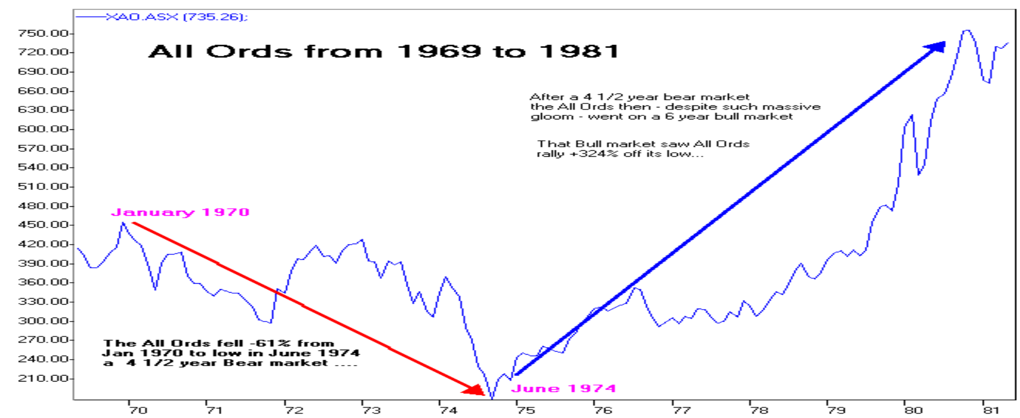
How to preserve and make money in a Bear market?

Almost five years into a bear market, readers will instinctively want to know for how long this bear market will continue. Investors that have their portfolios aligned to their long term needs and risk tolerance are well diversified across asset classes and defensive shares. Those who try to time markets will be a little more anxious. With timing being a cardinal sin of investing, where few get it right with any consistency, portfolio construction therefore must remain a key focus for investors. It is never too late to get this in order with the help of a good adviser.

Let's start by defining what is a 'Bear Market'. Investopedia suggests that "it is a general decline in the stock market over a period of time and reflects a transition from high investor optimism to widespread investor fear and pessimism". Vanguard refers to "a price decline of 20% or more over at least a two-month period "

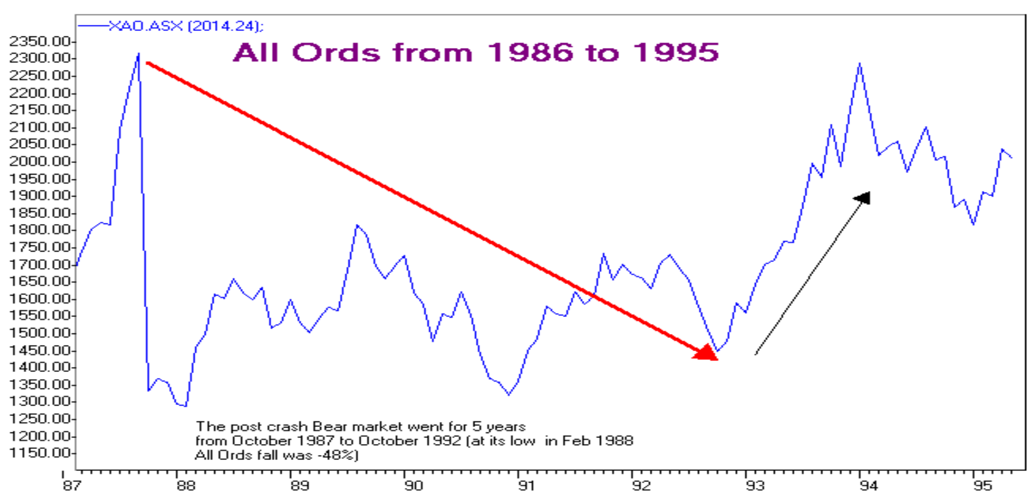
Past major bear markets in the Australian All Ordinaries have been as follows:

Jan 1970 to June 1974 Fall of 61% 4 ½ years June 1974 – June 1980 +324%



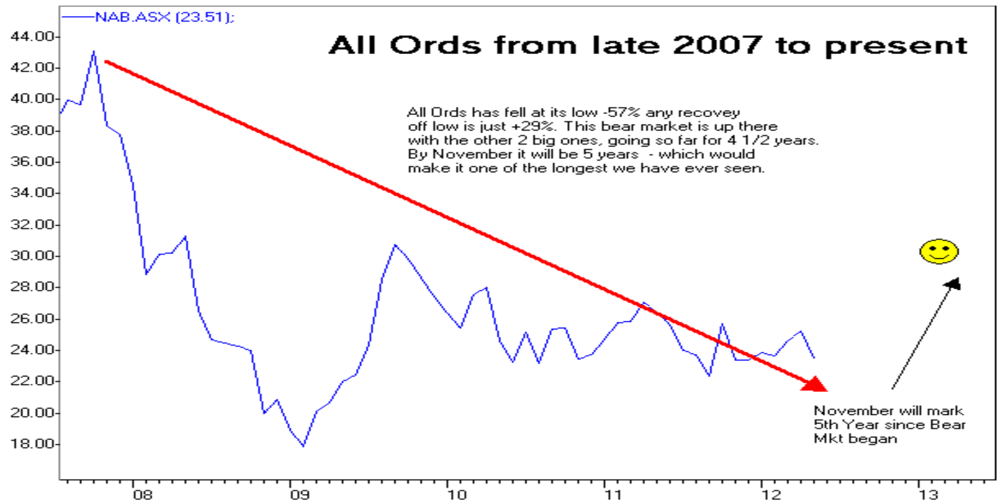
Source: Goldman Sachs

Oct 1987 to Oct 1992 Fall of 37% 5 years Oct 1992 – Dec 1994 +57%



Source: Goldman Sachs

Nov 2007 to July 2012 Fall of 40% 4 ¾ years



Source: Goldman Sachs

In the US, the Wall Street Crash of 1929 lasted until 1932 when the market fell by 89%, marking the start of the Great Depression. After a pronounced rally between 1932-1937, a five year bear market followed from 1937 to 1942. The most recent US experience was the GFC bear market between 2 Oct 2007 and 11 Mar 2009 – a fall of 51% in less than two years - followed by a 84% recovery to 6 July 2012. This makes the Australian five year bear market difficult to fathom.

In nearly every case, the bear market trend appears to have four distinct phases:

1. Sharp decline
2. Sharp rally – damaging those who sold after the initial sharp decline
3. Sideways move – historically have lasted 2-5 years
4. Recovery period – starts with highly sceptical ‘bear market rally’ amid fear and pessimism

So today after nearly five years of a bear market, with fear and pessimism rife, one has to ask what may be the right strategy? That would depend upon your present portfolio allocation and again the trade off between the correct investment decision, your needs, wants and your ‘sleep at night factor”. Your current adviser must help with this planning strategy. With no-one knowing when a sustained recovery may commence, Peak believes a deal of bad news is priced into markets and possess some classic bear market traits:

- Cash levels at record levels; equity holdings at multi year lows; bond yields at 61 year lows; Europe in crisis with China and US slowing; brokers laying off staff while corporate balance sheets across the globe are in the strongest shape for decades.

Bear market strategies are most realistically implemented at the beginning of stage 3 – the sideways movement period post crash and rally. It is worth recalling that in Australia, the market gained over 135% between 13 March 2003 and 29 October 2007. Sellers in March 2007 would have created sizeable capital gains and potential tax. While this is challenging in a high tax environment, it importantly reminds us that the investment decision should always come before a tax one!

I am also reminded that great businesses and share portfolios are started during the latter stages of a bear market. By way of example in a study of twelve post World War 11 bear markets in the US:

- Investors who bought **one week** after market rally began saw a 24.3% return during the first year of recovery (Source: MarketWatch report)
- Investors who bought **three months** after market rally began achieved 14.8%
- Bloomberg tells me that US investors withdrew a record $194bn from stock and mutual funds in 2008 after the initial crash. These fund investors would have missed out on the 2009 rally and I suspect may not re-enter the market until well into the recovery rally
- 'Dollar cost average' buying over the latter stages of a bear market can produce tremendous returns for those investors, who can then enjoy the early stages of the next bull market. This avoids the vagaries of timing.

So while history infers that we may, we hope, be in the latter stages of a bear market, let us still look at some strategies that may still be applicable should the present bear market continue for a while longer or indeed help us to prepare better for the next one!

1. Investors can diversify their portfolios across the following asset classes, ensuring that proper diversification is achieved across asset classes that are **not** correlated:
    a. Government Bonds – not a mature market in Australia for retail investors as with US Treasury Bonds or UK Gilt edge securities
    b. Corporate Bonds and Fixed interest hybrid securities
    c. Domestic Equities including listed property trusts
    d. International Equities inc Domestic equities with strong overseas earnings
    e. Alternative investments including Hedge funds and Unlisted investments
    f. Long and short term Cash

2. During crash conditions, equities have tended to have a contagion effect irrespective of their market location. Investors will also have a tendency to retreat to their home base as diversification benefits are ignored. Nonetheless an early allocation to bonds, a reduction in equities and an increase to longer term cash will provide some protection against a prolonged bear market.

3. In Australia with term deposits now under 5% and 10 year government bond yields at under 3.5%, one can see that these values reflect the maturity and the fear element of the bear market. The Equity market generally paying dividends of over 5% plus franking credits is being widely overlooked. Capital preservation appears most important. It maybe ironic that while much of the western world is in the grips of deflation (falling consumer and asset prices), Australia is in a 'hybrid situation' with a blend of high cost growth from its resources to China, a recessionary East coast and rising taxes and utility costs.

4. However it is important to recognise that Australia has various stocks and sectors that Peak believes possess good defensive qualities during the bear market sideways period (2010-2012). They have both preserved and enhanced capital. We encourage our clients to look at 'total returns' from their holdings, being capital return plus dividends and franking credits or deferred

tax benefits. Let me run through some of these more defensive sectors, stocks and dividend yields:

a. Banks (ANZ)	paying dividends of 10.3% inc franking
b. Listed Property Trusts (Stockland)	paying tax deferred dividends of 7.7%
c. Utilities (AGL)	paying dividends of 6.0% inc franking
d. Infrastructure (Transurban,Duet)	paying tax deferred dividends of 5.7% to 9%
e. Healthcare Stocks (Ramsay)	low dividends but reliable earnings
f. Food Consumer Stocks (Wesfarmers)	paying dividends of 8.2% inc franking
g. Telecom Stocks (Telstra)	paying dividends of 10.4%

5. I have mentioned above the aspect of franking credits to provide fully franked dividends. This can be worth up to 1.5% extra return to a portfolio of fully franked shares. In a bear market and by nature a lower return environment, this 'gift from the government' should not be overlooked, particularly from the defensive shares mentioned above.

6. For those investors who have the time and skills to trade successfully (a rare phenomenon!), there are 'options and futures strategies' using derivative instruments of varying complexity. Experience or experienced advice is paramount before using such instruments. The most simple would be 'buying a put' on either an individual stock or on the market that aims to profit from falling prices. The maximum loss for investors is the amount paid for the option or futures contract. To make a profit, investors need to correctly anticipate the date stock price begin falling and then to close out the position before the expiration date. A specialist skill indeed.

7. Many such short term traders and portfolio managers will follow technical analysis (' charts') closely as a means to assess the short term behaviour of stocks and markets. Such charting work is another strategy in a bear market for limiting downside risk and recognising quickly when a trend starts to deteriorate.
    a. Adopting a 'stop-loss strategy' by taking losses at say a 15% loss – of course we would automatically do this if we knew the market was to fall 55% in 15 months!(Nov 2007 to Mar 2009)
    b. Selling upon a breakdown of a downward resistance point – history tells us that stocks can fall rapidly from these levels

At Peak, we have managed portfolios for individuals during the big bear markets of 1987-1992 and the present one. Our value-add comes from a combination of detecting the bear/bull trend early and being in the right stocks within both trends. Most importantly our experience ensures that client's portfolios reflect the right balance between their return needs, their wants and crucially their risk tolerance or 'sleep at night' levels.

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