Seven Tips to Handle a Bear Market

Today's episode features Richard acting as his own guest once more and this time he is offering advice on how to handle a bear market. He begins by first outlining just what constitutes a bear market, and then proceeds to offer 7 tips on what you should and perhaps shouldn't do during a market downturn such as the one that has just taken place in March 2020.

Highlights:

- Probably the most important tip is to stay the course, but only if you've stress-tested your asset allocation and you know that you can withstand a market downturn.
- Many studies have shown that if you consistently rebalance your portfolio, your long-term investment performance will improve.
- It is recommended that you have a minimum of three to six months worth of cash reserves, which you don't touch unless you really have an emergency.
- Harvest your tax losses.
- Try maintaining your philanthropical commitments.
- Have a momentum strategy.

Quotes:

"You will thank yourself for not having made any radical changes to your portfolio during the market declines."

"Instead of panicking and selling your individual stocks, use the historical evidence that is out there."

"Make sure you have enough cash for this particular event that is an emergency."

"If your main concern is a decline in the value of your stock portfolio, consider yourself fortunate and maintain your charitable gifting."

"At the Dri Financial, we developed an investment strategy that buys the market when the S&P TSX trendline is upward and sells the market when the trendline is downward."

Links:

Toronto Stock Exchange - https://www.tsx.com/

Richard Dri: Hello, it's Richard Dri, and welcome to the Richard Dri Wealth Navigator Podcast where my mission is to motivate entrepreneurs to become financially literate and to convert their high income into true wealth. With wealth the entrepreneur can build a business free of financial constraints and they can focus on their customers, their family, and their health. My guest today is Richard Dri, me. Anyway, if you haven't gotten tired of me yet, you will hear a very interesting podcast today and it is entitled, 'Seven Tips to Handle a Bear Market'.

Now, since March of 2020, we have lived through what is a bear market. Now by definition, a bear market, if you were wondering, is a drop in the stock market, a particular stock market, of a minimum of 20%, that is from its high to its low. And in March of 2020, we definitely experienced that and you have lived through a significant drop, we all have. Now, how did that feel? What did that make you do? Did it make you run out and change your investments? Did it make you sell? Did it make you buy? Well, I'm going to talk about seven tips that I think are important, and I think I titled them things that you should or perhaps shouldn't do during a market downturn like we had in March of 2020.

Stay the Course (1:57)

Richard Dri: Now I'm recording this in May of 2020, when the markets have substantially recovered. I believe the TSX and the S&P are still down about 10% but they're nowhere near the lows that you saw in the latter part of March of 2020. So let me begin by discussing probably the most important tip and that is to stay the course. This is I think a tip that you may hear from everyone, whether it be on the radio, on the television or of course from the social media. Staying the course is something that everybody tells investors to do. And generally it's correct because it's based on the long-term track record of the TSX or the S&P 500. And historically those two markets have ended up higher after a market decline than they were before the market decline. So in other words, over time the stock market recovers and sets a new peak. So that means that if you stay the course, your portfolio will fall, but eventually over time will recover and set a new high, and you will thank yourself for not having made any radical changes to your portfolio during the market declines.

And that's why you generally hear the recommendation to stay the course. But at Dri financial we're a little bit more evidence-based and we like stress testing our individual courses to ensure that we can actually live through a bear market with the course that we've established. In other words, I feel that some people may not be able to stay the course because of the fact that their asset allocation or their investment policy statement has not really reflected their risk tolerance, the amount of risk that they're willing to accept.

Now let's take a look at that for a little bit. When you establish an investment policy statement and I've written extensively on investment policy statements, and you can find them if you wish to read more of the topic or you can find more information on the topic by going to richarddri.ca and you'll be able to read a lot more information on the topic. Now, in the investment policy statement, we have to set out an asset allocation strategy. That is a strategy where you decide how much money to put into bonds, especially when we only buy government of Canada bonds or provincial bonds, and we also buy short term.

The other portion of money has to go into stocks and this is called the risky component because you're buying companies, and companies have been known to go up in value, but they've also been known to go down in value. So you have to make an allocation to each of those asset classes and they have an implication on your overall return. Now, let's look at it from a historical point of view. Before we look at an example, the S&P 500 has had 16 bear markets, that is a drop of 20% or more, since 1926. So if you look at it, you can expect a bear market once every six years. They last on average for 22 months, therefore they generally take about two years to fully recover. And this is the important component is that the average drop during a bear market is 39%, a significant drop (see: https://www.tsx.com/).

Again, remember that historically the S&P has always recovered from that drop. So it's not necessarily a loss in your portfolio unless you change course, but it is a decline in the portfolio unless you trigger a sale. Let's assume that your asset allocation is 30% bonds and 70% equities. Let's also assume that during that period of time, your bonds go up by 5% and your stocks go down by 39% during a bear market, and the 39% is just the average decline that we have seen in a regular bear market in the past. That is for the US component. That is for the S&P 500 which are US companies. Canadian companies may go up or down by more, but we're going to stick with the S&P 500 for this example.

So we have 30% in bonds, 70% in stocks, bonds go up by 5%, stocks go down by 39%, if you do the math, your portfolio will decline by approximately 26.5% during a bear market. So if your portfolio hit a high of a million dollars before the bear market, then at the bottom of the bear market, you could probably look at your investment statements and see a market value of approximately 735,000 at its low, and if history repeats, it'll take about two years for your portfolio to recover back to the million dollar mark. At the bottom of the bear market, what will you be tempted to do? If you are tempted to stay the course, that's fine, then you have the proper asset allocation and you can stay the course. If you're attempted at the bottom of bear market to sell your investments and maybe become more conservative by adding more bonds or perhaps being even more conservative and buying cash with your portfolio, then I believe that your asset allocation is too risky.

You have to reduce the amount of money in equities and increase the amount of money in bonds. So let's take another example where you buy 50% bonds and 50% stocks, you use the same assumptions. In this particular case, your portfolio will drop by approximately 17.5%. Now, my question is: when you are doing the investment policy statement and you're stress testing your asset allocation, what asset allocation will help you to stay the course during a market downturn? If you experience a 26.5% decline, will you be tempted to make perhaps the wrong choices? If your portfolio dropped by 17.5% such as it would under a 50/50 asset allocation, would you then be inclined to stay the course?

These are the discussions that must take place when you establish an asset allocation because it ties into your risk tolerance. Some people are very tolerant to risk, others are not. It's a very unique situation and you must identify your own level of risk tolerance. Once you've identified your risk tolerance, then I think there's a very, very good chance that during a bear market such as a one that we have seen, in March of 2020, you will not make a harsh decision and perhaps hurt your portfolio by making changes to it that are not necessarily in your best interest long term.

So in summary, tip number one is stay the course, but I urge you to have done your homework before the bear market, and only stay the course if you've stressed test your asset allocation and you know that you can withstand a market downturn. And I'm referring to your ability to not change your investment portfolio during a market downturn. If you have an asset allocation which is appropriate, to your risk tolerance, you will not change your asset allocation in the middle of a bear market, and then I can say to you, you have the ability to stay the course.

Rebalance your portfolio (10:08)

Richard Dri: Tip number two is rebalance your portfolio. Now, many studies have shown that if you consistently rebalance your portfolio, your long-term investment performance will improve. If you wish to review the research on that, you can go to my website for further information, again, it's richarddri.ca. Now your investment policy statement will outline three major asset allocation decisions. Number one, which we talked about earlier, is your asset allocation. What percentage do you put into bonds? What percentage do you put into stock? Let's assume a 60% equity component and a 40% bond component for this discussion. The second decision your investment policy statement has to make is what weighting do you allocate to each of the individual stocks in your portfolio?

Again, for discussion purposes, we will assume 5% weighting for each individual stock. The last asset allocation decision that your IPS must make is at what point do you rebalance your asset allocation from the actual back to the target? And at what point do you take the individual stocks and either trim them down if they are weighing more than 5% or add to them if they're weighing less than 5%? And those are the triggers that will indicate when rebalancing must be commenced.

Now let's take an example. If your investment policy statement has an asset allocation of 60% equities and 40% bonds, and over time your asset allocation moves either up or down based on which of the two either bonds or stocks perform better. So let's assume that at a particular time that we look, our equities have gone down to 53% of the weighting and our bonds have increased to 47% of the weighting. So in other words, we have 7% more money in bonds than we initially wanted to as per our asset allocation, our target asset allocation and our equities are down by 7%. So that means our equities did not perform as well as our bonds. That would be the time when you be tempted not to do anything. But again, studies have shown that if you rebalanced back to your target over the long-term, your investment performance will be better.

In this particular example, we would sell 7% of the bonds and we would add it to the stock component therefore bringing back the asset allocation to a 60, 40 mix. Now that is a very difficult call to make because of the fact that bonds have performed better than stocks. But again, history is on your side if you do that. Now where do you put that extra 7%? Well, of course it goes into individual stocks, but again, where? Now here is where we would buy the stocks that have underperformed. So stocks that are no longer weighing the 5% that we wanted and therefore if a stock is now weighing say 3% because it underperformed, we would then buy that particular stock with the 7% and bring it back up to the desired weighting of 5%. We would also look at individual stocks that are now weighing more than 5% and we would trim them down and we would be allocated to stocks that are no longer weighing the 5% because they've underperformed and now are less. Say there may be three or 2%.

So we would be taking from the winners and we would be buying the stocks that have underperformed. I know during a bear market, if you're like me, you're going to be tempted to do something, especially if you're a type A personality. So instead of panicking and selling your individual stocks, use the historical evidence that is out there, read your studies and if you agree with the studies, you will follow a rebalancing approach where you bring your actual asset allocation back to the target annual reweigh your individual stocks back to their target.

Harvest your tax losses (14:33)

Richard Dri: Tip number three is harvest your tax losses. What we mean by this is to review your non-registered portfolio and in particular look at the stocks that have gone down in value and determine whether it is prudent to sell them at that particular time when they've gone down in value. If it is a good idea from an investment point of view to sell some or all of your underperforming stocks, then the tax man will help you because when you trigger a capital loss, a capital loss for tax purposes can be used to offset the capital gains that occurred in the calendar year or they can be taken back up to three years to be applied against capital gains or you can apply them forward indefinitely again against capital gains.

Make sure you have enough cash (15:29)

Richard Dri: Tip number four is to make sure you have enough cash for this particular event that is an emergency. Now, why do I say that? Because a market decline is usually followed by a recession and a recession is usually followed by higher unemployment and higher unemployment usually leads to lower revenues if you are a business owner. If your revenues have been reduced, the last thing you want to do is sell your stocks that are temporarily down in order to pay your monthly expenses. So we recommend that you have a minimum of three to six months worth of cash reserves, call them whatever you wish, an emergency pool of money, which you don't touch unless you really have an emergency and you use those funds during the time that your revenues have been reduced. If you are a retiree, we actually recommend that you keep between two to five years of living expenses in guaranteed investments such as GICs to again prevent you from going into the stock market and selling your stocks when the markets or when the individual stocks are down.

Don’t look at your investment statements (16:49)

Richard Dri: Now tip number five is probably the hardest one from an emotional standpoint. Now I know the headlines today are full of pandemic news and vaccines and everything else connected to the pandemic. And of course the effects that the pandemic has had on the stock market, especially when the stock market drops significantly in one day. We find that the news is extremely alarming and we are tempted to look at our statements if we have hard copies or most people are also connected online. And if you are not, but you wish to have the ability to review your statements online. Again, give my office a call and we'll be able to set you up with that particular service.

But let's say you do have that at this particular moment. You have the ability to look at your statements and the markets are down significantly. You look at your statements and I'll tell you, you must have an unbelievable amount of courage not to act if you see the market continually dropping. And what that might cause you to do, is it may cause you to make a decision such as to sell. And again, a short-term decision made during an emergency may actually lead to a detrimental result in the long-term.

Maintain your philanthropical commitments (18:20)

Richard Dri: Tip number six is to maintain your philanthropical commitments. As I mentioned earlier, a bear market leads to unemployment. Unemployment leads to potentially more and more people not having enough money to live. So let's be honest, if your main concern is a decline in the value of your stock portfolio, consider yourself fortunate and maintain your charitable gifting. Of course, it doesn't matter where the gifts go, you pick the location, but maintain the charitable gifting because that is definitely the time when it is required the most.

Have a momentum strategy (18:57)

Richard Dri: Tip number seven is to have a momentum strategy. Now at the Dri Financial, we developed an investment strategy that buys the market when the S&P TSX trendline is upward and sells the market when the trendline is downward. Now the result is that we are in the market when there's positive momentum and we're parked safely in cash when the momentum turns negative. Now we back tested this particular model for many, many years and historically the model flashes a buy signal very, very close to the market bottoms and in the opposite case, it flashes a sell signal very close to market tops. It's not perfect, but no model is. But it's been very good historically to signal the beginning of big sell offs.

For example, during the current pandemic, the model flashed a sell signal on February 26 2020. Yes, very early in the general market decline and if you had followed that particular signal, you would have avoided much of the decline in the indices. Well that is it, those are my seven tips for surviving a bear market. Hopefully they will help you in terms of what to do and not to do. If you need further information I've written numerous blogs on the topic. Again, you can go to www.richarddri.ca. If you wish to make an appointment, you can do that online again, go to www.richarddri.ca my calendar is there you can book a time and we will be able to conduct these meetings safely from the comfort of your home and the comfort of my home. That is it for this week thank you.