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Surviving the Bear Market

Welcome to the 14th bear market since the end of World War II. Officially, a bear market is one that falls 20% or more from a previous high. This bear market is unique because of its suddenness – the S&P 500 Index declined 20% in a mere 22 days after making its all-time high on February 19th. Every bear market brings its own unique worries, but also sets the foundation for periods of better returns in the years that follow -- for those investors who have the fortitude and discipline to avoid making counterproductive panicked responses. Perhaps some historical perspective will help.

Bear markets are a normal and recurring element of the economic cycle. Since 1928, there have been 25 bear markets and 26 bull markets in the S&P 500 Index. Since 1945, they've occurred on average about every 5 years with an average decline of just over 30%. At its low point thus far, this bear market has seen a 33% decline in the S&P 500. Stocks don't go down 30% for no reason. It takes a serious economic event to cause panic selling. Just like today, every bear market has seemed to be the result of unprecedented events. Eventually, the crisis got resolved, and the economy and stock prices recovered. The recent bull market lasted a record 11 years; making it easy to be a buy and hold investor. There were a few double-digit declines along the way, but nothing like the current situation. After 11 years without a bear market, a significant pullback was inevitable. Following the advice to "stand fast, this too shall pass" in the face of historic volatility is difficult; it's human nature to want to do something. Many investors are worrying about how to outsmart the bear market but what we really need to do is just survive it. It's normal to feel uncomfortable at times like this but over the course of your investing life, you will feel today's unpleasant emotions numerous times at regular, unpredictable intervals. We can expect to see 8 bear markets in a typical 40 year working career and, heaven help us, 6 more during a 30-year retirement. And each time a bear market hits, we'll be ***shocked!***

The arrival of bear markets is unpredictable, and their severity and duration are unknowable. No matter what you hear, no matter what you think, no matter what you wish, or what your financial advisor tells you, there is no formula or strategy for taking your capital out of harm's way in advance of a stock market decline and returning it to the market before a significant recovery. Stay away from the "suspicious experts" who claim to know how to do it. I've said it before; I'll say it again -- market timing is the pursuit of an illusion, a modern-day equivalent of alchemy.

The "equity premium" provided by stocks -- the long-term higher return of stocks vs. fixed income investments - is the way an efficient market compensates investors for enduring volatility. I believe that, most of the time, markets are highly efficient, with the trading of rational investors setting reasonably accurate prices and offsetting the "noise" of short-term traders. But sometimes, the noise overwhelms rationality and panicked traders take center stage. We usually think of volatility as rapid declines in prices, but volatility is characterized by rapid changes in stock prices -- both up and down -- in the short-term. Up and down volatility tends to cluster during market downturns, which is why we have seen both large declines and large gains just days apart in recent weeks. The only way to gain the long-term return of equities is to ride out their temporary declines. History tells us that investors with the emotional maturity and financial discipline to remain invested have the best chance to survive a bear market and achieve their long-term financial goals.

In recent weeks, it might seem as if everybody has been panicking. But that's not true, it's just that the financial media has given a global microphone to those who have been encouraging panic. We are herding creatures and doing what others are doing provides short-term comfort because it seems to be the right decision. This herding behavior is part of our human nature. It becomes apparent during bear markets and helps explain why it's so hard to find paper towels and hand sanitizer these days. The stock market is controlled by profit seeking institutional investors who are intelligent but are emotional creatures just like you and me. They're often less rational than they'd like us to think and exhibit a herd mentality that contributes to short-term volatility. An institutional investor who buys when others are selling or sells when others are buying takes a huge career risk because if he's wrong, he'll underperform the competition and soon be unemployed.

Investors are hard-wired to fixate on the present and the recent past. This is known as recency bias. When we focus too much on the immediate threats around us, long-term threats – like not having enough money to retire - are often out of sight and out of mind. The value of maintaining a long-term focus is greatest when it is the hardest thing to do.

The best way to keep a long-term focus is to ignore, as best as possible, the things you can't control – like the stock market. Focus instead on the financial planning issues that you can control and that will determine your long-term financial welfare. Things like how much you save and invest, budgeting, tax planning, estate planning, your portfolio allocation and periodic portfolio rebalancing.

One lesson that I hope you've learned from recent events is that making market or economic predictions is folly and following forecasts is a fool's errand. Even if someone correctly forecasts an unexpected event, we still can't know what its impact will be or how markets will react. Let's face it, we have no idea what will happen in the short-term. Once you understand this, it's easier to stick with your investment strategy because it removes any rationale for short-term portfolio tinkering. Even if we think that we've prepared for all the known risks, unknown risks lurk just around the corner. Nobody was writing articles six months ago about how to prepare your portfolio for a global pandemic. Recent events are a reminder that the stock market is unpredictable precisely because of the ever-present unknowns.

The economic uncertainty as a result of the coronavirus has translated into earnings uncertainty which in turn has translated into incredibly volatile markets. Long-term, equity prices reflect the underlying fundamentals of the economy, not the crisis du-jour. Bear markets should be understood as temporary interruptions in a permanent upward trend. Like all previous crises, this one will ultimately get resolved, economic activity will grow again, and the world will be back in business. To survive this bear market, investors need courage, optimism and patience. Embrace those qualities today and I'm confident that you'll be handsomely rewarded in the years ahead.

If this bear market has found you unprepared, how can you best prepare for the next one? Here are some ideas –

- Have a written financial plan -- one that is appropriate for your time horizon, risk tolerance and financial goals. Your plan should contain an investment strategy to follow in good times and bad and should include periodic rebalancing. It's important that you understand your strategy so that you can stick with it the next time the spaghetti hits the fan. Your focus should be on your plan, not on what the market did yesterday or today or what it might do tomorrow. Nobody enjoys a frightening market decline but selling into a panic means that you'll be on the sidelines during the initial upward swing of the inevitable recovery -- whose timing and magnitude are impossible to predict. The most important factor in your financial plan is your commitment to fund it. The growth will take care of itself long-term, but insufficient funding is a recipe for failure.
- Your portfolio should consist of liquid, high-quality transparent assets that you understand, not complex investment products that are full of promises and short on details. If your portfolio consists of a junk drawer collection of stocks and financial assets purchased long ago for reasons long forgotten, it's time to take remedial action. Your portfolio should contain an appropriate allocation to high-quality fixed income investments – regardless of their current yield. They are out-of-favor when the market is rising but act as shock absorbers when panic hits Wall Street. My strategy for those about to begin retirement is to have enough fixed income investments to finance at least a decade's worth of portfolio withdrawals. It is hard to put a value on the peace of mind that comes from knowing that you have adequate fixed income assets to outlast a bear market.
- Remove individual company risk from your portfolio. Own the global stock market, not just selected segments, countries or geographical areas. Individual stocks bring unnecessary additional risk into your portfolio. I don't care if Grandpa worked for the company. I don't care if it's been a blue-chip standout for a hundred years. Any company is a year away from being ground into powder by mismanagement and handing it shareholders a 100% loss.
- The only metric that matters is your progress towards your long-term financial goals. Therefore, annual reviews are an important component of financial planning to ensure that you're on course to achieving those goals.

We are at a moment of maximum uncertainty in the most significant public health crisis since the 1918 influenza epidemic and our response has been to put the economy into a medically induced coma. The short to intermediate term outcomes are unknowable. The sharper the containment measures taken, the deeper the economic hit will be in the near-term, but the more confident we should be about the rebound after such measures are lifted. Given the strength of the economy before the health crisis, some economists believe a recovery could be fairly fast and strong. No one knows, of course, but a 20% gain in the S&P 500 Index on March 24-26 gives us a glimpse of what we might see in the future when the collective emotions of market participants improves from the panic of recent weeks.

I have often written about the importance of having a financial plan that will act as your financial roadmap in good times and bad. Attaining your financial goals is a marathon that requires stamina in times like these. A characteristic of all long-term, goal-focused investors is acting rationally in an environment of uncertainty. Stocks have risen more often that they've fallen because of the economic expansion over time. We are in the midst of an economic and health care crisis. Both breed fear and uncertainty. Making impulsive investment portfolio moves today, in a time of such uncertainty is not likely to be a wise move.

In difficult times, America's greatest strength has come from pulling together – working shoulder to shoulder – to generate the ingenuity, resilience and tenacity that solves problems and creates opportunities. We've survived wars, terrorism, recessions and other pandemics and there are dedicated, wise people working together to help us get through this crisis too - from six feet apart, if necessary. We are likely to see permanent changes in how we socialize, do our work, and procure goods and services. What matters most – in terms of both health and finances – is how we do in the interim. Stay safe, this too shall pass. If your investment plan is sound, and you continue investing through this, you'll likely be able to survive the bear market and stay on track to reach your financial goals.

The CARES Act

Aggressive public health measures to stem the coronavirus outbreak and social distancing have brought economic activity to a halt. Policymakers aren't expecting the economy to bounce back on its own. Policies are being put into place to revive the patient when the time comes. The recently passed Coronavirus Aid, Relief, and Economic Security (CARES) Act is a $2 trillion emergency fiscal stimulus package that will hopefully help ease the effects of the economic damage. Some highlights of the act that apply to individuals are –

- The most notable provision in the bill is the direct payments to taxpayers. The act provides immediate cash payments of up to $1,200 ($2,400 for those married filing jointly) to many U.S. taxpayers. The amounts paid would be increased by $500 for each child the taxpayer has under the age of 17. The payments are reduced for higher-income taxpayers; they begin phasing out for taxpayers with adjusted gross income (AGI) of $75,000 for single, $112,500 for head-of-household filers, and $150,000 for those married filing jointly. The IRS will base these amounts on a taxpayer's 2019 tax return, or 2018 tax return if the 2019 return has not yet been filed. Individuals and families with income above their respective thresholds will see their relief payments reduced by $50 for every $1,000 of AGI. To be eligible, individuals must have a Social Security number and cannot be claimed by someone else as a dependent. You do not have to have had reportable income in 2019.
- From the retirement planning perspective, notable provisions of the CARES Act include the elimination of the 10% early withdrawal penalty (for those younger than 59 1/2) and the 20% mandatory withholding on in-service withdrawals of up to $100,000 from retirement accounts - so-called "Coronavirus-Related Distributions". Individuals can spread income taxation of the withdrawals over three years and can refund the withdrawal in the future. To be eligible for this provision of the act, an individual must fall into one of the following categories -
    - The individual, spouse or dependent is diagnosed with the coronavirus.
    - The individual's employer must certify to the plan administrator that the employee has suffered adverse financial circumstances as a result of the coronavirus.
- The suspension of required minimum distributions (RMDs) in 2020 for most retirement accounts as well as the option to return current-year distributions, provided this is done within 60 days of the withdrawal. Skipping RMDs will lower income tax bills for 2020 and could also reduce future Medicare premiums by allowing high income retirees to avoid or reduce the impact of IRMAA surcharges.
- The Act expands unemployment insurance provisions to include an additional $600 per week payment to each recipient for up to four months, and extends benefits to self-employed workers, independent contractors, and those with limited work history. The federal government will extend benefits for an additional 13 weeks through December 31, 2020 after state benefits end.
- The deferral of federal student loan payments through September 30, 2020 with no interest accrual during this period.
- The Act creates an "above the line" deduction of up to $300 for charitable contributions for taxpayers who do not itemize. The Act also suspends the 50% of Adjusted Gross Income (AGI) cap of charitable contributions for individuals who itemize in 2020.

Uncertainty breeds fear, and there are criminals ready to cash in on your fear. One scam involves letters to Social Security recipients warning that their benefits will be suspended as a result of SSA field office closures unless the beneficiaries call the phone number referenced in the letter. If recipients call the number, they may be conned into providing personal information or paying money. Ignore texts and emails about cash from the government. Stimulus checks will be forthcoming, but anyone who tells you they can get you the money now is a scammer. A March 30th notice from the Securities and Exchange Commission warned investors to beware of numerous internet scams that claim the products or services of certain publicly traded companies can prevent, detect or cure coronavirus and that the stocks of these companies are about to dramatically increase. This is just one more good reason to avoid owing individual stocks in your portfolio.