Eight Years Into A Bull Market, What Should We Do?

Saturday's With Jim

By Jim Pursley
President and CIO, Gaia Capital Management, Inc.
www.gaiacapital.com
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Dear Friends,

Throw out the yardsticks because the current bull market is older than all but one, which preceded it in modern history. But one day we will pay for excesses created in the magnificent run up in our account values. What might we do to ameliorate the crushing blow to stocks experienced when month after month the trend in stock prices is down, down, down? How can we distinguish between market action that is mildly corrective (market gets a bit too far ahead of the prevailing trend) and a swoon which will endure for several months, maybe years, resulting in a drop in our stocks' values of 30%-50%?

We can ameliorate the pain of falling stocks by lowering our stock allocation and raising our allocation to bonds, but we will also lower our long-term returns by doing so. We might simply stay with the asset allocation formula that works for our long run goals, rebalancing the winners into the losers annually, thereby partially alleviating stock bloat during bull markets as stocks zoom past bonds. There is another tool in our tool kit that will be advantageous if we get our signals right. We want to reduce our stock risk during the really nasty down periods that we experience roughly every four to ten years. Bull markets are lengthy and climb slowly, while bear markets are short and steep. Indeed, it is persistent volatility that defines bear markets.

The Workings of the Plan

In bull markets, we will carry 10% to 20% more in stock allocation than we might consider normal. In bear markets, we will revert to our normal allocation, selling some stocks and buying more defense in the form of high quality bonds. Our confidence to run home heavily than normal in stocks during periods of bull markets stems from the quality stocks we own as they show a far more consistent earnings and market price pattern than most stocks. Our quality stocks are roughly 10% less volatile than the volatility of the stock market. Furthermore, the cash dividends paid to our accounts continue unabated during bear markets, giving us an offset to stock volatility in addition to what bonds give us. Speaking of bonds, bonds may not add to our gains in bull markets, but in bear markets, high quality bonds rise in price even as stocks tank. Hence we think of bonds as ballast income.

A 60% Stocks/40% Bonds Example

Stocks rise about twice as fast as bonds in a bull market, but in a bear market stocks fall while quality bonds rise. We reason that we can ride out the 10%-15% moves downward in bull markets with an 80/20 allocation, but near the bull's demise we will begin reducing the allocation in bits to the standard 60/40 level. We will prune the most volatile and economic-sensitive stocks while upping up the quality of our bonds. We will weather the bear market with our reduced stock allocation, the income from our dividends and interest and our gains from the quality bonds. But what if a bear market should come upon us unexpectedly? They don't. Bear markets are accompanied by recessions within a few months of the bull market peak in all cases. Events like 911 don't cause bear markets. In fact, the drop they effect is a buying opportunity, not a selling one.

So What?

We can make small tweaks to an already good asset allocation to improve investments over a full market cycle. We accelerate the account a bit more than what the optimal asset allocation would have experienced in the bull market and we decelerate account risk near the beginning of a bear market. During the whole time, though, our income from dividends and interest is helping grow the account.

We are grateful that you chose us to facilitate your financial journey. Thank you for investing with us.