Survive and Profit in Ferocious Markets

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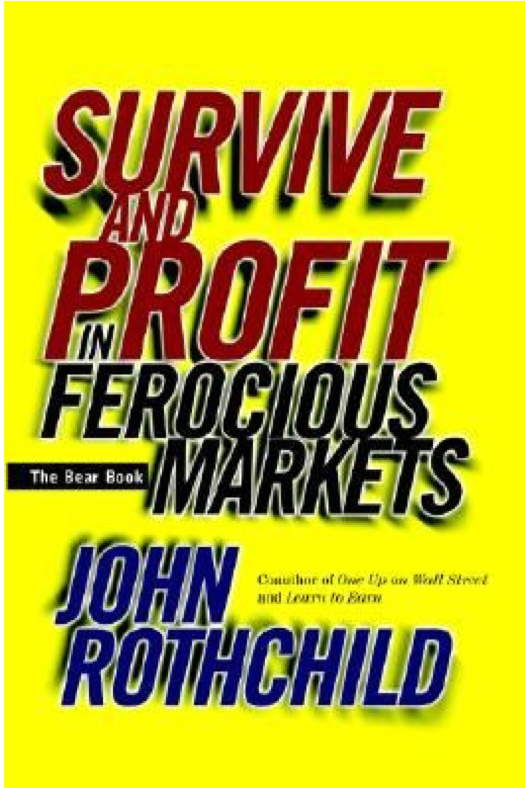
Journalist and author John Rothchild helps us understand bear markets including how maybe to spot them, what to invest in while in them and when coming out of them. His witty style helps make a difficult topic a bit more enjoyable. His views and those of investment advisers, strategist and fund managers fill an important information gap in writing about investing which focuses either on good times or doomsday.

Rothchild offers advice perhaps relevant for today when he says ...

> **"… at 20% down your in bear market territory. At 30% down you're in a moderately severe bear market and at 40% down and below, the risk of missing a new bull market is greater than the reward from avoiding the tale end of the bear. Yet it's a common feature of many bear markets that the largest contingent of sellers exit at the point of maximum loss"**
> ***[stocks hit bottom on huge volumes in 1929, 1937, 1974]***



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Early warning systems?

Bears maybe coming if …

Martin Zweig's three strikes

- Extreme deflation where cpi falls > 10%
- In a boom market where stocks sell for P/E>20 (P/E n/a during a bear market when E collapses)
- Inverted yield curve where long term interest rates < short term rates

Q ratio (market value of stocks / replacement value) > 1 or value > 75% of GDP

When large cap companies rise faster than small caps (aka San Juan theory)

Advance:decline ratio falls (ie. more no. of stocks sold then bought)

Unexplainable "Dow theory" – newsletter tips

Fed watching – bear market after 2nd tightening?

None of these would have reliably picked our current market decline which was more debt driven

.. but don't rely on

"the media aren't going to help you at key turning points ... reporters must explain ups and downs when no sensible explanation exists … nobody bothers to check on the accuracy of prior predictions"

Bearish forecasters and dooms day book writers suffer from the Cassandra syndrome – yes, will be right sooner or later but at the very point they should be taken seriously, they aren't

"Trained economists are no more adept"

Out of 160 newsletters tracked since 1980, only 18 survived to 1997, and only 3 offered predictions that beat the market

Magazine covers –evidence suggests they provide a kiss of death or are a contrarian indicator

Rothschild's "Buy to the sound of cannons" [war] and "Sell to the sound of trumpets" signals probably reversed, as war is more bearish and recovery bullish

"The psychological element makes bear markets hard to navigate"

Bear investing tips

If it's not too late (ie. expensive), switch <u>in</u>to defensive stocks like …

- **Food, drink, pharmaceutical, oil, tobacco, utilities, gold, home products**

… <u>out</u> of chemicals, retail, financials, building, transport, industrial, airlines, computers

- **Then switch again when recovery happens!**

Also get out of small stocks into the bear, then get back in quickly during recovery

- **Small (and large) "value" stocks are an exception as they hold value better**
- **Large stocks can rebound more slowly - momentum interrupted as people sell out once the price they bought in at is recovered**

"Pack your portfolio with dividend paying companies" – select carefully

- **Five year <u>bull</u> market in Great Depression (1932-1937) when investors re-entered a 14% yielding market while inflation/interest rates were just above zero**
  - **"A high yield is a buy signal, but no convincing case can be made for a low real yield as a sell signal"**

Use bear-friendly funds including those "run by old Fogies who've seen it before", Value style, Utilities, Short and Hedge funds

- **Warning label: "Short selling is rewarding on occasion. It can be habit-forming and potentially ruinous to wealth"**

"There are two sides to every Gold coin" – helped its owners in 6 of 11 losing streaks but $10,000 invested in 1980 worth $5,000 versus $70,000 in the Dow

Stocks <u>and</u> bonds

Bonds	Stocks: Under-perform	Stocks: Perform
Perform	Interest rates falling and inflation turns to deflation –esp. deep recession “Last time this happened was 1930”	Interest rates falling, inflation under control 1982 – 1997 – late in cycle stocks outperform bonds
Under-perform	Interest rates rising and inflation is out of control Like 1970’s	Inflation under control and interest rates are rising – but slowly Like 1950’s when people first thought stocks too risky

“a more aggressive investor will buy gold, commodities, real estate… if it’s too heavy to carry it’s worth owning”

Stocks or bonds can have their own separate bear markets or share one together.

“Jeremy Siegel in *Stocks for the Long Run*, shows how bonds outgain stocks in four years out of ten. Not only are bonds worth owning, but in certain periods, they’re the only thing worth owning”

A short history of inflation

"The Greeks gave us democracy, but their greatest contribution to government was watered-down money"

- Faced with having to 1) raise taxes, 2) cut back bloated spending or 3) continue spending, they chose (3) and put less precious metal into their coins

Romans followed when needing to pay for the war against Carthage

- "Overeating and late night partying may have contributed to the fall of Rome, but financial historians cite weak money as a key factor"

Paper money introduced by King James in 1250 was first welcomed as an alternative to coins but by 1700s faith was lost as government and private banks printed as needed

American colonies couldn't raise taxes to pay for the Revolution (after all they were revolting against British taxes!) so they printed and printed "Continentals"

Gold standard emerged to bring faith to paper money systems –conveniently abandoned to allow printing of Greenbacks to fund WWII and Vietnam wars

These days printing money is old fashioned – to create money out of nowhere the US government buys treasury bonds from one of several commercial banks and "pays" for it by crediting the bank with money in its cash account at a Fed branch

"On the back of every US bill are the words '*In God We Trust*'. Not "*In Cash We Trust*", because it can't. The only sure thing about cash is it will be worth less tomorrow than today"

"Could 1929 – that is 1932, happen again"

Everybody talks about the crash of 1929, however if you bought stocks at the beginning of the year and held until the end including recovery, you made money

- **The real loss was 1931 when Dow lost 53% in single month of September *(month which history shows to be the worst for investors)***

Then Wall Street was a "casino" with many buying shares with 10% down *[P/E peaked then at 34 vs. Oct 07 when was 17]*, banks lacked deposit insurance, monetary system was straight-jacketed by the gold standard

- ***This last feature may be highly relevant as some suggest that inflation will be encouraged to devalue current debts***

Story goes that the inexperienced Fed rose rates at the wrong time "strangling the patient", however, it did so to arrest the exuberance then after the crash it reduced rates 6x

- **Rates and stock prices fell so low that investors who re-entered the market enjoyed in 1933, 1935, 1936 & 1938 returns exceeding 30% pa**

"In some ways the US was in better shape in the 1920s. It had the fastest growing economy, no trade deficit, no federal deficit, low taxes and low levels of personal, corporate and national debt"

"Today [1998] we have slow growth and a big trade deficit. We're the worlds biggest debtor. Taxes are high. Instead of 10 factory workers for 1 government worker, we now have more government workers than factory workers"

Bearish humour (I)

"If bankers are busy, something is wrong" - Bagehot

"It's worse being a bear when you are right" - Metz

"A bear market is a bull in gestation"

"The safest time to buy stocks is when people are afraid to be in the market. The most dangerous time is when people are afraid to not be in the market" - Prechter

"We had no short seller as a speaker, because none has a pair of shoes to wear today" - Grant

" 'Buy and hold' have replaced 'I love you' as three most popular words in English language"   - Grant

"The country can regard the present with satisfaction and anticipate the future with optimism"
- Calvin Coolidge, Dec 19<u>28</u>

Bearish humour (II) – A National Park sign reads:

"When approached by a bear try to look big. Be forceful but not aggressive. Keep your pack on, wave your arms, talk loudly. Back away slowly but do not run. If a bear attacks you, assume the foetal position and protect your vital organs".

This is also the approved emergency plan for surviving a bear market. Assume a passive position and protect your vital asset, keep your shirt on, play dead with your broker, complain loudly if you must but don't flee your stocks or abandon your mutual funds"

John Rothchild

"Outdoorsmen should take care to avoid bear encounters. We advise they wear little noisy bells on clothing to give advance warning. We also advise you carry Pepper Spray.

Outdoorsmen should also be on the watch for fresh bear activity and be able to tell the difference between Black bear and Grizzly bears. Black Bear faeces are smaller and contain lots of berries. Grizzly bear faeces have bells in it and smell like pepper"

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