Our Thoughts on Market Volatility

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There are two unavoidable facts when it comes to equity investing – bear markets will happen semi-regularly and the economy's long-term growth will sometimes be interrupted by recessions. While we know there will be recessions in the future, we have no opinion as to their timing, depth, or frequency. What we do know is that on June 13, 2022 the S&P 500 officially closed in bear market territory, down over 20% from its January high.

Even though historical data is backward looking, it does provide important context. During the last bear market, our Q1 2020 Baird Trust Market Commentary looked back through history to determine how often bear markets happen:

> *Bear markets are actually more common than many suspect. Since 1928, the S&P 500 has experienced 12 declines greater than 30% and 20 declines greater than 20%. This means that, on average, declines of 30% happen every seven to eight years and declines of 20% happen every four to five years. The specific causes of bear markets are always different, but the commonality is immense uncertainty. This uncertainty raises doubts that a recovery is even possible.*

For equity investors, bear markets are a very normal fact of life. However, knowing historical stats about their average frequency historically doesn't provide much insight into their timing or cause because every bear market is different. How long this bear market will last and how severe it ultimately becomes will only be knowable with hindsight.

Stock prices always have been and always will be much more volatile than underlying business fundamentals. Because of this, we spend all our time and energy analyzing businesses and leave short-term stock price guesses to others.

We agree with Warren Buffett, who wrote in his 1987 Annual Letter to Shareholders: "Following Ben [Graham]'s teachings, Charlie and I let our marketable equities tell us by their operating results - not by their daily, or even yearly, price quotations - whether our investments are successful. The market may ignore business success for a while, but eventually will confirm it. As Ben said: 'In the short run, the market is a voting machine but in the long run it is a weighing machine.' The speed at which a business's success is recognized, furthermore, is not that important as long as the company's intrinsic value is increasing at a satisfactory rate."

Fortunately, the companies we own continue to increase their intrinsic values and have some important characteristics that position them well for stock price volatility and economic uncertainty. We believe the companies we own in client portfolios have durable competitive advantages, or economic moats. They are highly profitable, generate substantial cash flow, and typically have low levels of debt. Additionally, our portfolio companies are run by management teams that we think are honest, excellent leaders and terrific decision makers. Finally, as a group, the companies we own trade at a sizeable discount to our estimate of their intrinsic business values.

We often discuss these three key elements of our investment philosophy and process – the business, management, and price. They are core to everything that we do as long-term business owners, but they bring us even more comfort when investment markets become rocky and uncertain.

While these important characteristics don't insulate our portfolio companies from stock price declines, we believe they position our companies to take advantage of economic and market uncertainty and emerge stronger on the other side. Strong, advantaged companies with excess cash rarely must worry about survivability, so they can be offensive in today's environment rather than defensive. They can increase investment spending to take market share. They can use their position of strength to acquire weaker competitors. They can hire great talent from struggling companies that are cutting staff. And they can use their strong financial position to repurchase their own shares at heavily discounted prices, benefitting their long-term shareholders.

Even though bear markets are normal, they can still be painful and frightening because they are usually accompanied by overwhelmingly negative news stories and data points. Today, for instance, inflation is at 40-year highs and shows no signs of slowing, interest rates are surging, there is a war in Europe, COVID-19 is still lingering, consumer confidence is crashing, and fears of a recession are taking hold. In this environment, it is not surprising that stock prices are falling.

The psychology of fear and monetary loss can be overwhelming. Research has shown that losses hurt twice as badly as gains, so it is easy to forget how many good years of market returns we enjoyed over the last decade. Morgan Housel, author of *The Psychology of Money*, put it best when he said, "[Long-term] compounding is hard because a bad month can feel longer than a good decade."

We know watching stock prices and account values decline is unnerving. However, remaining focused on the long term and on your own individual investment plan is crucial in times of fear and volatility. Now is not the time to make drastic changes. As Peter Lynch once said, "The key to making money in stocks is to not get scared out of them." Fortunately, every bear market in history has ended, with the stock market eventually reaching new highs.

We have no control over short-term market fluctuations, but we have full control over our investment process. Our focus remains on the long-term compounding of your wealth over many years. We aim to achieve this by always acting as long-term business owners and ignoring market volatility unless we can use it to our long-term advantage. Our research efforts remain highly active, and we are finally starting to see great businesses trade at reasonable valuations for the first time in years.

As always, we thank you deeply for your relationship with Baird Trust. We are humbled by the trust and confidence you place in us as stewards of your financial assets.

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