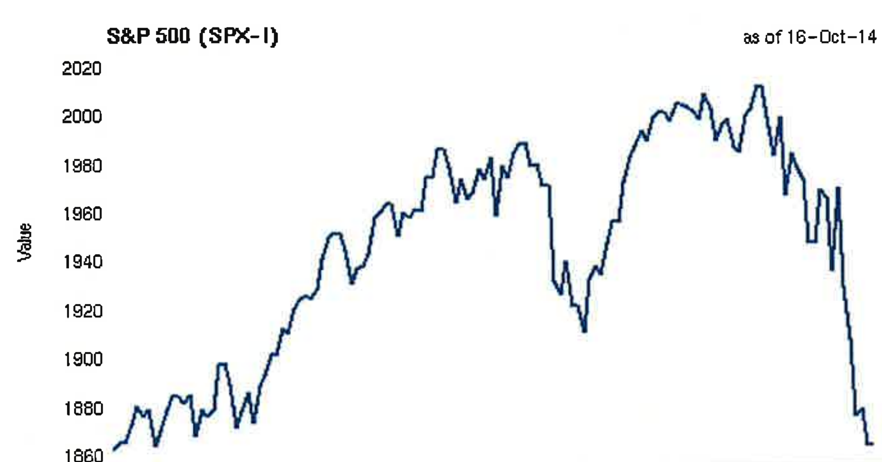
How to Survive the Coming Bear Market

As I write in mid-October 2014 the US market, as measured by the S&P500, has declined 9.8% from its recent highs. It may be over by the time you read this. Or not...

Financial media are quick to remind us that the S&P500, having more than tripled since the March 09 lows, and almost doubled since the last correction in 2011, is 'Teetering on the precipice' of another bear market[1]. Financial journalists run the requisite photos of alarmed floor traders. Allusions to 2009 underscore how bad it could be.

The chart below traces the US market decline as of October 16. Fearsome looking drop? Now, turn the page and consider the chart on page 2. It's the same market, the S&P500 index over the past 5 years[2]. Not so fearsome, is it? The point is that when you extend your time horizon out past the end of a media writer's nose, the decline of October 2014 becomes trivial in the scheme of the past 5 years. It's only slightly greater than any number of fluctuations, and less than the correction of 2012. So far, anyway ...

US Equity Market, 6 months



1 David Berman, Globe and Mail Report on Business front page article, October 2014.
2 Source Globe Investor; all market references to S&P500 unless otherwise noted.

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The truth is that the time between 10% declines averages 11 months; by September of this year it had been 36 months since the last one, so we were due for something[3]. This essay will hit market declines head-on. The bear you know is less fearsome than the one you don't.

A bear market is a decline of 20% or more. There have been 13 bear markets in the US since WWII[4], so you might think they happen about every 5 years, but that's not the way they work. The average bear market decline is about 30%, taking between 15 months (1998) and 3 years (1945), while the subsequent recovery varies similarly.

Declines of 10% - 20%, are known as 'corrections', and occur with similar frequency - there have been 14 of them since 1945. Declines of 10% happen so frequently that they don't have a name. In fact, when you run all the fluctuations together, the average decline within a year - from some high point in the year to some subsequent low point in the same year - is about 15%[5]. So markets decline all the time.

Second point: even the big bear markets are *temporary interruptions of a permanent uptrend.* Like a yo-yo on an escalator, the markets go up and down but the long term trend is always up. And the uptrend, if you are there for it, is fantastic.

The market peaked in 1946 at 19[6]. Today it is around 2000. So while those 13 bear markets inflicted temporary pain, the market went up over the same period by more than 100-fold - not including dividends (!). During my career of 30 years, there have been 6 bear markets, yet the market has gone up more than 12-fold, again, much more with compounded dividends. No other asset class comes close.[7]

US Equity Market, 5 Years

[3] Tetrem Capital Management October 2014
[4] References to declines, frequency, duration: Behavioral Investment Counselling, N Murray
[5] Average intra-annual US market decline 14.7% per Nick Murray newsletter
[6] Behavioral Investment Counseling p186
[7] Historical market data per Nick Murray Interactive, March 2014 p7. US real estate 1926 - 1992 = 8.7% vs the S&P500 at 10.3% and small stocks at 11.5% per Ibbotson Associates

Third, bear markets are not totally random, but they are not predictable either.

Markets and economies are, like most things in nature, *chaotic self-organized systems.* Like flocks of starlings or fractal mathematics, they seem quite random yet they have elements of definite patterns as well. As they say, 'Nothing goes up in a straight line'.

The smaller market fluctuations and corrections are much more random than bear markets. These random fluctuations, contrary to what financial journalism wants you to think, have little or nothing to do with global events. So when the headline reads, 'Markets decline on Ebola fears', it is not because a reporter analyzed some data and determined that markets were afraid of Ebola. It is a coincidence of two unrelated events that are erroneously perceived as having cause and effect. Fluctuations - both up and down - are largely random.

The biggest bear markets tend to have some common elements, such as euphoria and high valuations (1999, 1969, and 1929), yet bear markets can begin from modest valuations, triggered by economic shocks (2009). As Mark Twain said 'History doesn't repeat itself, but it does rhyme'. The message here is 'Bears are unpredictable'.

Finally, and probably most important, corrections and bear markets are unavoidable. You can't trade out of a market before a decline, and trade back in near the bottom. As Warren Buffet said, 'I can't do it, in fact, I don't know anyone who knows anyone that can do it'. That comment alone should end the discussion right there.

Trading out to miss a downturn is impossible to do consistently because you have to be exquisitely correct not once, but twice in succession: you need to sell close enough to a peak that the downturn continues and takes the price below what you sold at. And if trading out isn't difficult enough, you then need to buy in again before the price goes back up above what you sold at. Looks easy in retrospect but is trickier with real money.

Professional investors know and fear the 'whipsaw'. I learned the term my first year in the business. A whipsaw is where you think something will fall in price, so you trade out of it. But it keeps going up, so you buy back in at a higher price, just in time for it to fall. Not only did you miss the rise, but you were there for the fall. One or two whipsaws can rip through a lot of capital very quickly[8].

But don't just take my word for it. See Warren Buffett above.

What to do? Just nothing?

The difference may be nuanced to some, because the best thing to do in a bear market is usually nothing. But we aren't actually doing nothing - like a ship at sea, we have rigged for the storm long before it hits. Your portfolio has been designed for your specific risk tolerance, we have cash or bonds already in the mix if needed for withdrawals, and more importantly, you are aware that it is normal for your portfolio to go down from time to time. (This awareness is rarer than you think. If your advisor has deluded you into thinking your portfolio won't decline, fire him immediately and call me.)

Your investment managers have been selected because they invest where value is: high quality shares of companies with good management, strong financial fundamentals, decent prospects for growth, and whose shares are selling at reasonable prices.

8 A whipsaw can work on the way up, too: you buy something, thinking it will go up; but it falls; so you sell it, just in time for it to go up. You miss the upside and get all the downside.

Steering toward quality and away from risky speculation are of course no guarantee at all that your portfolio will 'outperform' anything, but it's funny how sometimes it has a way of working out.

Nevertheless, market corrections happen randomly, and we could see one any time. What should we expect?

My guess – when I began to write this essay in late August - is that many people will be easily spooked by a correction of only 10%. Investors remain traumatized by the near-death experience of the global capital markets in 2008/9. The trauma is not helped by the daily torrent of catastrophism from news media, who want nothing more than to feed your anxiety.

Today, the predominant emotion is definitely closer to fear than euphoria. The VIX index is a measure of market volatility and is widely regarded as a measure of fear. As of October 15th, with the market down only 9.5%, the VIX had spiked to 30, a level we hadn't seen since the summer of 2011 when fears of the Euro collapse sent the markets down almost 20%[9].

In January of 2014 the S&P500 declined a little less than 6%. The last week of this almost imperceptible decline saw the largest weekly withdrawals from equity investment funds and ETFs in United States history.[10] Just in time for the market to recover. See the paragraph on 'whipsaw' above.

Secondly, the market may be at 'all-time highs', but that is nothing to fear today. The market has only recently (mid-2013) regained the level first reached in 1999, now 15 long years ago. Those 15 years saw the tech crash of 2003, a recovery to previous highs in 2007, just in time for the 57% decline of the financial crisis. The last 15 years have been worse than 1969 – 1982, which is the only other time in 100 years (other than the 1930s) that we've had more than 10 years of zero return[11].

So, as much as the financial journalist scaremongers want you to believe we are 'defying gravity' in market stratosphere, it is more instructive to see that we have seesawed violently back and forth twice, and are only recently going higher than where we were 15 years ago.

More important than the market level is the valuation. Valuation reflects the emotional zeitgeist - the greed and fear - of the markets. Valuation describes 'what you get for your money' using measures such as the price to earnings ratio (P/E). The crushing bear markets are more likely with the euphoria of high prices, not average prices.

Interestingly, a VIX of 30 on a <10% decline indicates a high level of anxiety, which means that the correction may have done its job and could well be over. When there is fear on the newspaper headlines, you are much more likely at a market bottom, not a top.

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[9] Tetrem Capital Management, October 2014.

[10] S&P500 per Globe Investor, Nick Murray Interactive Newsletter July 2014; fund flows in dollars

[11] S&P500 10 yr. returns per CI Investment Consulting, 2012

During these 15 long years, the earnings of companies in the S&P500 have more than doubled, while the market went nowhere. This means that equity markets represent twice the value in terms of earnings than 15 years ago. Fifteen years ago the price/earnings ratio, was a sky-high 32. Today, based on next year's estimated earnings of about $125, the P/E is about 16, which happens to be right in line with the long term average[12]. So stock prices are average, not high.

Finally, the macro economic backdrop is positive and getting better: US economic growth north of 4% is very strong, a still-stunning 7.5% GDP growth for China, combined with declines in price of oil, coal, and grain are a huge boost for the global economy. Strong corporate profitability, and unemployment at 6.5% and 7% for the US and Canada[13] indicate that company earnings are well-supported by economic fundamentals.

Rising interest rates are not a great concern to equity markets at this point, because rising rates reflect an expanding and healthy economy. There is enough economic slack in the world that inflation is nowhere on the radar, so rates can stay on the low side for a long time yet.

The Euro zone remains flat as it struggles with a lack of political will for economic reforms, but is showing few signs of stress. As someone said, 'Europe may become the world's most beautiful museum: nice place to visit, but not much ever happens there'.

So my advice is do not fear the decline, whenever it may be. Know that it is perfectly normal, and quite unpredictable. Know that it too shall pass, as did the 6% this year, the 19% in 2011, and even the 57% in 2009. When we do see the next one, look for the calm serenity of other experienced investors, who know that when it's over, the markets will continue on their permanent uptrend.

[12] Average P/E ratio 1965 - 2014 = 14.1%, forecast P/E 16 per RBC Capital markets
[13] Data per The Economist, September 20, 2014

The Son Also Rises, Gregory Clark, Princeton University Press, 2014

Greg Clark is Professor of Economics at the University of California. Clark uses public records of births, deaths, university records (law and medical schools for example) and other data in Britain and France to look at the persistence of social status in families over hundreds of years. His finding, at odds with most traditional research, is that inequality is indeed persistent *at the family level*, even in egalitarian societies such as Sweden.

Clark finds that over longer periods of time, the primary determinant of a family's social status[14] is the social status of the parents, grandparents and their immediate relatives.

For instance, *Pepys*, a very rare surname in Britain (with only about 40 members in the 1600s), is far overrepresented in the upper reaches of British society. Since 1496, 58 Pepyses have been enrolled at Cambridge; 4 of the 18 Pepyses alive in 2012 were physicians, and the 9 who died between 2000 and 2012 left estates more than 5 times the average. Clark finds the chances of this persistence of high social status 'vanishingly small'.

Clark concludes that the persistence of inequality has a strong genetic component, but also demonstrates that there are strong learned elements to success, such as attitudes to obstacles, value of ambition or education, etc.: values that are absorbed from family. One surprising (but on reflection obvious) conclusion is that 'assortative mating' i.e., choosing a mate with similar values, can maintain a family's high social status 'forever'.

Although Clark too shares the typical academic critic's leftist inclinations, he reluctantly recognizes that the utopian goal of equality is not possible in a world where so much of success (and unfortunately failure) is learned from family values, and where parents try as hard as they do to have their children succeed.

The Son Also Rises is well written, academically rigorous, and a useful contribution to the discussion.

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[14] As indicated by occupation: physician, lawyer, university professor, elite university education, or leaving a large estate