THE BEARS ARE AT THE DOOR
(AND WHY WE SHOULD EMBRACE BEAR MARKETS)

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One of the longest global bull markets in living memory wound down in 2018. PAUL CLUER takes a closer look at bear markets and what they mean for long-term investors.

Bear markets are periods of depressed or falling security prices. They are characterised by lower global liquidity, rising inflation, rising interest rates, negative earnings news and negative sentiment. They are often cyclical but are typically shorter than bull markets. Bear markets are also characterised by investor and media boredom. There is a lack of major news flow and there is little market excitement and no frenzy.

That markets fall or correct when interest rates normalise upwards should be no surprise. This is because interest rates are associated with the market's cap rate — lower interest rates mean the present value of future earnings is higher and vice versa with higher interest rates. Interest rates have been rising in the US for two years now and the US Federal Reserve's planned trajectory has spooked investors accustomed to artificially low rates for the past decade.

Equity market investors are naturally elated at rising share prices. We all feel wealthier — at least on paper. As fund managers, we understand that prices fluctuate far more widely than values. Rather than despairing over falling prices, we see long-term buying opportunities.

In our experience, it is particularly advantageous to identify a bear market early in its cycle. This allows for timely defensive positioning, as restructuring portfolios during a bear market can become impossible. This is because stock broking activity reduces substantially given the lack of greed and trading volumes. As a result, investors cannot buy or sell stocks in significant volumes and liquidity is only exhibited in the top 20 or 30 shares.

Foord's portfolios have been cautiously positioned for at least two years. We are often criticised for being early but long experience has shown that it's better to be early than late when the bears are at the door. It is therefore often better to sit on one's hands once a bear market hits, having already prepared portfolios.

Despite gloomy sentiment, bear markets are good for long-term investors because they provide opportunities to buy shares in good companies at great prices and often in large volumes. This is because markets are less efficient during bear phases as many market participants are selling for reasons unrelated to valuation, for example to reduce gearing or to raise liquidity. Buyers of shares can therefore pick up bargains provided they have enough cash or liquid investments like bonds which are typically resilient in bear markets.

Not all shares go down during bear markets. There are many more examples of shares going up in a bear market than shares falling in a bull market, where all shares tend to rise. This is because earnings become premium during bear markets, with investors willing to pay up for better earnings quality, more earnings certainty and real earnings growth. Nevertheless, the lack of significant market liquidity in a bear market can mean that quoted prices may still be too high since sellers could never dispose of major volumes at ruling prices.

Defensive positioning in advance of a bear market and limiting losses to ‘less than market’ declines are only half of the equation. More important is for the portfolio’s securities to participate in market rallies after the bear phase ends. It is paramount that investors own companies that will not just survive, but will grow their earnings at above average rates when the global economy accelerates.

Investors should be able to cope with depressed earnings for a year or 18 months if faster earnings growth lies on the horizon. The most significant investment gains are achieved in the early stages of an ensuing bull market when long-term bargains are on the table. Investors must be invested when the turning point comes.

We often remind investors that all bear markets end. Sometimes this is difficult to envisage in the turmoil of market corrections. This bear market, too, will end — but not just yet. Normally, bear markets peter out when the interest rate cycle peaks, confidence returns and more money is available for the market. But we’ve yet to see the full effects of an unprecedentedly large quantitative tightening cycle.

Financial markets lead the real economy by many months and so the end of the equity bear market will precede an improvement in the real economy’s fundamentals. But investors shouldn’t underestimate the power of sentiment, which can be most negative towards the end of the cycle.

It is during these final stages of a bear market that the best bargain purchases can be made and there could be some great investment opportunities to be taken in 2019, particularly if prices continue to trend lower. Now is the time for investors to demonstrate patience to allow their fund managers to find the investment winners in the next bull market.

ABOUT FOORD ASSET MANAGEMENT

Foord Asset Management has been successfully growing retirement savings since 1981. The company offers a premium investment management service to long-term investors in retirement funds and unit trust portfolios. A multi-decade track record of successful investing evidences Foord’s ability to consistently deliver superior investment returns for a range of investment strategies.

- As an independent and owner-managed business built on the principles of investment stewardship, we place investors’ interests ahead of our own
- We construct diversified investment portfolios based on rigorous fundamental research, high conviction ideas and an adaptable, value-driven investment policy
- We embrace market volatility as opportunity, not risk.

ABOUT PAUL CLUER

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B Bus Sc (Finance) (Hons), B Com (Hons), PGDA, CA(SA), CFA

- Joined Foord in 2004
- Director of Foord Asset Management in South Africa, Singapore and Guernsey
- 22 years' financial services experience.