How to Survive a Bear Market

By
E.S. Browning
Updated March 8, 2015 11:03 p.m. ET

With the six-year bull market in stocks getting old, people are starting to wonder how they should prepare for a possible bear market.

The answer: Not the way you think.

The biggest mistake ordinary investors make, aside from not saving enough, is trying to predict the market.

Instead of tinkering with their holdings, financial planners and academics say, people should build all-weather portfolios of stocks, bonds, cash and other items that can rise in good markets and limit declines in bad ones. Then they might find themselves actually embracing bear markets as opportunities to buy stocks at discounts.

The less you tinker with the details, the less you have the opportunity to screw them up," says Terrance Odean, chairman of the finance group at Berkeley s Haas School of Business, who studies investor behavior.

People who change their holdings because they see a bear market coming almost always lose out.

The average investor in stock mutual funds made 3.8% a year over the past 30 years, according to Boston research firm Dalbar Inc. That is one-third of the S&P 500 s average 11.1% gain in that period. Dalbar s explanation for this sad performance: People buy and sell funds at all the wrong times.

No time to time'

Prof. Odean s studies have shown that people buy and sell stocks at the wrong times. They sell stocks that are poised to rise and buy stocks that do worse than those they

sold. They did worse than if they had been throwing darts," Prof. Odean said after completing one study.

This is the problem people have preparing for a bear market. They aren t good at picking the top, and they panic and sell once stocks have fallen heavily, when they should be buying.

Even people who get out before a bear market often shoot themselves in the foot: They are too frightened to get back in and miss the rebound.

The overriding emotions in an investor are greed in a bull market and fear and shame in a down market," says John Schott, a Harvard-educated psychiatrist who works today as a money manager at Steinberg Global Asset Management in Florida. People generally overestimate their ability to tolerate a market decline by a factor of two, he says.

Panic is overwhelming to the part of the cortex used in rational decisions and planning," he says.

The problem is especially bad now, Dr. Schott says, because people who were burned in the collapses of 2000 and 2008 have a fear in their own minds that they will be hurt again." That has kept many people out of stocks even as the S&P 500 has tripled since 2009. Anxiety also makes people trade too much, incurring losses, fees and tax liabilities, he says.

What to do now

If this is true, how can people be prepared for a bear market?

Money managers offer one solution: Give them the money, pay a yearly fee and let them worry.

For those who don t like that solution, there is an alternative: Weatherproof your portfolio. By diversifying broadly, with enough stocks to ensure gains in good years and enough bonds to limit losses in bad ones, investors can create a portfolio that can withstand bull and bear markets alike. Then they should stop trading.

Buy an all-market U.S.-stock index fund and a really broad-based international fund and a broad-based bond fund, to keep fees really low," Prof. Odean recommends. High front-end charges and annual fees charged by some funds and money managers can hinder annual gains, he notes.

People need to try to figure out their real risk tolerances, he says, and mix their stocks, bonds and cash to match those. Then rebalance the mix annually, so it stays steady. Some people do that by changing new purchases or rebalancing nontaxable retirement accounts, to avoid capital gains in taxable accounts.

Foster Group Inc., a financial advisory firm in West Des Moines, Iowa, is a microcosm of this philosophy. Founded in 1989, it started as a classic picker of stocks and sectors, trying to boost client performance.

Mark Stadtlander, now chief executive, found himself waking up with sore teeth in 1994. I was literally grinding my teeth because I was anxious about the service we were providing our clients," he says.

The firm s disappointing performance that year, a difficult one for stocks, drove home that trying to predict the market was the wrong goal. So Foster changed its approach. Today, it recommends broad mixes of stocks, real estate and bonds in the U.S. and abroad, rebalanced regularly. Its base suggestion is 60% stocks and 40% bonds. It adjusts that for the client s age, risk tolerance and other assets.

In 1997, Foster managed $100 million. Today, it oversees $1.6 billion.

Keeping out of trouble

How can people stifle the impulse to trade and predict? By not following the market," Prof. Odean says.

The most common thing investors wonder is: Where is the market headed?

What they should ask is: When? When do I need the money? Money to be spent in the next few years must be protected from decline, in short-term bonds or cash. Money

needed later has time to recover from a decline, so more can be in faster-growing assets like stocks.

An old rule of thumb is that your bond percentage should equal your age, although many financial planners say that, with people living longer, stock holdings should be higher than this benchmark suggests.

A common misconception is that bond funds are the same as bonds. In the long term, bond funds act like bonds, but in the short run, they might not. Bond funds value can decline if interest rates rise, because the value of existing bonds held by the funds, with their lower rates, declines. With an actual bond, you don t lose money unless you sell it. You get the interest you expected, just less than newer bonds may offer.

For people who can t stop trading, Prof. Odean has a suggestion: Take 90% of your money and put it in index funds. Take 10% and play with it, as long as you can afford to lose it.

Finally, it s important to remember something people have trouble accepting: Bear markets actually are great for long-term investors.

People who contribute regularly to funds and don t need the money soon should celebrate when stocks fall 30% or 40%. Their regular purchases now buy stocks at a discount, and history shows that broad markets always rebound. Over time, they are ahead.

Instead of selling, people should redouble their buying after a big drop. Easy to say. Hard to do.

Mr. Browning is a Wall Street Journal staff reporter. Email him at jim.browning@wsj.com.