“The Essence of Investment Management”

Key Takeaways

- A COVID 19-sparked recession, unprecedented market volatility met by equally exceptional fiscal/monetary policy responses have investors uncertain about what comes next.
- Despite such extraordinary circumstances, history provides a helpful framework in which to keep a balanced assessment of current market developments.
- In the face of extraordinary uncertainty, appropriately risked, prudently diversified portfolios remain key to guarding against extreme drawdowns and/or lost opportunities.

Bear Market Rules

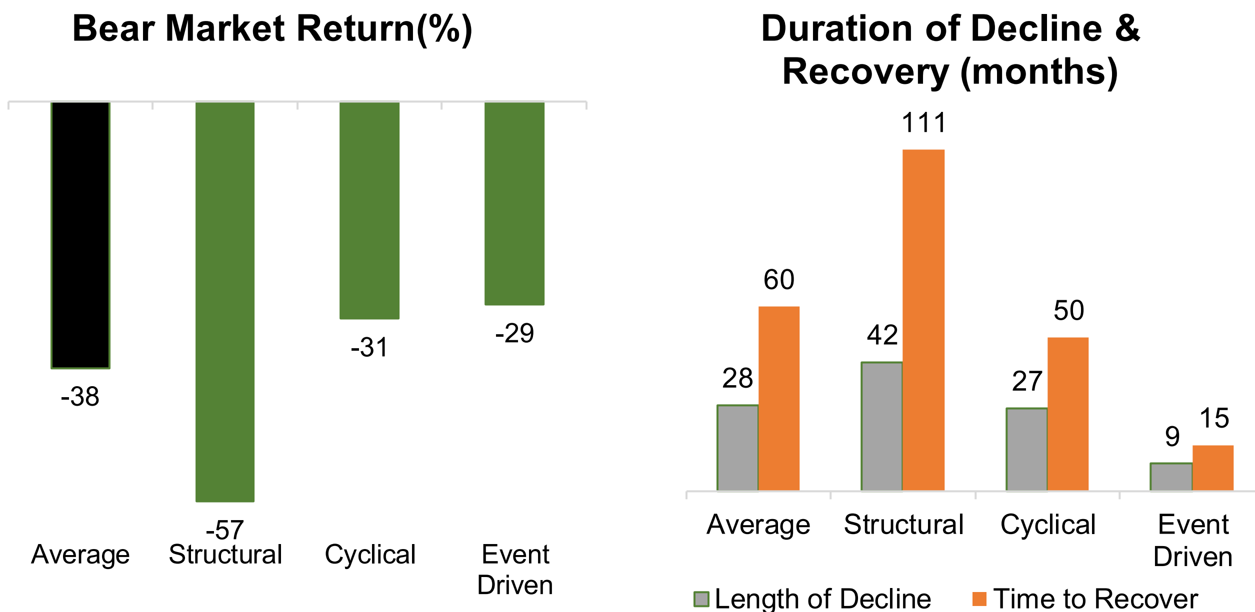
There is no doubt that global equity markets entered a bear market during the second half of the first quarter. From its peak to recent trough, the Dow Jones Industrial Average fell over 37% in just six weeks, marking its most severe short-term drop since the start of the Great Depression in late 1929. That reference alone has been enough to unnerve most investors. Will the markets of the 2020s resemble those of the 1930s? Fueling such speculation is the seeming lack of precedent for the main cause for this recent market volatility. While investors have faced flu-related outbreaks over the decades, none have driven officials to institute such widespread “shelter in place” policies that essentially shut down large segments of the economy for an unspecified period of time. The combination of the swift and sharp drop in markets, coupled with such an unfamiliar and uncertain economic future, has left investors feeling like these markets are nothing like we have ever experienced before.

But have we?

Goldman Sachs’ Chief Global Equity Strategist, Peter Oppenheimer, provides a helpful framework to assess bear markets. That is, bear markets can be differentiated by their triggers and distinct characteristics:

- **Structural -** Triggered by structural imbalances and financial bubbles (possibly pricked by overly tight monetary policy), a structural bear is very often accompanied by a ‘price’ shock, such as deflation. Structural bears tend to be the deepest of the bear markets, last the longest and take the longest to recover from. An example of a structural bear market was the Global Financial Crisis (GFC) of 2007 to 2009.
- **Cyclical -** Triggered by interest rates rising too high, a recession typically unfolds and is accompanied by a decline in profits. A cyclical bear market is more a function of a “classic” economic contraction, being of average depth and duration, and lasting much shorter than the preceding cyclical bull market. An example of a cyclical bear market was the 1980 to 1982 recession brought about then Federal Reserve (“the Fed”) Chairman Paul Volker’s drastic raising of interest rates to squash runaway inflationary pressures.

- **Event-driven -** Triggered by a one-off 'shock', such as an oil price shock, technical market dislocation, war or global pandemic, an event-driven bear market does not typically lead to a recession. As such, event-driven bear markets, though sharp, tend to be the mildest in terms of depth, duration and time to recover. An example of an event-driven bear market is that one that stemmed from Black Monday in October 1987.

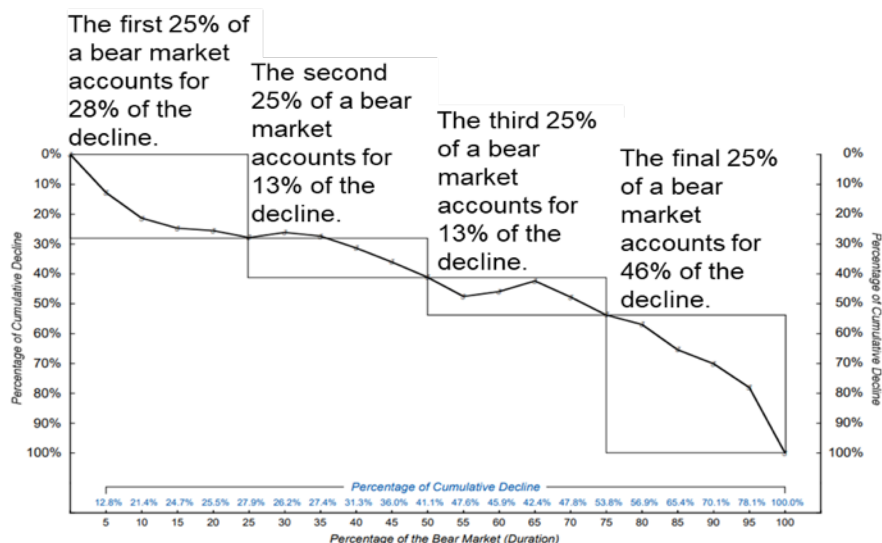


Source: Goldman Sachs, "Bear Essentials: A Guide to Navigating a Bear Market", March 9, 2020

Prior to February's market collapse, there were certainly few of the harbingers that have preceded either a structural or cyclical bear market. For example, while the U.S. Treasury yield curve did invert briefly in 2018, the balance of leading indicators were still pointing towards a growing economy in early 2020. While growth was definitely slower abroad, global manufacturing was actually showing signs of emerging from its doldrums. These lack of warning signs, coupled with the sudden manner in which COVID-19 infected both economies and markets, would lead to classifying the recent selloff as an event-driven bear market.

Complicating that "diagnosis", however, is the fact, driven by the social distancing policies designed to flatten the virus' growth curve, the economy is in fact in recession. Moreover, investors don't really know the magnitude of the effect those social distancing policies are having on the economy. Economic data is reported with a variable lag, and the depth of the recession won't start to really be known until the latter part of April and into May. It is for this reason that bear markets have historically mapped out the following pattern:

1. Start with short and sharp decline as investors brace for "bad news".
2. After this initial decline, markets stage a relief rally from oversold conditions that retraces a portion of the decline.
3. Then, as the full deterioration of the fundamentals start to be reported, markets resume their decline. It is for this reason that the most dramatic portion of a bear market decline tends to occur near its end.



Current bear market is not reflected. As of 4/7/20. Source: Crandall, Pierce.

Moreover, this pattern has historically been just as prevalent in event-driven bear markets as it has been for either the more severe and longer-lasting structural or cyclical bear markets. With this in mind, and given that the rally off the March lows has retraced over 40% of its decline, should investors be positioning their portfolios for the bear market to reassert itself?

Bull Market Rules

In addition to the swift and sharp drop in markets from February through most of March, investor uncertainty fires are also probably being stoked by the fast and furious rise in stocks witnessed since then. After all, as extraordinary as the policy response has been to COVID-19 from a social distancing perspective, so too has been the fiscal and monetary response. For example, the current response by both the Fed and Congress in terms of speed and magnitude looms large compared to their actions during the GFC, when the Fed's initial round of quantitative easing or Congress' $700B Troubled Asset Relief Program weren't launched until one year into it.

So, are markets undergoing just a relief bounce as posited in the previous section? Or could the rally actually be the start of a much larger and more significant move higher? While a bear market tends to be thought of a market that has dropped at least 20% from its peak, there is not similarly quantifiable and simple corollary for defining a bull market. Fortunately, Ned Davis' Chief U.S. Strategist Ed Clissold provides a helpful four stage technical framework to assess when a bear market might be bottoming:

1. A "waterfall" decline that results in deeply oversold conditions.
2. An "aftermath rally" from those deeply oversold conditions. Markets rarely move in a straight line for an extended period of time. The initial rally from market lows tends to be more about investors breathing a sigh of relief, characterized by relatively weak leadership (e.g. defensive stocks outperforming during the rally).
3. A retest (and possible breach) of the waterfall lows. In this stage investors, possibly shaken by deteriorating fundamental news, give up their aftermath gains, thinking that they may have prematurely priced in too rosy an outcome.
4. An impulsive rally that quickly moves higher. Unlike the aftermath rally, this move higher is characterized by strong leadership, both in terms of impulse (e.g. many days of most of the volume being behind advancing stocks) and leadership (e.g. more cyclical equity market sectors outperforming). In this phase markets appear to be discounting better fundamental days ahead, as opposed to just snapping back after possibly falling too far too fast.

US stocks certainly appear to be in the aftermath rally stage, after experiencing a 37% drop in the Dow Jones Industrials in just six weeks. However, at this point it is unclear if stocks will retest (or even possibly breach) their March lows, or if they continue higher with only relatively modest pullbacks. Similar to the December 2018 low, since March 23rd US stock markets have also experienced some days characterized by very strong upside volume (e.g. 10:1 ratio of advancing over declining volume) and is showing mixed and tentative signs of more cyclical leadership (e.g. consumer discretionary sector).

Risk Management Rules

So, which is it? Should investors be:

1. Reducing exposure to risk assets as the bear market readies for its next leg down? After all, stocks have staged a relief rally and the economic data is expected to be the worst since the GFC. For example, the unemployment rate is being forecast to climb into the teens if not 20%!
2. Increasing exposure to risk assets as the bottoming process continues. In fact, if market breadth (e.g. number of stocks participating in the rise) shows an increasing amount of promise (possibly due to continued signs of progress in flattening the COVID-19 growth curve) then it may be that that the worst of the bear market is behind us. After all, the low for stocks during Q4 2018 was never retested, and equities just shot higher without ever looking back.

Despite the seeming binary nature of the choice above, the reality is that a portfolio management process is about making decisions in the face of uncertainty and evolving risk environment. Portfolios that have appropriately sized allocations to a diversified set of strategies (strategies that are designed to protect against extreme drawdowns or participate in a rising tide) will allow investors to stay invested and on course. Indeed, in the current tumultuous and highly uncertain economic and market environment, it seems that value investing legend Benjamin Graham's "the essence of investment management is the management of risks, not the management of returns" is every bit as relevant today as it was over 70 years ago.

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