# A Bear Market Survival Kit

As the recent equity market decline briefly dipped into bear market territory, we have been pleased by the calm with which our clients have reacted. It appears our clients really do have a long-term perspective and stick to it in the face of adversity, and most of them have lived through difficult markets with us in the past. In any case, as market volatility persists, we thought it was appropriate to revisit a few lessons for successful bear market investing. While these ideas sound simple, history has shown that it's very easy to forget them just when they are most needed. As the great philosopher (and heavyweight champion boxer) Mike Tyson once said when asked about his opponent's plan, "Everyone has a plan until they get punched in the mouth."

## Win the War Before a Battle is Fought

**"Victorious warriors win first and then go to war, while defeated warriors go to war first and then seek to win"**

**- Sun Tzu, The Art of War**

One of the common misperceptions about bear market investing is that success requires active corrections and portfolio manipulations amidst the bear market. In fact, the most important key to success has nothing to do with the bear market period, but rather how one's portfolio is positioned entering the bear market. A common practice in portfolio construction is to build asset allocations based on backward-looking statistical simplifications. In our experience these allocations often fail to provide investors with sufficient downside protection, surprising investors with larger than expected losses, leading to fearful responses.

With a well-crafted portfolio, investors should feel confident riding through a difficult period and rebalancing their portfolios in a systematic manner. Running counter to our natural human response, this requires investors to add to areas of the portfolio that have experienced the largest declines and sell assets that have been relative safe havens. This is easy to say, but difficult if not impossible to do in an unsettled emotional state.

Confidence that your portfolio is appropriately constructed gives you the ability to withstand the inevitable bear market and is critical to long-term investment success.



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## Human Nature Is a Horrible Guide

**"Be greedy when others are fearful and fearful when others are greedy."**

**- Warren Buffett**

Markets move in cycles. Boom followed by bust followed by boom should be considered normal. What is not normal is the most recent 15 years of nearly uninterrupted gains. Investors must realize that corrections are to be expected as part of a long-term investment plan. One might even say it's the cost of investing. What matters is how we react.

Holding investments that decline in price is unpleasant and, it turns out, disproportionately unpleasant when compared to the enjoyment of portfolio gains. Prospect theory developed in 1979 by Daniel Kahneman and Amos Tversky accurately captured the asymmetric relationship that we have between losses and gains, stating that individuals' fear of losses is greater than their joy of gains. While the magnitude of this effect varies by individual, it is nearly universal and thought to have evolved from humans' survival instincts. It is why we have such a strong emotional response to portfolio declines and why our natural reaction is to flee or, in the case of our portfolio, sell.

It is also human nature to regret missing out on a good thing, albeit to a lesser degree. It's difficult to hear others bragging about their investment returns and not feel as though you missed out on something. The fear of missing out, or "FOMO," can be powerful, and resisting it and avoiding return chasing is just as important as staying the course during difficult periods.

The irony of this seemingly simple concept is that risk is actually highest when everything seems to be going well and the market is going up (and getting more expensive). In contrast, the panic experienced deep in a bear market or recession often provides the best investment opportunities, as the market has been significantly "de-risked." Capital markets tend to overreact, excessively extrapolating both good and bad news, giving rise to Warren Buffett's sage and contrarian advice above.

Numerous studies have shown that the average mutual fund investor performs worse than the average mutual fund. How can that be? If one were to merely hold a position, the average fund investor would fare the same as the average fund. Investor behavior is to blame. Human nature pushes us to sell investments with poor recent performance (and miss out on the likely recovery) and to chase those that have recently done well (and subsequently participate in their inevitable decline). Studies have also shown that these performance-reducing behaviors are present for relative performance as well as overall market performance, as investors pull money from recent underperformers and reallocate toward recent outperformers.

Good behavior is the most critical ingredient of successful long-term investing, and it's essential to avoid getting pulled into the vortex of our natural instincts and emotions. Discipline is hardest at market tops and bottoms when either greed or fear become

overwhelmingly powerful. Have the courage to ignore the anxious voices inside your head and stick to your long-term investment plan.

## Market Timing Doesn't Work

**"The best rule you can possibly follow is not 'Don't just stand there, do something,' but 'Don't just do something, stand there!'"**

**- John Bogle**

As the old saying goes, there are only two types of people when it comes to market timing, people who cannot do it and people who have not yet realized that they cannot do it. Numerous academic studies confirm that it's impossible to consistently profit from timing the market, and that makes sense. If there were a proven formula or pattern that signaled market tops and bottoms, everyone would know it, which would destroy the signal.

The level of precision required for successful market timing is prohibitively high, as missing just a small number of the best days dramatically alters the ending results. The return of the S&P 500 Index for the nine decades from 1/1/1930 to 12/31/2020 has annualized at a very respectable 9.6%. However, if an investor were to have missed the best ten days from each decade – an average of 1 day per year – their return would be more than halved to 4.1%. Further, if an investor were to miss the best 20 days of the decade, their return would begin to approach zero!

The same dynamic holds even more strongly in recent periods. Since the beginning of 2000, the S&P 500 Index has annualized at 6.3%. However, remove the top 10 days – an average of less than one day every two years – and that annualized return would be once again more than halved to 2.7%. Remove the top 20 days the return once again would approach zero.

To make matters worse, most investors are unaware of how closely the best days often follow the worst, making timing effectively impossible. Most of the positive returns of stocks are concentrated in sharp bursts during periods of great pessimism.

› Since 2020, there have been 17 trading days with a 5% or higher gain. 16 of those 17 days occurred within eight days of a 5% decline.

› More than half of those positive days came within two days of a 5% decline.

As a result, not only is incredible precision required to pick the very few dates that disproportionately account for equity market increases, but the successful market timer must also be immune to the emotions of losses and be willing to reenter the market when conditions are at their gloomiest.

Several other challenges exist for market timers. First, successfully timing the market requires an investor to be right twice, first exiting and then reentering the market. Accomplishing this just once has proven nearly impossible. Additionally, for taxable

investors, this type of market timing activity also accelerates gain recognition and capital gains taxes, creating a further hurdle for success.

However, you don't need to do nothing as John Bogle suggested. You should follow your systematic plan to rebalance your portfolio by taking gains from your high-flyers while adding to your laggards. This may not be as much fun as day-trading cryptocurrencies and message board meme stocks, but history has shown you'll be better off.

## Ignore the "Expert" Predictions

**"It ain't what you don't know that gets you in trouble. It's what you know for sure that just ain't so."**

**- Mark Twain**

"Where is the market headed?" "What is your prediction for equity markets for the remainder of the year?" "Has the market reached a bottom yet?" For most investors, after one of the worst first-halves in equity market history these types of questions are natural and expected. However, the biggest misconception about investing is that great investors know what will happen in the future. Admittedly, a crystal ball would be very helpful, but nobody has one. The overwhelming evidence from decades of academic research is that nobody can reliably and accurately forecast what the stock market will do. Short-term forecasts — including predictions of where the market will be one year from now — are a fool's game.

Jeff Sommer, writing in the New York Times recently, noted that "the median Wall Street forecast from 2000 through 2020 missed its target by an average 12.9 percentage points — which was more than double the actual average annual performance of the stock market." Even worse, during those 20 years, the median Wall Street prediction was never negative, yet the market was down six of those years, or nearly a third of the time. As John Kenneth Galbraith once famously said, "The only function of economic forecasting is to make astrology look respectable."

The most recent example of horrendous forecasting was in 2020. During the rollercoaster ride of the initial Covid pandemic, the equity market experienced its sharpest decline in history, dropping nearly 35% in the first few months of the year. At the beginning of the year, the consensus Wall Street forecast was for the S&P 500 Index to rise 2.7%. We can forgive forecasters for not predicting a global pandemic, but their revised forecasts, once they knew what was happening, confirm their ineptitude at a time when investors needed "expert" guidance the most. In April, when the effects of the pandemic were becoming clear, a Bloomberg survey found that forecasters consensus predicted the S&P 500 Index to finish the year down 11%. We know this was the opposite of what actually happened, as the market rebounded more than 60% from its lows to close the year up nearly 20%.

Yet Wall Street continues to issue erroneous predictions. Why? First, there is no accountability for their lack of accuracy as very few remember their predictions. Some suggest that the blame lies mostly with investors as we crave certainty or at least the appearance of it. The incentives for these big banks are to continue to be able to

sell their products and services, and these predictions calm their customers. These prognosticators are smart people and often have interesting things to say about what has already occurred, but as far as predicting the future, the record of Wall Street's and other experts is remarkable for its ineptitude.

If predicting the future is so difficult, what investment guidance can we provide? For long-term investors, equity markets are generally prone to increase, driven by the ingenuity and hard work of profit-maximizing company leaders. This is eventually reflected in the increasing value of both public and private companies. Equity markets have risen in roughly two-thirds of calendar years. It does not matter if it's an even year or an odd year, if it's a Republican president or a Democratic president, or any other random external condition.

Our prediction for the equity markets ahead? It will probably be up, but it might be down. While this may be unsatisfying, it is honest.

## What Should We Do?

**"In the midst of chaos, there is also opportunity."**

**- Sun-Tzu, The Art of War**

It's easy to say what not to do and whom not to listen to, but what should investors do? Here are several principles that will help investors achieve their long-term investment goals.

› Unpredictable market movements, unanticipated volatility and unexpected bear markets are the costs of being an investor. You can't reap the rewards of investing without paying those costs.

› Accept that we can't know what the market will do next year. Instead of relying on flawed predictions, be fully confident that nobody knows what will happen.

› Don't try to time the market by cashing out and don't pile into the investment trend of the day either. Human nature is a poor guide for investment decisions.

› Adopt a long-term perspective and stick with your investment strategy. Great investors ignore the noise and stay focused on their long-term goals. This requires contrarian behavior by rebalancing into assets that have declined and trimming those that have appreciated.

› Structuring all-weather portfolios that will share in the upside when the market is up and preserve value when it is down and, most importantly, that have an adequate margin of safety to ride through down markets, will allow investment decisions to be made free from fear and FOMO.

Bear markets also provide opportunities, as panicked investors can drive market declines to oversold conditions. Over the last 15 years these conditions didn't exist or didn't exist for long, as declines were short-lived and frequently rescued by aggressive

fiscal or monetary responses. The current cycle is different as we appear to be entering a true economic and business cycle downturn with limited possibilities for a rescue from the Federal Reserve or the federal government. Assets continue to be sold indiscriminately, some deservedly so, but others are very likely to represent great buying opportunities.

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