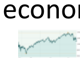
When the Bear Bites

As the troubled and turbulent summer that will forever be marked by the historic US debt downgrade gives way to what is already a "Red October" in the equity markets, many investors are understandably feeling more anxious than ever. **How low will it go?** Are we seeing a repeat of 2008? What should I do?

As I write, major equity asset classes are entering official "bear market" territory of 20% off recent highs. This is not to say that this decline will inevitably persist, nor that investors should change course based on the fact that equity markets seem to be approaching this rather arbitrary threshold. **We know that bear markets will come along**, we simply don't know when and for how long. **Our strategy should reflect this fact.**

Fortunately, clients of Passive Capital Management, LLC hold high-quality, short-duration bonds that are performing their assigned task of dampening portfolio volatility and showing negative correlations to equities. This is perhaps small consolation to the investor who is watching his equity holdings slide down a steep slope from recent highs, but it is critical in terms of long-term preservation of capital.

As investment advisors, we could offer predictions. We won't, because we know that there is no empirical evidence to suggest that either investment professionals or Nobel Prize-winning economists can successfully and consistently do so. We could insert a three-year chart of the S&P 500  to make our clients feel as though being substantially north of the 2008/2009 lows is a reason to take comfort.

The harsh truth is that nobody can guarantee that markets will not dip down to or beyond their 2008/2009 lows. History tells us that equity markets will provide negative returns in one of every four years, and that **we can expect a true bear market more than once in each decade**. This is part of the reality of investing in markets that are susceptible to macroeconomic factors, investor sentiment, corporate performance and random noise.

So what is an investor to do?

Any client of Passive Capital Management will have an **asset allocation that reflects his or her investment time horizon and tolerance for volatility.** If you will need the full amount of the funds in your portfolio within a year or two, you should not have 70%+ of your assets allocated to equities. If the time horizon for you or your heirs is longer, **you will need to tolerate corrections and painful bear markets** in order to benefit from the historic **long-term growth offered by the capital markets**. It would certainly be very nice to be able to leave the equity markets just before a downturn and hop back in at precisely the right moment before the upswing. The evidence shows, however, that **nobody can consistently get both of these decisions right.** As I illustrated in another newsletter, if your timing is off by even *one day*, you will feel a great deal of unnecessary pain.

We may not be able to look into the future, but **we can look into the past** through the lens of more than eighty years of excellent data. If we do experience a drop of more than 20%, 30%, or even 40%, what can we expect in terms of a rebound? What has happened in the past? The table below tells the story by studying the **six largest one-year dips** in the S&P 500, side-by-side with the same years in small cap value stocks, and subsequent **annualized** 15-year returns.

S&P 500, 1926-2010: +9.9%, Small Cap Value +13.8%.

Year	One-Year Return S&P 500	One-Year Return Small/Value	15-Year Period	15-Year S&P 500	15-Year Small/Value
1930	-24.9%	-47.5%	1930-1945	+4.3%	+12.2%
1931	-43.3%	-53.5%	1931-1946	+5.6%	+23.2%
1937	-35.0%	-52.7%	1937-1952	+9.0%	+13.4%
1974	-26.5%	-20.2%	1974-1989	+13.3%	+21.9%
2002	-22.1%	-11.7%	2002-2010*	+3.0%	+11.1%
2008	-37.0%	-44.5%	No data yet+	?	?

* this is only eight years of data.
+ in 2009, the S&P 500 returned +26.5% and in 2010, the S&P 500 returned +15.1%
Source: Standard & Poor's/DFA

If we control what we can control – costs, diversification, tax efficiency, discipline and rebalancing – and avoid the mistake of thinking we can foresee or control the uncontrollable – economic events and the swings of the market – then **we can anticipate a successful long-term investment experience**. Remaining committed to passive investing is perhaps most difficult, *and **most important***, during a correction or bear market. Those who do so will be around for the better times. Those who do not can expect to destroy value and underperform the market in the long term.

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October 2011

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