CAP PARTNERS

Investment Strategies in a Bear Market

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Thomas F. White, Managing Partner of CAP Partners, LLC, discusses investment strategies to weather through the current bear market.

Observations & Perspectives

Over the past month I have attended numerous meetings with different types of investors to get a sense of how widespread this economic downturn is. On the morning of the day Congress initially voted down the $700 billion bailout package (as it was then called), I was attending the FedEx annual shareholder meeting in Memphis, TN. From that meeting, it was evident that the company was preparing for tougher times ahead. Toward that end, they were ramping up their customer service campaign, known as the Purple Promise, to focus on retaining customers in a recessionary environment.

Three weeks ago, I was in Los Angeles to attend a conference for investment advisers. In my discussions with other advisers in attendance, I discovered that some of their clients have begun to reduce, if not cease, their long term systematic investing. This was the result of their clients' fear of losing their jobs and needing to save as much cash as possible for the short term.

Last week I was in Atlanta meeting with investment analysts of a mutual fund company that we use in client portfolios. I spoke at length with one analyst, who is based in London, and covered the mining and commodities industries in Europe and Asia. He shared with me that on a recent trip to Russia, he saw first-hand how oil and gas companies have scaled back projects midstream as a result of oil prices dropping from a high of $145 a barrel to today's price of about $70 a barrel. In China, this same analyst noticed that construction of buildings in the cities he visited had virtually stopped due to the lack of foreign investment and financing resulting from the credit crisis.

These discussions have provided me with fairly diverse points of view on how broad and deep this economic recession has spread throughout the global economy. Knowing how challenging the situation is, especially with the market down more than 30% from the beginning of the year, specific actions within clients' accounts are called for at this time.

First, a distinction must be made between client accounts in which income is currently being distributed or is planning to be distributed in the next three to four years, and client accounts in which growth of capital is still the primary objective over the next five or more years. In other words, the investment strategies to be employed in this bear market differ for clients who are currently retired or are planning on retiring this year and into 2011, and clients who are not retiring for the next five to twenty years or so. This distinction is critical because without it, we would not know how to interpret the devaluation of clients' investments relative to their financial goals.

Investment Strategies for Income Investors

For most clients who are currently retired and taking income from their investments, the market values of their accounts or portfolios are down for the year, but generally not to the degree that the overall market is. This is primarily because a significant portion of those accounts hold as much as 20% to 40% in bonds and cash depending on income needs, which have moderated the downside. The concern stems from the distribution rate of income taken from the accounts. Prior to the market's drop this year, most income accounts distributed 5% or less of the account value mostly in the form of dividends. With the market hitting a low of 42% from the beginning of the year this past week, that same 5% distribution has now risen to 7% or more (see Figure 1), which is not sustainable over the long term.

Figure 1

	Account Value:	Annual Income:	Distribution Rate:
Prior to Bear Market:	$1,000,000	$50,000	5%
Bear Market:	$750,000	$50,000	6.7%
Change:	-25% Decline	N/A	34% Increase

As an example, if a client had $1 million for an account balance prior to the market downturn, and they were receiving $50,000 per year (before taxes) from that account, the distribution rate is 5% on that account. Five percent or less is a reasonable income goal over the long term. However, once the account value falls 25% to $750,000 due to a prolonged bear market, then the same $50,000 per year equates to a 6.7% distribution rate. This could present difficulties for a portfolio to generate enough income from dividends without having to sell shares of investments and dip into principal. It should be noted that it is not inconceivable for an account to drop a quarter of its value, especially when the market is down 40%. This is true even if as much as 30% of the account is in bonds, since bonds also drop in value--albeit not to the same degree as stocks (see Figure 2).

Figure 2

	Account Value Prior to Bear Market:	Account Value in Bear Market:	% Change:
Cash & Bonds:	$400,000	$360,000	-10%
Stocks:	$600,000	$360,000	-40%
Total:	$1,000,000	$720,000	-28%

For clients who have sufficient cash reserves (a minimum of 5% of net worth or $50,000 in this example) outside of their long term investments, the strategy in this scenario would involve decreasing the amount distributed from their investments to $36,000 per year in order to maintain the 5% distribution rate. This income would then be supplemented with $14,000 from cash reserves to meet their annual expenses. This strategy would allow all assets in the account to recover for three years before the second phase of this strategy is put to work.

For clients who do not have the cash reserves to supplement the decreased income from their investments, the second phase becomes their first. The plan then is to use the cash and bond holdings of the portfolio to generate the $14,000 per year of supplemental income by selling those positions as needed. This would allow the stock holdings time to recover in value, and avoid selling shares of those stock holdings at depressed prices.

Due to the severe drop in value, we need to prepare for the possibility that the market's rebound may take as long as three years or more, especially since a 40% drop means that the market would have to gain 67% to fully recover. Keep in mind that the account in this scenario only needs a 39% return to fully recover, since it is not down as much as the market. Based on this example, the account has sufficient cash and bond holdings to weather a prolonged bear market without having to sell any shares of stock or equity holdings. It should also be noted that increases in income to account for inflation is not factored in this example. Once the account recovers to its pre-bear market values, income can then be generated again from the account without supplement from cash reserves or the account's cash and bond holdings.

Investment Strategies for Pre-Retirees (Growth & Income Investors)

Clients who are within one to three years of retirement can take a slightly different approach than those currently retired since they still have some time before beginning distributions from their accounts. Most pre-retirees are still working and they are still contributing to their retirement plans through work and/or through individual retirement accounts (IRAs). The strategy here is to allocate the contributions (and employer match) into the cash or money market portion of those accounts. Building up cash in a 401(k) as opposed to a regular savings account is still preferable due to the tax-deduction and matching benefits of an employer sponsored plan.

This strategy will enable the pre-retiree to build cash over the next few years until retirement and not subject it to further fluctuations in the market and in the event it does not recover by the time they retire. In which case, the cash they have built up over this period can serve as the source of income for the first two years or so of retirement without having to take income from the bond and stock holdings of those accounts.

For example, a pre-retiree who is contributing $23,500 per year by maxing out their contributions (including catch-up) into their employer's 401(k) plan and receiving a 3% match ($3,000/year) can accumulate as much as $70,500 in cash within their 401(k) over the next three years. This accumulated amount can serve as their source of income in the first year or two of retirement (depending on their income needs) in the event that the market has not rebounded by the time they retire. This would then give their stock and bond holdings as much as five years from today to recover.

The probability that the market would recover in that time is on the side of the investor. Over the past 60 years, there have been 12 bear markets lasting an average of 14 months with an average decline of 23% before recovering. By contrast, there have been 12 bull markets since 1948 with an average length of 45 months and an average gain of 124%. The most recent bear market from March 2000 to October 2002 lasted 30 months with a total decline of 43%. Thus, a five year time frame exceeds both the average length of a bear market and the most recent one. The downside to this strategy is that the contributions that are going into cash are not able to be deployed to buy equities that would be considered to be at bargain prices as a result of the overall decline in the stock market. That said, it is of greater importance to address the primary objective of the pre-retiree which is to be in the best possible position to retire in the next one to three years without having to rely on the market recovering in that time.

Looking on the bright side, history has shown going back to 1968 that the market on average had a total return of 35.45% one year after reaching the bottom of the bear market (see Figure 3).

Figure 3

Date of Bear Market	Length of Bear Market in Months	Total Return of S&P during Bear Market	Return of S&P one year after bottom
Dec. '68 to June '70	19	-29.3%	41.9%
Jan. '73 to Sept. '74	21	-42.6%	38.1%
Jan. '77 to Feb. '78	14	-14.1%	16.6%
Dec. '80 to July '82	20	-16.9%	59.4%
Sept. '87 to Nov. '87	3	-29.5%	23.2%
July '90 to Oct. '90	4	-14.1%	33.5%
Average	13.5 months	-24.4%	35.45%

Source: Bernstein and Ibbotson Associates

Granted we do not know where the bottom of a bear market is, and that is why we do not invest with an attempt to try to time it. This reminds me of an expression used amongst long term investors: "How do you make money in the stock market? Be invested at the bottom. How do you ensure you're invested at the bottom? Always be invested." In fact, if you were to subtract the returns of the five most rewarding days the S&P 500 has had over the past 10 years, you would have received 66% less than if you had been continuously invested. Thus, the mantra is "time **in** the market, not timing the market".

Investment Strategies for Growth Investors

Clients who have many years until they need to access their investments or until they retire can take advantage of the temporary decline in prices by selectively buying and adding to existing positions. As bleak as conditions may seem in the midst of an economic recession, the market and the U.S. economy have persevered through numerous political and economic difficulties in the past as illustrated in Figure 4. History has shown that investors can benefit from staying invested throughout a crisis.

Figure 4: Markets Recover from Crises

Political or Economic Event	Market Decline	1 year later	5 years later	10 years later
The Fall of France (1940)	-16.9%	5.0%	15.7%	13.2%
Attack on Pearl Harbor (1941)	-7.5%	15.8%	18.0%	17.1%
Korean War (1950)	-12.2%	42.2%	27.7%	18.5%
Eisenhower heart attack (1955)	-6.6%	11.9%	8.4%	11.5%
Cuban Missile Crisis (1962)	-9.9%	41.1%	15.8%	11.1%
Kennedy Assassination (1963)	-2.8%	27.8%	12.4%	7.0%
U.S. bombs Cambodia (1970)	-15.0%	49.0%	9.3%	9.3%
Nixon Resigns (1974)	-13.4%	30.2%	14.6%	14.6%
Soviets invade Afghanistan (1979)	-1.8%	36.5%	15.0%	18.0%
U.S. invades Grenada (1983)	-2.1%	9.4%	15.9%	15.0%
Market crash of 1987	-31.5%	27.7%	17.0%	18.9%
Invasion of Panama (1989)	-2.1%	-0.2%	9.3%	18.2%
Gorbachev coup (1991)	-2.3%	14.5%	15.2%	14.3%
First Gulf War (1991)	-4.0%	36.6%	17.3%	18.0%
World Trade Center bombing (1993)	-0.3%	8.0%	21.8%	8.7%
Collapse of LTCM (1998)	-2.0%	35.8%	1.8%	n/a
Russian ruble devaluation (1998)	-1.7%	35.8%	1.6%	n/a
9/11 terrorist attacks (2001)	-11.6%	-11.1%	8.3%	n/a
U.S invades Iraq (2003)	-2.1%	35.1%	n/a	n/a
Average gain/loss	**-7.7%**	**23.7%**	**13.6%**	**14.2%**

All returns include reinvested dividends. Returns for periods greater than one year are annualized.
Source: Thomson Financial

It is on the heels of a crisis when sellers are driven by fear that the best investment opportunities are revealed. One of the greatest investors of the 20th century, Sir John Templeton, wrote in the book *Investing the Templeton Way* that he relied on the following motto throughout his investment career: "To buy when others are despondently selling and to sell when others are avidly buying requires the greatest of fortitude and pays the greatest ultimate reward." To paraphrase him further, he also said that there is only one reason why the stock market is down, which is that there are more sellers than buyers. Once all the sellers have sold, then only buyers remain, and that is when the market begins its recovery.

Yet, knowing that all bear markets come to an end at some point is not sufficient in terms of taking advantage of investment opportunities. We must be selective and know what to look for. Today we are finding many such opportunities to invest at prices not seen in decades. The fear that has engulfed panicked sellers has spread so far and wide that the opportunities are more numerous and at better prices than it was in the last bear market of the dot.com bubble. For example, some companies' stocks are priced below what the total net worth of the company is or even below the value of just its cash holdings. Another example is when a company's stock price is so depressed that they become a potential takeover target by another stronger competitor whose stock price has not declined to the same degree. Finally, some of the best opportunities can be found when the dividend yield of a company exceeds the projected growth rate of their earnings.

However, risks remain. As a result of the current credit crunch, we search for investments in companies that also have a large cash position and are not dependent on debt or credit to continue their operations or expansion. Furthermore, companies that generate healthy cash flows are able to build up their cash position and make opportune acquisitions when competitors may be selling at a discount.

The basic strategy for growth investors is to lower your basis. The basis is an investor's cost or purchase price of an investment. The idea is to add to an existing position when the price has dramatically fallen as a result of the overall decline in the market. This strategy presumes that the underlying investment is down not because of any fundamental deterioration in the company or fund, but simply because sellers have panicked and sold. This concept applies to both individual stocks and mutual funds.

For mutual funds, the opportunity to lower your basis exists when a fund's short term return lags the market index (S&P 500) while its long term return continues to exceed the market. Naturally, part of the assumption is that the basic investment philosophy and management of the fund has not changed from the time you initially bought it.

Several high quality funds are currently down more than the market in the short term, but have superior returns than the market over the long term. This enables an investor to take advantage of the short term volatility and add to the fund at a discounted price.

Investment	YTD	1-Year	5-Year	10-Year
Calamos Growth Fund	-30.50%	-29.7%	4.23%	13.82%
Calvert Large Cap Growth Fund	-27.60%	-27.57%	4.26%	4.47%
Dodge & Cox Stock Fund	-26.10%	-29.59%	5.43%	8.90%
Growth Fund of America	-20.80%	-22.91%	6.95%	8.49%
Mutual Discovery Fund	-16.50%	-17.07%	12.03%	11.19%
S&P 500 Composite Index	**-20.70%**	**-21.96%**	**5.17%**	**3.06%**

Returns are as of Sept. 30, 2008. All returns are based on net asset value (NAV).
Sources: Calamos Investments, Calvert Funds, Dodge & Cox, American Funds, Franklin Templeton

For individual stocks, the opportunity to lower the basis is even more pronounced due to the exaggerated price swings of company stocks. One recent example can be seen in the stock of a high-tech industrial corporation whose workers went on strike for almost two months. This company currently has a record backlog of orders for its products and services equivalent to six years of annual revenues. Before buying the stock, we established a target price of $120 five years out.

We initially bought the stock around $80 before the strike. As a result of the strike and the widespread economic crisis, the stock fell to a low of $40. Once the strike ended, we began buying more shares around $45 to lower the basis (see Figure 5).

Figure 5

	# Shares:	Price/Share:	Amount
Original Basis:	100	$80.00	$8,000
Addition:	100	$45.00	$4,500
Total or Average:	200	$62.50 (average)	$12,500

The number of shares purchased in this example is hypothetical, and does not represent any particular client.

In this example, by purchasing an additional 100 shares when the share price was down 44% to $45 per share, it lowered the average cost or basis of the investment to $62.50 per share. We were able to buy the same number of shares for only $4,500 or $3,500 less than the first time. Without lowering the basis, it would require the stock to gain 78% to simply return to the original purchase price. Lowering the basis to around $62 from $80 potentially increases the gain on this investment if the target price of $120 is realized.

As long term investors, short term events can provide an occasion to capitalize on opportunities that wouldn't exist otherwise. With the return of the workers, we believe the company will be able to bring its production back to full capacity within the next few months. This particular example demonstrates the minimal impact of a short term event such as a workers' strike to the long term earnings of a company five years out.

Conclusion

Knowing one's investment objective, whether it be for income, growth of capital or both, is critical in terms of being able to properly interpret how market and economic events affect one's investments. Obviously, an income investor will be impacted differently than a growth investor. Investment strategies will differ when addressing not only these events, but individual financial goals and time frames. Without these strategies, mistakes can befall any investor and could ultimately lead to the failure of achieving their financial goals. It is for this reason that I continue to meet and talk with clients to assess the impact of the recent market downturn in relation to their financial goals, and to employ the appropriate strategies during this bear market.

*Sources: CPA Journal (Jan. 1995), Putnam Investments, *Investing the Templeton Way* by Lauren Templeton

The stock market is represented by the unmanaged Standard & Poor's 500 Composite Index (S&P 500), a widely used measure of stocks issued by relatively large U.S. companies. Past results are no guarantee of future returns.