

Optimize your
Outcomes

*Is Your Portfolio Ready for the
Next Bear Market?*



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Blue Mesa Reservoir, near Gunnison, CO

What is a Bear Market?

There are many ways to define a bear market. We consider a bear market one in which investors experience a decline of 20% or more over the course of two consecutive months.

Two recent bear markets have hurt investor confidence, and it's not hard to see why. Ever since the mid- to late-1990s markets have seen an unprecedented amount of volatility and extreme behavior. The Tech Bubble of the early 2000s saw more than a 40% decline from peak to trough and the Financial Crisis saw market declines of over 50% from 2007 – 2009. These meteoric rises and precipitous falls have left investors shell-shocked and wary.

One of the consequences of this lack of confidence is that many investors have abandoned tried-and-true investment strategies. Even worse, many have held onto 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, many investor's performance has been lackluster even though the market is currently around all-time highs.

So 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 hold them long-term. Warren Buffett has an approach similar to this when he says that investors should think and act for the long term. Unfortunately, this approach can cause real problems when turmoil strikes.

While "buy and hold" might make sense for a 30-year-old investor, there comes a point where a person's time horizon could be 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 many years to make up bear market losses, and a 40% downturn for a retiree can be catastrophic.



Roaring Fork Valley, near Aspen, CO

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

One of the primary mistakes investors make during highly volatile times with big losses is not to have a plan of action in place prior to the start of the bear market. Many people keep emergency supplies of water and fuel around in case of a natural disaster, but few people adequately prepare for a financial disaster; this failure to look ahead can be catastrophic. Failing to have a plan of action often 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 just a lack of discipline or a failure of "stick-to-itiveness." Investors who decide to sell everything 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.

Another common mistake is having the wrong allocation. A sound portfolio is one that anticipates bad times 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.

Alternative investments can be an overlooked asset class, but they can be incredibly important to helping preserve – and possibly even grow – 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 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 or entities. Additionally, alternative investments carry additional risks. They tend to be complex, the regulations governing them can be sparse, and they are often illiquid.

But for the right investor, alternative investments can be helpful hedges.



Red Canyon Overlook at Flaming Gorge Reservoir, near Dutch John, UT

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.

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 or is your portfolio concentrated in more than one area? Concentrated positions can exacerbate downturns and make a bear market even more painful.

Do you own any alternative investments? If you do not hold anything in your portfolio that is designed to hedge by limiting losses during a downturn, it could be time to explore this asset class. Seek the advice of a highly qualified financial advisor to see if they make sense given your personal needs, risk tolerance, and goals.

Once you have assessed your holdings, the second 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? An ideal portfolio for you should be designed to never cross that threshold.

Of course, it’s critical to remember that your portfolio should be designed never to cross that threshold. That does not mean it won’t. In a catastrophic situation you could very well find even a well-designed portfolio taking big losses. Knowing this, you must plan for this worst-case scenario and have a strategy in place to reduce risk and stem losses. But just as important is having a plan to bring your allocation back to its proper state once the markets stabilize.



Taylor Park Reservoir, near Almont, CO

Finally, you should make changes to your portfolio if there are gaps in your allocation. Many investors do not have the tools, knowledge, or interest to build a bear market-resistant portfolio. If you fall into that group seek out a financial professional who is competent and experienced enough to help you with this step.

Preparing for disasters is unsettling work. But you might be able to get a bit more sleep at night by knowing you have a plan. Whatever your strategy, don't go it alone. Find a financial professional to help you anticipate and prepare for the worst.

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