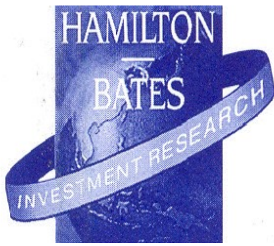

Hamilton-Bates
Bear Market Playbook 2018

December 26, 2018

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Ok now its official-the longest running bull market is over. It's a fitting end we suppose, as the market caps off the worst Quarter since the Financial Crisis with the worst December ever, and the worst Christmas Eve decline ever.

Bear Markets are actually fairly common, with one happening every 3.5 years on average (according to Ned Davis Research)—but we've enjoyed a decade without one since the Great Recession of 2008-2009. We also had a long period of subdued market volatility up through 2017, where the largest declines were less than 4%. That is not typical behavior, and that period of low volatility lulls investors and amplifies the psychological affect of a decline like that we are witnessing. Like jumping into a pool of cold water or a cold shower—its quite a shock indeed.

With this piece is to provide investors with some context, history, and guidelines so that they can get to the other side of this Bear Market with as minimal damage (portfolio and psychological) as possible.

What is a bear market?
The usual definition is that a bear market happens when stocks decline at least 20 percent from their peaks. A correction is when stocks fall 10 percent.

How long do they last?
The average bear market lasts for 15 months, with stocks declining 32 percent. The two most recent bear markets lasted just under 24 months, and shaved 50 percent off of the Dow Jones Industrial Average. Now those two bear markets (2000-2002 and 2008-2009) came on the heels of the bursting of the Tech Bubble and the Financial Crisis– both periods that had extremely excessive valuations and were coupled with severe financial dislocations. We are not yet seeing anything close to the financial market seizures of those two periods. The current decline is very much atypical to most bear market declines.

What sets off a bear market?
The bear markets of the last 50 years have had many different causes. Sometimes it's an external shock—the 1973-74 decline was set off by the rise of the OPEC and high oil prices. The 1990 bear market was set off by Iraq's invasion of Kuwait. The 1982 bear was instigated by the Federal Reserve, which raised interest rates to punishing levels in a successful bid to crush inflation.

Sometimes bear markets happen because the market decides economic fundamentals simply can't support stock prices and inflated valuations. An example of this is the post-2000 U.S. bear market, when the Internet bubble burst. Sometimes it's because economic conditions change in a key sector that spills over into stocks. The 2007-2009 bear market, which unfolded as the housing market tanked and crushed the financial sector, is a recent example.

One thing that can a correction into a bear market can be investor psychology. Since much of investing, especially in the short term, is about trying to gauge what other investors may be thinking and react accordingly, selling can breed more selling. That is, people who think other people are selling may try to get out of positions before they lose more value, depressing stock prices in the short term. That seems to be what's at play this time around. The thing that stands out to us so far at least, is that the fundamental background hasn't really changed or deteriorated that much (yet).

Cause DuJour—The Fed
There isn't any DNA evidence, but the Fed's fingerprints are all over this decline. And its not just the Powell Fed that is to blame. Fed Chairman Powell was handed a tough assignment, a Mission Impossible so to speak. He needed to thread the needle. He had to normalize rates, sell assets of the Fed's balance sheet, and do so in a manner that didn't upset a market or economy that had become addicted to 0% interest

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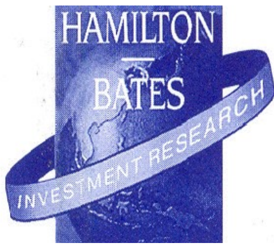

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rates. So part of the blame lies with PRIOR Fed chairs' (Bernanke and Yellen) who left rates at Zero far too long– this practically guaranteed a dislocation when rates were finally normalized. Powell for his part largely made mistakes of the mouth– he didn't seem to effectively communicate that Fed policy would be gradual and data dependent to a market that was deathly afraid of yet another Fed Policy Error. Traumatized after 2008, investors were looking for **any** signs of a Fed error, and on October 2nd Powell gave it to them.

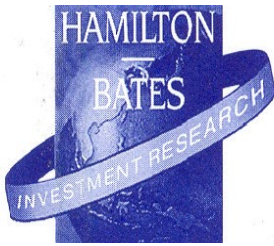
Although the major market averages were fine in early October, the Housing Market was already showing signs of weakness, and the Housing Sector stocks were down nearly 20%. So on October 2nd when Fed Chair Powell said off-the-cuff "that rates were a long way from normalized" - this was more than enough excuse for investors looking for any reason to sell. This set the stage for the first leg of decline from October to mid-December. Then the Fed compounded their mistake at this month's FMOC meeting and set that second decline in motion.

While they hiked rates as expected, once again it was comments made during the Q&A session that rattled the markets. The Fed Chair stated that while future rate hikes will be data dependent, the selling-off of assets from the Fed's balance sheet was on 'autopilot'. Although more nuanced than the early October ham-fisted statement, Powell spooked investors by coming off as not really getting the extent of the market's concerns, and still seeming behind the curve. The selling off of assets from the Fed's books is still a tightening of financial conditions, and the Fed needed to be much more sensitive to the market than it was. Since that December statement the market has sold off another 8%+ into the Christmas Eve low, taking the market firmly into 'Bear Market' territory. So clearly it has been the Fed, and the market's hyper sensitivity to a possible 'Fed Error' that has been the driving force behind this sell-off rather than a deterioration of fundamentals.

Ok—So What Should Investors Do?
In some cases, perhaps most cases, doing nothing is the right thing to do. This runs counter to human nature, which tells us to 'do something'. For most investors that 'something' would be to sell. For investors needing funds for the short-term, maybe that is the right thing to do. However making emotional decisions rarely pays off. Timing the bottom of a bear market is difficult, and once an investor sells they have to then decide when to buy back in. That is not very easy and is the more difficult decision. For most investors the decisions they make should be tied to their time horizon. Time not only heals all wounds, but most portfolios too!

What about younger investors?
It depends on whether they need short-term cash at their disposal. For millennials and others just getting going on their 401ks, it's probably a good time to boost contributions or shift the mix of funds in retirement accounts to be more aggressive (younger investors should usually be fairly aggressive anyway, since they have many decades to recover from short-term bear markets).

What about Older Investors?
Older investors who need cash returns like dividends and income payments to meet distribution needs should mostly sit tight as well, provided their asset mix is fairly balanced. Typical advice is to subtract your age from 100 to get a rough idea of the % amount of assets you should have in stocks if you are taking withdrawals. For those not taking distributions



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and for those with higher risk tolerances, that % can be much higher. If your caught out of balance—don't panic. The U.S. has the world's most fundamentally strong and stable economy right now. U.S. company dividends are not in apparent danger. Severe bear markets like 2000 and 2008 tend to occur around a Crisis– and we don't have one of those right now.

Nothing Goes Down in a Straight Line
Even in a 'worse case scenario', markets provide opportunities for gains and times to lighten up for those caught offside.

We took a look at 2008, one of the worst periods for stocks ever and the worst that we can remember– and even then there were was a window of opportunity. From October 2007 to March 2008 the S&P 500 market fell 20.3%, right about the size of the decline we have now, although our current case is more condensed into 3 months. From that March 2008 low the S&P rallied to recover more than half the losses of that initial decline, before rolling over once more into what was to become the teeth of that decline.

Even though the current decline comes like a sucker punch in the face, at a time seasonally and historically where we'd normally expect a rally—we'd still bet there will be a similar opportunity for gains—and its likely to come sooner rather than later. We could get pension rebalancing (into stocks) and new fund additions that are more supportive to stocks once the calendar turns to 2019.

Most investors should hold onto the stocks and funds they have rather than cash out at low values. Let the hedge funds worry about the day to day or month to month. The market should see a rebound fairly soon that lasts longer than just a few hours—and that will be an opportunity for investors to 'rejiggle' their portfolio if they can't sleep at night and feel the need to make a change.

Knowledge is Power—A Fiduciary Can Help
We have over 100 years of history showing that the stock market climbs higher over time and is the best source of wealth creation available for investors. We are believers in the US capital markets. But while the long-run may see risk assets move higher—there are plenty of cases where the short and intermediate term conditions play havoc with investors. No one allocation fits all investors. Each must find their comfort zone, and match portfolios with goals AND individual risk tolerances. We just ended the longest running bull market in history—most investors haven't experienced a significant decline in a decade. The past 10-years have a seen an extraordinary rise of passive investing—just in time for the current decline. Blindly buying and holding when things are great is easy—but what about when things go haywire? Then its not so easy.

We wouldn't pay too much attention to what the talking heads on TV are saying. Whether they're members of the media, hedge fund guys, or politicians, they all have an agenda. The Media use eye-catching headlines and to drive eyeballs to their platforms. Fear sells. Popular investors on Wall Street tend to like to talk up their books. And politicians are more likely to pander to their base than make productive statements that might help guide your investment decisions. There is no substitute for knowledge and experience. Knowledge is power, after all. It is important to find trustworthy sources that rely on facts over sensationalism. Furthermore, for investors who want help it's important to find a trusted fiduciary, who acts with your best interests and is well versed with the complication and nuances of the financial markets.

Managed Accounts
While we have been looking for a correction in the Fall, we didn't think it'd last through Christmas! This is highly unusual market behavior. We never did get much of an opportunity or signals to put sideline cash to work, and as a result cash built up to the highest allocation we have seen since 2008. Our Balanced Accounts had roughly 50% or more assets in areas other than stocks in Q4 of 2018. That didn't prevent a drop, but it did make the decline much easier to handle, as our discretionary portfolios fell half as much or less than the overall market.

If you like what you read and want to get Special Commentary like this along with our regular Market Updates—let us know. There is no obligation, we don't give or use your data in any way, nor will we contact you unsolicited.