Client's Corner

The Second Worst Thing You Can Do in a Bear Market

IN THE LAST OF THESE LITTLE ESSAYS, I SUGGESTED THAT THE very worst thing a long-term investor could possibly do in a bear market—that is, a generalized decline in stock prices exceeding 20% from a previous peak—is to sell out of a well-diversified portfolio of quality equities.

This is a species of catastrophic mistake that large numbers of investors are most severely tempted to make on an average of once every five years or so, for that is the relative rarity of such a steep decline. (Prior to the current unpleasantness, the last one was the 33-day, 34% decline in the S&P 500 when the global economy shut down in the early days of the pandemic; before that, it hadn't happened since the Great Panic of 2008-09.)

But it is a mistake from which many people's lifetime financial plans—and most pointedly their retirement plans—may never recover. That's because, having panicked out of a major decline only to see that season's financial hurricane blow itself out and equities' long-term advance resume, they freeze up, and miss all or a substantial part of the subsequent advance.

Second only to that pattern—but sadly not a distant second—is the terrible temptation to hold back cash that needs to be invested, trying to catch a market bottom.

The fundamental issue here is not simply that we're never going to succeed at catching the bottom—though of course we're not—it's that when we become riveted (however unconsciously) on near-term market phenomena, we've already lost sight of everything that really matters. And what really matters, simply stated, is our most cherished long-term financial goals, and the role of equities in the achievement of those goals.

In doing our retirement planning, many of us have long since concluded that we will not be able to accumulate the capital we'll need at retirement without the premium long-term historical return of mainstream equities. But we've discovered that those returns have historically required you to ride out equities' occasional 20%-plus declines (which, again, have occurred every five years or so on average since the end of WWII).

Moreover, we know that, in retirement, our income will need to keep rising as our costs of living rise. At trendline long-term inflation of just under three percent, it will take about $2.40 in the thirtieth year of retirement to buy what one dollar bought the first year. One excellent and highly comforting answer to this need has been the historical ability of mainstream equities to raise their dividends at a significant premium to inflation over time.

There's been a bear market about every five years since the end of WWII. That begs a critical question, namely: what have equities historically done in those other four years between bear markets?

In the half century since the end of 1970, for example, the Consumer Price Index—even with its significant recent flareup—has risen less than eight times; the dividend of the S&P 500 is up 19 times. Once again, that's:

CPI: up less than 8x
S&P 500 dividend: up 19x

(At a level of around 3,900 as I write, the Index itself is up well in excess of 40 times, but set that aside for the moment.) What renders these facts even more stunning is that during these 50-odd years, ***the S&P 500 virtually halved on three separate occasions.***

But then we see a headline—indeed, a great many headlines—trumpeting things like "Top analyst says bear market not over yet, predicts further 15% decline before market can bottom." And that paralyzes us. All our long-term planning and perspective go out the window.

Let's imagine that, by some fluke of nature on this one occasion, these soothsayers of lower lows turn out to be right—such that one fine day later this year, sure enough the S&P 500 bottoms around 3,300. That's about as well as you can expect to do in this scenario: scalp perhaps 600 more Index points on the downside before the turn comes. As soon as you accept the relatively minor rewards of being right in this instance, you'll want to think about how much more you might be risking by holding out for that magic number.

Again: there's been a bear market about every five years since the end of WWII. Perfectly true, but that begs a critical question, namely: what have equities historically done in those other four years ***between*** bear markets? I see you've already deduced the answer: they've gone up. Sometimes, they've gone up a whole lot…and fairly rapidly. ***But nobody rang a bell at the bottom.***

I'm guessing that if you went back and looked at financial media in late March 2020—when that bear market was bottoming around 2,200 on the S&P 500—you'd find a brace of banner headlines quoting big-name "experts" saying "Don't buy this dip. The pandemic is the new Black Plague and there's no end in sight. This market's got another 20% (or 30%, or **X**%) to fall." It didn't happen. And at today's 3,900, even after this year's savage selloff, the Index is still up pretty close to 75% in the intervening 30 months. That doesn't even count dividends.

I'm at least equally sure that in March 2009, as the Index crashed to 677, those same types of "experts" were saying essentially those same things—and drawing big coverage in financial media. Today, if we include reinvested dividends, the Index has about sextupled in a little over 13 years.

If you follow this line of reasoning to its conclusion, I think you'll decide that the really scary risk to a long-term investor these days isn't getting caught in a possible last leg down of the current bear market. It's being out of a potentially significant subsequent advance.

Today is the day to start making a plan with your advisor for dealing actively with that risk. I'm confident you'll find him/her eager to have that conversation with you.

Sources: S&P 500 prices and dividends: Standard & Poor's, NYU Stern School. Inflation: U.S. Bureau of Labor Statistics, inflationdata.com.