Introduction:
This blog is about how investors should behave in bear market. At a broad level, one can say there are three phases of markets at any point of time – bull, bear or flat markets.
The way time never stops, we can say market cycle never stops. Cycle of bull-bear-flat market always continues.

There is a famous saying that 'One cannot time the market', which is a time proven concept however one certainly needs to have different mind-set across different market cycles. This is important, since different market cycles have different impact on investors' behaviour and psychology just like different phases of Moon have varying impact on the Sea tides due to its gravity impact.

Behavioural biases have very strong impact on market participants' actions, thus it is important to be aware of the same and act rationally.

Bear markets

What leads to Bear markets– Over the long-term, markets follow what happens in the economy and same goes for an individual stock i.e. dependent on its earnings growth.Key reason for bear market is the failure of a bull market. Whenever market is extremely expensive, it just needs one strong reason to correct and market history suggests that different bull markets in the past have corrected due to irrationality of participants. Similar concept applies to an individual stock also i.e. *if stock is very expensive e.g. quoting at 70-90x PE, then it means market participants have very high earnings growth expectations from it and if it does not live upto those expectations, it gets de-rated.*

Reasons in the past for Bear markets – Expected slowdown in earnings growth due to various reasons e.g.increasing fiscal deficit of the Govt, NBFC crisis, policy paralysis, Brexit fears, European financial crisis,Global financial crisis and more recently, the Covid 19 shock.

What are market participants' biases in Bear markets – Most investors tend to have a very negative outlook about the business, economy and stocks. Since markets are always driven by recency bias, in this phase investors are generally not able to see the longer term picture of the Economy/stocks and strong fear exists in the market. One can say 'End of the world' mindsetprevails.

How market participants react in Bear markets – Due to fear, excessive selling happens and 'Sell at any price' prevails. During bull phase same set of investors would 'Buy at any price'. In this phase, we hear from investors – 'Capital preservation is the key, Will this company survive this phase, there is so much leverage on the B/S, I would sell currently and rather enter when things start moving and there is some clarity.' In this phase both large and retail investors want to get out thus all the stocks start falling.

In this phase, entire media will have negative outlook on the economy and market and each incremental news is taken in the negative way. During this phase investors generally lose interest in the market and sometimes they start focusing on other activities to distract themselves. Stress is at the peak in such times since we see drawdowns wiping out earlier MTM gains (i.e. unbookedprofits) and capital as well. There is a famous saying in Equity market – "It's easy to make money in market, but very difficult to take gains out of the market". In most of the times price appreciation remains in the form of 'Paper gains' only.

How should a rational investor act in Bear Markets – As Warren Buffet mentions 'Be Fearful when others are greedy and greedy when others are fearful'. Bear markets should ideally be the time for stock picking. However this quote is easier said than done, when our hard earned money starts seeing large drawdowns -(40-50-60% it can be anything, if we have not acted rational during bull phase).

However this is the time for maintaining rationality as well as belief in the markets.

Markets will continue to gyrate between Bull and Bear markets like a pendulum, which cannot be controlled by investors. We can only control our actions. One needs to be rational and optimisticin such times that things will settle down at some point and generally bear market/economic slowdowns are followed by stimuluses by Govt/Central banks to revive demand which acts as catalyst for future returns.

In such times one needs to remain quality conscious, since when markets rebound even Low quality (LQ) stocks will go up. However we should think it this way 'Do we have the conviction to hold those LQ stocks over long term beyond the initial gains'. LQ stocks by their own nature tend to be more volatile i.e. high beta stocks. Thus if someone buys LQ stocks and wants to cash out the gains then there will again be a ‘Reinvestment risk’.

Key dilemmas in this phase – When should I buy, what should I buy?

When should I buy – Though it’s a very difficult question to answer, however we have some useful tips to help here:

– First try to understand the gravity of the situation -How long the crisis may continue, take reference for similar situation in the past and in other countries in the world.

– Also focus on Top down approach i.e. focus on valuation of indices. Markets tend to follow mean reversion approach. If indices valuation are near or below -1SD valuations then only we can say that markets have become cheap *(i.e. when valuations are below long term averages).*

– Instead of putting all in one go, layered approach to allocate sums would be advisable. Don’t try and guess/capture bottoms. Averaging on upside is a better option, instead of focusing on the initial 10-20% from lows.

– One common mistake during such time is also Fear of Missing Out i.e. FOMO (though FOMO is generally associated with Bull market, but in bear market this happens when after initial fall in the market investors start accumulating stocks taking that as buying opportunity and don’t want to miss the Recovery of recent drawdowns. So due to this action, it happens that when stocks really become cheap, we are not left with money to invest since we would have deployed entire cash already.

During recent fall due to Covid 19, an interesting WhatsApp message was floating around:
“□□□□□□□□□□□□□□, □□□□□□□□□□□□! □□□□□□□□□□□□□, □□□□□□□□□□□□□□□!”

i.e. Everyone talks about investing at market bottom, however no one knows when will be the bottom.And when market really bottoms out, we are not left with money to invest”

What should I buy– *It generally happensin falling markets, we start finding all stocks in our watch list very cheap and market appears like an ‘Appetizing Buffet’. At this time stock picking appears very easy. Thus one needs to be very judicious of what to buy, because what* *we buy in such times will decide our future returns.*

Also in this phase, Low quality (LQ) stocks fall much more than high quality (HQ) stocks and thus LQ stocks start appearing a very high bargain game. However there are underlying business and financial reasons due to which LQ stocks fall more (e.g. weak market position, declining market share, high leverage, corporate governance issues).

There is also a strong Anchor bias in this phase i.e. we start comparing current price with earlier Highs. Thus even if stock in absolute terms might not be cheap, optically it appears cheap.

Some areas to be considered for portfolio/equity allocation in current environment:

a) Stick to HQ, Moat Businesses. We can also consolidate our existing portfolio towards HQ businesses since HQ stocks also come down during this time.

b) Dominant market share players should be preferred choice mainly because of their heft/scale etc. Marginal, leveraged, small size players might be a risky bet.

c) Under deep distress, if there are reasonably okay businesses available at attractive net-net values, or closer to their net cash values, they also can be considered as contrarian calls.

d) Asset based annuity businesses with utility value for economy/society at large, can also be considered if they offer attractive IRRs/Yields.

e) Focus on companies having natural resources, real productive assets and thus some exposure on contrarian basis on deep discount to underlying NAV/fair values can be considered. Again, stick to the lowest cost producers, as they are more likely to navigate through tough times.

f) For financial services/banks- Stick to Clean, Clear and Strong balance sheets. Don't chase growth, if balance sheet is strong, growth will be automatic.

Should we fear the Bear markets –A rational investor should fear more in the bull market rather in bear market, which basically means sitting on cash/other fixed income alternatives when valuations are very expensive. This will first protect from drawdowns and ensure ability to deploy money when stocks get very cheap in falling markets. However this is easier said than done, because in bull markets when stocks keep going up and up – we are not able to see the possible downside and selling the stocks become a difficult decision, but that's the time to act rationally.

Focus on intrinsic value – In a bear market stocks can become very cheap, which we might not have factored/expected. During such time instead of continuous averaging down, one should try to identify investment horizon and focus on the intrinsic value of the stocks.

We should try to find out the base value of stocks at which one finds significant margin of safety. This could be NAV value, Replacement cost value, High dividend yield, No growth value. We may also focus on Free cash flow based valuation instead of only looking at earnings based valuation.
One should analyse – Will this company survive this slow down/crisis, is valuation attractive, is there good long term growth opportunity? If all these three combinations are available, then one can go for that stock.

Survival + Attractive valuation + Growth opportunity = BUY

Conclusion

It's really difficult for anyone to comment on when market will bottom out. Thus, one should focus more on the fundamental aspects of the business/economy. As these opportunities don't come very often, this is a good time to sit back and assess the type of portfolio one would want to build/reconstruct the existing portfolio.

Statutory Details: Multi-Act Equity Consultancy Private Limited
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