CORDASCO
FINANCIAL NETWORK

When the Music Stops: Preparing for a Bear Market

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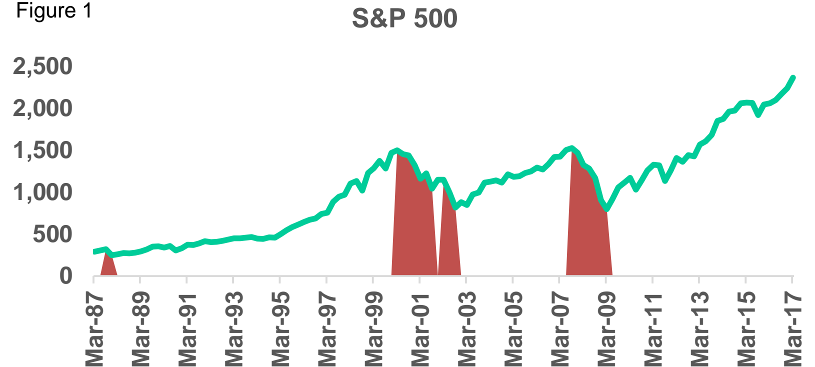
How Diversification Pays During Market Downturns

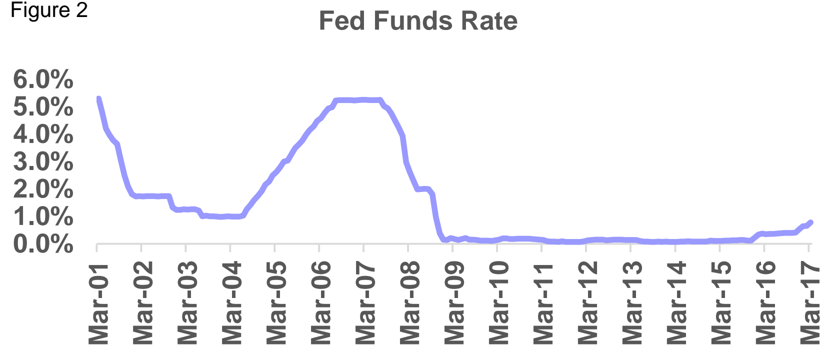
U.S. equity markets have enjoyed a sustained bull run for over eight consecutive years since the market bottomed on March 9, 2009 in the depths of the financial crisis. Aided by intervention from global central banks and a stabilization of the global financial system as a whole, the S&P 500 has generated an annualized return of 19.1% since then, or more than 310% on a cumulative basis, see Figure 1.



Source: Bloomberg

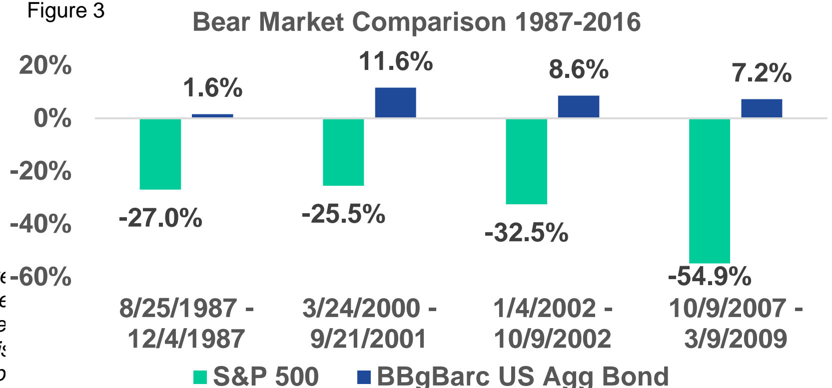
Despite the political uncertainty regarding a potential change of policy resulting from President Trump's surprise victory in the U.S. Presidential election, the market rally, which began in October 2016, continued as U.S. stocks enjoyed a winning streak of 110 consecutive trading days of not losing more than 1% in a single day, which is a historical outlier. The S&P 500 hasn't experienced a win streak of this magnitude since November 2006, and has only had win streaks greater than 100 days 12 times since 1950[1]. This streak may lead some investors to question why they should own anything outside of equities in their portfolios.

However, all good times eventually do come to an end. Few investors (if any) are able to predict when the market will give back some gains in an equity bear market. Instead of attempting to time the market, which we believe to be a futile exercise, diversification along the way makes far more sense. This includes owning a prudent allocation to fixed income, which has historically provided ample downside protection during adverse equity market environments.



Source: Bloomberg

Let's examine, for example, March 2007. The federal funds rate had steadily ticked up from June 2004 through March of 2006 from 1.0% to 5.0%, as shown in Figure 2, and had held steady for a year. Equities had rallied nicely and investors were faced with a similar decision as present day: what else should I own outside of equities? Well, if an investor had held only equities, the financial crisis was a far bumpier ride, as the difference in returns between bonds and equities was greater than 60%.



Source: Bloomberg

Over the last 30 years, equity markets have experienced four bear markets, as defined by declines of more than 20% in value. During that first

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market downturn, equities fell precipitously by nearly 27.0%, while bonds held firm, generating approximately +1.6% in positive performance. Bonds added further downside protection in the early 2000s and more recently during the financial crisis when equities fell by 54.9% while bonds were able to offer investors a safe haven, returning over +7.2% during the same time period, see Figure 3.

It is our belief that markets are impossible to time and that the best approach to investing is by formulating an integrated asset allocation plan that gives investors the best opportunity to generate positive returns over the long-term through both bull and bear markets. While past market performance is not indicative of future results, we are confident that by consistently holding a broadly diversified portfolio comprising various asset classes, investors will be far better off the next time the music stops playing.

[1] *www.marketwatch.com*

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