The New Survival Guide For Bear Markets

By Blaine Thiederman MBA, CFP
Founder and Principal Advisor
Progress Wealth Management

Table of contents

What is a bear market and should I be concerned?

Bears are among nature's most majestic creatures, but get too close to one and the experience can be terrifying. The same can be said for bear markets. Since 2000, two major declines wiped out nearly half of the stock market's value. Today, an entire generation of investors seems convinced that an appropriate investment strategy is "anything but the stock market." We disagree. On the contrary, we believe market declines are a normal part of the investment process and, if managed properly, can actually provide an opportunity for investors with a long-term perspective.

What is a Bear Market?

Stock market declines of 20% or more are referred to as "bear markets" because a bear attacks by swiping its paws downward. Stock market increases of 20% or more are referred to as "bull markets" because a bull attacks by thrusting its horns skyward.

- Recognize that stock market declines occur frequently and are a normal part of the investing process.
- Understand that, historically, bear markets tend to be short and have always been followed by bull markets. In the past, these bull markets have more than made up for the losses incurred.
- Know that market declines can occur at any time for any reason. They are wholly unpredictable.
- Attempts to avoid market declines usually result in lower long-term returns because investors rarely get back in the market in time for the next upswing.
- An investor's appropriate defense against short-term setbacks in the stock market, in our opinion, is to own quality investments in a well-diversified portfolio that is professionally managed.

	1 Yr	3 Yr	5 Yr	10 Yr
U.S. Large Stocks	19.7	10.0	13.8	7.4
U.S. Small Stocks	19.3	9.6	12.7	7.5
U.S. Bonds	0.6	2.8	2.2	4.3
Intl Markets Stocks	22.1	3.8	6.9	1.6
Intl Emerging Mkts Stocks	26.5	4.2	4.7	2.0
U.S. Inflation (CPI)	1.7	1.0	1.2	1.7

Source: Morningstar. Annualized returns for periods ended September 21, 2017. U.S. large stocks is the S&P 500 Index, U.S. small stocks is the Russell 2000 Index, U.S. Bonds is the Barclays US Aggregate Bond Index, Intl Developed Markets is the MSCI All Country World Index Ex-US, International Emerging Markets is the MSCI Emerging Markets Index. Returns include dividends and interest. Past performance is not an indication of future results. All indices are unmanaged and may not be invested into directly. The Indices mentioned in this report are unmanaged, may not be invested into directly and do not reflect expenses or fees.

PROGRESS
WEALTH MANAGEMENT

A Brief History of Bear Markets

Bear markets are often (but not always) triggered by downturns in the economy. The following table shows the history of economic contractions and expansions since 1854:

Contractions	Expansions	Average length:
1854-present	18 months	40 months
1945-present	11 months	63 months

Source: National Bureau of Economic Research (NBER)

As you can see, contractions tend to be short - lasting less than a year in the post-war period. On the other hand, expansions since World War II have lasted 63 months, or over five years.

The history of the stock market is similar to the history of the economy. Since 1928, the stock market, as measured by the S&P 500, has experienced 32 bull markets (defined by rallies of 20% or more) and 32 bear markets (defined by declines of 20% or more). But, historically, the bull markets have been larger in magnitude and duration than the bear markets. In fact, in the post-War period, bull markets have averaged a gain of 278% and lasted 68 months, or twice as long as the average since 1928.

The Anatomy of Stock Market Bull/Bear Market
S&P 500 (1/3/1928 to 9/19/2017)

	Average %	Average Length
Bull Markets	+158	34 months
Bear Markets	- 34	8 months

Source: Ned Davis Research

Market history suggests that market declines are quite frequent. Most dips (declines of 5%) in the Dow Jones Industrial Average don't turn into anything serious. Corrections (declines of 10% or more) occur, on average, once a year. Bear markets (declines of 20% or more) occur, on average, once every three or four years.

Why not just get out of the stock market before it goes down, then get back in before it goes back up? We believe forecasting turns in the economy and the stock market is a futile exercise.

The National Bureau of Economic Research is the official "scorekeeper" of economic recessions and expansions.

Here is a list of when the last few turns in the economy were officially recognized by NBER.
Note how long it takes for the "experts" to recognize changes in the economy - 11.6 months or nearly a full year after the economy has changed direction!

Peak/Trough	Announce Date	Months
June 2009 trough	Sept, 2010	15
Dec 2007 peak	Dec, 2008	12
Nov 2001 trough	July, 2003	20
March 2001 peak	Nov, 2001	8
March 1991 trough	Dec, 1992	21
July 1990 peak	April, 1991	9
Nov 1982 trough	July, 1983	8
July 1981 peak	Jan, 1982	6
July 1980 trough	July, 1981	12
Jan 1980 peak	June, 1980	5
Average		11.6 months

Even more difficult than calling the turns in the economy is anticipating turns in the stock market. The chart at the bottom of the next page shows how, historically, the stock market turns (dips) lower *before* recessions begin, and turns (climbs) higher *before* recessions end.

Bears can't be reasoned with. Bear markets can be tamed by sticking to sound investment principles.

The most successful strategies, historically

Surviving Bear Markets

Of course, the best time to prepare for a market decline is before one happens. In our opinion, the four most important necessary elements to survive a bear market are diversification, quality, a long-term perspective, and professional management.

Understanding your tolerance for risk is an important step towards building a portfolio that can withstand a bear market. By not having all of your portfolio invested in the stock market, your portfolio should fall less than the stock market when it does go down. In other words, owning investments that are unrelated to the stock market should help dampen the impact of a stock market decline. This is the principal of diversification. Quality investments are typically those that have stood the test of time, as well as sound fundamentals. They are like tennis balls—they bounce back after they fall. Poor quality investments are like eggs—when they fall they just break. Never hold investments today that you would not want to own in a bear market tomorrow. Maintaining a long-term perspective means maintaining control of your own emotions and not making a long-term investment decision in reaction to short-term events.

It also means giving quality investments time to work. Hav- ing your investment portfolio professionally managed means having your investments professionally selected, managed, monitored, and rebalanced when appropriate, which is what takes place within our Model Wealth Pro- gram. Having a calm voice and a steady hand guiding you can be an invaluable resource when markets misbehave.

It's all about Maintaining a Long Term Perspective

Some investors look at all of this history and suggest "this time is different." They believe that the challenges we face are insurmountable, or that the prospects for the U.S. economy are significantly worse than in previous periods. They long for the "good old days" when the outlook was much rosier. We disagree. It's human nature to remember the good things that happened in the past and to forget the fact that our nation's progress was achieved only after spilling a good deal of blood, sweat and tears. Here's a little walk down memory lane of some of the challenges we faced in the past, some of which were quite a bit more difficult than what we seem to face today.

The Least Successful Strategies, Historically

Before losing faith in the economy, ask if any of the below events were as bad or worse.

1929 Stock Market crash

1933 Great Depression, NYSE closes for Bank Holiday

1941 Pearl Harbor

1950 Korean War begins

1955 Eisenhower heart attack creates wave of selling

1961 Bay of Pigs nuclear showdown

1963 Kennedy Assassinated

1968 Tet Offensive (Vietnam), King Assassinated

1973 Arab Oil Embargo

1974 Nixon Resigns

1980 Prime rate hits 21 ½%

1982 Worst recession since WWII

1987 Market drops 508 points, or 22.6% in single day

1991 Gulf War I

2001 911 attacks

2003 U.S. invades Iraq

1997 Dow plummets 554 points on October 27

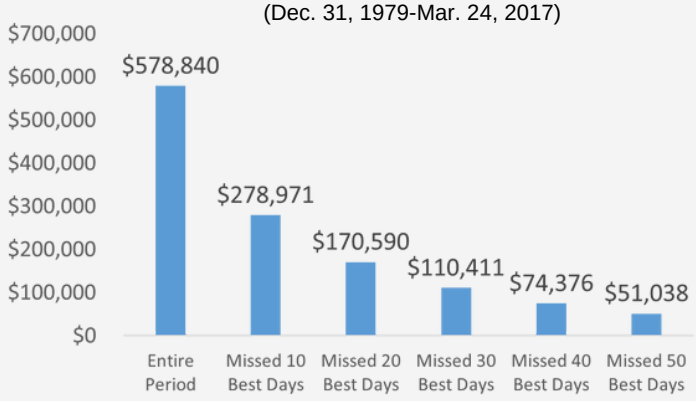
2001 Enron collapse, bursting of the tech bubble

2008 Worst financial crisis since the Great Depression

Lessons for investors

In our view, the lessons are clear. As legendary inves- tor Sir John Templeton once said: The four most dan- gerous words in investing are: this time is different. History has shown that, in spite of the many challenges we always face, our nation, and our financial markets, have always persevered. An investor's greatest ally is a calm voice and a steady hand that can guide him through difficult times. His greatest enemy is the emo- tions that can distract him from achieving his long-term investment goals. The emotion of fear can reach its peak during major market declines. It is our hope that this report has provided the necessary perspective to help you survive the next bear market, whenever it might occur.

Market Timing can be Problematic
Value of a $10,000 investment in the S&P 500
(Dec. 31, 1979-Mar. 24, 2017)



Key Points:

- If you're well-diversified and rebalance when appropriate, all that's required is patience.
- If you hold bad stocks in a recession with poor fundamentals compared to their competition, your investment strategy is mostly based on a hope and a dream.
- If you have a job that's likely to lay off employees when times are tough, you should ensure you have sufficient emergency funds to cover your time until finding new employment

Why Today Is Different Than the Past

Every time we turn on the news, we hear how bad everything is doing. Covid 19, inflation, war, supply chain issues, interest rates, Partisanship. Gridlock. Biden stalled. Trump ranting, etc. The economy is in fact, doing well despite what the news is telling us.

Given the fact that the news tells us that everything is going to hell, it's not surprising that Americans everywhere have less than positive feelings about the economy. However, the actual data about our economy point in a radically different direction: up. This doesn't mean that emotional moves driving our markets one way or another aren't unlikely but it's important to recognize when markets are depressed because of economic data or because of consumer sentiment mostly driven by politicians and our media outlets.

If you take a big step back things look different than how they're portrayed. The various ways we gauge our economy's health are almost all as good or better than they've been in years. In fact, better than they've been since the beginning of the 21st center. GDP Growth, unemployment rates and average wages are all moving in the *right direction.*

*U*nemployment is at about 4%, a multi-year low even with places like New York City lagging behind; GDP growth is expected to be above 6% for 2022, the best since 1984. Wage growth for the bottom of the economic pyramid has been notable for the first time in a generation. In fact, wage growth for the bottom of the economic pyramid has actually been faster than the one thing that dampens the picture: inflation. While it's true that inflation is bad for low earning consumers, it's not true that high inflation is terrible for an economy. Things figure themselves out, eventually.

What makes today truly different is that we have the strongest economy that we've had during a market downturn in over 4 decades. Despite how painful this bear market is, there are FAR more reasons to be optimistic than pessimistic about our future rebound.

What Opportunities Exist Within a Bear Market

When To Make A Change

The first step is to ask yourself if it actually makes sense to make a change to your investment strategy during a bear market because many of us shouldn't.

Before making any changes, be sure to talk to a financial planner or a tax professional. This is purely financial education and not advice.

What to look for?

1. When a lot of your investments are concentrated in highly speculative stocks that you aren't sure will rebound.
2. When your job is at a high likelihood of being laid off because of company cutbacks.
3. When you or a family member is sick and you potentially need to pay for major medical bills out of pocket above and beyond what your health insurance and emergency fund can support.

If any of these sound like you, it's **possible** you may need to make a change.

What kind of change might you want to consider?

1. If you're overweight on any one stock that's unlikely to rebound as fast as the broad market, it might make sense to sell and reinvest the funds into a broadly diversified portfolio of stocks and bonds in line with your risk tolerance and goals.
2. If you have a job that's highly likely to be eliminated in the near future and you're confident it'll take you longer to find a new one than what you can afford to support with just your emergency funds, you may need to sell to pay your bills despite markets not having rebounded. Sell the day you get laid off or immediately, if you think markets will fall further.
3. If you expect major medical bills in the near future and believe it's likely markets will fall further, it might make sense to sell the investments immediately that ensure the affordability of the medical costs.

Financial Planning Opportunities

The real questions you need to ask yourself when you're managing your financial life during a bear market is, "what empirically provable strategies are truly available RIGHT NOW that won't be when markets rebound." Many don't realize the opportunities they may be missing out on.

Roth Contributions and Roth Conversions

Many people whom are high earning individuals mainly contribute pretax because it defers a tax bill until retirement, however, contributing to a Roth 401k or IRA can be incredibly valuable in the middle of a bear market because you can benefit as the markets rebound substantially and tax free. Just be sure you under under the income limits for contributing to a Roth IRA before doing so.

In addition, a Roth Conversion can be a valuable move at this point in time. By converting a portion of your pretax portfolio at this point, you'd pay a hefty tax bill (all converted funds would be taxed as ordinary income) but your portfolio would also rebound tax free as well. Read our article on Roth Conversions here if you want more info.

Exercising your ISO's, NSO, NQSO's and buying the stock.

If you believe in the efficacy of your company and want to own the stock, there's no better time than in the middle of a bear market to exercise your options. Why? The tax bill upon exercise is based on something called the "bargain element" which is the difference between your strike price and the market price of the stock (or 409a value of your privately traded company stock, which may or may not matter depending on a variety of factors. Contact us if you'd like help.). This is *smaller* during a bear market almost for sure which means you'll likely pay less taxes by exercising them in this market. In addition, you'll be buying low and selling high (assuming it rebounds as fast or faster than the market).

Tax Loss Harvesting

It's important to recognize that our losses offset our gains when investing. By missing this point, you'll miss out on tax free gains in the future. Harvest losses by selling one investment in your non-retirement account that you have a loss on and buying a similar (but not too similar) can ensure you're in the game for the rebound but still get to write a loss off of future gains which will save you money.

Estate Planning Opportunities within a Bear Market

Estate Planning Opportunities

Historically, Bear Markets are followed by Bull Markets, where the losses are more than recovered for those investors with the stomach to stick it out. Indeed, the best growth in the market most often comes in this subsequent Bear Market. The result is that the Bear Market is an opportunity to take advantage of the decline in values in investments to leverage gifts that will appreciate in the future, as well as taking advantage of some current income tax benefits.

Gifting can be done in many ways, but the most common is either to make an outright gift or to make a gift over time. Either type of gift can be structured as a trust. In either case, the possible gift tax due is based on the Fair Market Value of the assets transferred as of the day that the transfer takes place. So, for example, if you gave away a share of AppleAAPL +1.1% stock on January 1, 2022, the Fair Market Value would be $182.01, but if you gave away the same share of Apple stock on May 24, 2022 the fair market value would be $139.325, that is a 30.6% less taxable value, than if you gave the stock on January 1. 2022. When there is a recovery in the market, a company like Apple is more likely than not to lead such a recovery and even exceed the overall growth of the market in a recovery. In addition to the likely growth in the value of investments in a recovery, you are also making a gift of the future income, that is dividends and interest, paid by the investment.

In addition to outright gifts, you can also make split-interest gifts. This is where you make a gift, but split the interest in the gift between current beneficiaries and remainder beneficiaries. One example is a Grantor Retained Annuity Trust, or GRAT. A GRAT is where you make a gift to a trust, but retain the right to annuity for the term of the trust. Depending on the amount of the annuity, the actual gift value of the GRAT could be reduced to near zero. If the assets appreciate in value at a higher rate than the payout of the annuity, then the remainder beneficiaries will end up with an amount greater than the initial gift to the GRAT.

Many of these split interest gifts are highly sensitive to rising interest rates, and some of these gifts such as GRATs have been targeted for more onerous tax treatment in both regulations and proposed new tax laws in the Build Back Better Act. The result is that there may be a narrowing window in which you can use these gifting techniques while the interest rates are at historical lows, there is a Bear Market, and the tax laws and regulations are more favorable than they are likely to be in the future.

The New Survival Guide for a Bear Market by Progress Wealth Management