Quadrant
ASSET MANAGEMENT

Bear in Mind the Aging Bull

QAM Perspectives – May/June 2016

Quadrant's regular newsletter that highlights topics we believe will affect markets or are important in understanding them.

¨What counts for most people in investing is not how much they know, but rather how realistically they define what they don't know."
Warren Buffett

Quadrant Asset Management
Suite 720, One Lombard Pl
Winnipeg, MB
Ph: (204) 944-8124
email: inquiries@quadasset.com
web:www.quadasset.com

Most investors have probably heard the terms "Bull Market" and "Bear Market" before. A Bull Market characterizes a period of upward trending markets, while a Bear Market describes a period of downward trending markets. But where did these terms originate from? There are two main theories:

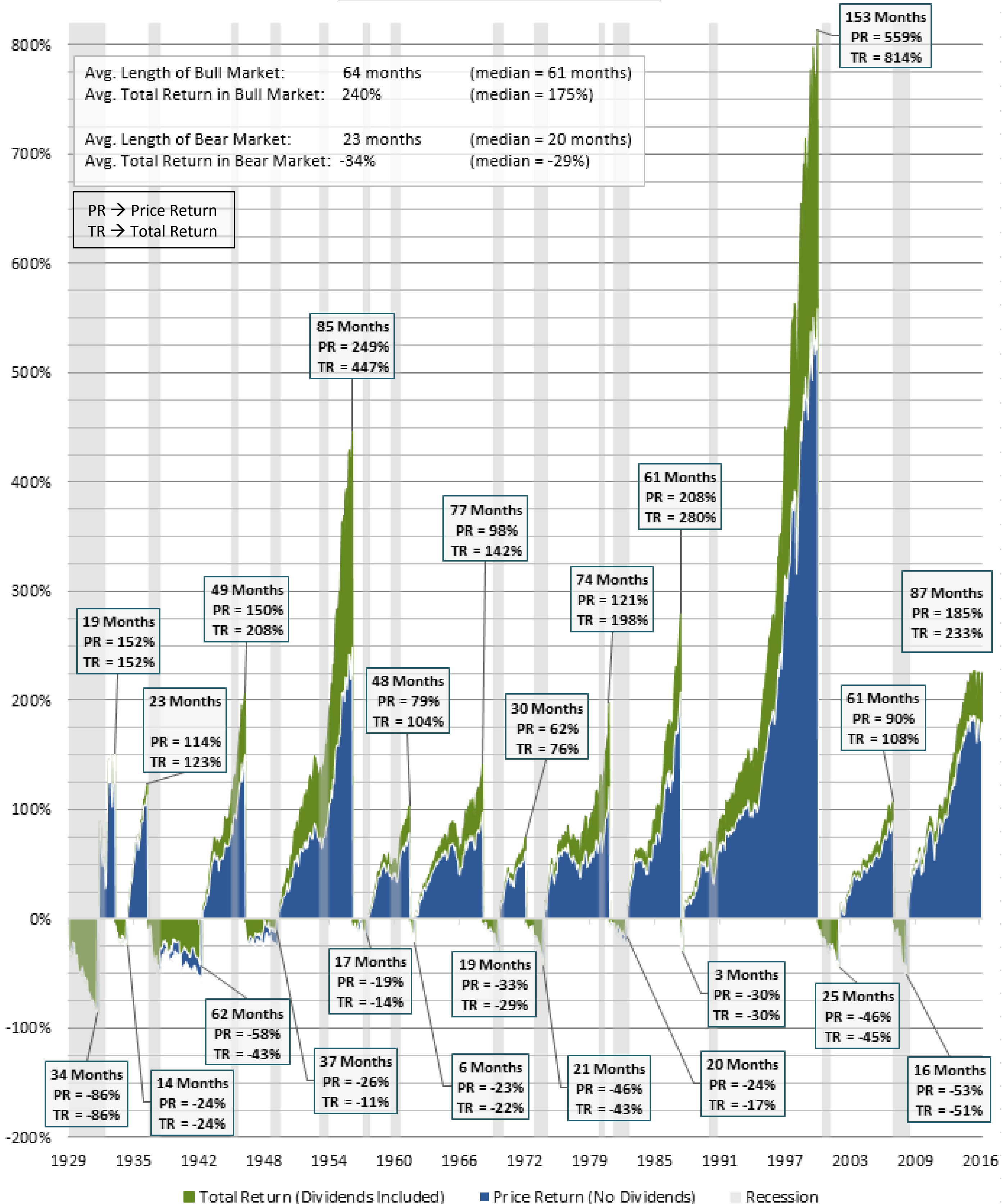
1. The Bull and Bear Markets are named after the way in which each animal attacks or defends itself. A bull charges and drives its horns up into the air while a bear is generally more defensive and paws downward on its opponent.

2. In England, middlemen involved in the sale of bearskins would sell skins they had yet to receive, speculating on the future purchase price of the skins from trappers. Profit would be made if the bearskins were first sold at a high price and subsequently purchased at a low price (akin to short-selling stocks). These middlemen became known as "bearskin jobbers" or "bears" for short. The term "bull" likely arose because bulls and bears were once considered to be opposites due to the historically popular blood sport of bull-and-bear fights.

Regardless of what the true origin of the terms are, it is safe to say that at any point in time the market is composed of competing Bulls and Bears. A sustained dominance of either the Bull or the Bear over a period of time is known as a market cycle.

The current Bull Market for the S&P 500 has been in the headlines lately as it appears to be getting a little long in the tooth by historical standards. In fact, the current Bull Market is now the second longest since at least the Great Depression (data prior is not very readily available or reliable). At 87 months, or 7 years and 3 months, the longevity is second only to the 90s tech boom which lasted 153 months, or 12 years and 9 months.

The chart below examines 24 alternating Bear/Bull market cycles of the S&P 500 since 1929[i]. Bull Markets in this analysis are defined as a price increase of approximately 20% or more from its previous low point. Likewise, a Bear Market is defined as a price decrease of approximately 20% or more from its previous high. The blue area on the charted market cycles represent the price return of the index while the green area represents the additional effects of reinvested dividends. The visual separation of price return (no dividends) and total return (includes dividends) highlights the compounding effects of the dividends in Bull Markets and the slight stabilizing effect in a Bear Market.


S&P 500 Bull vs. Bear Market Cycles
Avg. Length of Bull Market: 64 months (median = 61 months)
Avg. Total Return in Bull Market: 240% (median = 175%)
Avg. Length of Bear Market: 23 months (median = 20 months)
Avg. Total Return in Bear Market: -34% (median = -29%)
PR → Price Return
TR → Total Return
800%
700%
600%
500%
400%
300%
200%
100%
0%
-100%
-200%
153 Months PR = 559% TR = 814%
85 Months PR = 249% TR = 447%
61 Months PR = 208% TR = 280%
77 Months PR = 98% TR = 142%
74 Months PR = 121% TR = 198%
87 Months PR = 185% TR = 233%
49 Months PR = 150% TR = 208%
19 Months PR = 152% TR = 152%
23 Months PR = 114% TR = 123%
48 Months PR = 79% TR = 104%
30 Months PR = 62% TR = 76%
61 Months PR = 90% TR = 108%
17 Months PR = -19% TR = -14%
19 Months PR = -33% TR = -29%
3 Months PR = -30% TR = -30%
25 Months PR = -46% TR = -45%
62 Months PR = -58% TR = -43%
37 Months PR = -26% TR = -11%
6 Months PR = -23% TR = -22%
21 Months PR = -46% TR = -43%
20 Months PR = -24% TR = -17%
34 Months PR = -86% TR = -86%
14 Months PR = -24% TR = -24%
16 Months PR = -53% TR = -51%
1929
1935
1942
1948
1954
1960
1966
1972
1979
1985
1991
1997
2003
2009
2016
Total Return (Dividends Included)
Price Return (No Dividends)
Recession

Notable in the chart is the comparative return differences between the Bull Markets and Bear Markets. On average, the total return in a Bull Market has been about 240%, which is much more significant than the average of -34% for Bear Markets. Additionally, the average length of a Bull Market is 64 months (about 5 years and 4 months), more than two times the relatively short average Bear Market length of 23 months (just under 2 years). By historical standards, the current market cycle is about two years older than the average Bull and about on par with the average cumulative return. Does this mean that now is the time to pull out of stocks and prepare for a Bear attack?

It is natural for investors to want to avoid losses. The thought of losing hard-earned money is scary and can bring about great anxiety for many people. Studies from behavioural economists Amos Tversky and Daniel Kahneman have suggested that losses are twice as powerful, psychologically, as gains. This bias can cause investors to act irrationally and make poor investment decisions in an attempt to avoid short term portfolio losses.

From a high level perspective with the benefit of historical data it may seem easy to describe past market cycles as being predictable or "time-able" (getting out at the top and entering at the bottom). In practice, however, it is remarkably difficult to do. The Hindsight Bias, also known as the "knew-it-all-along effect", is the inclination for humans to view data in hindsight and attribute responsibility or predictability to past events that were not apparent at the time.

Volatility and uncertainty occurs within every market cycle and the immediate Bull/Bear trend is not readily apparent to investors. The very process of classifying Bull Markets and Bear Markets involves using historical data that only becomes clear in hindsight. This is one reason why it is so hard to "time the market" and avoid a Bear cycle – by the time you know you're truly in a Bear Market it is probably too late to sell. Furthermore, timing the market not only involves an accurate prediction of when to get out, but also when to get back in. Exiting too early involves the opportunity cost of any market gains that are missed, exiting too late essentially locks in investment losses at the bottom, and re-entering too late results in missing out on the recovery boom. Given that Bear Markets tend to be relatively short in length, the window of opportunity is small and prone to timing errors.

At any point in time there will be coexisting predictions for either a continuation of the current trend or an impending reversal of the trend – it just depends who you ask. For example, there are currently a number of factors that some investors claim could spark a downturn in the equity markets. Some of these factors include the situation in Europe in which some member countries may try to exit the European Union (previously "Grexit", more recently "Brexit"), a Chinese economy that is seemingly overleveraged and facing slower growth, uncertainty surrounding the US presidential election, relatively high equity valuations, and the rampant manipulation of interest rates by central banks around the world that is contributing to a negative yielding bond environment. On the flip side, Bullish investors make the case for a continued uptrend due to persistent low interest rates fueling the stock market (a function of access to cheap credit as well as an influx of investors seeking a higher return than bonds currently offer), a potential oil price rebound, and apparent improvement in economic fundamentals particularly in the US.

Trying to predict short term market movements is not an exercise that QAM finds beneficial. Instead we remain cognizant of the fact that the current Bull Market is mature when compared to past cycles and will eventually reverse its trend at some point in the future. The fact that Bear Markets are almost a guarantee in the equity markets is actually one of the reasons that stocks tend to offer higher returns over the long term. The risk premium is higher in order to compensate investors for enduring heightened volatility and periodic downward trend cycles. One important conclusion we can make by looking at the

chart on Page 2 is that investors that maintained a disciplined investment approach with a long term horizon may have experienced losses in multiple Bear Markets, but they also experienced extraordinary Bull markets that more than made up for those periodic losses. Additionally, in the context of portfolio management, a systematic process for rebalancing a portfolio amongst asset classes provides a built-in mechanism that sells assets high and buys assets low.

As always, QAM remains diligent and disciplined in the management of client portfolios and understands the importance of sticking to a long-term plan. Furthermore, our external managers continue to manage risk and seek value through active security selection, sector allocation, and diversification.

It is unclear how much longer the current Bull Market will last, and it is unclear how long the next Bear Market will last. The only certainty is that market cycles will continue to roll on.

---

[i] For periods prior to 1957 (inception of the S&P 500 Index), data is hypothetical and aims to recreate the index using the same methodology. All data is monthly and sourced from Bloomberg as of May 31, 2016.

Disclosures

This report is prepared for the use of Quadrant Asset Management personnel and clients and may not be redistributed, retransmitted or disclosed, in whole or in part, or in any form or manner, without the express written consent of Quadrant Asset Management. Any unauthorized use or disclosure is prohibited. The information herein was obtained from various sources and Quadrant Asset Management does not guarantee its accuracy. Neither Quadrant Asset Management nor any director, officer or employee of Quadrant Asset Management accepts any liability whatsoever for any direct, indirect or consequential damages or losses arising from any use of this report or its content.