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# Bad Habits and Bear Markets

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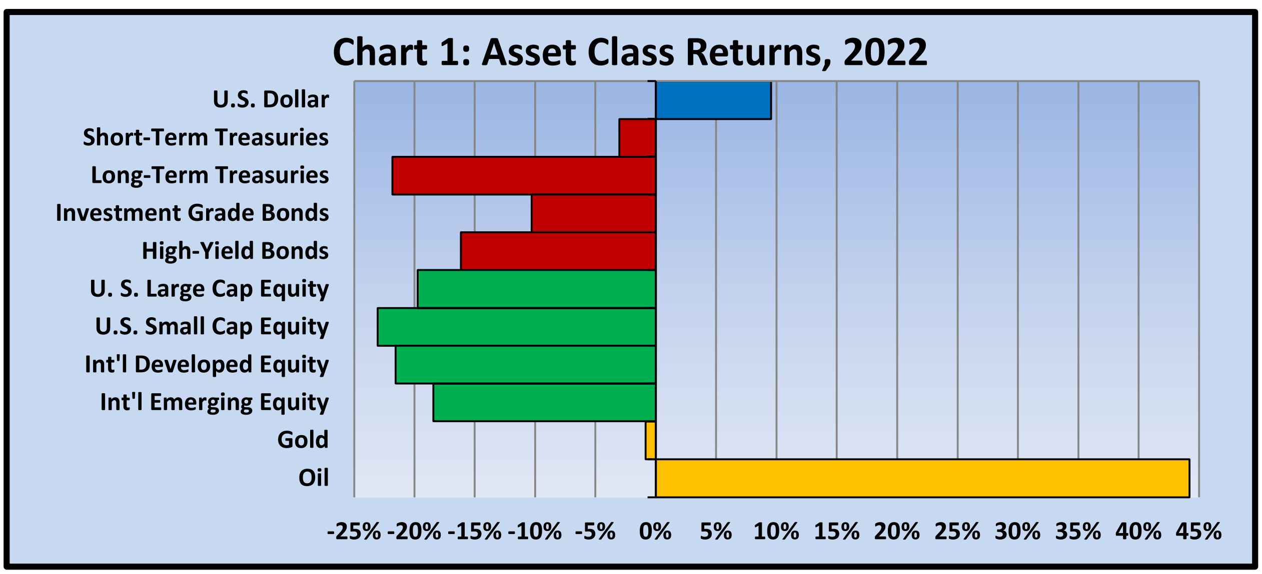
Bear markets feed on bad habits. They feast when we yield to our worst impulses, giving in to despair and anxiety. They trigger bad behavior. We see the value of our investments falling, and we begin to worry that our financial plans are going awry. When we can no longer bear the pain, we pull money out of the markets. We sell when we should be buying. Then we feel regret at taking a loss, and even more regret when the market inevitably recovers. The British pop star Ed Sheeran caught the mood perfectly last year:

> *My bad habits lead to wide eyes stare into space*
> *And I know I'll lose control of the things that I say*
> *I was looking for a way out, now I can't escape.*

It's easy to fall into bad habits, and very hard to escape them. That's true for smoking, slicing tee shots, bailing out on the stock market after prices have fallen, biting fingernails, tailgating at high speed, and many other behaviors. In many respects, professional investment management is nothing more taking the bad habits out of the process of preserving capital and saving for the future.

That's not to say that the pros will avoid losses; we can't. But good investment managers know when to have patience, and when to have fortitude to ride through the markets' perturbations without panicking. This year has certainly been a test, as just about every asset class has been dismal (Chart 1); there has been nowhere to hide.




Source: FactSet; Data for January 1 through July 1, 2022

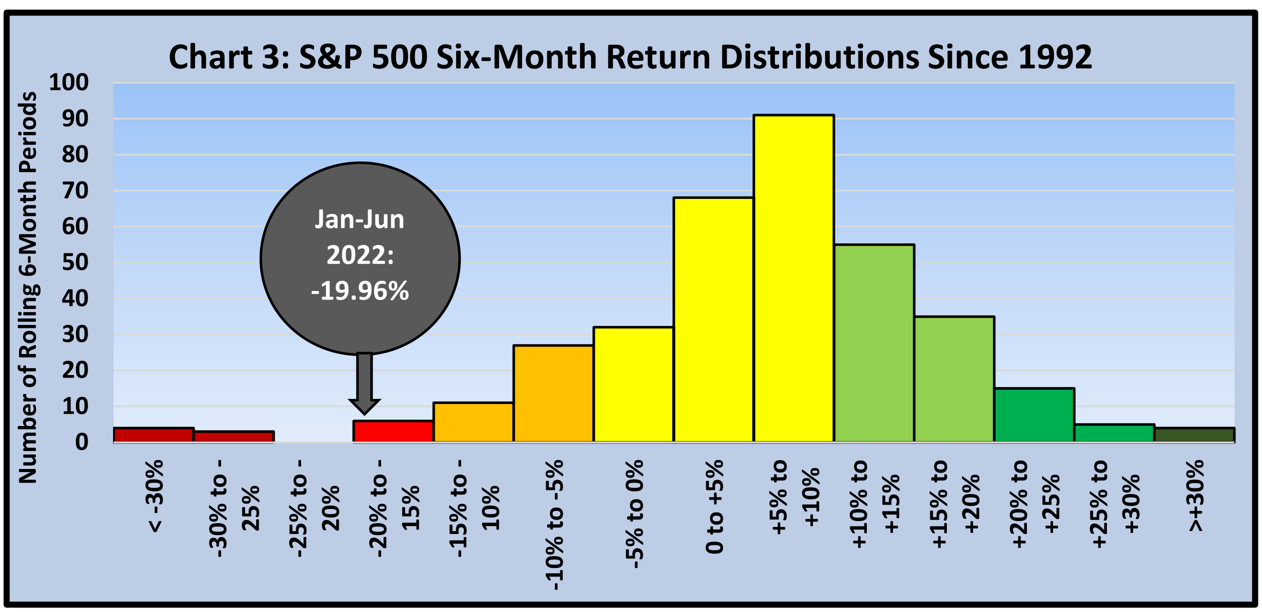
Indeed, the losses this year have been historic: This was the bond market's worst-ever first half, more than twice as bad as *any* previous January-June period since 1926 (left side of Chart 2). The period since July 2019 was also the single worst three-year streak in bond market history.

**Chart 2: Worst January-June Periods Since 1926**

| | Bonds | | | Stocks | |
|---|---|---|---|---|---|
| Year | Jan-June | July-Dec | Year | Jan-June | July-Dec |
| 2022 | -10.4% | -- | 1932 | -43.3% | 62.0% |
| 1994 | -3.9% | 1.0% | 1962 | -22.3% | 17.4% |
| 1974 | -2.8% | 8.7% | 2022 | -20.0% | -- |
| 2013 | -2.4% | 0.4% | 1970 | -19.5% | 29.1% |
| 1984 | -1.7% | 17.1% | 1940 | -17.6% | 9.5% |
| 2018 | -1.6% | 1.7% | 1939 | -15.7% | 18.1% |
| 2021 | -1.6% | 0.1% | 2002 | -13.2% | -10.3% |
| 1999 | -1.4% | 0.6% | 2008 | -11.9% | -28.5% |
| 1996 | -1.2% | 4.9% | 1973 | -10.4% | -4.8% |
| 1955 | -0.9% | 0.3% | 1974 | -10.2% | -18.1% |
| Bond index: US Government Intermediate (1926-1988); Bloomberg U.S. Aggregate Bond (1989-2022) | | | Stock index: S&P 500 | | |

Source: BlackRock

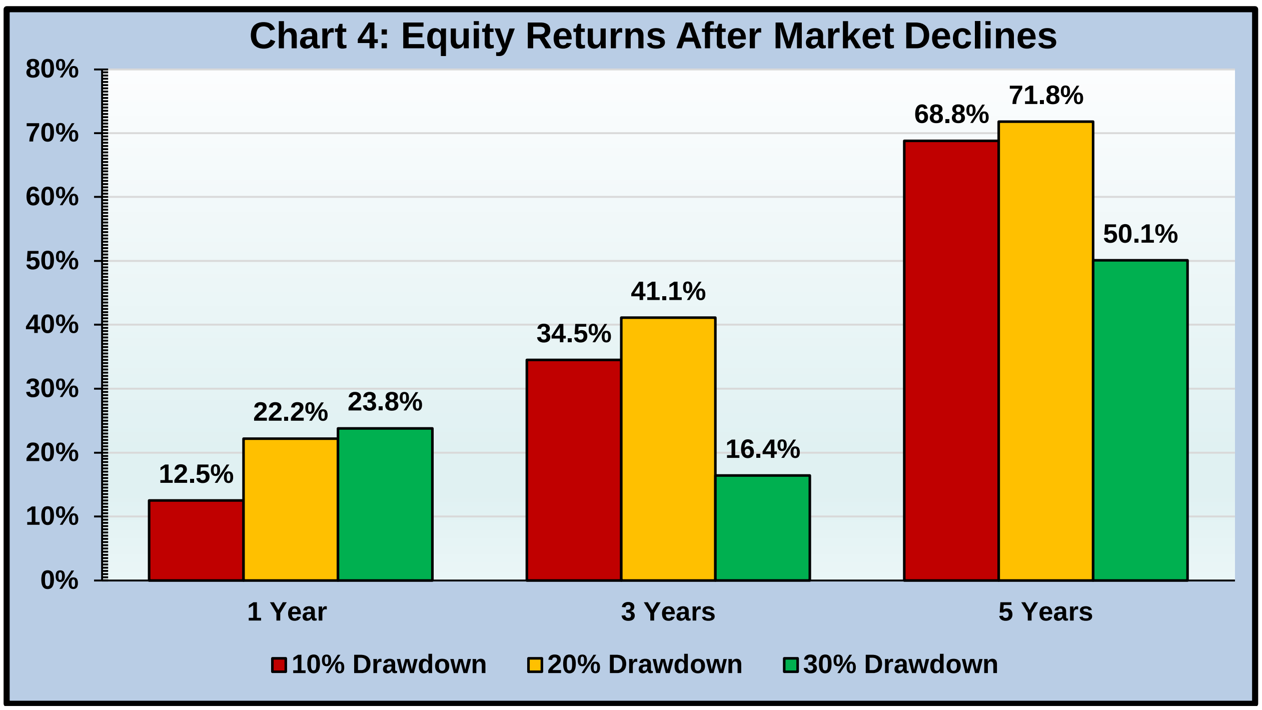
On the right side of Chart 2, this was also the third-worst start for the nation's stock markets over that same 96-year history. Looking not just at January-to-June but at all 355 six-month periods (e.g., February-to-July, March-to-August, etc.) since 1992, only seven such periods were worse than what we have just seen (Chart 3). That visceral dread in the pit of your stomach is very real, and very justified: Taking stocks and bonds together, the last six months have been like no other similar period in our lifetimes.




Sources: FactSet, Eastern Bank Wealth Management

Many people have developed three bad habits when faced with paper losses on this scale: They shorten their time horizons; they sell after prices have already fallen; and they fail to maintain proper asset allocation through the downturn. When the going gets tough, the best investors stick zealously to their discipline, staying fully invested and avoiding these bad habits.[1]

The reason for this discipline is simple: Markets always recover. Looking back at Chart 2, bonds staged a rally in the second half of every one of the "ten-worst" years shown, while stocks made up ground in more than half. More comprehensively, Chart 4 shows that U.S. stocks have historically staged big and sustained rallies over the one-, three-, and five-year periods following significant market declines since 1926. On average, corrections and bear markets are short; the recovery is often sooner, sharper, and more sustained than many investors anticipate. Shortening one's time horizon – that first bad habit – means forgetting that stocks and bonds represent claims on corporate earnings, and that the earnings will eventually recover.




Source: Dimensional Funds Advisors

The second bad habit stems directly from the first: We can't see the recovery because we're not looking deep enough into the future, so we bail out now. Sometimes we'll find some factoid to support our panicked exit, for example a news report about rising unemployment or a CNBC talking head yammering about expensive valuations. We may promise ourselves that we'll get back into the market soon enough, when the economy is looking better and when stocks are lower than they are today.

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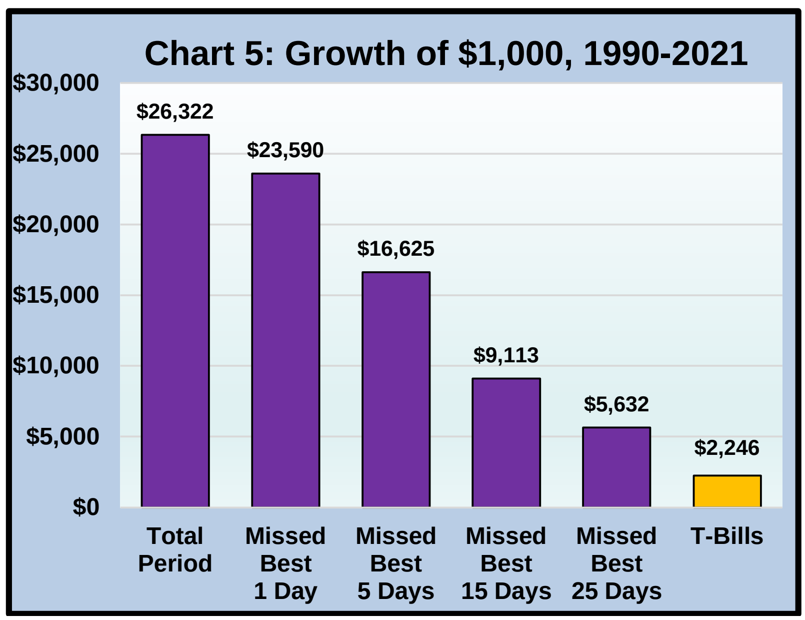
[1] Sometimes life events force an ill-timed sale, of course, but these ideally should be few and far between. Most financial advisors – including us – recommend keeping sufficient cash in bank accounts to handle several months' worth of normal expenses and/or any unanticipated needs, precisely because no one can predict market conditions with any confidence.

The fallacies embedded in that rationale are manifold. First, we indulge our bad habit of confirmation bias, selectively choosing which factoids and commentaries to believe based only on the sinking feeling in our guts. We latch onto the most bearish-seeming data points because we're depressed – but valuations and other market metrics should be handled with care.

A second fallacy is the notion that if we do sell, we'll know when to get back into the market. We don't know. We can't predict when, precisely, the economy will start to improve.[2] We also can't be sure that stock prices will be lower in the future even if the economy does deteriorate; markets begin to recover as soon as investors see the first glimmers of possible recovery in the future, even if the current situation remains sluggish. And even if we correctly sense that the time is right, we often are paralyzed by fear and we fail to act on that insight; we miss the upturn.

Further, some of the biggest one-day gains have come *during* bear markets, or at major turning points. This is the crux of the third fallacy: We don't and can't know when to get back into the markets – and we fool ourselves if we think we'll have the courage to do it, too. Timing the market is a terribly bad habit because we sell badly (after stocks have gone down) and then we buy badly (if at all), missing the recovery. We also pay taxes on any embedded gains when we sell, taxes that could have been deferred for many years just by staying fully invested.

Chart 5 shows the impact on long-term returns from missing out on just a few of the stock market's best trading days. There have been approximately 8,000 trading days since January 1990; missing out on just the best 25 of them would have erased 79% of an investor's total return over that 32-year period. The result would be returns not much better than those of Treasury bills, but with much more volatility. Since we can't know in advance which days will be great, we need to stay invested at all times.



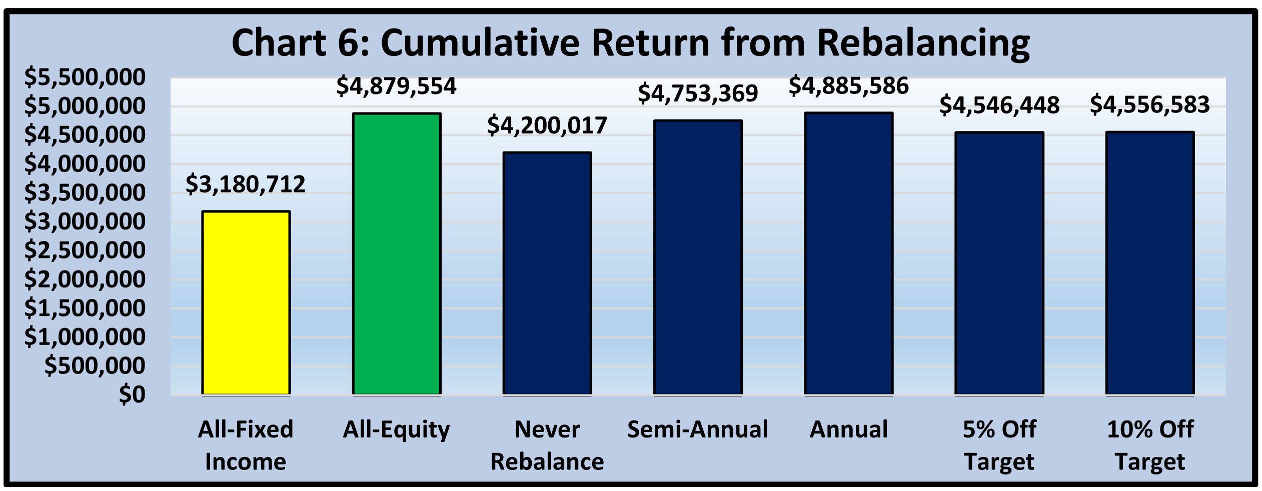

Source: Dimensional Funds Advisors

[2] Some anecdotal but powerful evidence in support of this conclusion: There is an office building at the corner of 20th Street and Constitution Avenue in Washington, DC, that houses the offices of hundreds of the world's best trained and most highly educated economists, whose sole job is to predict the future of the U.S. economy. Despite all this erudition and expertise, the forecasting record of the Federal Reserve is, ahem, not very impressive. A cottage industry has evolved in parsing the Fed's quarterly "Statement of Economic Projections" and "Dot Plot," comparing them to the forecasts embedded in prices of various Treasury bonds and futures contracts. Generally speaking, the markets have a better track record than the Fed does.

Staying fully invested doesn't mean doing nothing, however; completely hiding one's head under a pillow is the third bad habit that many investors unfortunately adopt during bear markets. Instead, it's important to rebalance portfolios periodically back to their long-term allocation targets. That's because stocks and bonds usually move in opposite directions; in an equity bear market, losses in stocks are typically cushioned by gains in bonds.[3] When this happens, the allocation to each asset class moves away from its target. In 2020, for example, a portfolio that had 60% in stocks in January was down to 52% by March, just because stocks fell by 35% while bonds held their value. By rebalancing, an investor takes profits from one area and reinvests in cheaper securities elsewhere; it is the embodiment of "buy low, sell high."

Charts 6 and 7 demonstrate the value of periodic rebalancing. These charts use historical data to show what a portfolio of $1 million would have done from January 2001 through June 2022. On the left side of the two charts, an all-stock portfolio grew to be 53% larger than an all-bond portfolio over the 22-year period, but it was nearly twice as volatile along the way. The five columns on the right side of each chart show the results of applying various rebalancing methods to an initial 60/40 blend of stocks and bonds. The "never rebalance" (Rip Van Winkle) strategy produced a return between that of all-stocks and all-bonds, but with lower volatility than either pure strategy; that's a reasonable trade-off, to be sure. But note that using *any* active rebalancing strategy[4] produced returns that were nearly as good as equities, but with barely half the volatility of an all-stock portfolio. In fact, the simple strategy of rebalancing back to 60/40 every January resulted in a total return *higher* than an all-stock portfolio generated: More gains, less volatility.

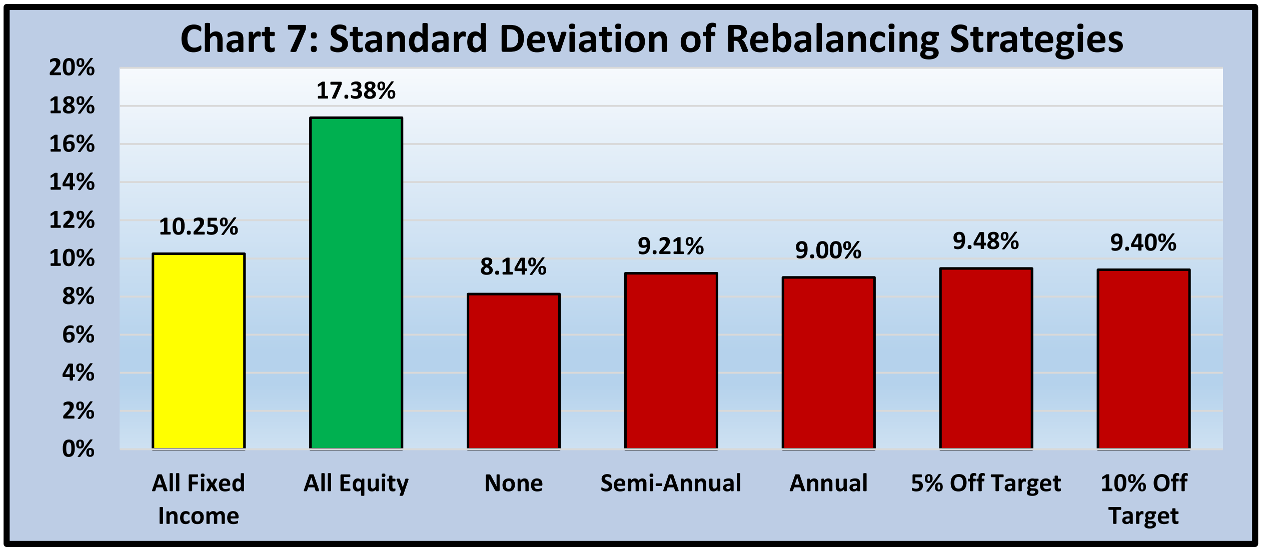



Sources: FactSet, Eastern Bank Wealth Management

[3] The first half of 2022 was historic in that both stocks and bonds endured painful losses at the same time.

[4] The strategies reset the portfolio back to 60% stocks and 40% bonds by selling one asset class and buying the other, according to the following schedule:

- "Never Rebalance": Set the portfolio to 60% stocks, 40% bonds at the beginning of 2001, and go to sleep for 22 years with no changes.
- "Semi-Annual": Rebalance every January and June, making no other changes.
- "Annual": Rebalance every January, making no other changes.
- "5% Off Target": Rebalance whenever the stock portion dips below 55% or above 65% of the total.
- "10% Off Target": Rebalance whenever the stock portion dips below 50% or above 70% of the total.




Sources: FactSet, Eastern Bank Wealth Management

There's no question that 2022 has been a historically bad market environment, and it's also true that the outlook is still cloudy. We don't know how the war in Ukraine will play out, but we do know that the war will continue to affect global supplies of oil, natural gas, corn, wheat, soybeans, fertilizer, and many other items. We don't know whether the Fed's aggressive rate hikes will succeed in tamping down consumer spending, and if so whether we will find ourselves in a recession or just a slowdown in growth. We don't know whether more companies will follow the examples of blue chips like AT&T and IBM in tempering their profit expectations.

We can't know the future, but we can control our behavior. With stock prices down, bond prices down, and our spirits down as well, this is the right time to break our bad habits: Don't shorten your time horizon; don't sell out at the bottom; don't be paralyzed by fear. Practice good habits: Stay true to your long-term objectives and targets; stay fully invested; rebalance according to a regular and defined method; remember that markets always recover; exercise patience. And when you slice your tee shot into an alligator-infested pond, don't chase after it.