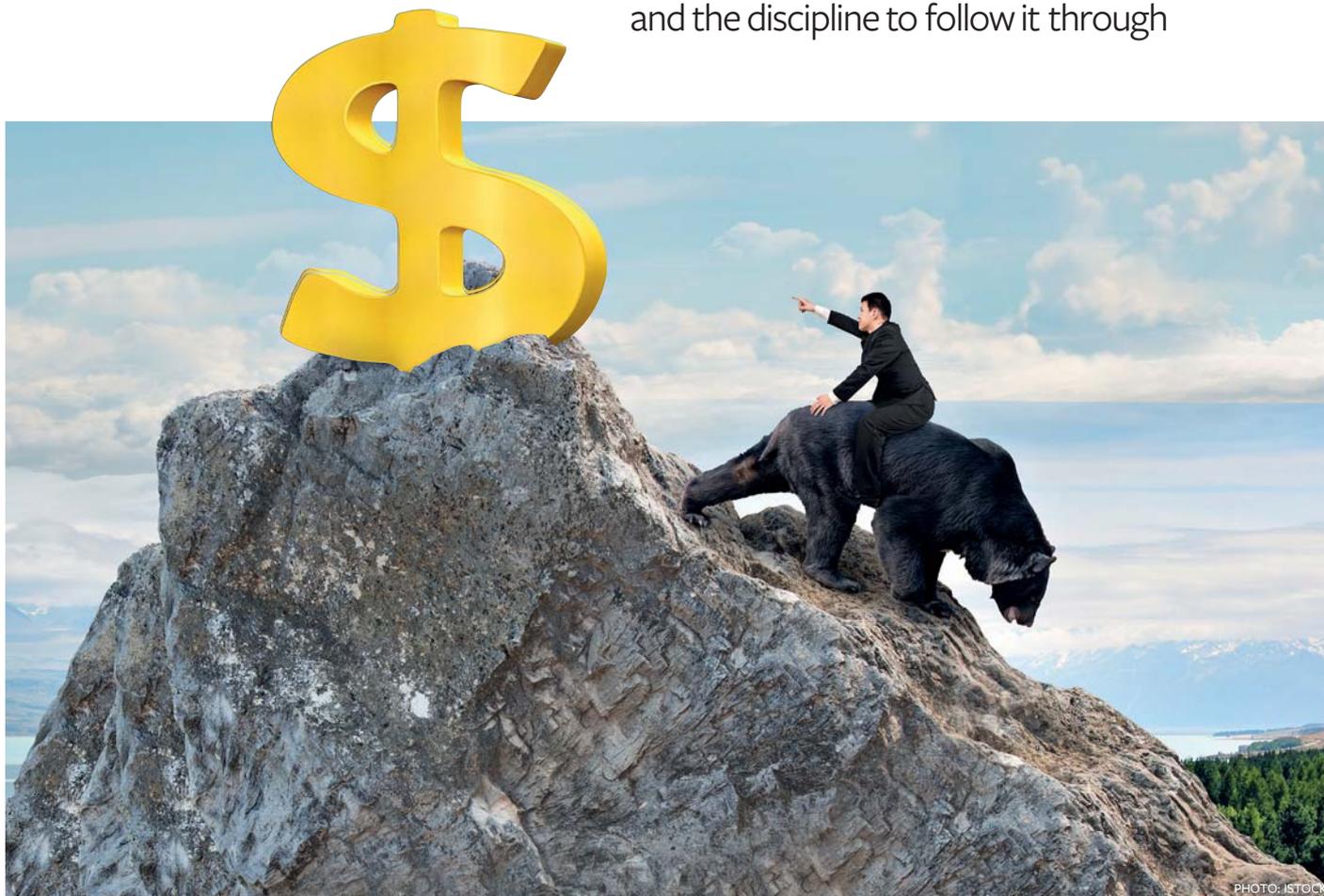


Surviving bear markets

Investors need a plan that has been proven historically to work and the discipline to follow it through



Leonardo Drago
Co-founder
AL Wealth Partners

“YOU get recessions, you have stock market declines. If you don't understand that's going to happen, then you're not ready, you won't do well in the markets.”

“I've found that when the market's going down and you buy funds wisely, at some point in the future you will be happy. You won't get there by reading 'Now is the time to buy.'”

The above two quotes are attributed to Peter Lynch, one of the most successful mutual fund managers who averaged a 29 per cent annual return, making his Fidelity Magellan fund the best performing mutual fund in the world. His quotes were in the context of navigating through bear markets that reappear every few years, and his answer is that his fund's total return would have been lower if the bear markets had never occurred.

As we have now entered a period of market weakness, studying how these successful investors navigated such markets in the past should help every investor achieve the same.

Investors need to understand what's

happening, have an investment plan that has been proven historically to work, and have the discipline to follow such a plan. Not having such a plan in place causes sleepless nights, frustration, and fear to take action. For such investors, each succeeding market decline is a continuing source of significant stress.

Logically all investors know that profits are achieved by buying low and selling high. But when the low prices finally happen, they are always accompanied by bad news, high uncertainty and volatility. Stock markets do not drop more than 20 per cent when everything is going well, they suffer this reaction when the economy is weaker than expected, and there are unforeseen shocks, such as all the recent events surrounding China's stock markets. This negative news-flow causes fear of further losses, and investors suffer the normal emotional reaction to freeze, or worse still, to sell in order to conserve the value of their investment portfolio.

The most common reaction is to wait for things to stabilise, or wait for the fundamentals to improve. But the low point in prices occurs when uncertainty and fear is at its highest, and when the bad news is at its worst. By the time things have stabilised and fundamentals have improved, markets have already moved significantly higher. No one rings a bell at the bottom telling people to buy. Instead, we see descriptions of the causes of the fall and the risks of further downside, urging caution.

In the sequence of events above,

investment decisions are based primarily on emotions that change on a daily or even hourly basis in response to negative news. Instead, what investors need is a sound investment plan that fits them, in order to develop a deeper understanding of markets, changing the end result from fear to opportunity. There are many ways to do this, and we highlight a simple plan below, based on the following historical observations:

- Stock market cycles are caused by expansion and then contraction of P/E (price-earnings) multiples. This is the prime cause of bull and bear markets.
- P/E expansion is caused by investors becoming bullish about future prospects, and more willing to pay a higher premium today for expected growth in the future.
- P/E contraction occurs when previously bullish expectations do not materialise, and the future looks less positive.
- These cycles alternate and repeat as aggregate investor expectations change. When extremes in valuations have been observed in the past, markets have always reverted to the mean.

Based on the following simple observations, an investor can conclude that he should sell when P/E expansion has made the stock markets expensive (generally a P/E above 20), and he should buy when P/E contraction has made the stock markets cheap (generally a P/E below 10 for developed markets, and below eight for emerging markets).

The end result in investing is all about

probability analysis. Just because stock markets get to a P/E of 21 does not mean they will immediately reverse, as they can (and do) often go higher. Similarly a P/E below 10 does not mean an immediate bottom. In the late 1970s US equities stayed at a P/E below 10 for six years, before starting the longest bull market investors have ever experienced.

This probability analysis means that the probability of an investor making a profit is significantly higher when P/Es are 10, compared to when they are 20. This probability becomes even higher when P/Es are nine, even higher at eight, and so on.

A simple plan would be to buy when valuations hit the low end of the P/E cycle, and if they keep moving lower from there, to buy a fixed dollar amount of additional exposure on every 10 per cent drop in price.

This simple plan achieves two objectives. First, an investor becomes overweight the cheapest stock markets, resulting in a higher probability of a larger profit when the cycle turns. Second, buying a fixed dollar amount ensures that at every purchase an investor is buying 10 per cent more shares with the same amount of money, resulting in a faster averaging down of one's book cost.

Contrast the above plan with what most investors do, which is buy too much when P/Es are high and the economy is strong, then buy less as the markets move down, and soon stopping purchases outright when the selloff becomes more severe.

The plan described above is even easier to implement for investors who have a regular source of income from their salary or business, compared to professional fund managers. Professionals manage a fixed pool of assets so averaging down means selling something else to buy more of a cheaply valued market; the benefits of such a switch are much less when all markets go down at the same time.

Instead, non-professional investors would normally have a separate source of income that they can invest into markets. The correct investment plan would be to keep buying (and if possible increase the buying) during periods when markets sell off like now, instead of staying on the sidelines and stopping the purchases. Diligently following such a plan will reduce the impact of emotions in investment decisions, lower an investor's stress level, while also leading to higher profits when the negative news-flow eventually subsides and reverses. ▣

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