BY JOHN KINGHAM

THE FINAL WORD

WHY I LOVE BEAR MARKETS

It took me a very long time to realise it, but bear markets really are a long-term investor's best friend. Not that you'd know it from all the panic-inducing hype put out by the mainstream media. But despite the relative smallness of this latest bear market, the oft-repeated mantra of being greedy when others are fearful is still the single most important idea that investors are ever likely to hear.

This idea is entirely counterintuitive. After all, why would anybody want to buy something that's going down in value, or sell something that's going up? Surely it makes more sense to hang onto whatever's going up and sell what's going down?

That's exactly what I used to think. I remember selling virtually all of my stock market investments in 2003. The market had gone down for three years in a row and I was worried that those declines would be permanent. In my case – and I think this applies to most investors who panic when prices are falling – I was focusing on the wrong thing. I was focusing on the market price of my investments rather than the investments themselves. This is a key distinction and it's an area where stock market investors would do well to learn from property investors. For most property investors what matters is the property itself and its ability to generate cash. Yes, the market price of the property is important, but only when the investor is looking to sell, which is typically many years or even decades in the future. As long as the property is cash flow positive what the market value of the property is this week or this year is virtually irrelevant.

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But most stock market investors focus far more on the price of companies than they do the long-term cash generating ability of those companies, and that's usually a huge mistake. Take my younger self from 2003. All I could see was that the FTSE 100 had fallen from around 7,000 in 2000 to 3,500 in 2003 – a 50% decline in market value. I sold out because I had no idea how low it would go, and whether it would ever come back up again.

I was totally focused on the market price, but what about the cash generating abilities of the companies that made up the FTSE 100? In other words, how did the dividend change between 1999 (just before the peak of the market) and 2002 (just before the bottom)?

In index point terms, the FTSE 100's dividend in 1999 came to 141 points (the yield was just 2.1% at the time). In 2000 the dividend fell to 135 points and stayed at the same level in 2001. By 2002 the dividend had rebounded to 140 points and in 2003 it reached a new all-time high of 143 points. Amazingly enough, during that 50% bear market decline between 2000 and 2003, the FTSE 100's dividend only declined by 4%.

Imagine a property investor who decided to panic sell and lock in a 50% capital loss just because the rent on their property fell by 4%. Most people would think that was crazy, but that is effectively what I and many other investors did in the bear market of 2003.

So if selling is usually the wrong thing to do in a bear market, what is a more sensible course of action? The answer is to do what most people do when goods are on sale: *Grab your wallet and start shopping.* The evidence from history is that this is almost invariably a good idea, as long as you have a multi-year investment horizon, which should be true of almost all stock market investors.

Here's one example of what I mean by "evidence from history":

By looking at the S&P 500's cyclically adjusted PE ratio (CAPE – which compares the current price to the ten-year average of inflation-adjusted earnings) at a particular point in time, and then comparing that valuation ratio to the index's subsequent average total returns (measured over all periods from one to 30 years), we can see how today's valuation and an index's future returns relate to each other.

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The results are very interesting:

- When the S&P 500's CAPE ratio was below 10, the average future total return was 9.8% per year.
- When CAPE was between 10 and 20, the average future return was 6.6% per year.
- When CAPE was between 20 and 30 the average future return was 2.7% per year.
- When CAPE was above 30 (which happened only twice between 1881 and 1985, which is the period this example covers) the average future return was a not very impressive 0%.

So when CAPE was high (i.e. during major bull markets) subsequent returns were poor, and when CAPE was low (i.e. during major bear markets) subsequent returns were excellent.

In terms of the S&P 500's historic bull and bear markets:

- Returns after the 2000 bull market have so far averaged a terrible -2.5% per year.
- Returns after the late '60s bull market averaged less than 1% per year.
- Returns after the late '70s and early '80s bear markets averaged a very impressive 13.8% per year.

- Returns after the 1932 Great Depression low averaged 12.4% per year.

The idea that bear markets are excellent buying opportunities stands the test of time for most investors in most markets at most points in history.

For investors who are in the accumulation phase and who still have at least a decade to go before switching to the income phase, bear markets are not something to fear; they are something to look forward to. They are an opportunity to buy good companies and good indices at low valuations, with high yields and with valid expectations of high future returns.

So where are we today, with the FTSE 100 hovering around the 6,000 mark, which is more or less where it was almost two decades ago? Thanks to the recent bear market, the FTSE 100's CAPE ratio is currently just 11.8 and although the FTSE 100 is not the S&P 500, I think the UK market is likely to produce returns that are broadly similar to the US market when starting from similar valuation levels.

On that basis I think it is reasonable to expect the FTSE 100 to produce average total returns that are in the region of 10% per year over the next 30 years. Given that the UK market's long-run average return has been around 7% a year, I expect this recent bear market will once again prove to be a good opportunity for long-term investors.

About John

John Kingham is an experienced private investor, investment blogger and newsletter publisher. His professional background is in computer software for the insurance industry, where he worked for clients ranging from Lloyd's syndicates to some of the world's largest general insurers.

In 2011 John left the computer software industry and began publishing UK Value Investor, a monthly investment newsletter for defensive value investors.

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