Standing Up to the Bear

APRIL 2020

Diversification can give you an edge in down markets

Accelerating uncertainty surrounding the spread and eventual impact of the coronavirus sent U.S. equity indexes into bear market territory in March.

Bear markets make investors nervous. And jittery investors are prone to jumping in and out of stocks and bonds, a chancy tactic that can leave investors sitting on the sidelines just as markets rocket to recovery.

Fortunately, there is one approach that can help calm jangling nerves and may provide a measure of relative stability in bearish markets: diversification.

As many of you have experienced, diversifying your portfolio means spreading money among many stock and bond asset classes or investment vehicles, along with money market instruments—and even among different types of stocks and bonds. Building a diversified portfolio, in other words, means not putting all your investment eggs in one basket. That way, when one type of investment hits a rough spot, the other investments might rise in value, which could help smooth out volatility.

While diversification cannot guarantee protection against loss, it can potentially limit your losses during a severe market decline. For example, during the bear market, from February 19-March 27, 2020, stocks plummeted about 25%. But during the same period, a diversified portfolio with an allocation of 60% stocks and 40% bonds would have lost about 15%. Not a pretty performance, but far better than returns from a stock-only portfolio.[1]

The potential benefits of diversification are often evident during bear markets

The charts on the next page demonstrate how a diversified portfolio performed, versus an all-stock portfolio, during two of the worst periods in market history (Exhibit 1).

If it walks like a bear and growls like a bear ...

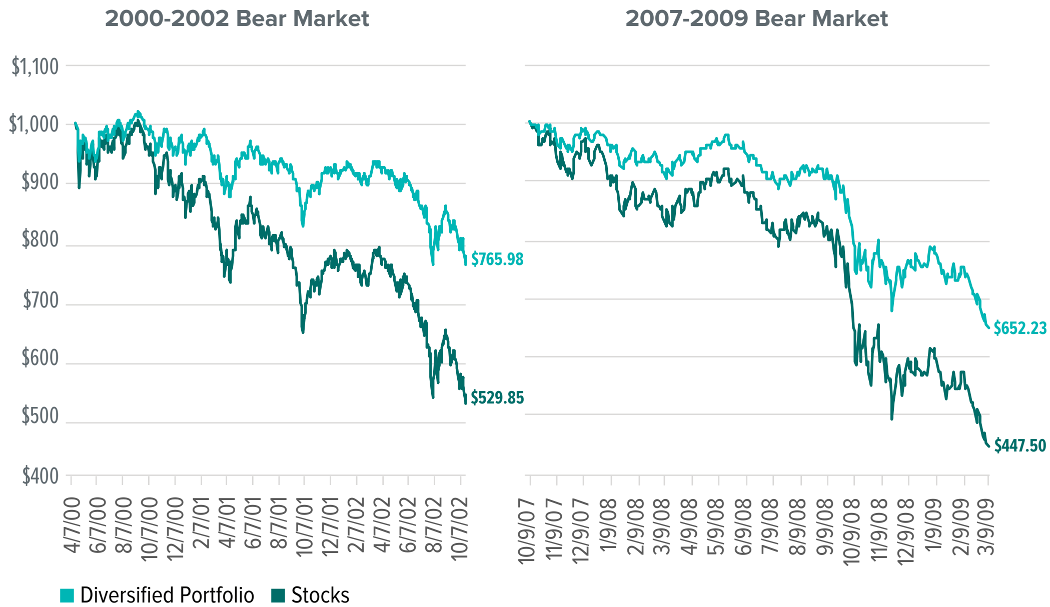
Defining a bear market: One generally accepted definition is a decline of 20% or more in a broad stock market benchmark, such as the S&P 500 Index, from its recent peak.[2]

The current bear market became "official" in early March: On March 12, less than a month after hitting its all-time high in February, the S&P 500 Index had declined 20% from its earlier peak. Two trading days later, the market had fallen almost 30% from its high.[3]

Historical perspective: Since 1966, there have been eight bear markets in the S&P 500 Index, including the current one. (A few other market corrections, each losing just under 20%, came close to earning bear status.) The previous seven bears lasted, on average, just under 1 ½ years, during which the market lost an average of 35%.[4]

[2] Source: Investopedia.com.
[3] Source: Bloomberg
[4] Source: Bloomberg. Based on historical daily closing values for the S&P 500 Index. The S&P 500 is an unmanaged index, it does not reflect any management fees, transaction costs or expenses and includes 500 widely traded stocks. It is not possible to invest directly in an index. Past performance is no guarantee of future results.

Exhibit 1: Diversified Portfolios and Bear Markets



Stocks in this example are represented by the S&P 500 Index. Bonds are represented by the Bloomberg Barclays U.S. Aggregate Bond Index. The early 2000s bear market occurred from 4/7/2000-10/9/2002. The 2007-09 bear market was from 10/9/2007-3/9/2009. An investment cannot be made directly in an index. The data assumes reinvestment of income and does not account for taxes or transaction costs. Past performance is no guarantee of future results. Diversified portfolio: 60% stocks, 40% bonds. Hypothetical value of $1,000 invested on 4/7/2000 and 10/9/2007, respectively. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index.

While the average bear market lasts less than 1½ years, the average bull market thrives for almost 4½ years—three times as long. The just-ended bull was the longest in history, at over 11 years.

Source: Bloomberg

In the chart above, the left graphic covers the bear market following the implosion of the tech market in April 2000; the right graphic, the bear market from 2007 to 2009 during the great financial crisis.

In both graphics, the dark teal line illustrates the hypothetical growth of $1,000 invested only in stocks. The light teal line illustrates the hypothetical growth of $1,000 invested in a diversified portfolio of 60% stocks and 40% bonds.

Over the course of both time periods, the diversified portfolio didn't just lose less than the pure stock portfolio, it also showed far less volatility in its returns.

Over longer periods of time, the more volatile stock-only portfolio could be expected to outperform the less volatile diversified portfolio. However, we should keep in mind that one of the main goals of diversification is to reduce risk and volatility, not necessarily increase returns.

Short-term volatility smooths out over time

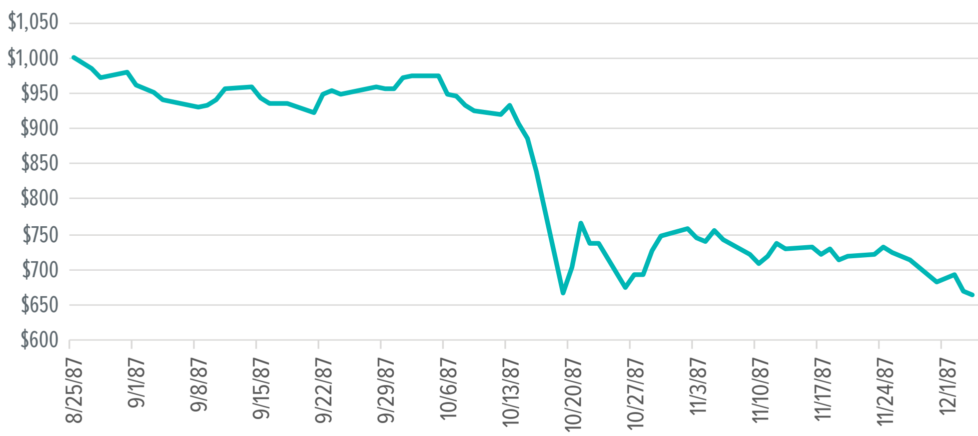
It's volatility that concerns investors and lures many of them into thinking that selling their assets in a bear market is a prudent decision. But investors tempted to jump ship during volatile periods would do well to consider long-term historical trends.

Let's look at these two charts. Exhibit 2 shows the S&P 500 Index during the bear market of 1987, a time when stocks declined by more than 30%. Visually, the losses are stunning, and it's easy to understand why investors might want to go to cash.

Now let's pull back with Exhibit 3, which puts the late 1980s bear market in broader perspective. Over the second chart's 30-year period, stocks climb powerfully and deliver outstanding returns—in the midst of a record-setting bull market—to investors committed to a long-term plan.

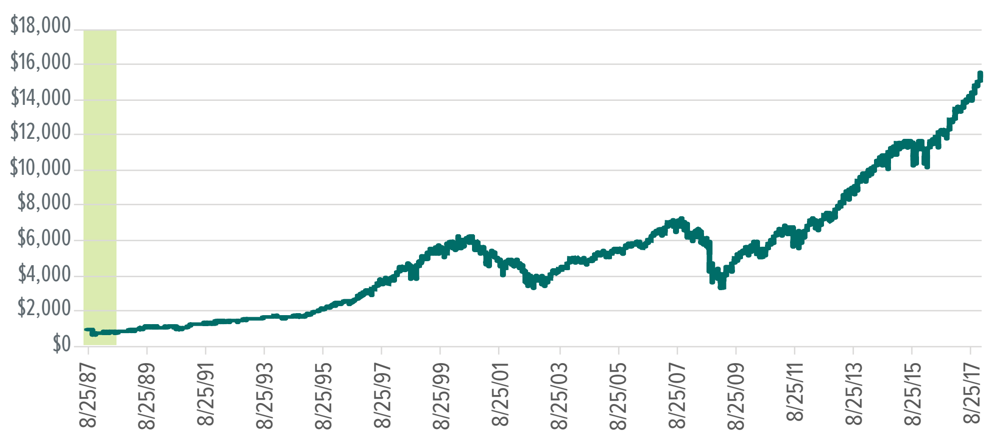
And where does the 1987 bear market show up on Exhibit 3? It's the small, nearly inconsequential blip in the highlighted area.

Exhibit 2: S&P 500 Index: August 25, 1987, through December 4, 1987



Shows the plunge of the S&P 500 Index during the bear market of 1987

Exhibit 3: S&P 500 Index: August 25, 1987, through December 31, 2017



Shows the powerful climb of the S&P 500 Index over the next 30 years. The seemingly negligible decline in 1987 is indicated by the highlighted area.

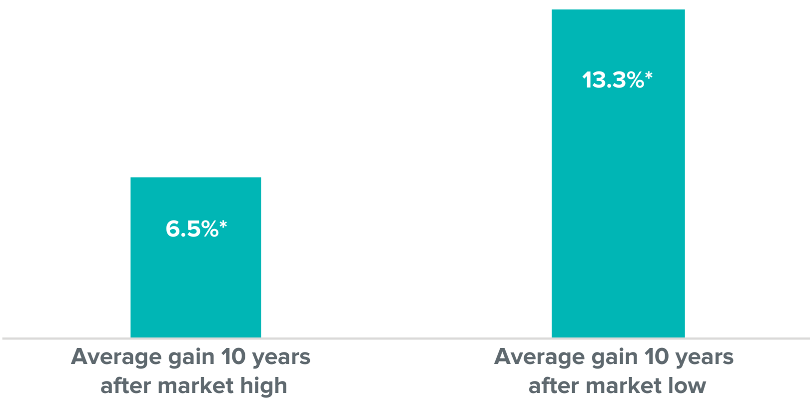
Sources: Bloomberg, SEI. Data spans 8/25/1987-12/31/2017.
Index returns are for illustrative purposes only. Index returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

Give the market, and your portfolio, a chance to recover

We've already discussed the advantages of diversifying your portfolio. Another valuable attribute during bear markets is patience—the patience to understand the market's long-term cycles, to withstand the temptation to sell your assets and go to cash, to wait for the market to regain its typical positive momentum.

Bear markets can be very different from one another—in duration, severity and time of recovering. But as this chart illustrates, all bear markets have historically shared one significant similarity: They have all eventually ended and set the stage for fresh surges in market values (Exhibit 4).

Exhibit 4: Markets have recovered in seven bear markets since 1966



*Represents average of the annualized total returns of the S&P 500 Index over the 10-year periods following the seven bear markets.

Source: Bloomberg

Past performance does not guarantee future results.

A well-diversified portfolio can help alleviate the need and desire to continually adjust your investment allocations to "chase" the market trends and can help reduce the urge to buy or sell to take advantage of market swings up or down.

What can you do when the bear is on the prowl?

Don't make any impulsive decisions. Keep investing on a regular basis. One of the easiest ways to do this is through dollar-cost averaging.

And if you have any questions or concerns, talk to me. As your financial advisor, I am committed to:

- Helping you understand how the financial markets operate, including the cyclical nature of positive and negative momentum.
- Providing you with the information and support you need to effectively deal with bear markets.
- Maintaining close contact with you on a regular basis, and especially during periods of unusual economic and market activity.

Together we will continue to focus on diversifying your overall portfolio to help defend against recurring volatility in the stock and bond markets and reduce the overall risk in your portfolio.

Investing involves risk, including possible loss of principal. Bonds will decrease in value as interest rates rise.

This material is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice and is for educational purposes only. There can be no assurance your goals will be met.

Diversification does not eliminate the risk of experiencing investment losses.

Index returns are for illustrative purposes only and do not represent actual investment performance. Index performance returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged; an investor cannot invest directly in an index. Past performance does not guarantee future results.

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The Bloomberg Barclays Aggregate Bond Index, is an index used by bond traders, mutual funds, and ETFs as a benchmark to measure their relative performance. The index includes government securities, mortgage-backed securities (MBS), asset-backed securities (ABS), and corporate securities to simulate the universe of bonds in the market. The index consists of securities that are of investment-grade quality or better, have at least one year to maturity and have an outstanding par value of at least $100 million.

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