The Bear Market Security Blanket

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We've all been hearing the rumblings: This bull market is in its sixth year; earnings are ahead of themselves; the Fed is about to raise rates and rain on the parade. Headlines shout the various reasons why the bull market's blue sky should begin to fall. Markets are inherently volatile and it is a reasonable expectation that there may be some type of correction in the near future. If the bear market is inevitable, how do you prepare?

Don't try and anticipate – Research has continually shown that investors who try to time the market invariably come up short. No one has a crystal ball that accurately predicts market tops and bottoms. Usually, investors end up buying into the euphoria of rising markets, adding to holdings at the absolute wrong time. Similarly, after a market plunge few have the courage to put money back in to take advantage of bargain pricing. A cautious balanced approach is best. Select your target equity ratio and add to holdings when they fall below the target, pare back when they exceed.

Don't overreact – All of us who are of a certain age remember the pit in our stomachs when equity markets plunged in 1987. For the younger generations, ditto that feeling in the 2000 dot.com bust and 2008 financial meltdown. The underlying sector-specific market problems were exacerbated when investors panicked and threw the baby out with the bathwater – even healthy companies that didn't carry the specific industry baggage plunged. History and research show the better strategy was to just sit tight. The S&P 500 is up over 200% since bottoming out in March 2009.

Remaining un-invested and in cash has risks as well – Sitting on the sidelines in cash while waiting out the bear market may seem like a viable strategy for preserving capital, but is not without risk. While asset preservation is there during the ride down, few will put their money back into stocks at the right time. With cash currently earning close to zero, and almost always underperforming other asset classes (equity, fixed income), the lack of return and the opportunity cost of a missed re-entry point is something investors should consider. In addition, inflation continues to erode cash's real value.

Diversify your portfolio - The best insurance is a portfolio designed to handle the dips in various markets. Asset classes often move in opposite directions of each other. An appropriate mix of stocks and fixed income can cushion the blow. While bonds historically have not generated the returns seen in the equity market, they are also not as volatile and usually provide superior income generation. Often when equity markets sag, the bond market rallies as investors seek quality and safety. This was exemplified by the outperformance of Treasury bonds in 2008. A properly diversified portfolio will help you to ride out the storm. Similarly, within asset classes diversify by industrial sectors. Too much exposure to any one sector, be it technology or financial stocks, magnifies the risk.

Select an asset allocation and rebalance – There are many formulas out there for calculating the optimal stock/bond asset allocation for various life scenarios. However, the

magic really is wrapped in an investor's individual needs: what type of return do you expect, how much risk you want to take to get it and how much income does your portfolio need to generate for you? The longer your timeframe and the larger return you want, the more your assets should be shifted to equity. Once you determine and implement that allocation, revisit your portfolio's makeup to be sure the parameters are holding. Many have been burned by letting a bull market cause stocks to take up a larger share of the pie, only to have the bear market tank a disproportionate share of their wealth. When stocks move up, take some off the table and redeploy into bonds and vice versa. Keep balanced. Having a set asset allocation serves as a mechanical prompt to rebalance when market fluctuations drive you away from the target. Rebalancing reduces risk by reducing outperforming and perhaps overvalued names.

Incorporate dividend-paying and undervalued stocks- Dividend plays tend to do best in an uncertain market. When investors get skittish and market returns fall, the onus often rests on dividends to drive total stock returns. Dividends have contributed approximately 34% of the S&P's total return since 1926. In periods of stock declines, such as the 1970s and 2000s, dividends were the only returns investors received. Investors look to these established, larger names with demonstrated earnings generation capability. The dividend payment often serves as an anchor, connecting the payment stream with the underlying fundamentals of the business versus the volatility of the overall market.

Find assets that zig when markets zag – Within stocks, commodity based issues (metals, mining, and energy) often move in the opposite directions of the general market. The traditional appeal of commodities is their lack of correlation with other major assets classes such as stocks and bonds. When stocks or bonds fall, commodities often remain stable or move in the opposite direction. Similarly, international markets often move differently than US markets and can provide a stabilizing influence on a portfolio.

Embrace the opportunity – If an investor has a long-term time horizon, a bear market provides a red tag sale of sorts. Good core stocks can be purchased at bargain prices, depressed multiples and with universal pessimism dictating the value. We all like to be value buyers.

Focus on the long-term – If your time-frame permits, always take the long-term perspective. Looking back over modern financial history, markets have always bounced back. While the recovery was often dotted with smaller setbacks and took a longer period of time than most investors wanted, the optimism in the world and U.S. financial system has been rewarded.

Bear markets, while not frequent in U.S. financial history, are a necessary corrective mechanism for overheated equity markets. While we should not get overly obsessed with anticipating or predicting the timing of the next "big" one, we can take steps to protect our downside. Allocate your portfolio between stocks and bonds, rebalance when the market moves up or down, and diversify within your equity holdings by sectors and industrial segments. Focus on the long-term and you will usually be rewarded as we have always bounced back from a bear market.