Stock Market Perspective: Bear Market Drops

The Dow and S&P 500 have moved more than 20% below their all-time highs seen last year, and the Nasdaq Composite is down that much from its peak value last year[1]. According to the popular media, that means we are "officially" in a bear market. I put the word in quotes because I think it is a mild occurrence of Wall Street Gibberish (http://www.pankin.com/gibberish.htm), which I discuss later in that section.

The more important issues are what does such a drop portend for the remainder of this cyclical bear market[2] and is there something magic about a 20% drop. I have daily closing values for the S&P 500 index going back to 1950. Although I have data for the Dow Jones industrials further back, I will use the S&P for the analysis because it is considered to be more representative of the broad U.S. stock market.

▶S&P continued drops after falling 20%: If you ask a typical stock broker or TV talking head whether you should be concerned that the market is now in "bear" territory, you are likely to hear that now is not a good time to lighten up on stocks[3] because in the long run "stocks always go up." Historically, this is true provided that in the long run can mean a period of quite a few years and if one can hold on if the market goes considerably lower, which it can do and has done during secular bear markets. I will take a more practical approach to see what has happened until the market recovered to the point where the bear came out of its cave.

[1] The Nasdaq is still less than half of its all-time peak made over eight years ago.

[2] As I have discussed in many previous issues, I believe we are in a "secular" (i.e. long-term typically lasting 15-20 years) bear market that began in 2000. Cyclical bears usually last less than two years.

[3] I agree, but in an entirely different way. The good time to reduce stock holdings for those wanting to avoid substantial drawdowns was several months ago when the models I use to manage Tactical Asset Allocation (TAA) accounts turned negative.

To do that, I need a definition for "recover." Because the index might move back and forth across the 20% below the high level, I added a condition about how much it rose above the low made after the bear trigger was first hit. In this case, I decided a rise of 10% would be reasonable. That meant the market had recovered for the purposes of the analysis once the S&P had gotten back to the point where it first was 20% below the high and had also risen 10% above the post-bear low. Once that happened, the "inning"[4] was over. The next one would start when the S&P once again fell more than 20% below the all-time high, which may be the same one in play at the beginning of the prior inning.

Since the beginning of 1950, there have been 25 such innings, the first of which in October 1957 relative to the high in August 1956. The high in January 1973 was the basis of eight of the innings. The peak in August 1987 was followed by six, the first of which was on "Black Monday," October 19, 1987, and the first four took place before the end of 1987. That illustrates the volatility of the period, and I will take a closer look later. The next high that saw a drop of at least 20% was in March 2000, a gap of over 12 years, and it was the basis of three innings. The most recent inning that started on July 7 is based on the S&P's all time closing high of 1565.15 last October.

The most interesting question is how much further did the index fall once the inning began. Three of the 25 times, it did not fall any further before the inning was over. The ones in 1976 and 1979 marked the beginning of a period of rising stock prices in a secular bear market. The other was on October 19, 1987, and it is a strange case during a period of extreme

[4] Perhaps "droppings" would be a better term, but that has connotations that may or may not be appropriate. Being a baseball fan, I like the idea of innings.

volatility. The index closed 11.5% and 16.1% below the high in August on the Thursday and Friday before Black Monday. After the crash, it was down a third from the high, so this one, unlike the others, did not move more or less gradually across the 20% threshold. Two days later, the index had risen by almost 15%, but it was still more than 20% below the high, so another inning began a couple of days later on October 23. It too was short lived since there was a sharp, quick rise to end it. There were a couple more quick rises that resulted in new innings in short order. It wasn't until late November 1988 that the S&P climbed above 20% under its August 1987 high and stayed there.

Should an investor start to worry when the S&P falls 20%? The right time to take action is before that happens.

Only five of the 25 cases saw the index fall more than another 10%. The one that started on November 3, 1987 was just above that amount falling another 10.7% in about a month, and that was the bottom. It was during the 1982-99 secular bull market. The other four that saw large additional drops—in 1970, 1974, 1975, and 2001—were during secular bear markets.

Not counting the three cases when the index did not go lower before gaining 10%, the further drops ranged from 0.4% (in 1957) to 35.8% (in 2001), with an average of 8.8% and a median of 5.6%. That is a wide range although the average and median suggest the 20% needed for an official bear market does not indicate a great deal of danger ahead. However, the worst cases were during secular bear markets like the current one.

The subsequent lows were seen in less than a week in some cases to over a year and a half. The average time was about three months with a median of five and a half weeks.

▶**How long did the recoveries take?** It is also worthwhile to get an idea how long it can take to get back to the point when the bear was officially recognized. In effect, that is asking how long it will take to get back to break even if one does not sell that day. Ignoring the three cases where there was no further drop, the range was from two days (in 1957) to over three and a half years (starting in April 2001). Overall, the average was 172 days and the median was 66 days. In general, the ones that began during secular bear markets took the longest, which is not at all surprising.

▶**Is 20% a "magic" number?** I did a similar analysis to see how the S&P did after a 15% drop from a high and a 7.5% gain from a subsequent low and exceeding the value at the start of the inning and also a 10% and 5% gain. Obviously there will be more innings with a lower drop required: 29 for 15% and 45 for 10% ignoring cases when the start was also the low. The average subsequent drops were similar to the 20% case: 8.8%, 9.2%, 8.0% for 20%, 15%, 10%, respectively. The mean times until the starting level was again surpassed were not very different: 172 (20%), 195 (15%), and 174 (10%) days. The medians for these categories showed somewhat more variation. My conclusion is that except for the desired frequency by those who want to proclaim bear markets, it would not make much difference for "official" levels in the 10% to 20% range. I also checked what happens after a 5% drop. Without hurling more numbers at you, the analysis showed that the further drops were shallower and of shorter duration than was the case for 10%, 15%, and 20%.

The above is based on the closing prices of the index. If the total return including dividends had been used, the size of the drops and the times until recovery would have been not as bad. However, adjusting for inflation, which was quite high in the 1970s and early 1980s would make the story scarier. The relative comparisons between the levels needed to declare a bear market likely would be similar to what is shown.

My thinking is that deciding when a bear market starts is irrelevant. Assuming we want to avoid substantial drops in the value of our stock holdings, there is no specific level below a prior high that is going to tell us when we should not be holding stocks or adding them to our portfolios. Instead, I want to identify when the risks of owning stocks are high relative to likely gains. Another way of saying this is determining when stocks likely are in a meaningful trend down that figures to last from a few months to possibly several years. The model I use for TAA accounts has a long term record of doing that. It is far from perfect as all investment and trading methods are, but it is designed to keep us out of a lot of trouble.