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The positives of a bear market

Bear markets are a fact of life. They occur. They are unpleasant. Portfolios typically take a dip—often, a big dip. But bear markets should never come as a surprise. Nor should an investor be unprepared for them.

Active, risk-managed strategies always have a game plan for bear markets long before they occur. They have a strong rules-based exit strategy in place when they make their first investment purchases at the start of any new bull market. Active managers are realistic; they know that all bull markets end with a bear market.

Many managers profess to being active and having a risk-management strategy, but investors won't know who does until a real bear market occurs. As Warren Buffett stated, "Only when the tide goes out do you discover who's been swimming naked."

Markets around the globe are either well into bear-market declines of over 20% or flirting with those levels. These bear markets/corrections have been going on for more than a year and a half in developed countries and emerging markets and for three-quarters of a year in the U.S. Emerging markets have been hit the hardest, with a 35% decline, followed by a 23% loss for developed countries. Within the U.S., only the large caps have avoided a bear-market decline.

What to do now?

First, check to make sure your strategy really has a defense. If your investment approach has not applied the brakes yet, it probably does not have an adequate risk-management strategy.

Second, if risk management is important to you, move now to a strategy that has demonstrated both a strong offense and strong defense. The Denver Broncos' Super Bowl win is a great demonstration of having both a great defense and talented offense. (Yes, our firm is located in Colorado!)

EXHIBIT 1: SECTOR GROWTH AND ULTRA SECTOR INDEXES (AVG)

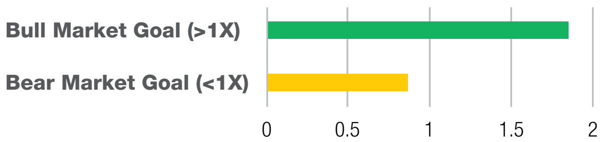
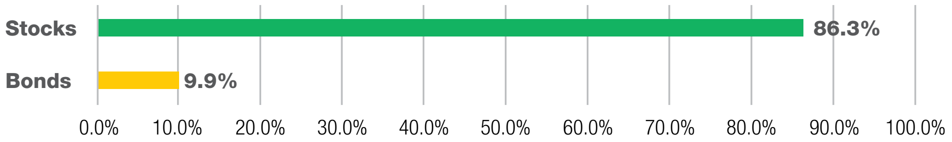


EXHIBIT 2: LOST OPPORTUNITY IN LAST CYCLICAL BULL: STOCKS VERSUS BONDS (9/2011–5/2015)



Source: STIR Research

Third, and most important, think of this bear market as a window of opportunity to get positioned for the next cyclical bull market. That means doing the research today for winning equity strategies that can do well in both up and down markets.

In our book, "Dow 85000! Aim Higher!," we presented two rules-based risk-managed sector strategies (Sector Growth and Ultra Sector) that strived to do 150% better than the broad indexes in bull markets and perform no worse than major indexes (such as the S&P 500) in bear markets (see Exhibit 1). If that could be accomplished, over a series of cyclical bull markets followed by cyclical bear markets in the 20-year long-term secular bull that we are forecasting, a final return of over 2100% could be achieved versus 700% for the market. Sounds outrageous, but that math works because of compounding gains and controlling losses.

Avoid this mistake

The gut reaction of many investors is to now move out of "bull-market strategies" and into "defensive strategies" such as low-volatility strategies. Low-volatility or equity-income strategies may not be the "safe haven" in bear markets, as many believe. Many of these strategies are relatively new and untested in lengthy bear markets. For example, one of the nation's largest equity-income funds, which is highly correlated to many low-volatility funds, experienced over a 50% loss in the 2008–9 bear market.

Lastly, think about your bond allocations at this time with the attitude of "buy low, sell high." Bonds have been rallying, while stocks have been falling. Get prepared and think ahead. We believe the next major move will be another bull market in equities. During the last bull market, bonds lagged (up 9.9%) and stocks ruled (gaining over 86%) (see Exhibit 2). This should be a cautionary note for what might occur again.

Use the window of opportunity during this bear market to get positioned in true risk-managed active strategies that will add value during the next equity bull market and protect against future bear markets.