

Surviving Bear Markets

Risk, Discipline, and Opportunity

by Ken Robinson

When the market goes down, it usually takes investor confidence with it. It is crucial for our clients to understand the nature of bear markets and The Monitor Group's strategy to overcome them.

Risk

Risk management is the most important element of the investment process. As many investors learned during the recent bear market, ignoring risk and focusing solely on potential returns can be disastrous. The two primary sources of risk within investment portfolios are business risk and market risk.

Business risk is company specific and represents the danger of permanently losing your entire investment in the stock of an individual firm. Business risk is also known as **diversifiable risk** because it can be practically eliminated through diversification. There is no justifiable reason to subject a portfolio to business risk. With diversification across more than 8,000 stocks in the equity portion of the The Monitor Group portfolio, business risk is virtually non-existent.

The second type of portfolio risk is **market risk**, which refers to the up and down cycles of the overall market. With business risk virtually eliminated through diversification, the primary source of portfolio volatility is market risk. It is also referred to as **non-diversifiable risk** because it cannot be diversified away and is present in all equity portfolios. The unpredictable nature of stock market cycles and economic events will never go away. Therefore, it is important for clients to expect these unavoidable cycles and more importantly to avoid emotional reactions by staying focused on long-term objectives and avoiding the urge to "bail out" during the inevitable downturns.

Discipline

Sticking to a carefully designed long-term plan and remaining fully invested throughout these market cycles allows the investor to avoid the pitfalls of panic selling and market timing. Panic selling results in *selling low* while the markets are down and locking in losses. Attempting to time the market and "get back in at the right time" usually results in *buying high* after missing a significant portion of a market recovery.

Markets usually turn around quickly. Frequently, the majority of gains for any given year are earned during one brief "spurt" over a period sometimes as short as one month. Two good examples were the bear markets of the early 1970's and the most recent downturn of 2000-2002. The S&P 500 was down 14.67% in 1973 and 26.46% in 1974, only to come roaring back in 1975 and 1976 with annual returns of +37.21% and +23.85% respectively. The S&P 500 generated a total return of 41.84% during the first six months of 1975, and a total return of 14.97% during the first three months of 1976. Following the most recent bear market of 2000-2002, the S&P 500 returned 28.69% in 2003. The majority of the S&P 500 returns in 2003 were achieved over the two-month period of April and May during which the total return was 14%. Discipline pays dividends!

Opportunity

Despite the unpleasantness of bear markets, there are two valuable opportunities during these unavoidable down cycles - Rebalancing and Tax Loss Sales. Rebalancing serves a crucial role in risk reduction. Rebalancing involves selling from asset classes that have out-performed and buying into asset classes that have under-performed. This allows us to maintain your target weights for each asset class within the portfolio, which is essential to preserving the low risk characteristics of your portfolio design. Rebalancing also has a very positive effect from a performance standpoint by systematically “selling high” and “buying low”, the direct opposite of the market timing pitfalls mentioned above.

In non-qualified (taxable) accounts, opportunities for tax loss sales often arise during a downturn. Tax loss sales allow you to realize tax losses that can be used to offset or “cancel out” taxable gains. If there are more losses than gains in a given year, current tax law allows you to take up to a \$3,000 deduction against ordinary income and then carry forward the remaining losses indefinitely. The key to tax loss sales is to find a suitable alternative investment in the same asset class to hold as a replacement for the one being sold. This allows you to remain fully invested while simultaneously generating tax savings.