HELM
INVESTMENT MANAGEMENT

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HOW TO COOK A BEAR

The official definition of a bear market is a 20% drop from a recent high of the S&P 500 or Dow Jones industrial average. The S&P 500 just hit that mark: It's currently down 20% and the Dow is only down 17%. Yet plenty of other major indexes have passed into bear country: The NASDAQ composite of mostly technology stocks is off 24%, the MSCI EAFE of non-U.S. large cap companies from developed countries is down more than 23%. The FTSE/Xinhau index of Chinese companies, one of the hottest in 2007, has plunged 44%.

In some ways, bear markets are a mirror of bull markets. Just as investors as a whole tend to shrug off bad news during a bull market, the same group of investors tends to ignore good news during a bear market and accentuate the negative.

That's not to denigrate the importance of the sort of bad news that moves markets from bull markets to bear markets. Consider the litany of economic and financial woes we now face:

- The sudden turn from a housing bubble to a housing slump
- The unwinding of bad fixed income bets and collapse of firms such as Bear Stearns and the Carlyle Fund
- The return to a weak U.S. dollar
- The probable start of a recession
- Oil at $110 per barrel
- The fears about a combination of inflation and slow growth not seen since the 1970s.

These are all difficult problems that will take time and effort to correct.

Typical recent recessions have lasted about 9 months. The official dates of the start and end of a recession aren't known until months or years after the fact, due to the way the economic statistics arrive and are revised. But it's possible that we're a third to half way through this recession.

That's important to keep in mind on bad stock market days (and there likely will be more big drops and bounces up in the coming weeks), since the stock market often begins to recover from the bear mauling about halfway through a recession. After all, the financial markets are mechanisms of anticipation: investors buy today with a view toward what the world will look like six months ahead.

Now some bear recipes. If you had the foresight to sell stocks last summer or fall, good for you. But unless you plan to stay out of stocks forever and watch your money gradually lose ground to inflation, you need to get some money back into stocks. That can be tricky as the bear market ends. A recent newsletter from MFS Investment Management notes that missing the 20 best stock market days in the past 20 years (one day per year on average) cut your return from an average 9.3% per year to only 4.8%.

If you have a balance of equities and fixed income (anywhere from 80/20 to 50/50 equities and fixed income), you are in a stronger position than many hedge funds and other institutional investors. If you need income, you can live off the interest or proceeds from the sale of your liquid bonds. And if you're ready to try a spicier bear recipe, consider rebalancing some of your fixed income into stocks – if your investment horizon is long enough and you have the stomach for it!

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