

Staying the Course: The Power of Long-Term Thinking in Volatile Markets

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Sir Isaac Newton was a physicist, a mathematician, and a central figure of the scientific revolution. He is also well known for developing the theory of gravity after watching an apple fall to the ground and wondering why it couldn't fall upward or sideways. His investment career, however, was not so fruitful. Newton was an early investor in the notorious South Sea Company, which was founded in the early 1700s to help manage Britain's national debt. He invested initially in 1720, cashing in his shares and roughly doubling his investment. It appears Newton then experienced the case of FOMO, fearing that he would miss out on a further run-up of the stock. So he re-entered at just about the worst time possible, right before the company hit its peak valuation, and he exited after it crashed. Newton racked up losses in the millions of dollars, if adjusted for inflation to today's dollar. It's rumoured that Newton summed up his investing expertise saying, "I can calculate the movement of stars, but not the madness of men."

Newton was a genius in the world of physics, yet he made one of the most common mistakes in investing, trying to time the markets. Investors today know the financial markets aren't always rational, but we still make some of the same mistakes and allow some of the most common cognitive biases to influence our decisions. Volatility in today's markets is testing even the most seasoned investors, and the geopolitical world order is also shifting rapidly, adding layers of uncertainty.

Do the fundamental principles of long-term investing still apply, or is it time to pivot? And how can we avoid the most common mistakes that harm portfolio returns?

To understand today's investment landscape, it's important to know how we got here. This is The Outthinking Investor, a podcast from PGIM that examines the past, the present-day opportunities, and the future possibilities across global capital markets. Three experts will discuss the principles of long-term investing. Barry Ritholtz is Chief Investment Officer at Ritholtz Wealth Management and author of the book "How Not to Invest: The Ideas, Numbers, and Behaviours That Destroy Wealth -- and How to Avoid Them." Scott Bok is author of the book "Surviving Wall Street: A Tale of Triumph, Tragedy, and Timing," and formerly chairman and CEO of the investment banking firm Greenhill & Company. Jim Devaney is PGIM's Head of US distribution for the retail market.

The global equity markets have racked up two years of strong returns. Momentum is one of the factors that drives stock market returns, until it doesn't. Barry Ritholtz looks at historical data for US stocks over the last 100 years or so to help gauge the possibility that 2025 could mark the third year in a row of returns greater than 20%.

In order to generate at least a modest body of work to look at, we did -- let's see how many plus 20% years there are consecutively. Still a relatively small data set, but much bigger than plus 25. And what we found were two really big things. One, the range of outcomes were relatively tight, plus 10% to minus 10%, plus or minus. But generally, you end up with a modestly positive year following two big back-to-back years. And the caveat is always hey, any of this can change if we get bad news or bad policy or what have you, but the economy is healthy, and it takes a lot to knock a healthy economy off its footing. And we'll find out soon enough whether or not we're in the process of doing that here.

The next crisis will always be around the corner, but that's not a reason to stay out of the market. Scott Bok's biggest takeaway from his time on Wall Street over the past few decades is how frequent crises have become and the importance of avoiding emotionally-charged decisions.

Obviously, it's simplistic to say, you know, have the discipline to buy low and sell high. Unfortunately, we all have this cognitive bias to do exactly the opposite. But I think actually studying history, I think it's very valuable, where you realise, you know, you have to kind of learn it again and again that crises come out of nowhere. I mean, the long-term capital collapse in late 1990s, came out of Russian debt. That was not an area most Wall Street folks focused on.

The great financial crisis was born out of U.S. home mortgages, not normally thought of as a place of great risk. But if you just can keep yourself in a mindset that whenever things look like they're going great and they're going to keep going great, you want to be wary. And frankly, you also want to have the nerve to realise that, you know, as some folks have joked, you know, the world doesn't end that often. So once these crises start, there's often very quickly this sense of like, "Boy, this is the end of the world as we knew it. This is going to change things forever." And it just doesn't. You look at the great financial crisis, certainly the greatest crisis of the century, going all the way back to the 1930s and the Great Depression. The bottom of that market was only a few months later. It was only in March of 2009, just, you know, six months after Lehman Brothers failed. And yet, that's already the time to be buying. So it takes real discipline. But I think studying history and seeing how often the crises come, how unexpected they are, and yet how quickly they bottom, I think, can make you a better investor.

That's especially important today as high volatility and slow growth are the consensus view for the global economy over the short and midterm. Geopolitical tensions and tariffs have started to affect companies to varying degrees across sectors. If the pace of de-globalisation continues, how might that impact financial markets? We will see more firms moving from multinational to multilocal?

Really, the story of extraordinary growth in Wall Street was a story of globalisation. When I began my career, graduated college in 1981, the stock market, Dow Jones Average, was below a thousand, a level it had first crossed more than a decade earlier. So obviously, a really stagnant, difficult period in markets. Today, it's 40 times higher. There was almost no merger and acquisition activity way back then. Now there's trillions of dollars of M&A activity every year. And you think about what really drove that, what drove that incredible value creation, what drove all that M&A activity? I would argue, in retrospect, it was globalisation. Back in the day, every town had its own bank, had its own radio station, had its own newspaper. Every region had its own soft drink brand, its own other consumer brands, and things like that. And really, that trillions of dollars of M&A, which my firm and I were proud to be a part of a lot of those transactions, created first national and then global enterprises that today really drive our whole economy. And what allowed that, I would say, was a whole series of landmark events. There was the World Trade Organisation, which at one point admitted China as well, in a step that's still somewhat debated. There was the formation of the European Union. There was the falling of the Berlin Wall. There was the North American Free Trade Agreement, known as NAFTA. There was just a whole series of governmental decisions, both in the U.S. and elsewhere, that opened up borders to do transactions and to build global enterprises. I think if you pause and say, "Well, maybe we're going to stop that now, or we're going to roll that back," I think you have to believe that's going to dramatically reduce transaction activity and it's going to decrease valuations. If we benefited on the upside from the opening of borders, it's hard to conclude that closing those borders would do anything but the opposite.

Incorporating geoeconomic risk into portfolio decisions has always been a challenge, even for institutional investors. They may have the resources to research and analyse potential scenarios, but it's very difficult to know when to exit a position.

It turns out that institutional managers, mutual funds, ETFs, endowments foundations, wherever you want to go, they're really good buyers of stocks. The problem is they're terrible sellers of stocks. And the very, very clever way academics research that was they looked at 680,000 transactions across tens of thousands of portfolios run by all these different managers. And whenever the manager would make a sale in an alternative portfolio, the academics would randomly sell any one of their other holdings. And shockingly, a random sale outperforms a purposeful decision by the fund manager, by anywhere from 50 to 100 basis points a year, where everybody's scratching out one or two basis points. They want to beat the market. Wait, my sales are costing me 100 basis points a year and underperformance. And if you stop and think about it, it makes a lot of sense. When people buy stocks, it's rational and objective, and quantitative. Hey, we like this group of companies. Here's how they look from a valuation perspective, a price to sales ratio, their profit margins. There's a little bit of wishful thinking in it, but fundamentally, it's a data-driven analytical process. The sale process is completely emotional. Sometimes it's like, "Oh, we've made a bunch of money in this, and I'm going to sell here because I'm afraid we're going to give this wins back." Or the reverse, a modest pullback and people get panicked out, or a deeper pullback and people just double down and keep buying. And all of those choices are emotional decisions.

Individual investors are doubly challenged. Not only do they lack the resources to make more fully informed decisions, but their transaction costs and management fees are higher, and they have a higher tax hurdle. As Jim Devaney explains, the tax consequences are an important factor in each investment decision.

Advisors are very much aware of the after-tax returns of their clients. I think that is why you're seeing a growth of ETF investing, especially on the equity side. It's a more tax-efficient vehicle than a mutual fund equity product. One of the fastest-growing parts of the separately-managed account industry is what's called direct indexing. And it's a different kind of alpha. The goal is to have the same return of the underlying index, but provide tax benefits. So you're measured in a different kind of alpha. It's an after-tax alpha versus the index along the way. So I think advisors very much are focused on how to reduce their clients' tax burdens at year end when it comes to investing. And that is driving some of the trends, the ETF adoption, the SMA adoption, where you have your own cost basis and where you have strategies like direct indexing, where you get tax benefits on top of the underlying index return. Again, a different way of measuring alpha, not investment alpha, but after-tax alpha.

Investment alpha continues to be the prize for institutional investors, and especially diversified sources of alpha. For decades, the 60-40 stock-bond portfolio was a safe bet, while the bond market offered a decent real return and the stock market went through fairly regular cycles. But after seeing the success of David Swensen at Yale University with his so-called endowment model, many institutional portfolios gradually shifted toward alternative assets. They expected similar risk-return benefits, not fully appreciating that Swensen was ahead of the curve.

There wasn't a lot of competition. He was able to dictate terms, and it was just incredibly lucrative for him. Suddenly, it's become a competitive marketplace. The inefficiencies he identified, he was an early investor in timber. Who the hell puts money into timber back in the 1980s? Nobody. It was a giant winner for Yale because they were the first ones. And so when we talk about the endowment model, especially the Yale model, you have to recognise he had advantages that modern portfolio managers, modern foundations, and endowments don't have. And so just be aware. Why do you want to own these alternatives? The Wilshire 5000 is now 3,400 companies. There are a lot of private firms that are staying private and not IPO-ing for longer, and an increasingly large portion of the economy is still in the private markets, not the public markets. If you want to have 5, 10, 15% of your portfolio in some combination of non-correlated, high-quality, private debt, private credit, private equity, private real estate, and you're comfortable with the manager and their process and the track record, I never really have a problem with that.

There's no substitute for conducting due diligence on the manager, their process, and their record, along with a good dose of humility, because even this knowledge is based on the past while our decisions are about the future, and the financial markets are constantly evolving.

The origination of my firm, Greenhill, a specialist in mergers and acquisitions, was a group of Morgan Stanley managing directors who left to start that firm. When the founder of my M&A firm first started there a long time ago, Morgan Stanley had about 100 employees and a few million dollars in capital. And it was a pure investment bank. It took no risk. It had no balance sheet, so, therefore, it had no balance sheet risk. It was a very small and focused and American business. But in terms of the evolution of the industry, there were two major transitions it had. One was from the world of investment banking and sort of advising and helping clients to trading, to actually having a balance sheet, to taking positions, to making bets on markets and bonds and currencies, and stocks all over the world. And the second one was shifting more toward retail investing. And both of those transitions caused incredible turmoil within the firm. They led to the departure of senior managers who got pushed out of CEO roles or who didn't get CEO roles they thought they were going to get. In both cases, there was a lot of risk that had to be adapted to. I mean, the growth in the trading business nearly put Morgan Stanley out of business in the Great Financial Crisis. It was really only becoming a bank, getting access to Federal Reserve funding, getting a big investment from a Japanese bank that kept them going. And if anything, that shift even later to the retail business was even more controversial and difficult within the firm. If you want to survive long term on Wall Street, you have to evolve. But that evolution is not easy, and it will not be easy vis-à-vis your senior management, and it will not be easy vis-à-vis your employees. And that's what makes it so challenging to survive these not only remarkably ferocious market cycles, but the shifts in the industry, the changes in technology and products and who the investors are and the fee structures. I mean, every single thing changes.

A similar kind of rapid evolution has been taking place in the alternatives market. Access to alternatives started with only the largest institutional investors, and that was just a couple of decades ago. Now, individual investors are gaining access and are attracted to the potential for more sources of return.

Institutions have been long-term users of private investments. Their allocations are much, much larger than the retail investor. Average retail investor has 2 to 3% alternative exposure. So I think the starting place matters in the discussion. But with all the new products that are being offered in retail, there is a natural question: Is this appropriate? The illiquidity premium that you get in alternatives, will it still be there? And the answer to date is yes. So in terms of portfolio construction, in the low starting place allocation, we're just getting started on this in retail and fully expect those allocations will grow into the double digits over time. There is illiquidity, and the longer your time horizon is, it's a natural asset class if you get better returns, lower risk, less volatility, and better yields. So most retail investors are starting with a public-only portfolio. So there is liquidity in their overall portfolio. And that's why our distribution partner firms are advocating for bigger allocations for their advisors and their advisors' clients. And that is why I think you're seeing a lot of managers like PGIM, which have alternative capabilities born out of our general account in managing insurance assets, robust infrastructure, starting to offer alternative products through the retail marketplace.

Another area of interest is direct indexing for stocks and bonds. Even for investors who have a clearly articulated and specific goal, there's still a lot of psychology behind how we invest. We want to look smart, and we often want our portfolios to reflect our values and our thought process.

There is certainly a big social component to that, and I'm kind of fascinated by direct indexing, because I thought that was going to be the biggest use case for it. But it turns out that the biggest best use for direct indexing has been tax loss harvesting. It's double or triple what you get when you're just using mutual funds or ETFs because the wrapper is open. You could go in and sell the bottom 10%. If a fund is plus 1, 2, 3% for the year, well, there's no loss harvesting. But a fund that's plus whatever to the positive, there's a bell curve distribution, and there are always going to be stocks that are down 10, 20, 30, 40% in that portfolio.

You occasionally sell those stocks, replace them with equivalent stocks, so you don't affect the overall performance of the portfolio, but you're harvesting those losses. We have found this to be especially useful for IPO stock, employee stock options plans, founder stock, inherited wealth, sale of a business where managing capital gains is a huge part of the total return over time.

The asset-allocation decision is often thought to have the biggest impact on performance, but that doesn't take into account the effects of market timing. While there's no single recipe for investment success, the most successful long-term investors tend to have a good deal of self-awareness and self-control, which helps avoid emotionally-charged decisions.

I have a chart from my colleague Michael Batnick, which goes back 100 years, and it's called "Reasons to Sell". And you see every year, there's a different reason going back to the Depression and World War II and Pearl Harbour. And there's always a reason to sell. And yet, somehow we all have to get up each day, send the kids off to school, dress and feed ourselves, go do our thing. In the U.S., that's, I don't know, 20, \$25 trillion worth of activity plus other expenditures we have. It takes a lot to derail the economy, and it takes a lot to keep it derailed because we all have things to do. We've seen this in the financial crisis. We saw it in the pandemic. We even saw it in the dot coms. Ultimately, if things get bad enough, the government will step in and say, "All right. We're going to put a stop to this. We have some circuit breakers built in."

Thanks to Barry Ritholtz, Scott Bok, and Jim Devaney for their insights on investing for the long term. The Outthinking Investor is a podcast from PGIM. Follow, subscribe, and if you like what you hear, go ahead and give us a review. If you enjoyed this episode and want to hear more from PGIM, tune in to our Speaking of Alternatives podcast. See the link in the show notes for more information.

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