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Preparing for a Bear Market

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As a long time financial industry professional, I often marvel at the pictures that accompany investment headlines. They often show a picture of a 'trading floor', with a concerned individual, in a sports jacket that looks more like a lab coat, wearing a phone headset, and jotting notes into some sort of electronic device. Surrounding him are other similarly anxious looking characters all crowded into a room that could just as easily be the flight deck of the Star Trek
Enterprise. When I see these pictures, I often think, "who are these people and where is this", because it bares absolutely no resemblance to financial services as most of us know it.

The point is this, these headlines and pictures of concerned, frantic faces are not designed to help you invest, nor are they designed to help you protect your wealth. They are designed to drive you to keep reading, so that more advertisers can get exposure to your eyeballs via clicks of your mouse. Since we're driven towards bad news however ("bad news is good copy"); it doesn't take long for us to convince ourselves that "the market" is doomed, and thus so are our investments.

Since this isn't a constructive way to look at things, let's address our fear by meeting it head on and consider an aspect of investing that we would rather not talk about, the bear market. Today we'll look at what a bear market is, why they happen, and what you can do about it.

Bear Markets Defined

Officially, 'bear market' is a term used to describe a decline of 20% or more in multiple broad market indexes like the S&P/TSX, the Dow Jones Industrial Average, or the S&P 500 over a period of two months or more. Typically a combination of bad news and pessimism drive investors into a blaze of selling, that is fed by media stories fueling their concern that "this time is different". And then as suddenly as it begins, the bear market ends. The credit crunch that began in October 2007 and ended in 2009 for example, drove the S&P500 down 57% from peak to trough, and then on March 10, 2009, it began to go up again and with the exception of a couple of minor setbacks, hasn't stopped since.

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Why do They Occur?

There are different causes for bear markets. The obvious one being a poor or slowing economy; however, two of the more recent bear markets have been caused by excessive valuation or “bubbles”. For example, in the late 1990s, the World Wide Web (internet) became available to the masses and this led to an excitement in technology that seemed unprecedented. New “dot com” companies were arriving on the scene daily and multi-millionaires were created seemingly out of thin air. Unfortunately no profits existed for many of these companies (or sales for that matter) and for the ones that did, their profits couldn’t keep up to the lofty prices people were willing to pay for their shares. It was a “new paradigm”, many would say, and “this time was different”. The old profitable companies were abandoned for the new dot com companies trading on the NASDAQ. Then something happened. The NASDAQ peaked on March 10, 2000 at 5048. Shortly thereafter, some of the larger companies on the index (like Cisco and Dell) began placing large sell orders on their own stocks. Panic ensued, the market plunged, and capital dried up. The dot com bull market was over.

The 2008 credit crunch was caused by an excess of borrowing by individuals and companies who were uncreditworthy, followed by a complex structure of leveraging up on that borrowing by financial institutions all over the world. While investors believed they were enjoying the ongoing safety of global financial companies, particularly the giant banks of the United States and Europe, and the lofty and consistent dividends that they paid (leading many to overinvest in them at the expense of adequate diversification), most failed to notice (with the exception of a few) that all of these companies were borrowing and lending from one another and were becoming more and more interconnected.

Then in March 2008, Bear Stearns failed, and JP Morgan was asked to buy them at an emergency price. This frightened the market, but it stabilized. In September 2008, Lehman Brothers went into bankruptcy, and the world found out just how interconnected the global financial markets were as those that had leant, or had investments with Lehman wondered how they were to get their money back, while all at once, every other financial institution around the world called in their loans from everybody else and nobody could pay. Down the market went until the US Federal Reserve Board intervened to stabilize the financial system. Of course the collapse of the global financial system led people to say “this time is different” and “it’s a new paradigm” and many abandoned the equity markets. Yet, for those who held onto their investments, or even better, added more money to their portfolios during those hard times, the benefits have been immense.

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What Should You Prepare for the Next Bear Market?

Historically, since World War Two and up to 2008, bear markets have occurred approximately once every four to five years or so. The market goes down temporarily and then it resumes its long term rise. We've now gone close to ten years without one and that has many people becoming concerned. Given that, what should you do? Here are three options:

1. You can sell and go to cash. You can always do this; however, is it the wisest decision? The key point to remember when you do that is that you actually leave yourself with two decisions to make. The first is when to get out and the second is when to get back in. It's the second one that is often most difficult. Consider yourself, when the S&P500 touched 676 on March 9, 2009, after declining from a peak of 1552 in July of 2007, could you have been a buyer? Many who got out during the credit crunch stayed out, and were still out in 2013 when the market got back to that 2007 peak. Today the S&P sits at a little over 2793. Many people who got out originally are still on the sidelines, not only missing out on the growth of the index, but the dividends (often higher and more tax efficient than GIC rates) that go along with equity investments.
2. You could leave your investments as is, and accumulate cash for a rainy day. Given our ten year bull market, and also given past history, doing this might create an opportunity to take advantage of the next bear market when it arises. But be prepared as you could be waiting a long time earning very little on that cash, while at the same time preparing yourself to pull the trigger when the time ultimately arrives (which it will – and remember, it will feel like "a new paradigm" and that "this time is different").
3. You could do nothing, but stick to the asset allocation that has been specifically designed for you based on your family's goals and needs, and rebalance periodically to ensure that you a) remain diversified, and b) don't get over-weighted in any one area of the capital markets. By following this discipline, you are adhering to the belief that there is no such thing as a "new paradigm" and that "this time is never different". The declines are temporary, and you will be invested for the resumption of growth, which is inevitable. This system requires no decision making and no market timing on your part; however, if you look back on the last 100 years or so of investment data, this is a system that has worked exceptionally well.

How LGK Wealth Management Can Help.

As we've often mentioned in past articles, we are not good at market timing. We don't know when the next bear market is going to arise, and when it does, we don't know when it is going to end. What we do know is that we believe that bear markets are temporary, and that your long term success involves you staying invested.

We build client portfolios based on the needs and goals that you and your family have for now and in the future. We analyse and interview managers so that we may identify those that will deliver solid relative returns through all cycles. In other words, we look to identify managers that do well during good markets (but not necessarily too well – i.e. are taking unnecessary risks), and that don't do too badly during bear markets (i.e. again, they have demonstrated an ability to manage their downside risk).

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If you're concerned about the markets we'd like to discuss them with you. That's what we're here for. We can't control the capital markets; however, we can control our behaviour and now is as good a time as any to ensure that we're both financially and mentally prepared for the next bear market.

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