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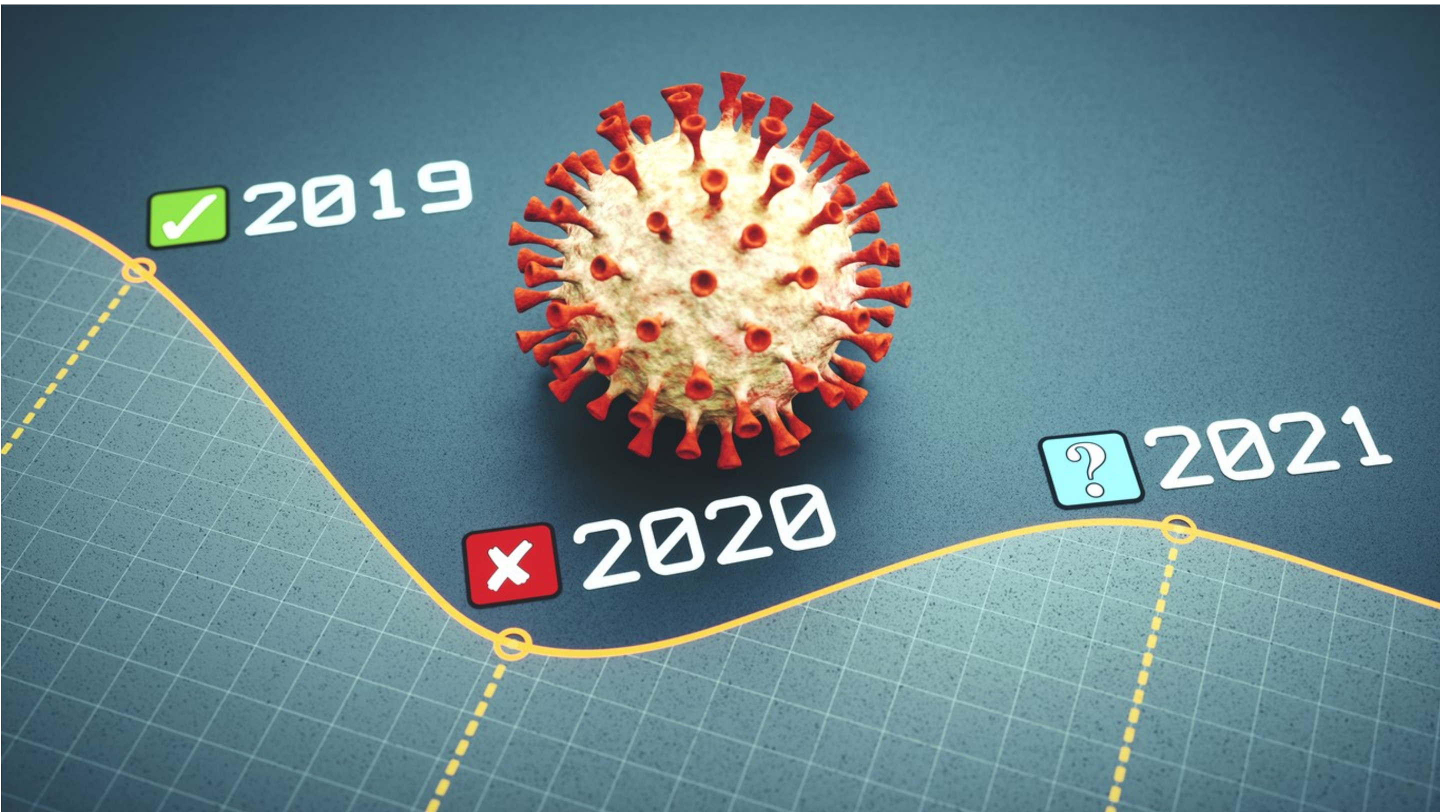

Are You Ready for the Next Bear Market?

Tips for preserving your portfolio when the markets fall

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When the market is on fire, investors are eager to take on additional risk. Everyone loves a bull market, and it can be tempting to think that *this time* it will never end. But during these bull markets, it is important to be prudent about market cycles and to carefully consider how your portfolio is aligned to weather the next *bear* market.

What is a Bear Market?

There are many ways to define a bear market. Generally, a bear market occurs when investors experience a decline of 20% or more during a two month or longer period.

Two recent bear markets have hurt investor confidence, and it's not hard to see why. Since the mid- to late-1990s, stock markets have seen an unprecedented amount of volatility and extreme behavior. The Tech Bubble of the early 2000s saw a -49% decline from peak to trough and the Financial Crisis saw market declines of over -56% from 2007 – 2009. Most recently, the COVID-19 pandemic resulted in the fastest and hardest drawdown ever witnessed; -34% in less than 30 days time. These meteoric rises and precipitous falls have left investors shell-shocked and wary.

The extreme volatility in the stock market has caused average investors to abandon tried-and-true investment strategies. Even worse, many have held on to mountains of cash or fled to the supposed safe haven of gold and other precious metals. As a result of this fear-based asset management, the performance of many investors has been lackluster, even though the market is currently near an all-time high.

Should I Go Back to Buy-and-Hold?

For many years the idea of "buy-and-hold" has dominated financial advice. The idea is to buy great companies and resist the temptation to sell them when the markets are down. Warren Buffett hints at this approach when he says that investors should think and act for the long-term. Unfortunately, this approach can cause real problems when a bear market strikes.

While "buy-and-hold" might make sense for a 30-year-old investor, there comes a point when a person's time horizon becomes quite short. Many investors need their portfolio to provide a certain amount of income during retirement. What happens if the market undergoes a strong downturn just before that income stream is needed? Retirees do not have the luxury of waiting years to make up bear market losses. A -40% downturn for a retiree can be catastrophic. If you depend on your savings for income, or plan to in the near future, it is time to rethink your buy-and-hold strategy.

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What are the Biggest Mistakes that Investors Make During a Bear Market?

The primary mistake investors make is not having a plan of action before the bear market hits. Many people keep emergency supplies in case of a natural disaster, but few people adequately prepare for a financial disaster. The key to surviving a bear market is to plan ahead.

Failing to have a plan of action leads to panicked or emotional decisions that can be very costly. Over and over again, we have seen investors sell their holdings and run to cash at or near the market's low point. This is not a lack of discipline or a failure of investors to "stick to their guns." Investors who decide to sell everything in a bear market generally do so because they do not know what else to do. Because they lack a plan, they take drastic measures that can ultimately make matters worse.

A common mistake in a bear market is incorrect *asset allocation*. A sound portfolio is one that anticipates bad markets and is designed to withstand the downturns that inevitably happen over time. Portfolios that hold up well during bear markets tend to be well-diversified between asset classes like stocks, bonds, cash, and alternative investments.

Another mistake many investors make is incorrect *diversification*. They may be tempted to hold real-estate investment trusts (REITs), global equities, commodities, and "defensive" sector equities to diversify their portfolio. In reality, each of these asset classes may in fact move in unison with a down market, as seen in this piece in the American Association of Individual Investors journal . Do not mistake magnitude of returns for correlations between securities. REITs, global equities, and the other examples listed above may provide higher returns in a bull market or decreased losses in a bear market, but they may still move in the same direction as equity investments and follow the general trend of the market.

Perhaps the worst mistake made by investors is after the bear market ends. By staying on the sidelines and keeping their money out of the market, investors take all of the losses and miss out on the early gains from a young bull market. Buying high and selling low will lead to disappointing investment performance.

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How Do I Prepare for a Bear Market?

After two "once-in-a-lifetime" bear markets in less than ten years, investors realize their broker's advice to "stay the course" is inadequate in light of today's economic conditions. If you want to effectively prepare for a downturn, you need a more sophisticated approach to investing. The first step to prepare for a downturn is to know what you own. Have a look at your account statements and understand what you hold and why. If you have questions about particular holdings, call your financial advisor for an explanation.

Consider your allocation across individual positions and across asset classes. Are you well-diversified? Is your portfolio concentrated heavily in one area? Concentrated positions can exacerbate downturns and make a bear market even more painful. Portfolios with a healthy amount of diversification have less business-specific risk, and are more protected in a bear market. If you have few holdings that make up large percentages of your portfolio, you are exposing yourself to business-specific risk in the next bear market.

Alternative investments can be an overlooked asset class, but they can be incredibly important to preserving – and possibly growing – wealth during severe downturns in the market. We define alternative investments by what they are *not.* They are not bonds, stocks, or cash. Managed futures, hedge funds, private equity, and financial derivative products all fall under this category. Because they tend to be more exotic investments they are generally held by institutional investors or high-net-worth individuals. The returns from these investments can have low or negative correlations to the returns seen from stocks and bonds. This means alternative investments can move separately from stocks and bonds, a good trait in a bear market.

"I See What You Mean" – *Lawrence Argent*

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Ensuring your portfolio is bear market ready is not a one-time job.

Alternative investments carry additional risks. They tend to be complex, can have few regulations, and are often illiquid. Despite these risks, alternative investments can be helpful hedges for the right investor. Seek the advice of a highly qualified financial advisor to see if they make sense given your personal needs, risk tolerance, and goals.

The next step is to decide where your "breaking points" lie. Take some time to sit down with a pen and paper and be honest with yourself. Under what sort of conditions would you decide to take a more conservative approach to your investments? At what point would you be tempted to sell most or all of your assets? Your ideal portfolio should be designed to never cross that threshold.

It is critical to remember that your portfolio should be *designed* never to cross your breaking point. That does not mean it won't, it should just have a high probability of keeping you above your threshold limits. In a catastrophic situation you can always find well-designed portfolios taking big losses. Plan for a worst-case scenario and set your loss limits before a bear market hits.

Finally, you should make changes to your portfolio and adjust your asset allocation to match your thresholds. When the inevitable bear market does come, stick to your plan and do not let emotions affect your decision making.

Recap

You should avoid heavily concentrated positions, properly diversify, reserve some of your portfolio for investments that will limit your losses, such as alternative investments, and decide on loss thresholds that shape your investment strategy. Ensuring your portfolio is bear-market ready is not a one-time job. It requires rebalancing and monitoring your investments to ensure they do not become too closely correlated to one another. Many investors do not have the time, tools, or knowledge, to build and maintain a bear market-resistant portfolio. Preparing for disasters is unsettling work. But you might be able to get a bit more sleep at night knowing you have a plan. Whatever your strategy, don't go at it alone. Find a financial professional to help you anticipate and prepare for the worst.

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