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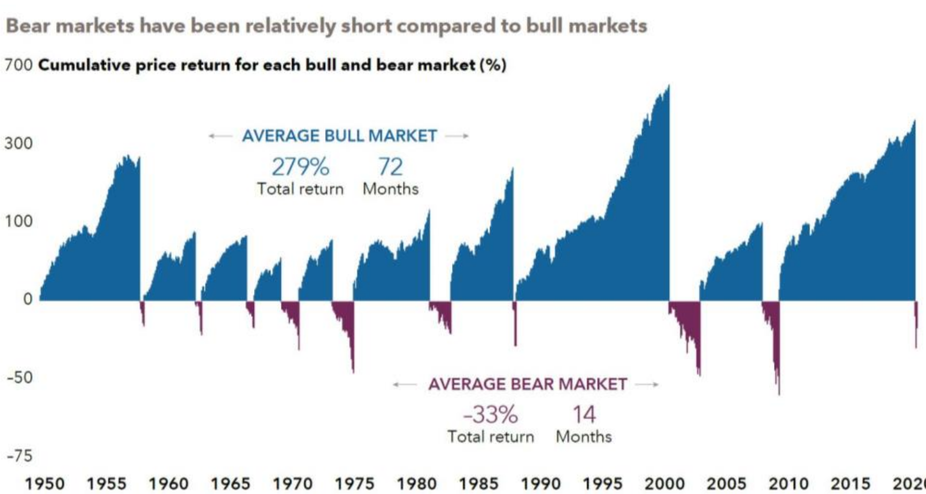
Bear Market Blues

To paraphrase Thomas Paine -"These are the times that try investors' souls." Our instincts and emotions are not reliable guides in stressful times. In the first six months of 2022 the S&P 500 declined 21%, its worst first half performance since 1970, and the Aggregate Bond Index fell 11%, according to Dow Jones. Despite high inflation and to the dismay of gold bugs, the WSJ Dollar Index, which measures its value against a basket of 16 currencies, increased 8.7% in the first half of the year – its best first half since 2010. Even for those of us who maintain a long-term perspective, these are the times that test our inner resolve. They also test the quality of the downside protection that we put in place during the good times – assuming that we were prudent enough to do so.

Stocks are considered to have entered a bear market when the S&P 500 falls 20% or more from a previous high. Bear markets end and a new bull market begins when the index bottoms and begins to recover. The S&P 500 moved into bear market territory for the 13th time since the end of World War II on June 13th when the decline from its January 3rd record high reached -20.8%, according to Bloomberg. This ended a 651-day bull market that began when the index reached its Covid bear market low point on March 23, 2020. The financial media was quick to provide images of a grizzly bear rampaging through markets and terrorizing investors, using fearful images to generate eyeballs, ears, and clicks. But I have a different definition -- a bear market is a period of time when people who think, "This time it's different!" sell their stocks to people who believe that "This too shall pass."

Many people think that stocks decline when there are more sellers than buyers. This is not true. Even when stocks are falling, the stock market efficiently brings buyers and sellers together by lowering prices to a level that is satisfactory to both. Investors who buy stocks in a bear market do so in the belief that lower prices today mean a higher expected return in the future.



Sources: Capital Group, RIMES, Standard & Poor's. As of 4/30/20. The 2020 bear market is considered current as of 4/30/20 and is not included in the "average bear market" calculations. In all other periods, bear markets are peak-to-trough price declines of 20% or more in the S&P 500. Bull markets are all other periods. Returns shown on a logarithmic scale. Returns are in USD.

Bear markets are a normal and recurring element of the economic cycle. Historically, they have been temporary interruptions in a permanent upward trend. This chart shows bull (blue) and bear (purple) markets in the S&P 500 Index from 1950 through the end of the Covid bear market in March 2020. The average bull market ran for about six years, delivering an average cumulative return of 279%. The average bear market lasted roughly 14 months, yielding an average cumulative loss of 33%. The longest of the bear markets lasted 31 months (dotcom crash, 9-11). It was followed by a nearly five-year bull run. The shortest was the pandemic-fueled bear market in early 2020, which lasted a mere 33 days.

Since World War II, a bear market has occurred on average about every 6 years. So, we can expect to see 7 of them in a typical 40 year working career and, heaven help us, 5 more during a 30-year retirement.

We tend to think of volatility as rapid declines in stock prices. But volatility should be understood as excessive stock market movements -- both up and down -- in the short-term. As is so common in bear markets, the best and the worst days this year have occurred near one another. The June 18th issue of the *Wall Street Journal* had this headline - "Market Wraps Up the Worst Week Since 2020." The article noted that for the week ending June 17th the S&P 500 fell 5.8%, its worst week since March 2020. A week later, the June 25th issue of the *Wall Street Journal* had this headline - "Dow Jumps

800 Points on Easing Rate Fears." The article noted that for the week ending June 24th the S&P 500 rose 6.4%, including a 3.1% gain on Friday June 24th - its largest daily percentage gain in more than two years.

It can be frustrating when the stock market rallies one day and then falls a day later, for no apparent reason. This is a common occurrence in bear markets because professional stock traders live in a world that is unrelated to the one you live in. On a day with a nice upward momentum, they'll buy into the rally. The next day, they'll sell when the rally begins to lose steam, to lock in their short-term gains. This cycle is repeated throughout every bear market. It heightens the volatility that scares many investors, but the trading frenzies of these short-term professional speculators is irrelevant to you and your financial goals. Most market obsessed traders would sell their souls for the great advantages you have over them –

- The freedom to ignore the stock market's daily gyrations which are irrelevant to achieving your financial goals.
- The ability to have a down month, quarter, or year without worrying if it will cost you your job.
- The freedom to spend time pondering your blessings as you let time and compounding work on your behalf.

Bear markets bring prognosticators out of the woodwork like nothing else. Ignore these "guessing experts". No one can predict the mass psychology of crowds. Nobody knows how tomorrow's news will influence tens of millions of traders and trading algorithms around the world. Each bear market is the product of unique circumstances and brings its own unique worries. Be skeptical when comparisons are made to previous bear markets. Today's elevated inflation is being compared to the 1970s, even though the causes of inflation today are not the same as in the 1970s. Some are focusing on the valuations of popular technology stocks and comparing them to the early 2000s – when these companies had no earnings. Others are comparing home prices with the housing bubble that created the financial crisis, ignoring today's higher mortgage lending standards. The severity and duration of bear markets are unpredictable, they follow their own path and listen to no man. Thus, comparisons to past bear markets provide little or no value and are likely to be misleading.

No matter what you hear or think, no matter what a book title says, no matter what a YouTube video claims, there is no formula or strategy for taking your capital out of harm's way in advance of a bear market and getting back in before stocks rebound. The greatest danger for investors isn't bear markets, it's trying to time the market. History reveals that stocks usually bottom and a new bull market begins before the economic news improves, to the exasperation and dismay of all market timers. I've said it before; I'll say it again -- market timing is the pursuit of an illusion, the modern-day equivalent of alchemy. According to Dimensional, if you invested $1,000 in the S&P 500 from 1990 through the end of 2020 and reinvested the dividends, you would have $20,451. If you missed the best day, you'd have $18,329 and only $12,917 if you missed the best five days.

Peak	Trough	% Decline	# of Days
5/29/1946	10/9/1946	-26.6%	133
6/15/1948	6/13/1949	-20.6%	363
7/15/1957	10/22/1957	-20.7%	99
12/12/1961	6/26/1962	-28.0%	196
2/9/1966	10/7/1966	-22.2%	240
11/29/1968	5/26/1970	-36.1%	543
1/11/1973	10/3/1974	-48.2%	630
11/28/1980	8/12/1982	-27.1%	622
8/25/1987	12/4/1987	-33.5%	101
3/24/2000	10/9/2002	-49.1%	929
10/9/2007	3/9/2009	-56.8%	517
2/19/2020	3/23/2020	-33.9%	33
1/3/2022	6/13/2022	-21.8%	161
Averages		**-32.7%**	**351**

This chart, from Ben Carlson's blog, reveals the starting date, ending date, total percentage decline and length of all 13 bear markets in the S&P 500 Index since the end of World War II. Of note is the fact that the second bear market ended the day I was born. Surely an omen of good things to come. Another thing to note is that when the S&P 500 crossed the bear market threshold on my birthday this year, it was already 161 days old – the number of days since its last all-time high on January 3, 2022.

In every bear market, two things are sure to happen. The first is that the financial media will give much time and space to pundits and prognosticators who claim that buy and hold is dead. Underlying this assertion is the erroneous assumption that temporary price declines represent permanent loss. The second is that financial advisors will dust off the old marketing brochures of investment products that promise to provide the upside of the stock market without the downside. Be on your guard.

Ten things to keep in mind as we go through the current bear market -

- The first casualty of every bear market is perspective because investors focus on current stock prices and forget the long-term benefit of owning profitable companies. In the short run, investors' emotions determine stock prices but in the long run, corporate earnings determine stock prices. Nobody knows how long this bear market will last but there's comfort in knowing that sufficient time heals most stock market wounds. If it doesn't, your portfolio balance will be the least of your worries. Historically, domestic stocks have generated annualized average returns of about 10% during a period that included a Great Depression, two world wars, commodity shocks, pandemics, and other crises. Remaining steadfast during bear markets is the price we must pay to receive the "equity premium" -- the long-term higher return of stocks vs. fixed income investments.

- For younger investors, whose investment time horizon spans many decades, a bear market is good news. It provides them the opportunity to put cash to work by buying equities at significantly lower prices. Often, what seemed like the darkest point for the stock market was, in reality, a great opportunity to buy equities for the long term. Some day in the future, panicked behavior today will end up looking silly through the perfect lens of 20/20 hindsight.
- Capital markets are forward looking. The expected impact of stubbornly high inflation, the Ukraine war and higher interest rates are already reflected in current stock and bond prices. What moves markets is the unexpected. If news on inflation, interest rates, the Ukraine and other geopolitical events turn out worse or better than expected, then prices will quickly adjust, likely before you hear the news.
- For more than a decade, investors have complained about miniscule bond yields. That is now no longer the case. Income investors can now receive the highest yields in many years.
- Human nature makes us lousy investors. Our emotional decisions are often flawed and prone to error. Thus, we see an ongoing cycle of periods of irrational exuberance followed by periods of irrational dread. We are subject to "recency bias", focusing on what's happening now and projecting it into the future. What matters is your long-term investment horizon, not today's headlines – which will likely be forgotten by next week. Warren Buffett has often said that to be a successful investor one must be fearful when others are greedy, and greedy when others are fearful. Your financial wellbeing depends on being disciplined enough to stay focused on the long term.
- Stick to your plan. A good financial plan is built according to your goals, time horizon and risk tolerance. It makes allowances for times when all the news seems bad. It provides a cushion of cash and uses disciplined rebalancing to keep you on target for your goals. Your focus should be on your plan, not on what the stock market did yesterday or today or what it might do tomorrow. Keep in mind that neither bear markets nor bull markets are permanent – they just exchange places on stage at irregular intervals. Nobody enjoys a bear market but selling after stocks have declined almost guarantees that you'll be on the sidelines during the initial upward swing of the inevitable recovery -- whose timing and magnitude are impossible to predict.
- Although the S&P 500 Index has never failed to fully recover the losses sustained in a bear market, the same can't be said for individual stocks. Owning individual stocks brings unnecessary additional risk into your portfolio. I don't care if Grandpa worked for the company. I don't care if it has been a blue-chip standout for a hundred years. Any company is a year away from being ground into powder by mismanagement or by more adept competitors and handing it shareholders a 100% loss. So, while investing means taking risk for expected reward, investors should mitigate risks where they can. Diversification is the most important risk mitigation tool. Own the global stock market, not just selected segments, or geographical areas.
- Bear markets are stressful for advisors and clients alike. The job of a financial advisor isn't to shield investors from bear markets. It's to put them in a position to survive them (both financially and emotionally), in order to achieve their long-term financial goals. This bear market is especially painful for those people who spent the last few years investing foolishly or not investing at all. We all hate seeing our portfolios decline in value and it can be hard to implement actions that have resulted in investment success when being bombarded by the constant drumbeat of negative headlines. But fleeing equities after the arrival of a bear market is putting a noose around the neck of your financial goals.
- Anything can happen in the stock market and the economy, and nobody knows what's next. (I hope you knew this before I wrote it.) Thus, you can ignore 95% of everything said in the financial media and by other investors whose focus on the short term and today's headlines inevitably leads them to inaction or counterproductive decisions.
- You're either a saver or an investor. If you can't take the volatility of the stock market or remain emotionally composed in bear markets, it's likely that you're a saver, not an investor. There's nothing wrong with that. Unfortunately, your only recourse is to invest in fixed income assets, maximize your savings rate and then pray for deflation. That's a strategy that is unlikely to achieve the financial goals of most people.

Investing is a marathon, not a sprint. In the short run, nothing is predictable because stock prices are at the mercy of investors' opinions and emotions. But in the long-run, stock prices rise in tandem with corporate earnings. The global economy will continue to grow and well managed, innovative companies will increase their earnings over time. I'm not a betting man but there's one thing I'm willing to bet on - the S&P 500 hasn't experienced its last all-time high. This time will not be different. Eventually, the current bear market, not the world, will end. If you don't believe this, you probably shouldn't be invested in stocks. If history is any guide, investors who have the optimism and courage to remain steadfast in this latest bear market will be handsomely rewarded.