Key Questions

Bear Market is Back: What Should Investors Do?

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Don't succumb to panic: Stay disciplined and seek opportunities to upgrade portfolios.

A few weeks ago, colleague Dan Fiedler and I wrote an essay providing some broad tips that investors should consider amid volatile markets. In that piece, we encouraged readers to refer and adhere to a written plan (presumably created during a period of relative market calm) known as an Investment Policy Statement. Such a plan serves as a useful guide when market chaos erupts.

Since then, after having avoided several near misses, US equities fell into bear market territory for the first time in over 11 years, plunging a dizzying 32% from record highs registered just one month ago and ending the longest bull market in history. Aptly labeled as the "Coronavirus Crash" by Stephen Hoedt, our Managing Director of Equity and Fixed Income Research, the pace at which this peak-to-trough decline occurred has been the swiftest ever. The hibernating bear has come roaring back in a major way.

In addition to materializing swiftly and suddenly, the bear market has been widespread, with nearly all asset classes (save cash) experiencing losses in the past few weeks. In statistical terms, correlations amongst a variety of financial asset prices have converged to approximately +1.0, representing perfect correlation. As a result, many investors are justifiably asking, "What should I do now?"

First and foremost, we strongly believe that investors should not panic and abandon their long-term plan, nor should they eliminate equities from their portfolios in a wholesale manner. As the primary growth engine for most portfolios, equities will benefit from future economic expansion once it re-emerges.

That said, it is also important that investors carefully evaluate the types of equities represented within their portfolios and consider making some minor tweaks during this time of extreme uncertainty.

In particular, while we reiterate our view not to sell equities indiscriminately, we urge investors to enhance an existing equity portfolio by adding high-quality companies and pruning lower-quality companies. High-quality companies are those that exhibit above-average and relatively enduring profit margins, possess lower levels of leverage on their balance sheets, and are led by experienced, proven, and aligned allocators of capital.

Low-volatility stocks represent another category of equities that can provide some cushion during a bear market. As their name suggests, these stocks are intriguing for their defensive asymmetric attributes: They participate in up markets but decline less than broad market averages in down markets when volatility typically surges. Similarly, large-cap growth stocks tend to outperform their small-cap value counterparts during bear markets when, in general, earnings growth is scarce. We have emphasized minimum-volatility stocks within clients' portfolios for roughly nine months and have recommended a tilt toward both large-cap and high-quality

stocks for several years. These decisions have proven beneficial, and we continue to believe they should be featured within an investor's portfolio.

In addition, individual and institutional investors who are willing to surrender a degree of transparency may benefit from owning hedge funds in this environment. Unlike mutual funds, hedge funds' net asset values are not published in newspapers or on the "crawl" at the bottom of a television screen. However, hedge funds possess greater flexibility and have more tools at their disposal relative to their mutual fund peers.

By forgoing a certain amount of transparency and by equipping skilled managers with greater resources, investors stand to benefit from less-volatile performance over time. We acknowledge that hedge funds are not appropriate for every investor. Further, not all hedge funds are created equal, thus placing a premium on selectivity, deep due diligence, and ongoing monitoring. But a thoughtfully curated collection of fundamentally oriented hedge fund strategies can offer benefits to investors as well.

Investors can also seek unique returns from other means. One such strategy seeks to capitalize on the volatility risk premium (VRP). Designed to provide protection against market volatility, this approach has proven to be beneficial over time. That's because most investors overpay for protection, just as most people overpay for insurance they never use (thankfully). Several of my colleagues have written extensively about the VRP and hedge funds over the past few weeks, and I would encourage you to read this information to understand more.

Understandably, bear markets trigger emotional responses in all of us. Fueled by an incessant cascade of negative events, recency bias can stoke fear and cause investors to extrapolate the present to the future, often leading them to overreact or freeze in place. In our view, while it may still be premature to add aggressively to equities just yet, we think investors should assess the types of equities they own and consider upgrading their portfolios during this time of immense uncertainty.

We also advise investors to be mindful of potential opportunities to improve the diversification of their portfolios and help position them for the future. Sunnier days will arrive, and we believe that investors who remain deliberate and disciplined, do not allow themselves to be overtaken by panic, and seek opportunities to upgrade and enhance their portfolios will be rewarded over time.

For more information, please contact your Key Private Bank Advisor.

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