CRESTWOOD ADVISORS

Investing Through Recessions

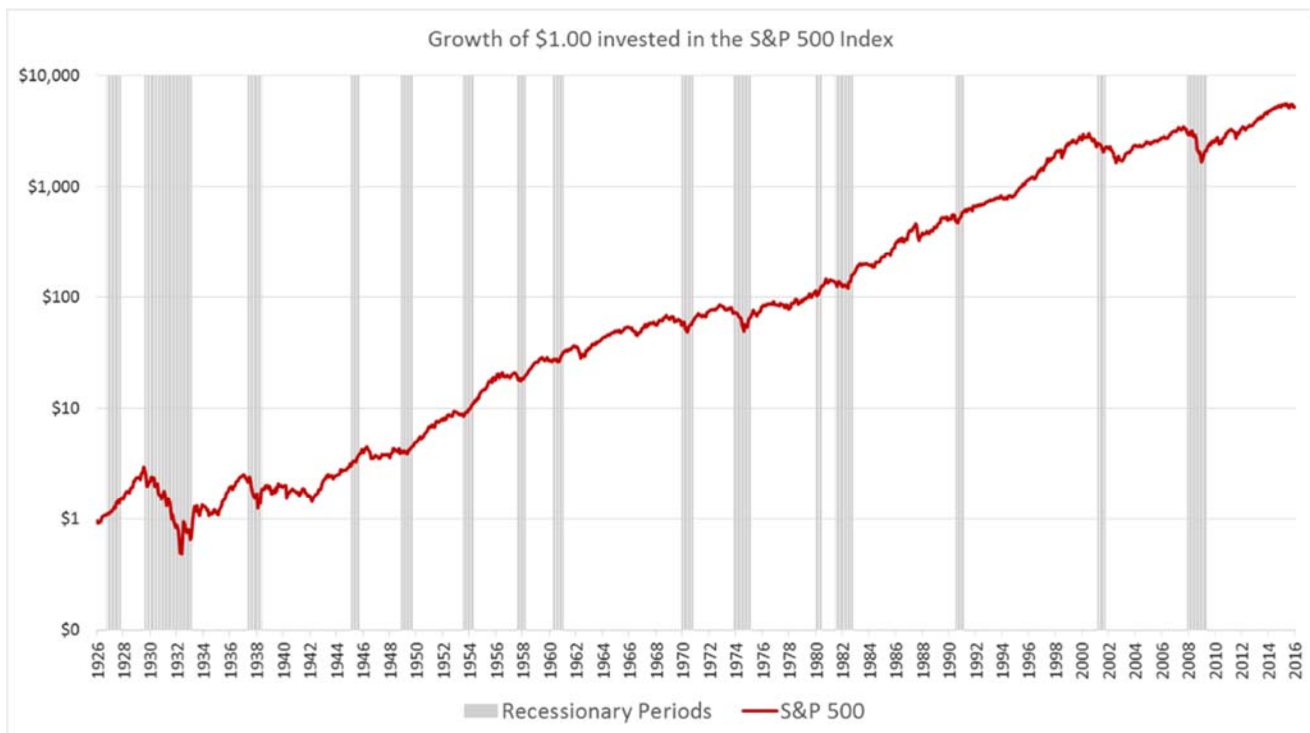
The U.S. economy has now grown for 69 straight months, making this the sixth-longest period of economic expansion since the 1850s. The stock market has climbed apace—albeit with plenty of volatility along the way.

Still, the law of gravity hasn't been repealed. Economic growth and contraction have always alternated, and at some point we'll experience a recession. That, of course, will impact stocks.

Recessions' Toll on Stocks

Recessions are defined as periods in which Gross Domestic Product—a measure of trade and industrial activity—shrinks for two successive quarters. Slowing economic activity typically coincides with lower corporate sales, earnings and profit margins, higher unemployment, as well as higher levels of bankruptcy. Typically, equity indexes will fall in advance of and during a recession. Often a bear market, a period when stock prices drop by at least 20%, and a recession, will overlap one another.

U.S. Stock Market Returns and U.S. Economic Recessions Since 1926



Source: Standard and Poor's and St. Louis Federal Reserve

Since 1926, stocks have fallen an average of 26.5% from the top to the bottom of the market around recessionary periods. For example, during the latest recession, from April 2008 to June 2009, stocks plunged more than 46% from peak to trough. But importantly stocks do recover: Since 1980, U.S. stocks have returned an average of 93.1% in the five years after a recession while bonds have averaged returns of 46.6%.

The Difficulty of Predicting Recessions

"The only function of economic forecasting is to make astrology look respectable."
–John Kenneth Galbraith, economist

In April 2008, the consensus among economists was that none of 77 major economies would fall into recession in 2009. In reality, 49 of them did just that. As one researcher noted: "The failure to predict recessions is virtually unblemished."

The fact is that it's difficult, even for those who have devoted their lives to the study of economics, to accurately forecast recessions. This means that it's also extremely difficult to predict the market declines that typically accompany, and often precede, recessions. For investors, the ability to anticipate a recession and "time the market" is equally as difficult. The best strategy is one that focuses on long-term investment goals.

At Crestwood, we seek to mitigate the impact of recessions on our clients' ability to achieve their long term goals in three main ways.

1. Developing the Correct Investment Strategy

The Crestwood team works with each client to gather information about their goals, wealth, ability and willingness to take risk, time horizon and income needs. The information helps us to determine an appropriate investment strategy for each client. In addition, the suitability of this strategy and any changes in client's goals are frequently discussed to ensure portfolios are structured appropriately.

2. Employing Intelligent Diversification

Crestwood's approach to diversification incorporates the performance of various asset types during periods of recession and stock-market declines. Many investments provide diversification during normal times, but not all of them provide it when stocks fall—which, of course, is likely during a recession. For

example, an asset class that performs well during recessions are high quality bonds, which have appreciated an average of 15.1% during recessions since 1988. Including asset classes which can preserve value and appreciate during various market conditions allows us to build portfolios that will be more durable during recessions.

3. Focusing on Quality and Price

During recessions, low-quality, high-priced investments tend to experience the sharpest declines. Crestwood equities have a history of competitive performance during market downturns, and a key reason is our preference for buying quality investments at reasonable valuations. This preference is expressed throughout our portfolios. We implement our investment philosophy by investing in companies and funds that reflect this approach.

The Importance of Staying the Course

Individual investors face temptation on a daily basis. One need only turn to the financial media to hear about a hot opportunity possibly being missed today, or the grave danger lurking. At Crestwood, we continually discuss the importance of remaining focused on long-term goals.

During the late stages of any economic expansion, temptation rears its head in the form of high recent stock returns. It's important to remember that stock returns, along with high valuations, often look strongest just before a recession—but that recessions generally spell the end of bull markets. This is when many investors, chasing return, make the classic mistake of buying stocks near their highest price. Too often, those same investors end up selling stocks near their lows.

The prudent approach for balancing risk and reward through changing economic and market environments is to develop, and stick with, a well-diversified portfolio. Impulsively increasing your stock allocation and assuming greater equity risk is likely ill-timed, as much of the gains may have been already realized.

To illustrate why, consider a portfolio with a 75% allocation to the S&P 500 index and a 25% allocation to the Barclay's Aggregate Bond index, which features a cross-section of different bond types. Such a diversified portfolio has a risk level that is 24% lower than the S&P 500 index alone.

	Before Market Peak	After Market Peak		
	Five years prior	One year	Three years	Five years
Stocks	126.8%	-14.1%	5.6%	90.4%
Bonds	38.2%	8.4%	30.9%	88.6%
75% Stocks /25% bonds	101.4%	-8.8%	11.6%	91.1%

Source: Crestwood and FactSet. Stocks are represented by the S&P 500 Index and Bonds by the Barclay's Aggregate Bond Index. Recessions since 1976 are used to calculate the average returns.

The chart above shows historical performance of a diversified portfolio versus a U.S. equity stock-only portfolio (100% S&P 500 index) for five years just before the top of the stock market during a U.S. recession and just after the top of the stock market for recessions dating back to 1976. As you can see, an all-stock portfolio appears to be preferable right before a recession, based on trailing five-year returns.

But stocks underperform significantly during a recession. In the five years following a recession, a portfolio of 75% stocks and 25% bonds outperforms a 100% U.S. stock portfolio. Although a more aggressive, U.S. equity only portfolio may outperform a diversified portfolio prior to recessions, the diversified portfolio's steadier overall performance through market cycles typically makes it an appropriate strategy for investors who want to mitigate stock market downside typical of recessions.

The takeaway is clear: Rather than chasing returns and increasing allocations to stocks at the top of the market, set a diversified strategy for the long term, and stick to it.