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Lessons of a Bear Market

Investors who ignore history are doomed to repeat it.

Mutual Funds: Dealing with Market Downturns

During the past 12 to 18 months, the stock market has for the most part resembled a down escalator. While experienced investors remember the market decline in 1973 to 1974, and more recently in 1987, many of today's mutual fund investors took their first plunge into the market in the last 12 to 15 years. This means these clients are inexperienced in weathering a down market, creating trying times for some CPA/financial planners.

The Facts of Life

Many mutual fund investors first entered the market as 401(k) plan participants. Since 1985, the number of 401(k) plan participants has more than doubled, from 10 million workers to 25 million in 1997. The growth in 401(k) plans coupled with the roaring bull market means stocks now represent a tremendous share of personal wealth. Although clients have more money than ever before, they have less investing experience than any previous group of investors. As a result, many have developed unrealistic expectations. According to one survey conducted by Montgomery Asset Management just before the October 1997 market correction, investors expected a 34% average annual return on their mutual fund investments over the next 10 years.

As every financial planner knows, past performance is no guarantee of future success. Double-digit returns do not endure and market declines are simply a fact of life. Data from Ibbotson Associates in Chicago show that during the 75-year period from 1925 to 2000 large company stocks posted annual declines more than 20 times—approximately 1 year of decline for every 31/2 years of positive returns. A look at the entire 75-year period suggests a brighter view. The average annual return on stocks—as measured by the Standard & Poor's 500 Index—was over 10%. Stocks outpaced both long-term U.S. government bonds and U.S. Treasury bills.

Still other data support stocks as long-term investments. In evaluating nearly two centuries of stock returns (1802–1992), University of Pennsylvania professor Jeremy J. Siegel found that for nearly all of the rolling 30-year periods from 1882 to 1992, stocks provided returns at least 5% higher than inflation and higher than cash or bonds. In his book, *Stocks for the Long Run: A Guide to Selecting Markets for Long-term Growth* (McGraw-Hill, 1998), Siegel concluded that, "Although stocks are certainly riskier than bonds in the short run, over the long run the returns on stocks are so stable that stocks are actually safer then either government bonds or Treasury bills."

While Siegel's time horizons may seem extreme, his data show that the benefits of stocks also apply to shorter time periods. He contends that for periods of 10 to 12 years there is little risk in stocks compared with bonds or cash. For periods of 20 years or more, Siegel believes cash and bonds carry more risk than stocks.

The year 2000 brought the most extraordinary stock valuations in modern times. Siegel points out that it is important to remember that before the historic 1999 to 2000 surge in the NASDAQ, tech companies were viewed primarily as cyclical stocks with some potential for long-term growth. The price/earnings (P/E) ratio for the 82 companies in the S&P 500 technology sector was only slightly above the average for the other 418 stocks in the index. But when tech stocks soared in 2000, they reached prices 75 times earnings and more than three times the P/E levels of non-tech companies. Their subsequent collapse occurred

when earnings growth faltered. Will these companies lead the new economy or revert to their historical pattern—rapid growth followed by sharp contradictions in demand? Siegel cautions investors to approach this sector with the “utmost caution” in view of its history.

Some investors and planners have also been agonizing over the choice between growth and value mutual funds. History provides some peace of mind. In the late 1990s, growth funds were the way to go. For example, if you invested $10,000 in an average mid-cap growth fund in January 1998, that investment would have been worth $24,000 in February 2000. In contrast, a $10,000 investment in an average mid-cap value fund over the same period would have been worth only about $11,000.

Recently the tide has turned in value’s favor. A March 2000 investment of $10,000 in a mid-cap growth fund would be worth only about $7,000 in April 2001. However, a similar investment in a mid-cap value fund would be worth about $13,000. Over the long term, according to Morningstar data, either style does the trick. The 10-year average annual return for large-cap growth vs. large-cap value was 13.7% vs. 13.6%; mid-cap growth vs. value was 14% vs. 14.4% and small-cap growth vs. value is 13.4% vs. 13.3%.

Dealing with Down Markets

While it may be natural for the market to decline periodically, it is never easy to help clients stay calm. Here are a few successful strategies CPAs can recommend that may help mutual fund investors weather the storm.

Help clients develop realistic return expectations. Although investors were thrilled when annual returns on the S&P 500 Index topped 35%, most investors should expect less than 10% returns from the U.S. stock market in the next 40 to 50 years. History is the best indicator of what the market may do in the future. It’s the CPA’s job to use past experience to manage client expectations.

Recommend that clients diversify their portfolios. As one of the most venerable portfolio strategies, diversification can reduce overall volatility. It has long been understood that different asset classes react differently to changes in the economy and the financial markets. A portfolio composed solely of small-company mutual funds may not perform in the same way during a market downturn as a portfolio of small-, mid- and large-capitalization companies. By suggesting consistent investment in mutual funds that concentrate on various areas of the market or that have different investment philosophies (such as growth or value funds), CPAs may be able to help clients build a portfolio that reduces volatility while maintaining appreciation potential.

Look for investment potential overseas. Overseas investments can help defend a portfolio against domestic down markets. Economies around the world may perform differently from the U.S. market and can even outperform it. The recent stellar performance of the U.S. market has masked the long-term trend: U.S. markets’ best years have had an average return in the range of 30% to 40%, compared with 116% for the United Kingdom, 126% for Japan and 136% for Germany.

Consider some actively managed funds over all passive funds. In recent years, passively managed mutual funds (also known as index funds) have become popular. In downturns, these funds mirror the market and move where the market moves. Actively managed mutual funds may be able to find more attractive and promising investment opportunities and take defensive action, shielding against the downturn. Active managers can move from one asset class to another based on their perceptions of the markets as a way to preserve capital and provide consistent portfolio growth.

Encourage clients to add to their portfolios using dollar cost averaging. This strategy takes the guesswork out of when to buy because it is impossible to know where prices are headed daily.

Encourage clients to stick with their investment plans. When clients’ portfolios are tailored to their goals, risk tolerance and time horizons, they probably don’t need to make drastic changes. A key job for their financial advisers is to review these factors with them. Explain how their risk tolerance affects volatility, which in turn affects market returns. Once clients understand this, they often are better able to make informed portfolio decisions that reflect their goals rather than their fears.

Beyond Performance

CPAs can play a key role in helping clients to analyze opportunities objectively, rather than make decisions solely on the basis of performance. A key step is to underscore history's lesson about stock market returns: Over the long-term, equity investments provide strong returns and outperform inflation and many other asset classes. Perhaps the best way to help clients prepare for an uncertain future is to do two things: encourage them to keep a long-term focus and help them make sure their portfolios are adequately diversified and fit their risk tolerance.

—Phyllis Bernstein

Phyllis Bernstein, CPA/PFS, is president of Phyllis Bernstein Consulting, Inc., in New York City. She was previously director of the AICPA personal financial planning division. She can be reached at Phyllis@pbconsults.com.

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