January 15, 2008

Special Report: The Bear Market

"It is a bear market when the low point becomes lower than the previous low points. It is often difficult to judge whether the end of an advance has come because the movement of prices is that which would occur if the main tendency had changed."

The ABC of Stock Speculation (Nelson) 1903

"There are many assertions trotted out by investors during bear markets – never catch a falling knife, nobody rings a bell at the bottom of the market, etc."

Anatomy of a Bear (Napier) 2005

Introduction

The dreaded "Bear Market" – As experienced investors know, it is not "if" you are going to experience a significant decline in investment values, it is "when". These are fast moving and volatile events that happen to all investments (stocks, bonds, real estate, etc.). For stocks, they can range from mild (such as the one-year -7% decline in the S&P 500 during 1990, where the losses were made up within the first month of 1991) or a major, multi-year Wall Street catastrophe (such as the -46% decline of 2000-2002, where it took eight years for the market to make up all lost ground).

Over the last 50 years, these conditions have occurred 24% of the time, with an average annual decline of -11%. Over 41% of these bear markets were considered severe, lasting two years or more, with total declines of approximately -40%.

This report is timely because, by most indications, stocks, real estate, bonds, and preferred stocks are all currently in bear markets – a rare occurrence! (see following charts):

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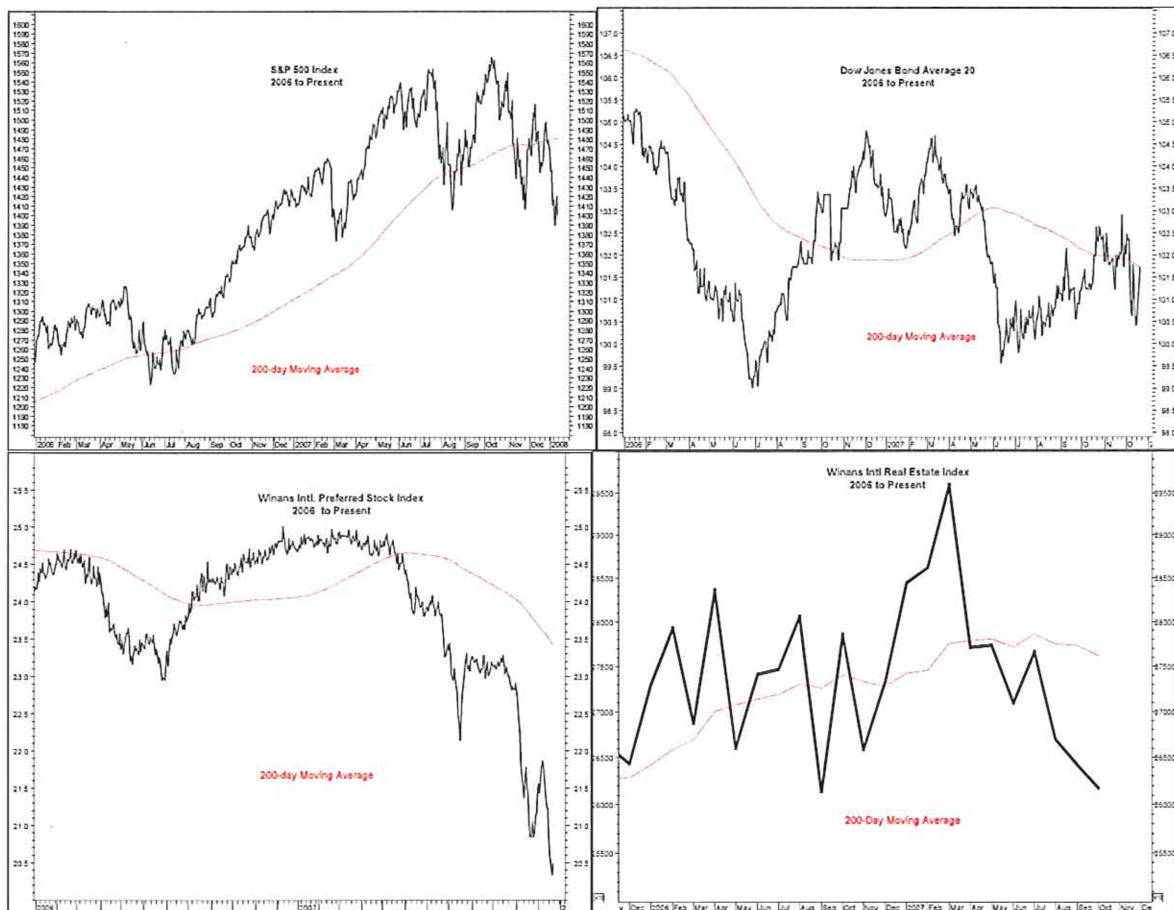

How Do You Spot a Bear Market?

The first thing investors need to get out of their heads is the foolish notion that there is a proven, consistent way to get out "at the top" or that the pros on Wall Street are going to line up and tell them to "get out" in a single voice.

While there is always a lot of media buzz near market tops and bottoms among the "talking heads" debating their bullish or bearish perceptions, there are time-proven indicators that signal a bear market has begun:

Negative Signals on the S&P 500's 200-day Moving Average – Although many types of moving averages are used, the 200-day (40-week) moving average is one of the most common indicators followed on Wall Street. In fact, it is listed in financial publications such as *The Wall Street Journal*, *Investors Business Daily*, *Barron's*, and *Business Week*. Websites such as www.StockCharts.com post it daily at no charge. (All charts in this report show the 200-day moving average as a red dotted line.)

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How do you use a moving average? When the price is below the moving average, the price trend is down and when the price is above the moving average, the price trend is positive.

The **Winans Trend Indicator (WTI)** uses the 200-day moving average with a filtering process to improve the accuracy of detecting the early stages of a bear market.

In multiple back-tested studies on 50 years of data, it has proven itself effective as an "early warning system" for approaching investment storms.

As can be seen in the tables below, by using the WTI's sell and buy signals, an investor could have avoided most of the downtrend experienced by investors who decided to stay fully invested.

For example, WTI produced only minor losses that averaged -2.4% during declining years in the stock market, while the market suffered approximately -11% declines on average. This is especially true of the severe bear markets of 1973-74 and 2000-2002 where average annual losses of the S&P 500 Index exceeded -16%, while the WTI only declined -3%. In addition, there are no cases in which the market outperformed the WTI during bear market years.

All Negative Years:

Years	WTI Signals	Buy & Hold
1957	(4.2%)	(11.3%)
1962	2.4%	(8.7%)
1966	(4.5%)	(10.0%)
1969	(0.0%)	(8.3%)
1973	(10.9%)	(13.3%)
1974	7.3%	(25.3%)
1977	(5.0%)	(5.8%)
1981	(0.6%)	(3.0%)
1990	(1.4%)	(2.6%)
2000	(7.3%)	(8.4%)
2001	3.8%	(11.2%)
2002	(7.9%)	(22.4%)
Average Decline	**(2.4%)**	**(10.9%)**

Major Bear Markets:

Years	WTI Signals	Buy & Hold
1973	(10.9%)	(13.3%)
1974	7.3%	(25.3%)
2000	(7.3%)	(8.4%)
2001	3.8%	(11.2%)
2002	(7.9%)	(22.4%)
Average Decline	**(3.0%)**	**(16.1%)**

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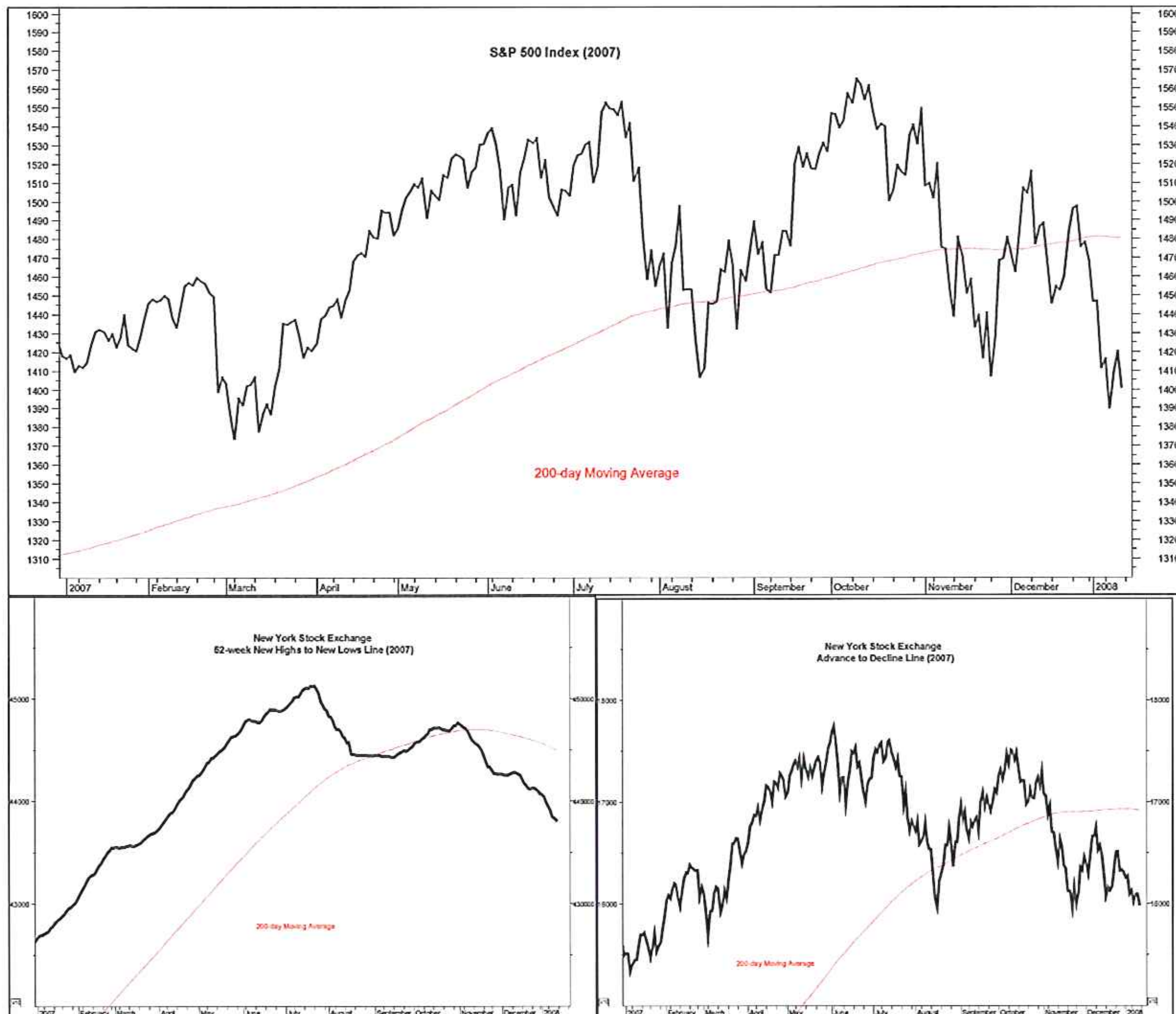
The Winans Trend Indicator gave its first negative signal in over five years on 1/4/2008, S&P 500 Index = 1412. This indicates we are in the early stages of a bear market in U.S. stocks.

Divergences Between the S&P 500 Index and Market's Overall Strength - In healthy market conditions, stock prices move up with more stocks advancing in price than declining and more stocks posting new 52-week price highs than new 52-week lows. In late-stage bull markets, major market indexes (such as the S&P 500 Index) often rise to new record levels while fewer and fewer stocks continue to advance and make all-time highs (called a divergence). This deterioration in overall market breadth is not sustainable over the long-term and often leads to significant price corrections.

As can be seen in the charts below, both the NYSE advance/decline line and the NYSE high/low line crossed below their 200-day moving averages in October 2007, while the S&P 500 Index itself moved to record levels during the same time. The last time this situation occurred was in 1999 and 2000 during the "Dot Com" bubble.



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What Should Investors Do?

As a bear market begins, many investors frantically focus on the two extremes of: (1) Riding through the bear markets and hope for the best, or (2) "Cashing out" by selling everything, paying the taxes and commissions, and coming back to "fight another day".

In reality, a good investment strategy includes a well-thought-out plan to deal with bear markets that include the following basics:

1. *Focus on Minimizing Losses* - It should not be unusual to keep 25% to 50% of the portfolio in cash equivalent investments and wait for a better environment to materialize (like a positive crossing of the S&P 500 Index above its 200-day moving average). Remember that there are tremendous buying opportunities near the end of bear markets and you will need money for investing.

2. *Profit Taking* – There is a common belief that ALL stocks perform poorly in bear markets. In reality, stocks from certain industries such as healthcare, consumer staples, and utilities typically weather bear markets well. However, bad news or changes in an analyst's opinion can wipe out a stock's profit quickly in the pessimistic environment, so don't hesitate to take profits during powerful bear market rallies such as the 25% 4-month rally after 9/11.

   For Advanced Investors:

3. *Hedging Strategies* – For large, complicated portfolios, selling off significant portions of investment holdings is not practical. By using various hedging strategies that use derivatives (i.e., stock options, stock index futures, etc.), or short selling ETFs on major market indices, investment losses can be minimized because the value of the portfolio's original holdings has been "counterbalanced" by the hedge that increases in value if the original investments decline. This way you can "lock in" the value of the portfolio (for a small cost) without selling its original contents. Near the end of the bear market, the hedges are "closed" and available cash can be used to purchase new investments.

4. *Shorting the Market* – Aggressive traders try to capitalize on the fast pace of a bear market for a "quick buck" by short selling investments or using "naked" put options in hopes that the positions can be closed out at a much lower price in the near future. Since losses can be substantial, most investors are discouraged from these kinds of trading activities.

Summary

Bear markets are a normal part of the investment process and are handled poorly by many investors who "buy high, sell low". A shift in investment mindset is required to successfully deal with a bear market. By focusing on minimizing losses, repositioning investment holdings into defensive stocks, and profit taking without hesitation during bear market rallies, an investor should be in a strong position to capitalize on the powerful rallies typical of early stage bull markets. Remember the 28% advance in the S&P 500 Index in 2003!

Kenneth G. Winans, CMT, MBA
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Additional information is available upon request.

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