

Embrace the Bear:

*Waiting for the Bull
Could Cost You a Fortune*

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Thank a Bear When You Make a Million

What we all know: Bulls make stocks go up. Bears make stocks go down. Simple

And misleading.

People fear bear markets too much. They shouldn't. Every bull market has a bear market at the front and back of it. They're normal, recurring, and they can be extremely profitable. *If you know how bears really work, you'll know one of the market's great secrets... and your investment confidence will swell as you learn to use it.*

We all love bulls when we're holding stocks. Bulls catch the market on their horns and drive it up. Bears reach out and slash down, as the conventional wisdom goes...

But there's a key insight missing from the conventional wisdom. The case with bears is slightly more complex. Despite their reputation for knocking stock prices lower, bears are also the first ones in when new bull markets begin. It is the bears, not the bulls, who are the kickoff specialists.

That's because of an essential truth about their bear mindset. They are not cowardly. They are cautious about getting in danger. Bears are only temporary pessimists waiting for a reason to be optimistic again. They don't knock over the trashcans unless they smell the food.

Contrary to their reputation, bears are NOT investors who hate stocks. People who never like stocks don't matter to us at all. They aren't even in the bidding. But bears are. In fact, they are always "in" the market. If they are not buying, they are resisting buying and putting the brakes on.

It's been a little more than a decade since my friend Bob Meier offhandedly said to me, "Bears start every bull market." At first, I thought, "Huh?" But the more I thought about it, the more sense it made. As the years went by, I got a chance to observe a number of additional bull and bear rallies with this thought in mind. And I could see that the investment wisdom in this idea was a great tip.

What will it do for you to know that bears start all rallies? It will give you reason to stay calmer, give you a better viewpoint on the profit cycle, and show you the most natural buy-low/sell-high system in the world. Let's look at the bear truths...

Hanging With Bears

In the last century-plus (1900 through 2007), bear markets and less adverse periods have been frequent visitors. Any investor who can't handle bear markets will frequently feel overwhelmed.

Dips: A drop of 5% or more is a “dip.”

Since 1900, the market has dipped 359 times.

The average frequency for dips is three to four times a year.

The average decline has been 11%.

The odds were one in three that any of these dips turned into a correction.

Corrections: A 10% or greater drop is a correction.

Since 1900, the market has seen 119 corrections.

The average frequency of a correction is slightly longer than once a year.

The average decline for corrections is 19%.

Nearly half of the corrections moved on to become bear markets.

Bears: A bear market is a 20% or more drop in stock prices.

Bears occur approximately every three years, though not regularly.

The average decline for bear markets has been 34%.

I got these interesting facts from Edward Jones and updated them for the past year. But I liked Jones' take on bear markets, corrections, and dips: “We believe stock market declines help return stock to their rightful owners—those who understand what they own and why they own it.” Sounds like a value investor to me.

Bears Always Want to Buy—at a Price

Part of investment success is confidence. That doesn't come easily to a thinking person who knows the risks. It's abnormally hard when the headline news keeps announcing how much the Dow and Nasdaq fell again. But this should help:

Somebody always wants to buy stocks.

Sometimes the bulls want to buy, but they are apt to spook when the market slips. But bears always want to buy stocks if the price is right. I don't care what the Fed does, what the analysts say, how gloomy the headlines may be. At a certain price, any reasonable stock will become attractive to bears. They'll run the figures forward and see a profit in the deal. They will buy at the worst times. They'll also buy in the best markets, but they'll be much choosier and lean toward picking off the unfavored while prices are good.

Bulls are the ones who say, "Microsoft is going up again (or bound to go up), and I don't want to miss out. Somebody must know something."

Bears say, "Microsoft may be going up, but it's not worth the risk to me unless I can get it for \$22. I'll wait until it gets there."

Bears are usually thought of as sellers. In fact, they are standby buyers. When stocks are falling, the market is scary and no one is expecting it to get better soon. It is not the bulls who will brave investing. It is the bears. They will come just to grab bargains.

Look at the market from the floor trader's point of view and you will see how bears stand by. This happens every day, and on a small scale it is precisely the same process that rules the longer-term direction of the market.

Say the floor trader has five larger orders from investors who want to sell their stock now that it's reached \$24 and they can bank some profits. Every bull who was interested has gotten in. There are no more new buyers willing to pay more. So the floor trader lowers the ask to \$24.99 to see if he can get any buyers at that price. Still not good enough. \$24.98, \$24.96... \$24.90... Now one of the bears is interested. He'll take some stock. The others wait.

The price continues down. At \$24.80, more bears are happy. They'll take some more off the market maker's hands. Over the next few weeks, the process continues. The stock drops to \$23, and there's been just enough buying to keep it there. More bears will assess the price to be right for them between \$23 and \$24.

Finally, the price will fall enough to provide a range of comfort for the cautious bears. The stock will appear to be rising as bears do their buying within that range from \$23 to \$24. And now the bulls see the price begin to go up again... and back they come.

The bulls wouldn't have started the rally. They jump off when opinion turns. It takes bears to create buying... on their terms at lower prices.

To you as an investor, this process means that, except in the extremely rare cases where a stock falls to zero with no warning, somebody WILL buy your stock. The question is, at

what price? Perhaps not for as much as you'd hoped, but your stock will continue to have value. Unless you have bought something exceptionally awful, your stock is not going to be worthless tomorrow or the day after. It is a real asset as long as the business continues to have some enduring value and the ability to make profits in the future.

That's why value investing is a safer discipline than pure growth investing. As a value investor, you are buying your stocks at or close to the prices where bears will be interested. In the worst conditions, your stock should not have to fall as far as an overvalued story stock before an astute bear takes an interest. To put it technically, you have "bear support," and it's not far away.

If You Lose 50%, You Have to Make 100%... And, And, And...

Every time I hear someone say "If you lose 50%, you have to make 100% to get it back," I wonder why no one notices the obvious. Getting it back is twice as profitable!

Why do you think bears like stocks after they've fallen so much?

Let's take a \$10 stock as an example. If it goes up \$5 to \$15, you'd have a 50% profit. That would be quite a nice win.

But suppose that stock didn't go up first. Suppose it fell from \$10 to \$5. Now let's say you have looked at the company and the situation and you can see there's no good reason for the stock to be that low, so you buy it. You turn out to be right, and it gets back to its old price of \$10.

And you made 100% on the way up, an even better gain on a \$5 move.

Not only does the same \$5 move from the lower bear market price mean a bigger reward, but this kind of advance is very likely to happen if all is well with the company.

It is easier for a stock to get back to an old high than it is for it to reach a new high. That means it is easier to make 100% on a decent company whose stock is down 50% than it is to make 50% on a decent company trying to set new highs.

This is one reason why I am cautious about setting up trailing stop losses. They have their uses, but if relied on indiscriminately, they are often bad for you.

In strong bear markets, thousands of stocks will drop and you are apt to see yourself cashing in stocks at losses all over the place. That will prove to be a mistake, because the good stocks will recover nicely as the bear market passes or the economy improves. Why dump your good companies at low prices just so some smart bear can say, "Hah! A

bargain!” You’re just giving him the means to make 100% while guaranteeing that you will lose 50%.

Of course, I used an extreme example. Most of our stocks don’t drop by 50% in a normal zigzag. But here’s the math...

If a stock loses:	It will go up:	when it gets back to its original price
10%	11%	
15%	18%	
20%	25%	
25%	33%	
30%	43%	
35%	54%	
40%	66%	
45%	82%	
50%	100%	
60%	150%	

Realizing this, two things become apparent.

One, if you already have the stock, you need to be able to decide whether it’s a dud on its way farther down or a decent company on a setback that will soon repair. That calls for some fundamental analysis, which is what the value investor does well.

Two, buying other people’s losers after they’ve needlessly panicked is likely to be a very profitable enterprise. Again, though, you need to be able to evaluate the prospects of the underlying company. Advantage to the value investor again.

Paper Cuts Sting, but Real Cuts Bleed

Given all the cheap bull advice, my favorite is the saying that the first rule of investing is “Don’t lose money,” and the second rule is “See rule #1.”

Talk about dumb advice! First, no one invests without losing money on something, at least for a while. Never happened.

Second, any idiot knows that the idea is to make money. It’s a pointer or two about how to avoid *losing* money that would be useful advice. This is like saying the first rule of crossing the Grand Canyon on a tightrope is “Don’t fall.” Well, of course it is! So what?

And third, what it means to “lose money” is ambiguous. If your stock is quoted at \$26 today and \$25.75 tomorrow, are you really losing money? If you sell for a lower price, then it for darned sure is a loss. But if the lower price is nothing but a change in the

quotation on an offer you don't expect... well, that's like the weather on Hungry Mother Mountain. Wait an hour and it will be different.

Most people who quote that "don't lose money" rule use it to justify their stop losses. While stop losses do have a place in investing, please note that the term is literal. You are stopping a LOSS from getting bigger. You still have a loss. Anytime you sell for less than you paid, you have a loss.

In fact, selling a stock when it is down *might* prevent further losses. But it also might prevent you from getting whole and going on to further gains. When you hit a stop loss and sell, you **absolutely cement a definite loss into place**. You cannot take advantage of a stock rising from a dip if you no longer own it. Someone else will eat that fruit. Who? Probably a bear who saw that the stock was trading at a good price compared to its earnings potential.

The smart investor will always think like a bear. He may act like a bull and partake of buying, but he should know what his stock will look like to a bear. If it's down and it's a bargain because the company's prospects are good... then someone is going to make money when those prospects come true.

What's the insight here? Don't sell your stocks at prices that will attract bears. You'll just watch them make money on your losses. How to tell? The smartest way is to know your company. Know its prospects and why its stock is down—whether it's a passing blip or real trouble. And if you read the stock's chart, you can see its support and trend lines. These will show you where the bears are likely to become buyers.

Knowing how to find the bear support trend line is a good skill, even for the value investor who abides by fundamentals first. To find it, look at a chart, or a section of a chart, that has been rising. Find the lowest point. Put a ruler under it and connect it to the next-lowest point. Draw a line. That's bear support.

Very often when a stock price drops to a bear support line, it recovers. Bears take interest around those prices and begin buying. You can avoid selling on the drops and wait for buying to begin again. It's only when a stock decisively drops through the bear support line that the trend is changing and a bullish stock is apt to be turning down for a good while.

Bears Run Faster, Bulls Run Farther

Nature didn't make any hills without valleys, and the market doesn't make any bulls without bears. Every bull market followed a bear.

Newer investors have the notion that the market is generally friendly. From 1984 to 2000, it went up, up, up. That was an unusually long good run. In truth, the market is bearish nearly half the time. If you cannot use bear markets, you will be severely challenged to succeed at investing.

There are two kinds of cycles in rotation at all times.

The first is a long-term trend, which will be a “secular” bull or bear market. The secular trend is broad and enduring. It will last from a year to a few years to over a decade. 1984 to 1994 was a secular bull market, just as 1929 to 1949 was a secular bear market.

Within these secular trends, you will still have periods of ups and downs. These are the bear rallies that puncture long-running bull markets and the bull rallies that enliven secular bear markets. These cyclic bull and bear markets come around often and tend to be short.

Since 1942, the stock market has swung from bull to bear and back again 16 times. On average, you’ll see both bear and bull cycles in every four-year span. The bull cycles tend to last about three times as long as the bear cycles, although you can’t count on mathematically perfect spacing.

Overall, the market has been in cyclical bull cycles for 49 ½ years since 1942, and in bearish cycles for 15 ½ years.

If you plan to invest for more than a couple of years, you are going to see some bearish markets. Might as well learn to use them

You should know that returns tend to be outstanding after bear markets. What’s more, the cyclical bull rallies within bear markets can be outstanding. The worst secular bear market in U.S. history was from 1929-1949. But the bull rally that interrupted it, from 1932-1937, resulted in a 334% gain, one of the best runs in history.

That’s why smart investors like bear markets. That’s the time to buy low to get in place to capture those bull-rally, post-bear gains. But the only people who catch them are the bears. The bulls have quit. They’re waiting for the next confirmed bull market so they can buy high and hope to sell even higher. Only the bears are in at the beginning of the new bull market.

You Can Make More Money in Bear Markets

To paraphrase James Taylor, “I’ve seen bear and I’ve seen bull. I’ve seen cloudy days when I could not find a friend... but I’ll be glad to see a bear market anytime again.” Because I’ve made money in every bear market.

2001-2003 were great years to my way of thinking. Even the end of 2000, when the tech bubble spectacularly burst, was an outstanding time to pick up non-tech stocks.

In 2000, you could buy Centex for \$10, recently \$25 even after the recent housing bust. That’s the kind of safety that comes in bear markets.

You could also get Apollo Group for \$8 (recently \$77), Fossil for \$5 (recently \$35), Zimmer Holdings for \$27 (recently \$67), Dentsply for \$8 (recently \$45), Express Scripts for \$4.50 (recently \$70).

These are just normal stocks, not obscure bio-techs that came out of nowhere. They are all stocks an average investor could find. We are now in another bear cycle, and all those stocks were off their highs at the beginning of 2008. But nobody who bought them in the last bear market is hurting.

The Sweet Honey Payoff—Indexes Don't Tell All

There is another thing that very, very few investors—including most college-trained professionals—don't know about markets. The indexes that we all use misrepresent reality by miles. They especially fail to show how much money investors who stay active in a bear market make during the next bull cycle. Let's take the most recent case of a bear and a recovery.

2002 was not a good year for investors. The S&P opened at 1176 and dropped to 794 by September. Then the climb began.

On the surface, the indexes showed a drop of 32.4% in 2002. And from that low, the S&P rose 95.8% to 1555 by July 2007.

That sounds good, doesn't it?

The truth is, bears had it much better. When we calculate what the S&P did for a single year, or any time period, we just take the starting price and the closing price and work out the percentage.

But that's not how we invest. Active bears were dribbling money into the market all the way down. Every month, their stocks got cheaper.

Let's say they bought shares once a month. And rather than use specific stocks, we'll let the S&P 500 SPDRs (SPY) be our stand-in. If a bear had thrown in \$1,000 every month in 2002, he would have bought a variable amount of SPY shares. At the beginning of the year, he got 8.7 shares. By August, the same contribution was buying a full 11 shares. In October, the investor was getting 12.1 shares.

If he had put his whole \$12,000 into the SPY at the beginning of the year, he would have gotten 104 shares of the S&P ETF. (SPY is an exchange traded fund.) But, being a bear, he was buying on the way down, so he got 120.6 shares.

Now go into the bull market with this smart bear. By January 2004, the S&P was up above our investor's starting price. The market had turned bullish. How did the bear do compared to what you would expect based on the indexes? Let's see...

When a Bear Goes Shopping

S&P	Mkt. Gain	What the Bear Bought	Bear Gain
January 2002 1154		*Bought 120.6 shares of SPY	
January 2004 1112	5%	120.6 shares now worth \$13,410	11.7%
January 2005 1212	8%	120.6 shares now worth \$14,616	21.8%
January 2006 1248	8.1%	120.6 shares now worth \$15,050	25.4%
January 2007 1418	22.8%	120.6 shares now worth \$17,101	42.5%

**The bear spent \$1,000 a month as the market fell, accumulating 120.6 shares of the S&P 500 SPDR throughout 2002 for a total investment of \$12,000.*

As you can see, the bear's bargain shopping paid off handsomely in the bull market that followed 2002. Much more than you would expect from what the indexes—and the media—led you to believe. The bear's returns were almost double what everyone thinks the market did.

We happen to be in another bear market that began in late 2007 and made its way into 2008. Most people are praying the bear will leave and the bull will return.

But if you are really smart, you'll embrace the bear a while longer.

It only stings a little while...

Time Is on the Bear's Side

The facts of buying low—which is what bears do—are clear. When the market's down, you get more content for your money. And then, you make more on your investments when they begin to rise. So why doesn't everyone buy stocks as the market falls? It makes perfect sense. History shows it works.

Because it is scary. People invest to make money, and it is darned hard to convince them that they are on track when they keep pulling quotes that tell them they're going the wrong way. And there's nobody who can tell you with certainty how far down your stocks will go or how long you'll have to wait for them to get better. Most bear markets are fairly short, much shorter than bull markets. But the next one could be long.

Because of this, I strongly believe that you should never put any money you are going to need in the next two to five years in the stock market at all. The date you plan to sell and use your gains might not work out well. If you know your market history and have a long horizon, though, you can remain much calmer and take advantage of these special “buy-low” extravaganzas we call bear markets.

But for long-term money, holding onto your good stocks as they drop in a bear market, as well as buying stocks that are going down, is not as daring as it may seem. Provided you have done some reasonable checking and the company is sound, the market is on your side. The U.S. stock market has never lost money over any 20-year period since 1926. That includes stretches such as 1929 to 1949, the Great Depression, and the World War II upheaval.

Nor has it lost money over any 10-year stretch in the past 50 years, and has done it only twice since 1926.

Even a five-year holding has been strongly in favor of investors: The stock market made money in 87% of the rolling five-year periods since 1926. It has lost money over only four 5-year periods since 1950. Those were 1970-1974, 1973-1977, and 1998-2002.

Give a bear a hug. He’s got a gift for you.