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**September 2008**

## **Research Perspective: Why It Has Paid to Weather Bear Markets and Turbulent Times**

This report provides investors with a historical perspective on the U.S. Stock Market. In addition to this broad overview we detail past bear markets, price volatility, and the importance of staying the course when the occasional bear market occurs. The key points to take away are:

### Bear Markets

- Bear markets have occurred with a degree of frequency and though scary, have ended.

### Price Volatility

- Price volatility is high today, but no higher than previous levels despite current perception.
- Increases in volatility are frequently associated with the latter stages of bear markets and rarely with market peaks.

### Staying the Course

- Being out of the stock market for a small number of the best market days has been hazardous to your long term wealth.
- Getting out of stocks after reaching bear market levels has likewise been hazardous to your wealth. The market has, in the majority of cases, been kind to investors one, two, and three years later.

## **I. Historical Overview of the U.S. Stock Market**

For the purposes of this historical overview of the U.S. Stock Market, we used the S&P 500 Price Index. Please indulge a somewhat dry statistical overview.

### Statistical Summary:

- Daily data was studied from 1/1/1940 thru 7/31/2008 [68 years and 7 months; 17,244 trading days].
- Prices rose 54% of the days and declined 46% of the days.
- Returns, excluding dividends, were 7% annualized (11% including dividends).
- 78% of the time the market was in a bull market (rising) and 22% of the time the market was in a bear market (falling), using a plus/minus 20% change to define a bull and bear market.
  - Stocks were in a bull market about four out of every five years on average.
- There were 13 such bear markets (excluding today's) over this time period:
  - Average decline was 31% from peak to trough (ranging from -21% to -48%) and lasted 14 months.
  - Average decline after the index reached the bear market level (-20% or more from the peak) was -8% (ranging from 0% to -28%) and lasted an additional 131 days.

For more details please refer to Appendix A: Bull – Bear Market Historical Table .

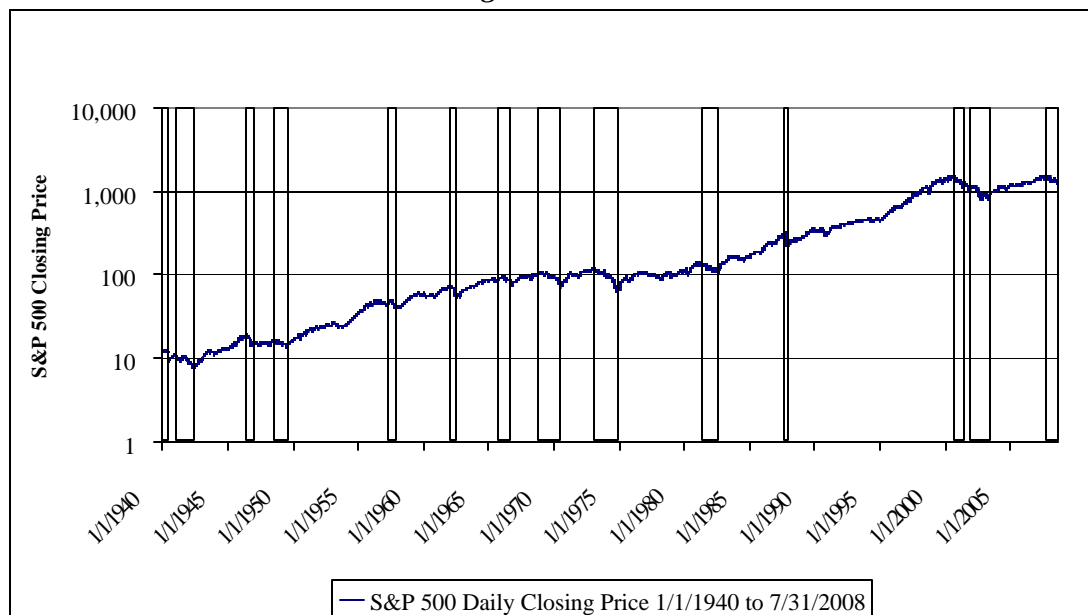
## II. Bear Markets

While there are various definitions for what constitutes a bear market, its primary characteristic is a falling stock market of at least 20%. A bear market can be accompanied by economic recession, high unemployment, rising inflation, declining corporate profits, and bankruptcies. To make matters worse, newspapers, magazines, and “experts” on TV fuel pessimism by focusing on these stock market declines and negative economic factors. Oftentimes, the media will also forecast more of the same going forward. And seeing account values go down for months in a row doesn’t help an investor’s psyche either. As a result, bear markets can scare investors into selling their stocks... just when we believe they should be holding or adding to their equity investments.

Why should someone invest during a bear market? Because fearful investors drive stocks down to the point where they become oversold and very undervalued. It is very much the opposite of the technology and dot-com “boom” (where widespread optimism led to unjustifiably high valuations). Unlike the technology and dot-com “bust”, investing during a bear market can result in considerable profits down the road.

Our perspective is supported by historical data. We looked at bear markets in the U.S. going back to 1940. The bear markets are identified by the shaded areas in *Chart 1* below. As you can see, the market always recovered afterward. Having sold during these bear markets would have resulted in missing the recovery that followed.

***Chart 1: S&P 500 Historical Closing Price with Bear Markets Shaded***



While investing during bear markets is oftentimes emotionally trying, it can be very profitable. Warren Buffett has summed up his investing strategy as follows: "We simply attempt to be fearful when others are greedy, and to be greedy only when others are fearful."

### III. Price Volatility

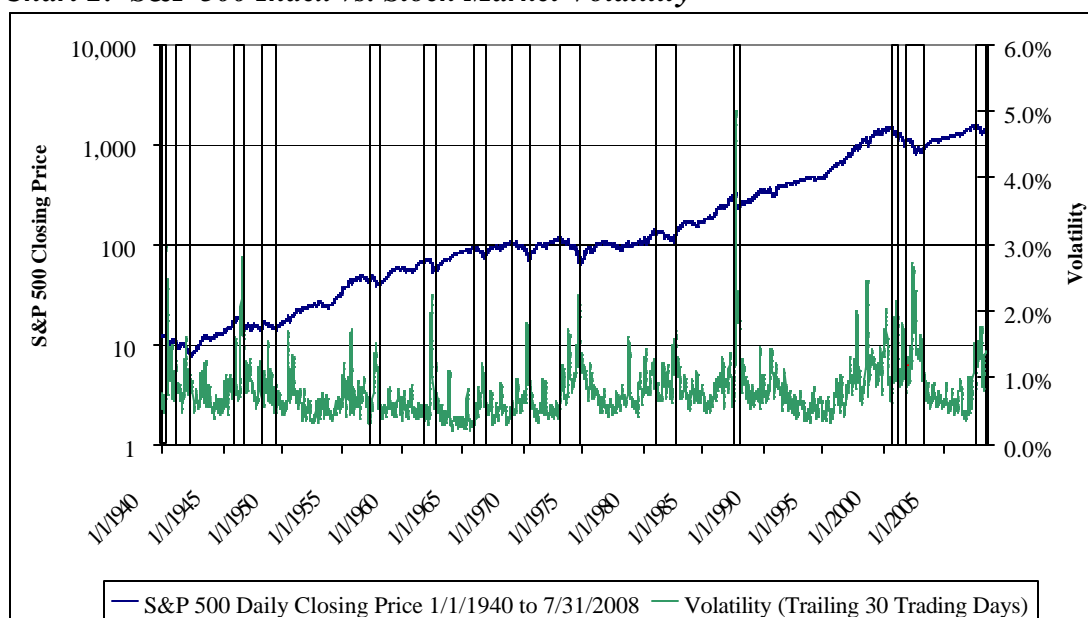
Daily price volatility is another characteristic of the stock market that may be associated with both bear and bull markets. While it can feel good to see any stock in your portfolio increase significantly over time, it can be emotionally more painful for an investor to see a stock holding – or entire portfolio – decrease 5-20% over the course of a day, week, or month. When volatility increases in the stock market, many investors tend to get nervous. The media increasingly cover the large stock market swings and report on it for their benefit (covering large stock price movements tends to sell additional newspapers and increase TV ratings more than reporting on small changes in stock prices). In our opinion, many investors increasingly feel like selling their stocks at just the wrong time!

We looked at historical stock market volatility going back to 1940, and compared that data to how the S&P 500 Index performed over the same time frame (refer to *Chart 2* below). Notice the frequency with which a sharp increase in volatility occurs during bear markets. *Buying* stocks during periods of significant stock market volatility has turned out to be much more profitable than *selling* stocks during those same volatile periods.

We believe this phenomenon can be explained by **fear** and **greed**. While some companies deserve to have more volatile stock prices during uncertain times, **fear** drives investors during these volatile times to part with stocks because of changes in stock *prices*, not business *values*. This can lead to undervalued stocks.

During times of low stock market volatility, investors are less fearful and more confident in purchasing stocks in hopes of making a profit. As **greed** creeps in this can lead to stocks becoming expensively priced relative to their actual values, which may feel good at the time but does not bode well for future returns.

**Chart 2: S&P 500 Index vs. Stock Market Volatility**



Note: Volatility is defined as the standard deviation of daily % price changes over the trailing 30 trading days.

## **IV. Staying the Course**

One question frequently asked is: “Why don’t I sell all my stocks during bear markets or when stock markets are going down, and then buy them back before the stock market goes back up?”

In a world where you had perfect foresight, that probably would be the best thing to do. The problem is we haven’t seen an investor or investment philosophy capable of doing this well over time. No matter how many commercials or mailings you may receive on how to get rich quick via timing the markets, there is a large body of research supporting the view that it is not consistently achievable.

A primary risk in trying to time bear markets and the stock market in general is that it can have a significant negative effect on returns. This can be a result of missing a relatively small number of days when the stock market rises sharply or not participating in the recovery of stock prices that typically comes after a bear market ends.

### ***A. Best Performing Stock Market Days***

We once again used data going back to 1940 to analyze what happened if an investor was not invested in the best days for the stock market. The impact of missing the top “X” number of trading days (in terms of percentage price gained) is outlined below:

- A \$100 investment in the S&P 500 on 1/1/1940 would have increased to \$10,172 on 7/31/2008, assuming one stayed invested in the market the entire time (the analysis excludes dividends).
- Miss the 20 best days and your \$100 would have grown to \$3,732 (yes, that is \$6,440 *less* than had one been invested the entire time!).
- Miss the 40 best days and your \$100 would have grown to \$1,189.
- Miss the 100 best days and your \$100 would have grown to merely \$255.
- Miss the best day in each of the last 69 years and your \$100 would have grown to \$1,318.

If you weren’t invested in the top 20 days when the S&P 500 rose the most since 1940, meaning you stayed invested 99.9% of the days but missed the 0.1% that were the best days, you would have lost 22% of the annualized returns versus being invested in the S&P 500 the entire time. You would have missed 80% of the annualized returns if you weren’t invested in the stock market during the 100 best performing days! It becomes obvious that if you try to time the stock market and are not invested during many of the best performing days, you could forgo a good portion of the returns the stock market has to offer. For more details please refer to Appendix B.

### ***B. Riding Out the Last Part of a Bear Market***

Another question that could be asked is: “What would happen if you get out of the stock market after it initially crosses into bear market territory (defined as falling 20% or more from the last peak)?”

Looking at the prior 13 bear markets, we found that from the closing price on the day the S&P 500 initially hit bear market territory, it took a relatively short period of time (four months on average), and a small additional decline (8% on average), to hit the final low point.

More importantly, one, two, and three years from the point bear market territory was first reached, the market treated investors kindly the vast majority of the time. The S&P 500 increased 15%, 23%, and 30% on average, respectively, over those time frames. For more details refer to Appendix C.

## **V. Conclusion**

We recognize that bear markets, and the volatility that often accompanies them, can be frightening for investors. However, for the disciplined investor they can offer great opportunities for future wealth. Both history and our experience tell us that staying the course has proven the winning strategy in times like these.

We do not take lightly the trust our clients have placed in our abilities to navigate these difficult markets. We will continue our disciplined strategy of investing in undervalued businesses. We appreciate your confidence and as always, thank you for the opportunity to serve your investment needs.

## Appendix A:

<b>Bull - Bear Market Historical Table</b>						
[based upon + or - 20% definition]						
<b>Bear</b>	<b>Peak</b>	<b>Peak</b>	<b>Trough</b>	<b>Trough</b>	<b>Total Days</b>	<b>Total %</b>
<b>Market #</b>	<b>Date</b>	<b>Price</b>	<b>Date</b>	<b>Price</b>	<b>Peak to Trough</b>	<b>Decline</b>
1	11/9/1938	13.8	6/10/1940	9.0	579	-35%
2	11/7/1940	11.4	4/28/1942	7.5	537	-34%
3	5/29/1946	19.3	5/19/1947	13.8	355	-28%
4	6/15/1948	17.1	6/13/1949	13.6	363	-21%
5	8/2/1956	49.7	10/22/1957	39.0	446	-22%
6	12/12/1961	72.6	6/26/1962	52.3	196	-28%
7	2/9/1966	94.1	10/7/1966	73.2	240	-22%
8	11/29/1968	108.4	5/26/1970	69.3	543	-36%
9	1/11/1973	120.2	10/3/1974	62.3	630	-48%
10	11/28/1980	140.5	8/12/1982	102.4	622	-27%
11	8/25/1987	336.8	12/4/1987	223.9	101	-34%
12	3/24/2000	1,527.5	9/21/2001	965.8	546	-37%
13	1/4/2002	1,172.5	10/9/2002	776.8	278	-34%
14	10/9/2007	1,565.2	7/15/2008	1,214.9	280	-22%
Average Days/ Decline					408	-31%
Maximum Days/Decline					630	-48%
Minimum Days/Decline					101	-21%
		<u># of Days</u>	<u>% of Days</u>			
Total Period		25,451	100%			
Bull Period		19,735	78%			
Bear Period		5,716	22%			
Notes:						
♦ Price = S&P 500 closing price (excluding dividends)						
♦ Days = trading and non-trading days						

## Appendix B:

<b>S&amp;P 500 Price Index</b>		
<b>From 1/1/1940 to 7/31/2008</b>		
<b>Missed the Top XX</b>	<b>Percentage of</b>	<b>Amount of Annualized</b>
<b>Best Performing Days</b>	<b>Days Missed</b>	<b>Upside Lost as a</b>
		<b>Percentage of Total</b>
		<b>Annualized Price Gains</b>
Top 20	0.12%	22%
Top 40	0.23%	47%
Top 100	0.58%	80%

## Appendix C:

<b>Bull - Bear Market Historical Table With Subsequent Returns</b>									
[based upon + or - 20% definition]									
Bear Market #	Peak Date	Peak Price	Trough Date	Trough Price	Total Days		Market Returns		
					Peak to Trough	Total % Decline	After Reaching -20%		
							1 Year	2 Year	3 Year
1	11/9/1938	13.8	6/10/1940	9.0	579	-35%	18%	-6%	-23%
2	11/7/1940	11.4	4/28/1942	7.5	537	-34%	2%	23%	45%
3	5/29/1946	19.3	5/19/1947	13.8	355	-28%	2%	8%	2%
4	6/15/1948	17.1	6/13/1949	13.6	363	-21%	42%	59%	80%
5	8/2/1956	49.7	10/22/1957	39.0	446	-22%	31%	44%	36%
6	12/12/1961	72.6	6/26/1962	52.3	196	-28%	26%	45%	59%
7	2/9/1966	94.1	10/7/1966	73.2	240	-22%	25%	32%	28%
8	11/29/1968	108.4	5/26/1970	69.3	543	-36%	12%	21%	35%
9	1/11/1973	120.2	10/3/1974	62.3	630	-48%	-27%	-5%	7%
10	11/28/1980	140.5	8/12/1982	102.4	622	-27%	30%	38%	61%
11	8/25/1987	336.8	12/4/1987	223.9	101	-34%	23%	54%	39%
12	3/24/2000	1,527.5	9/21/2001	965.8	546	-37%	-1%	-32%	-5%
13	1/4/2002	1,172.5	10/9/2002	776.8	278	-34%	7%	21%	32%
14	10/9/2007	1,565.2	7/15/2008	1,214.9	280	-22%	-	-	-
Average Days/ Decline/Recovery					408	-31%	15%	23%	30%
		<u># of Days</u>	<u>% of Days</u>						
Total Period		25,451	100%						
Bull Period		19,735	78%						
Bear Period		5,716	22%						
Notes:									
♦ Price = S&P 500 closing price (excluding dividends)									
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*Past performance is no guarantee of future results.*

*Market data has been obtained by third party sources (S&P 500 price data from Bloomberg, and S&P 500 total return data from Ibbotson Associates). This data, while believed to be reliable, has not been independently verified by EBS.*