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How to Invest in a Bear Market

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A “Bear Market” is defined as a decline of 20% or more in the equity markets. Importantly, the definition of a Bear Market is different from that of a Recession, which is defined by two consecutive quarters of economic contraction in Gross Domestic Product. The two events typically overlap with one another. However, stock prices are typically a “leading indicator” of an economy’s overall economic health, leading into (and out of) a Recession. In other words, stock prices are likely to show signs of an imminent Bear or Recession (or the demise thereof) prior to other economic indicators such as employment and GDP.

Bear Markets naturally occur at the conclusion of a business cycle—which, at their peak, are typically indicated by full employment, rising wage pressures (inflation), rising interest rates, and a deceleration of GDP growth. The actual trigger for a decline in stock prices varies from cycle to cycle. Yet these typical indicators are almost always present.

In the Dot-com bubble, it was over-valuation and speculation highlighted by the events that followed September 11, 2001. The Great Recession was plagued by over leverage, coupled with a credit and liquidity crisis. And today, we find ourselves in the midst of a Bear Market (that is certain to become a Recession) as a result of a global pandemic that has brought human movement and the economy to a halt.

Even though the circumstances have varied in these most recent business cycles, the common indicators noted above were present during each of them.

Investing through severe market corrections will test the mettle of an investor who has endured a loss of capital within a short period of time. One day, you wake up and you’re thinking about the purchase of a new car, a summer vacation, or a new appliance for your home. The next day, you watch your account balances decline and not only do you *have* less money than you did the day before, but you *feel* like you have less money, which jets any further thought of new purchases. This negative “wealth effect” is a common byproduct of any recessionary cycle.

Personal consumption accounts for 70% of the U.S. economy. When we stop spending (or slow it way down), that directly impacts corporate profits, which leads investors to value stocks at even lower prices, which further magnifies the sudden loss of wealth - a vicious negative feedback loop.

The good news about Bear Markets is that we are presented with new opportunities to invest in great businesses—typically at much cheaper prices than their Bull Market trading days. Sometimes these corrections lead to once-in-a-lifetime buying opportunities for long-term investors.

Bear Markets are an especially great time for new investors to get started. If you are new to investing, you likely had limited exposure to the stock market downdraft – so the wealth effect had little impact on you. Now you are at liberty to start building positions in the market with index funds or individual companies at cheaper prices. (U.S. News & World Report: How to invest in a bear market as a beginner.)

Unfortunately, doing so is often very difficult and it takes not only courage but a lot of nose holding to deploy one's hard earned capital as prices are in free fall. The best way to tackle this is to buy some now, wait another week or two and as prices go down (or up) buy a little bit more, and do the same two weeks after that. By dollar cost averaging into the Bear this way, you are building long-term positions in indexes or companies that you intend to own over the long-term without worrying about where the bottom may lie.

Warren Buffett, the most successful and famed investor of our lifetime, draws on our own consumerism to explain why it is best to buy stocks as prices fall. Buffett loves hamburgers, and when the prices of hamburgers go down, he says he naturally buys (and eats) more hamburgers.

Let's extend this to something you like or get enjoyment out of – maybe it's shoes, or cars, or trips to Florida – if the price of those things fell by 30%, you would likely get very excited by the "deal" you were getting and, naturally, you would want to buy more. Alas, as investors we behave in an opposite fashion: When prices of great enterprises fall by 30%, we often feel miserable and behave irrationally. We forget that prices are likely to trade higher in 12 to 18 months, and instead of buying "on sale" we tend to want to sell at lower prices. Dollar cost averaging can help us invest through this behavioral trip up and allow us to focus on the longer term at a time when short-term market pain is pervasive.

Once the Bear bottoms and we emerge on the other side, thoughtful investors will re-evaluate the positions they've added to and revisit their overall asset allocation. Weightings to both will certainly have drifted during the correction and rebound. We recommend that you take stock of where your new portfolio risk lies and adjust accordingly. Of course, if you need help with any of these items having a conversation with a fee-only registered investment advisor may also prove to be a well-timed investment!

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