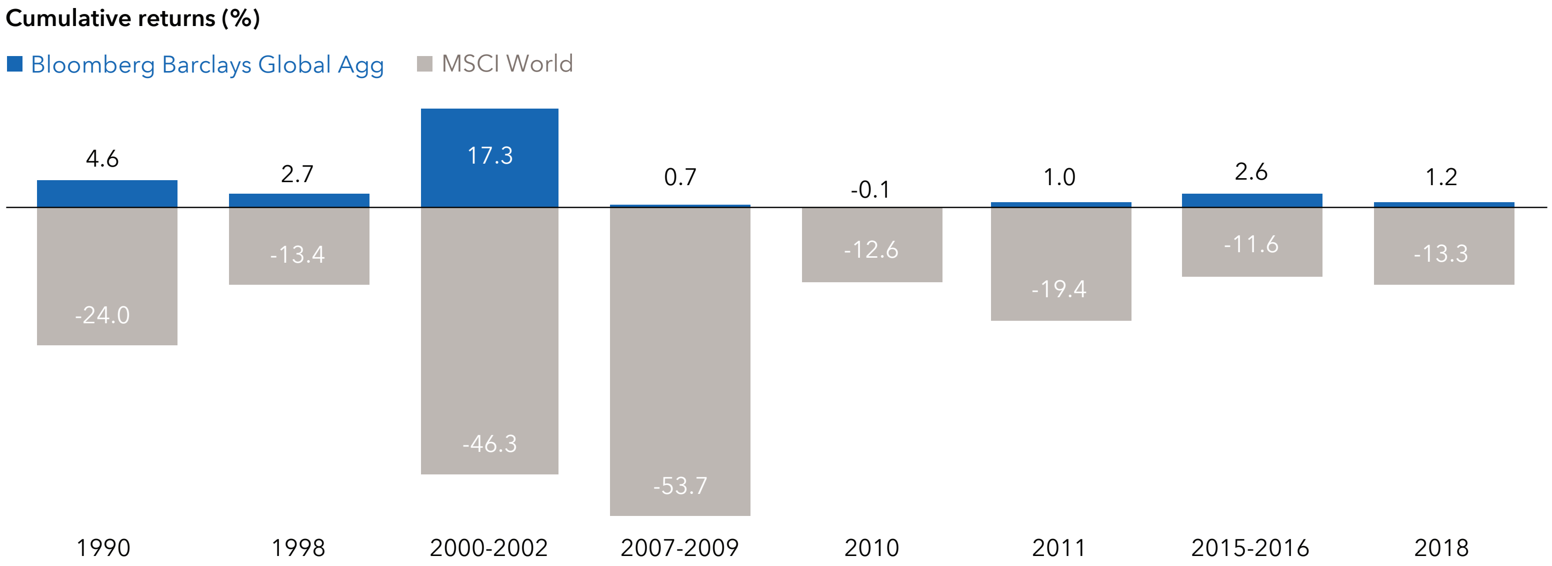
Bonds could help mitigate volatility and provide balance in a diversified portfolio

"There are four roles of fixed income in a diversified portfolio: diversification from equities, income, inflation protection and capital preservation. Nowhere in there does it say, 'Try to be as equity-like as possible.' That's not the fifth role."

MIKE GITLIN

HEAD OF FIXED INCOME

Bonds have provided a measure of capital preservation in periods of market turbulence



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Data as at 31 December 2019. Bloomberg Barclays Aggregate Index and MSCI World (gross dividends reinvested) in USD. SOURCES: Bloomberg Barclays, MSCI

Bonds play a variety of roles in a diversified portfolio, including providing income, capital preservation and inflation protection. They also help mitigate volatility. When equities are volatile, bonds typically provide balance to a portfolio. The chart shows that in market declines of at least 10% during the past three decades, bonds have, in all but one period, provided relatively significant positive returns. In today's environment, there is a need to withstand headwinds and, at the same time, a desire to create income, which can be difficult with global interest rates at such low levels. However, with accommodative global central banks (March has seen the US Federal Reserve and other central banks make cuts in a bid to counter possible slowing global growth as a result of the spreading coronavirus), the negative impact of any widening bond spread can be cancelled out by reductions in the base rate.

We believe that the ability to provide resilience in periods of equity market corrections should be one of the goals of short-, intermediate- and core-bond strategies. Funds that provide diversification from equities can be good building blocks to help create durable portfolios. They also allow investors to rebalance their asset allocation at an appropriate time in market cycles. This approach can help investors achieve long-term investment and savings goals.

Long-term investors have weathered market declines

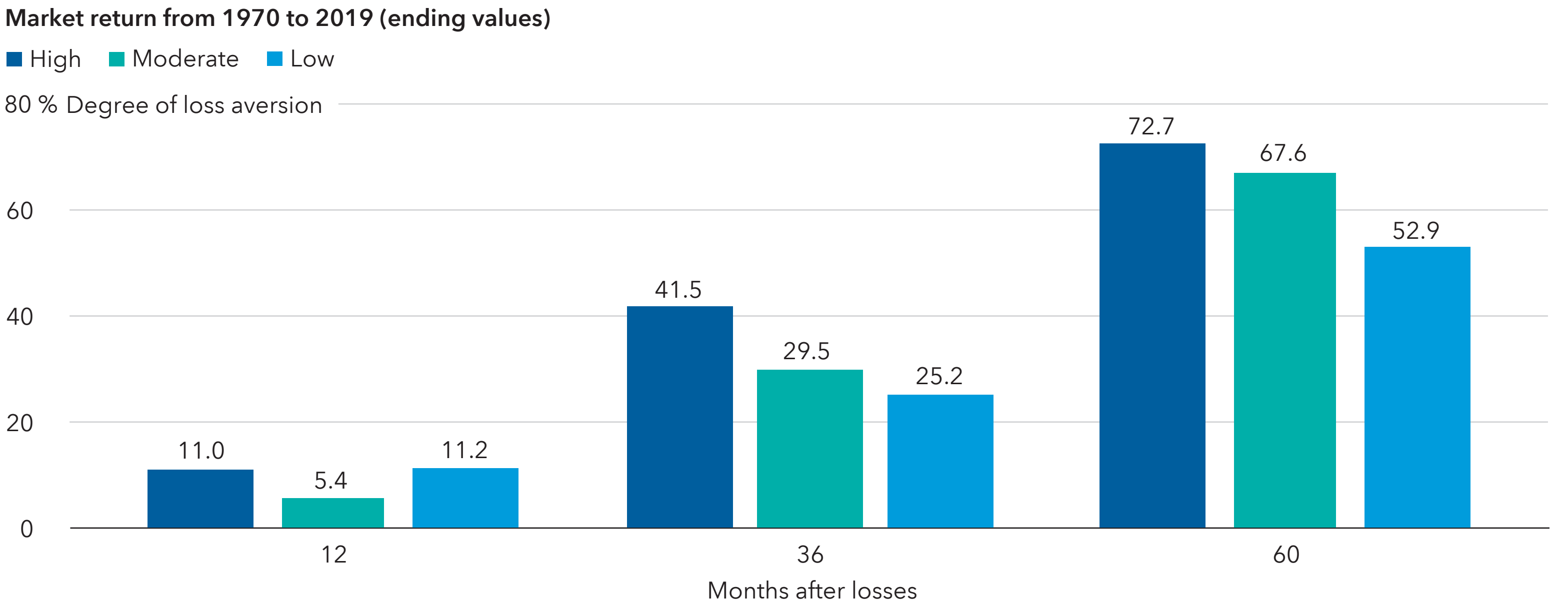
Avoid the urge to time the market

"When we go through [volatile] times like this, it's easy to respond by focusing on the short term. But I think the right thing to do in such an environment is to push your time horizon. You need to be thinking for the long run."

CARL KAWAJA

PORTFOLIO MANAGER

Be aware of the cost of getting out and staying out of the market



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Data as at 31 December 2019, from published sources calculated internally in USD. MSCI All Country World Index (net dividends reinvested) from 1 January 2001; previously MSCI All Country World Index (gross dividends) from 1 January 1988 and MSCI World Index (net dividends reinvested) from 1 January 1970. SOURCES: Capital Group, MSCI

Substantial market corrections are not uncommon and should not be unnerving. However, when investors see the value of their investments dwindling, their aversion to losses can compel them to sell at a loss and stay out of the market. But that can cost investors dearly over time. Why?

Because stock markets tend to have a reassuring history of recoveries. Yet, as no one can predict how long a decline will last, investors should avoid the urge to attempt to time the market. Our analysis, with data from 1970–2019, looked at returns 1, 12, 36 and 60 months after an investor leaves the market. While there was little meaningful impact one month later, the chart above shows that the consequences were significant one, three and five years down the road.

For instance, a highly loss-averse investor who rushed for the exit when the market dropped 10% would have, on average, missed a cumulative return of 73% five years later. The lesson is simple: the longer the investor waits to re-enter the market, the more damaging the potential consequences. In short, staying invested can help produce higher returns.

The following information pertains to the chart on the page specified below.

Page 2: Dates for declines shown represent market peaks. Peak-to-trough dates are as follows: March 1973 - September 1974, February 1980 - March 1980, November 1980 - July 1982, March 1984 - July 1984, August 1987 - November 1987, December 1989 - September 1990. June 1998 - August 1998, March 2000 - September 2002, October 2007 - February 2009, April 2010 - June 2010, April 2011 - September 2011, May 2015 - February 2016, September 2018 – December 2018. May 2015 is not an official decline. More severe declines are those associated with recessions beginning within 12 months of the market peak.

Risk factors you should consider before investing:

- **This material is not intended to provide investment advice or be considered a personal recommendation.**
- **The value of investments and income from them can go down as well as up and you may lose some or all of your initial investment.**
- **Past results are not a guide to future results.**
- **If the currency in which you invest strengthens against the currency in which the underlying investments of the fund are made, the value of your investment will decrease.**
- **Depending on the strategy, risks may be associated with investing in fixed income, emerging markets and/or high-yield securities; emerging markets are volatile and may suffer from liquidity problems.**

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