PART I

# Five Wall Street Fairy Tales and Why the Conventional Wisdom is Flawed

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There are many good reasons to actively manage your portfolio but one of the most compelling is to try to avoid the devastating consequences of bear markets.

Bear markets happen more frequently than you might imagine and do devastating and long-lasting damage to investors' portfolios. But it is possible to avoid these downdrafts and later we'll get into trading systems ranging from simple to complex that are designed to do just that.

For decades, Wall Street and the financial media have fed investors a steady diet of investment advice and concepts that have been proven to be devastatingly flawed during the Tech Wreck of 2000–2002 and again during The Great Recession of 2008.

The financial carnage has been well documented in the press with trillions in assets disappearing, maybe forever, as investors followed advice like "buy and hold," "invest for the long term," and "hang on, it will come back."

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And the result was no different during The Great Recession of 2008 than it was during the Tech Wreck or the Bear Market of 1982 or any bear market dating back to the Great Depression.

In every case, the average retail investor typically bought at the top and sold at the bottom and watched the stock market devour his or her hard-earned savings. As the old saying goes, "the stock market will make as big a fool out of as many people as possible," or put another way, "the market will do everything it can to separate you from your money."

In this section we're going to take a look at the 5 Wall Street Fairy Tales that I feel are at the root of these problems and how they're a real and present danger to your net worth. You've heard of all of these before but we're going to delve into each one and see why it's a hazard to your net worth.

And the danger isn't past once The Great Recession ends because there will be other bear markets and other dangers and challenges along our paths.

So let's start with a look at bear markets and how they're an ever-present danger to your portfolio and financial future.

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CHAPTER 1

# The Bear Facts about Bear Markets

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Bear markets are a frequent, normal part of the stock market life cycle, just like recessions are a normal part of the economic cycle and both of these facts create a potentially very dangerous environment for investors around the world.

## THE BEAR FACTS: ANOTHER BEAR IS OUT THERE WAITING TO MAUL YOUR PORTFOLIO

Bear markets are defined as drops of 20 percent or more in the overall market typically as defined by the S&P 500, the 500 most widely held stocks in the United States.

Bear markets usually precede recessions by nine months.

Bear markets aren't as rare as you might imagine. There have been 26 bear markets in history and they have occurred on the average of less than one every six years.

The typical decline of the major indexes in a bear market is more than −35 percent.

Put those two facts together and once every five to six years you expose yourself and your nest egg to the chance of losing −35 percent. The arithmetic regarding losses of this magnitude isn't pretty, as outlined in Table 1.1.

**TABLE 1.1** Bear Market Arithmetic

| Amount of Loss | Profit Required to Return to Breakeven |
|---|---|
| 20 percent | 25 percent |
| 30 percent | 43 percent |
| 50 percent | 100 percent |

In recent years we have seen "ultra bears"—in 1973–1974 with a decline of −48 percent, 2000–2002 declining −49 percent and 2008 declining −49 percent.

Recovery from these bear markets can be long and hard. On average, since 1929, the time to reach breakeven has been more than five years, however this time can be much, much longer. The 1929 bear market took 25 years to breakeven, the 1973–1974 bear market took more than 8 years to break even.

From 2000 to 2010, the market has still not managed to hold onto its previous highs, and investors have endured a negative rate of return for more than ten years as we went from the Tech Wreck to momentary new highs and then into The Great Recession of 2008.

In 2010, we heard a lot about the "lost decade" since the S&P 500 generated a negative rate of return between 2000 and 2010. However, it wasn't the first secular bear market nor will it likely be the last. The most famous bear was the 1929 crash that lasted more than 20 years. Less famous is the bear that ran from 1966 to 1982, a period of 17 years, and as I write this in early 2010, we are still not back to break even from the bear that began in 2000.

Over the course of the last 80 years we have had three secular bear markets lasting a total of 48 years. Put another way, someone who began investing in 1929 has spent 60 percent of his investing career in bear markets with negative or only slightly positive returns to show for his or her efforts.

Figure 1.1 shows what a typical bear market looks like.

In the chart in Figure 1.1 it's easy to see the devastating drop of the S&P 500 between the beginning of 2008 and the March, 2009 lows. And this type of action isn't so unusual if we look a little farther back at the Tech Wreck of 2000–2002 as shown in Figure 1.2.

Comparing the two charts, a couple of interesting facts immediately stand out. Both bear markets started from approximately 1500 on the S&P, only nearly a decade apart from each other.

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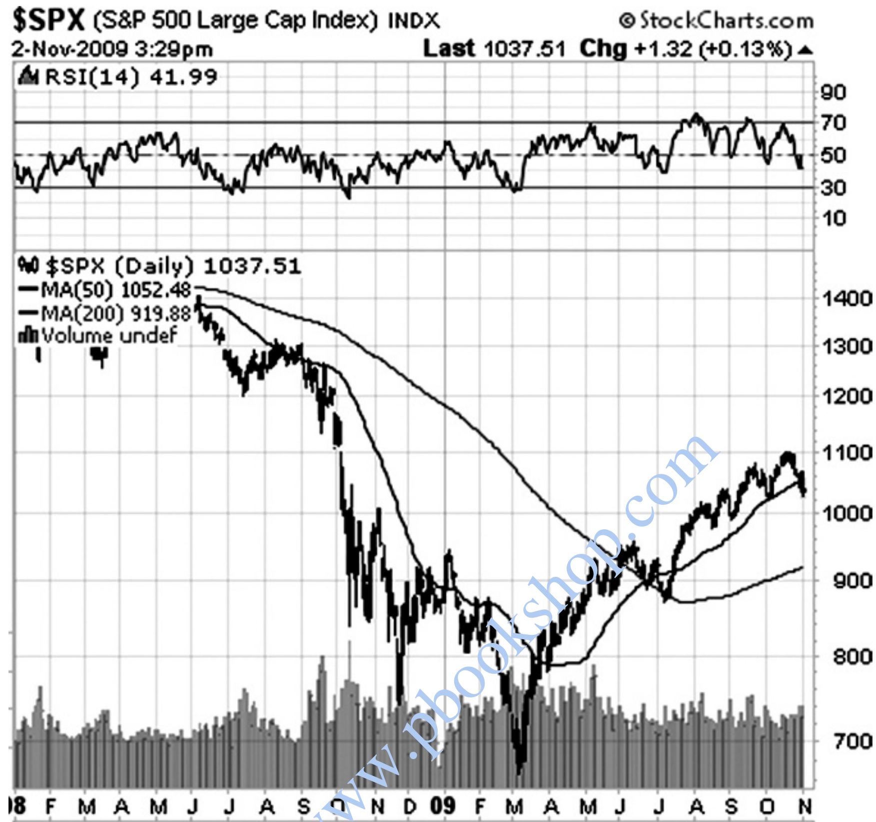


**FIGURE 1.1** Bear Market of 2008
Chart courtesy of www.StockCharts.com

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The 2000 Tech Wreck declined approximately −48 percent over 3.5 months while the Bear Market of 2008 declined a total of approximately −55 percent over five months.

And the subsequent rebounds look very similar when put side by side. Figure 1.3 shows what the last ten years look like altogether:

In Figure 1.3 we can see how in very real terms the stock market, as measured by the S&P 500, has generated a negative rate of return since 2000. And for many investors who tend to buy high and sell low, the returns have been much, much lower.

Of course, the picture becomes even bleaker when you factor inflation into the picture and the lost opportunity costs of nearly a decade of your investing life.

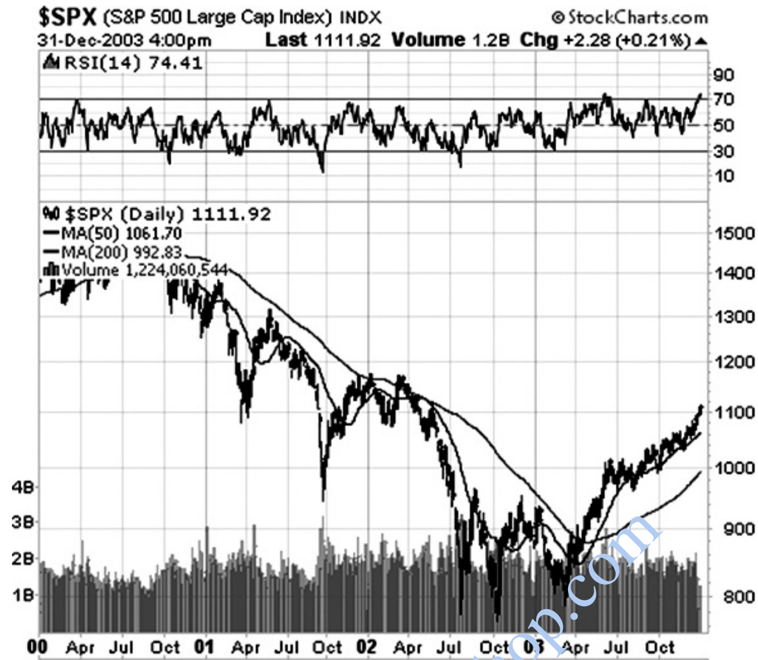


**FIGURE 1.2** Tech Wreck
Chart courtesy of StockCharts.com

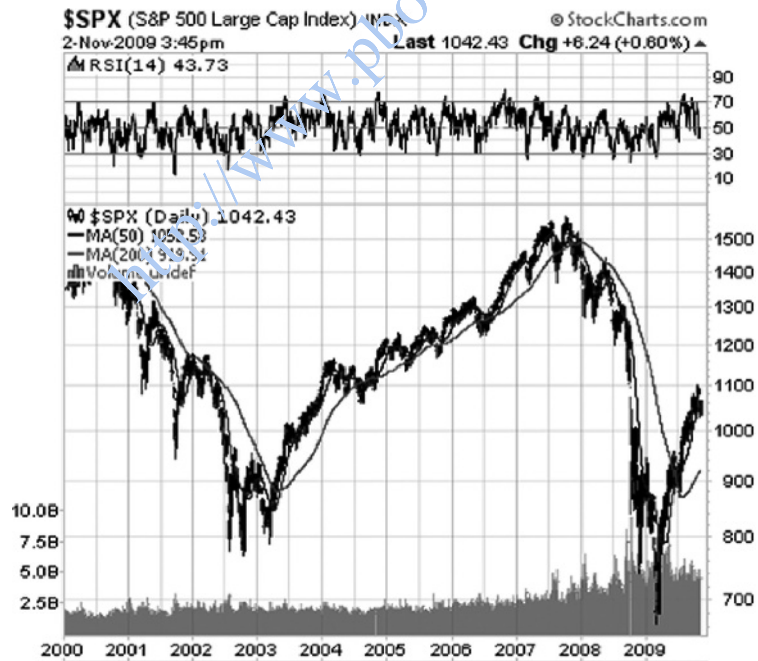


**FIGURE 1.3** Ten Year Chart of S&P 500
Chart courtesy of StockCharts.com

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## CONCLUSION

So after looking at the last ten years, the obvious questions must be, "Isn't there a better way to invest than what is put forth by 'conventional wisdom?"' And "what would your investment returns look like if you could consistently dodge bear market bites?"

The point here is plain and simple. For investors pursuing a buy and hold strategy, it's a matter of when, and not if, another bear market comes along and takes a big bite out of their portfolio.

In today's high-velocity markets, where money travels around the world at literally the speed of light, it becomes vital to have a plan to survive and prosper in a world that has changed and possibly changed forever.

Unless you believe in a stock market that can only go up and so will somehow magically take you to your investing goals, the obvious conclusion is that all in all, it would be a good idea to avoid bear markets and protect your capital so you'll have more to grow during upswings in the market.

The purpose of this book is to outline practical methods designed to give you a chance to make that seemingly elusive goal a reality.

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