Russell Investments

Insights

Tools for sound decision making

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In this issue – Surviving a bear market

Whatever you do, don't panic!

It is often only through the experience of a bear market that many investors truly develop an appreciation for the benefits of diversification.

For more information

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Surviving a bear market

Synopsis

Historically, we face a bear market every seven years or so. Seasoned investors know that while they do cause concern for many, the sharemarket always recovers.

In the meantime, there are a number of ways we can remain focused and calm, and deal with these trying conditions.

The past eleven months have dealt a blow to investors' confidence in the sharemarket. The sharp downturns in most equity prices, along with rising inflation and interest rates and ever-increasing energy prices, have left many investors wondering whether they should reduce their exposure to equities, or sell out altogether. Fuelled by media speculation and warnings of doomsday scenarios, investors are questioning if their resilience to the bear market will be rewarded.

Yet, as we explain in this issue of Insights, a bear market can be an opportune time to take advantage of deflated prices in order to further diversify your portfolio. We also provide you with some strategies to help you fend off the bear.

The most common definition of a bear market is a twenty per cent downturn in the sharemarket's value. Bear markets may occur in only portions of the market, or vary in severity and duration from one segment to the next.

So where are we now?

The Asian sharemarket – as measured by the MSCI AC AP Ex JAP – peaked at a record high of 1068 in October 2007 after an outstanding six-year run.

How quickly things can change.

Since the start of 2008 to the end of the financial year, the value of the Asian sharemarket dropped by 56% as at end November 2008.

Correction? Unfortunately not. What we are officially now experiencing is a bear market.

Where to now?

It's not as bad as it may first appear.

Facing a bear market is simply a natural part of the investment cycle. History shows us that on average, we experience a bear market every six or seven years.

The good news is that bear markets typically last around 15 months, and can sometimes run their course as quickly as one quarter. While there is no certainty about how long this current market will endure, there are a few strategies investors can adopt to ride out the storm.

What should I do?

Quick definitions

Correction

A change in momentum, typically at least a 10% reversal that stops short of signalling a bull market to a bear, or vice versa. Corrections occur when investors feel the market is over or undervalued. A bull market could feature several corrections without becoming a bear market.

Bear market

The most common definition of a bear market is a 20% downturn in share prices.

Recession

A recession requires two consecutive quarters of negative economic growth as measured by the country's gross domestic product (GDP). Because GDP is a backward-looking measure, recessions aren't known until they have begun. Recessions are typically economy-wide and impact all sectors.

Lim Meng Tat
Director,
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Table 1: The history of the bear

Bear market	Total decline	Months to reach bottom	Months to recover to previous high	% gain one year after bear end
Nov 1968 – May 1970	-36%	18	22	44%
Jan 1973 – Oct 1974	-48%	21	70	38%
Nov 1980 – Aug 1982	-27%	21	3	58%
Aug 1987 – Dec 1987	-34%	3	20	21%
July 1990 – Oct 1990	-20%	3	4	29%
Mar 2000 – Jul 2002	-45%	28	58	24%
Dec 2007 – ?	?	?	?	?

Source: Standard & Poor's, Bloomberg, DRI's; Index: S&P 500

First and foremost, don't panic. We've encountered bears before, and we'll most certainly meet them again.

There are few ways to deal with the impact of a bear market – quite similar to the way you would react if you were to run into a bear in the wild.

1. Remain calm. Don't panic or make sudden movements.
Veterans of previous bear markets know that the key to surviving is to act rationally, not emotionally, when making financial decisions.

Switching your investments to conservative portfolios with investment options heavily weighted to cash and bonds means that you will probably miss out on the gains when the sharemarket recovers.

In fact, over the past 20 years, there have been only seven incidences of a conservative option outperforming a growth option of the average super fund. Keep in mind that even small annual differences in returns make a substantial impact on your retirement savings at preservation.

History has shown that markets tend to recover just as quickly as they fall at the beginning of a bear market or correction. By switching your investments after a drop in market value, you're effectively locking in your losses by reducing your exposure to growth when the market recoups.

A look at the best 20 trading days in different markets over the past decade repeatedly shows that a high proportion of these days occur very shortly after the worst 20 trading days.

Therefore it is difficult to be invested during the best days, and also avoid the worst days. Remember, it is impossible to time the market.

2. Never run from a bear.
Equity markets in the short-term are affected more by sentiment than they are by fundamentals. Prices are set by two groups – buyers and sellers – and whether they rise or fall is dependent upon whichever group holds more power at a particular time.

The key difference between fundamentals and sentiment is the speed with which they change. Economic fundamentals drive equity valuations in the long-term. Sentiment determines equity valuations in the short-term. Economic fundamentals change gradually, while sentiment can change dramatically very rapidly. This is why timing equity market is so difficult.

It is intuitively appealing to try and outrun the market, but it's like believing you can outrun an angry bear. The reality is more likely to be a mauling.

3. Don't just grin and bear it.
Opting not to sell equity holdings in a bear market does not mean that you should be a passive investor. On the contrary, this could be an important time for you to review your portfolio and long-term investment objectives to ensure the two are inline.

A prudent bear market strategy involves taking advantage of depressed prices to create a well-diversified portfolio; one that minimises risk and maximises the potential for returns when the market begins to rise again.

It is often only through the experience of a bear market that investors truly develop an appreciation for the benefits of diversification.

4. Prevent bear attacks. Wear protective gear.
When travelling in bear country, be prepared. A sound, well-diversified portfolio with a long-term focus will help protect you from bear attacks.

All investments carry a level of risk; however Russell's MULTI ASSET MULTI STYLE MULTI MANAGER™ investment approach is based on the principle that risk can be managed by diversification at multiple levels – across investment managers, their styles and across asset classes – without sacrificing long-term investment returns.

Surviving a bear market requires all your discipline and determination. You must follow through your long-term investment strategy despite market volatility.

When the bear is breathing down your neck, the key to survival is staying calm.

5. Keep it in perspective. He's not that big and scary.
While being attacked by a bear in the wild is certainly something you could have bragging rights to with your mates, experiencing a bear market shouldn't be such a big event for the long-term investor. By looking at history, you should understand that a bear market – or any correction for that matter – is just a part of the topsy-turvy world of investing.

Twenty percent-plus falls in sharemarkets have been rare in recent years but are not that unusual in a long-term context, as evident in table one.

Unfortunately further falls cannot be ruled out, and as shown, it sometimes takes a while to regain previous highs. Generally, such falls in sharemarkets are usually followed by a strong rally over the subsequent year.

Keep in mind that the markets always recover. Over the medium to long-term, despite the sometimes frequent ups and downs, equity investments always return a positive result.

6. Bears can be slow-moving creatures; give him time to move on.
Regardless of a down market's length, it can take longer for a market to recover to previous levels. This is because the market must rise further than it originally fell in order to breakeven.

Recovery takes longer if you don't participate in the whole market swing.

Remember, paper losses don't become real until you make the choice to sell. However, if you invest through the market cycle – that is, buying low – returns as markets reclaim their previous levels can excel the recovery of paper losses.

"By looking at history, you should understand that a bear market – or any correction for that matter – is just a part of the topsy-turvy world of investing."

Conclusion

Over the last 50 years there have been numerous examples of sharemarkets falling by 20% or more, but these are in the context of a long-term trend which remains up, with shares providing better long-term returns than most other assets.

As such, investing in shares should be seen as a long-term plan.

While there may well be further weakness ahead, trying to time the bottom is impossible so the best approach for long-term investors is to sit tight.

Surviving the bear

Remain focused on the long-term
Despite short-term volatility, successful investors should follow through with their long-term strategy in order to survive the bear.

Don't let fear guide your investment decisions
Act rationally and resist the emotional aspects of investing. Basing your decisions on fear and panic won't do you any good in the long-term.

Diversify to soften the blow
It's critical to have a well-diversified and well-positioned portfolio to help cushion the impact of a sharp market downturn.

Never try to time the market
Keep in mind that sentiment drives the market; and it can recover at any time.

Stay invested
Don't miss your opportunity for financial gains by removing yourself from the market. You have to be in it to win it.

We encourage you to visit Russell's website, *Your Toolkit for Financial Security in Volatile Markets*, which hosts a range of educational material.

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