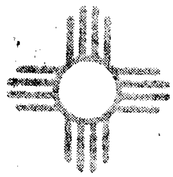

Business

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Riding out the bear market is usually a profitable strategy

Given the market's latest gyrations, I thought it would be helpful to provide a "midquarter" update on the U.S. stock market and what we think might happen in the markets going forward.

At the end of this February, the market — as measured by the S&P 500 Index — returned the S&P to its December 1998 level. This broad index of the 500 largest U.S. companies has now declined 20 percent from its high, reached a year ago in March 2000. In the much-watched technology sector, the damage is more severe. The NASDAQ index is now down over 60 percent from its zenith of March 2000.

What a difference a year makes. Stocks

ROB RIKOON

Real Money

have not performed this poorly since 1981-82, in terms of both the depth (loss) and breadth (time) of the decline. This is the mark of a bear market; one that is distinguished not only by the level of the decline (the percentage of loss on paper), but also by the amount of time. In a bear market, it is usually the extended time period, not the loss of capital, that causes investors the most psychological pain. The longer one is forced to endure watching investments decline, the greater the tendency to sell at the bottom.

During the 1981-82 bear market, the S&P 500 Index declined 24 percent over a 20-month period.

What lessons can be learned from studying the 1981-82 bear market? First, we know that holding stocks through that bear market was painful. Second, one needed to continue holding stocks through the decline in order to participate in the sharp rebound that began in August 1982 and lasted 10 months for a gain of 67 percent. When markets recover from bear-market periods, the rebound is fast and stunning. No one knew when that rebound was going to happen; the only way to participate in those gains was to ride out the bear market.

Admittedly, we do not know when this bear market will end. We do know that we want to be broadly diversified across economic sectors, own the best companies in industries that are, or soon will be, growing, and we want to pay reasonable prices for these stocks. Trying to predict when a bear market ends inevitably leaves one on the sidelines

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when the market recovers. No one has proven that they can consistently time the market. While riding a bear market is not enjoyable, the worst thing an investor can do is panic and sell out of their stocks at the bottom.

Although professional money managers should not be in the business of picking stock-market bottoms, we do see several positive factors indicating that the markets may find their bottom soon. First, the Federal Reserve began aggressively cutting interest rates in January. Fed rate cuts are not a quick fix, but they do provide a powerful monetary stimulus for businesses and the economy. Historically, interest rate cuts by the Federal Reserve lead to higher equity prices over the subsequent 12 months. Second, inflation remains low, providing a very positive environment for equity prices. Third, we believe that some type of tax cut will emerge from Congress this year, and it may well be retroactive to the beginning of 2001. Tax cuts provide a powerful fiscal stimulus to the economy.

And finally, from a technical perspective, it looks to me that the markets are close to putting in a bottom. Below is a 1-year daily chart for the S&P 500 Index.

The Federal Reserve began cutting interest rates on Jan. 2 of this year. To provide a historical perspective on what Fed rate cuts mean for the stock market, at right is a table listing each date the Federal Reserve began cutting interest rates, and the stock market returns in the following 3-month and 12-month periods:

This means that 50 years worth of history argue for staying invested in a bear market, as long as you are well-diversified and own top-quality companies. Thirteen out of 14 times, the S&P was higher three months after the Fed began easing. Twelve months later, the market had gained 20 percent, on average. (The one exception is 1968, when the Fed eased and then not long afterward, tightened.)

I am convinced that stocks will continue to provide long-term capital appreciation and also believe that the strategy of investing in high-quality companies at reasonable prices will produce above-average returns with below-average risk. While we are in the midst of the worst bear market in 20 years, it is important to remember our goals, maintain perspective and focus on the long term. Although these are trying times, we feel that well-diversified portfolios will not, in the long-term, suffer any damage, unless the emotion of fear overpowers the discipline of patient investing.

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The S&P 500's response to Fed interest-rate cuts

Date of Ease	S&P 500	3-Month Change	12-Month Change
Feb. 5, 1954	26.20	8.0%	41.1%
Nov. 15, 1957	39.44	4.8%	34.6%
June 10, 1960	58.00	-3.3%	14.9%
April 7, 1967	89.94	1.9%	5.6%
Aug. 30, 1968	98.74	9.8%	-3.3%
Nov. 13, 1970	84.15	17.0%	9.6%
Nov. 19, 1971	92.13	14.3%	25.4%
Dec. 9, 1974	65.01	30.7%	34.3%
May 28, 1980	112.66	8.4%	18.5%
Nov. 2, 1981	117.08	0.8%	17.4%
Nov. 21, 1984	164.18	9.7 %	22.7%
June 6, 1989	322.03	2.3%	13.3%
July 6, 1995	547.26	6.4%	20.1%
Sept. 29, 1998	1048.69	18.4%	20.9%

Source: Baseline