

# keeping one step ahead of the bear

## the bear and the bull

Bears and bulls have been synonymous with the stock market for almost 300 years. A 'bear market' is one in which sellers outnumber buyers, as the value of shares falls consistently over time. A 'bull market' is one in which share prices are consistently rising.

In stock exchange terms, a 'bear' is someone who sells shares while their value is falling, often hoping to eventually buy them back at a lower price. The name is thought to have derived from the phrase 'bearskin jobbers' – traders who sold bearskins, often before they even had the skins to sell.

Opinion on the origin of 'bull market' is divided, but it's likely that it evolved from the need for a term to describe the opposite to a 'bear market'. The phrase seems to have appeared in the stock exchange in around 1714. One common theory is that it arose from the notion that, while bears attack by pressing down on their victims, bulls do the opposite; throwing their victims upwards with their horns!

Violence and myth aside, at the heart of the origin of these phrases lies a pertinent message, warning against over-optimism through an old proverb.

*'One should not sell the bearskin before one has caught the bear.'*

# essential steps for surviving a bear market

Let's face it, confronting a bear is never going to be a tranquil experience. It requires a certain amount of composure and a steady nerve.

Bear markets too can be a time of nervousness and uncertainty for any investor, but with the help of your financial adviser, there are steps you can take to navigate through the woods and hopefully come out the other side with your investments – and your nerves – intact.

## First step – spotting the bear

The first stage in combating the falling market is to recognise the bear. A bear market is generally accepted as a sustained fall in stock market indices of more than 20% from a recent high. To be considered a bear market, the fall should certainly last longer than a few weeks, and must be across the index as opposed to individual stocks and sectors.

Traditionally bear markets have three distinct phases:

**Phase one** sees a sharp fall in prices.

**Phase two** begins when bargain hunters move in and buy up 'cheap' stocks, causing the market to rise.

**Phase three** begins as demand trails off, with a long and slow downward trend in share prices. As the fall in the market passes 20% it officially becomes a bear market. It is generally recognised that bear markets tend to last about 16 months, but major bear markets may last for four years or more.

## Second step – avoiding the bear

It's always hard to tell whether volatile markets are temporary or the beginning of a drawn-out bear market. Either way you may wonder if there is anything you can do to avoid, or at least reduce the impact of, a sustained fall in the value of your investments.

Obviously the best way to avoid a bear would be to steer clear of the woods altogether. But if you have long-term goals, you may not want to entirely abandon your investment plans. After all, we all know that equity markets are fundamentally volatile, but over the longer term your aim is to see your investments rise in excess of inflation – otherwise why do it?

One approach might be to switch investments into something 'safer' when the markets have reached, or are near, their peak. This 'market timing', though, is notoriously difficult even for investment management professionals.

## Third step – understanding your defensive options

There are of course other approaches you could adopt to minimise a bear market's impact while maintaining your long-term investment goals. The key is not to panic; investing wisely, no matter what the market conditions, should bear fruit in the long term.

First, if you haven't already done so, speak to your financial adviser for expert help. Second, take a look at the rest of this brochure to explore some of your options.

Remember, no investment is guaranteed to be 'bear-proof'. But, if you take care and rely on an independent expert for suitable advice, you might keep one step ahead of the bear.

# standing up to the bear – risk profiling and asset allocation

During a bear market, it's essential to keep the volatility of your portfolio to a minimum. The simplest way is to spread the risk by investing in a number of different asset classes with different strategies – the investing equivalent of not keeping all your eggs in one basket.

## your defensive options

Your financial adviser is now able to match more accurately than ever before your personal attitude to risk with the most suitable asset allocation (the spread of assets in your portfolio).

Your financial adviser will assess your attitude towards taking risks in return for potentially greater rewards from your investments.

Whether you are a cautious investor, a risk-taker or somewhere in-between, your financial adviser will use appropriate asset allocation to put together a portfolio of investments that is designed to provide optimum potential for returns at your chosen level of risk exposure, according to established principles, for example the Modern Portfolio Theory.

Your attitude might change over time, depending on your personal circumstances and your perception of the current economic outlook. Regular reviews are therefore essential to ensure that your investment continues to reflect your attitude to risk.



### Volatility

The tendency for the overall value to rise and fall unpredictably.

### Principles behind Modern Portfolio Theory

The principle behind Modern Portfolio Theory is that the risk level of a portfolio should be considered as a whole, rather than in terms of its individual assets.

The values of the investments within a portfolio may fluctuate, but because they all behave differently, the peaks and troughs can cancel each other out. The aim is to utilise this cancelling out to achieve the highest possible returns for a given level of risk.

# standing up to the bear – non-equity investments

Non-equity investments are usually considered lower risk, and lower return, than stocks and shares. This naturally makes them an option worth considering during times of market uncertainty.

## your defensive options

### Cash

In times of market downturn, cash is often considered something of a short-term safe haven. Whilst the returns may not be huge, your investments should generally be safe and receive interest on the capital.

By allocating at least some of your investment to cash, you will have access to funds for your short-term needs and reduce the overall volatility of your portfolio.

Of course no investment is 100% secure, and during a credit crunch when banks are also hitting financial trouble, even cash does not look as safe as it once seemed.

### Fixed interest

Fixed interest investments or bonds tend to be considered less risky than equities. They work on the basis that they are fixed term loans to the government or corporation providing the bond, paying a fixed interest to the end of the term.

In a bear market, bonds can continue to provide a steady source of income for investors even though the market value of the bonds may be in decline.

Fixed interest funds are diverse and wide-reaching, providing exposure to government and corporate bonds on a global, regional or country-specific basis.

For funds investing in high-yielding corporate bonds, the high yield reflects a higher risk of capital loss through default.

### Property

Property may be categorised as commercial, eg shopping centres, or residential, eg your home. Commercial property is most commonly associated with property investing.

In a bear market, falling interest rates make it cheaper to borrow money to buy properties, and can boost property prices. So long as occupancy rates remain high, property can also potentially provide an attractive source of income.

Different fund types offer different kinds of exposure to commercial property. For instance, 'real property' funds invest in bricks and mortar, while others invest in the shares of property companies. Those funds investing in shares are more likely to behave like equity funds than real property funds and can be considered higher risk.

From a risk perspective, property is generally considered to sit somewhere between equities and bonds.

The value of property is generally a matter of a valuer's opinion rather than fact. In addition, property investments may not be readily saleable, which could lead to constraints on your ability to sell your investment or switch from the fund.



The rates of interest and inflation will affect the returns gained from cash, fixed interest and property.

Please note that not all fund types are available in every jurisdiction.

# standing up to the bear – equities

It is with equities that most investors associate a bear market. Whilst this usually refers to shares, there are literally thousands of equity funds available and each one is likely to feel the impact of a bear market – and some might even grow as a result.

There are a number of ways in which you might remain invested and still reduce the bear market impact on your equity exposure.

## your defensive options

### High yield

The total return on an investment is often made up of capital growth and income. Some companies pay much higher dividends to shareholders than others – these are considered high yield shares.

In a bear market, when capital values are steady or moving down, the dividend yield might prove the difference between positive and negative growth.

There are funds that invest in income producing shares whereby the dividend factor again may temper any loss.

Whilst the dividends paid by the underlying shares may come as a welcome respite in a bear market, unlike bonds they are not guaranteed.

### Defensive sectors

Some equities may fare better in a bear market than others. Those that have historically done well include shares in electricity companies, major pharmaceutical companies, food producers, major oil companies, telephone companies and tobacco manufacturers. In particular, utility companies tend to pay generous dividends which help sustain their share price.

You can invest in some funds which concentrate on these areas of the market.

### Defensive funds

As the name suggests, defensive funds are specifically designed to be cautious. The Cautious Managed sector includes funds with a maximum exposure of 60% in equities and a minimum of 30% in cash and/or fixed interest (and varying degrees in between).

Some cautious managed funds will be more cautious than others. The exposure will also vary over time depending on the fund manager's outlook.

Even greater defence against the bear may be found in the shape of guaranteed or protected funds, although the guarantees and protection offered varies by fund. Also, the protection will come at a cost, eg through charges or through not participating fully in the upside of market movements. Your financial adviser can give you a full overview.

### Market capitalisation

Some funds invest only in companies with either a large, medium or small capital value (cap).

During a bear market, although it is usually the companies with greater capital value, or 'large cap' firms, that bear the brunt of the initial drop in a bear market, 'small caps' soon follow and then often suffer the heavier falls.

If you can gain an understanding of the importance of company size during a bear market, you have a great advantage when deciding where to invest in and when.

Investments held by some specialist funds, including emerging markets, technology and smaller companies funds, tend to be volatile and the fund prices could move sharply up or down at times. They can also be difficult to sell, which can make it difficult to sell your investment or switch from these funds.



#### Always read what it says on the tin!

It's important to understand a fund's investment objective and policy. For example, a fund that appears to be focusing on pharmaceuticals could actually be investing primarily in something more risky, like biotech companies.

# standing up to the bear – equities (continued)

## Derivatives

A derivative is a form of investment whose price and performance are dependent upon (or derived from) one or more underlying assets.

One way of using derivatives to make money whilst all around are losing it is through short selling, or 'shorting'. Simply put, 'shorting' the market means borrowing shares, selling them when the price is high and then returning the borrowed shares by buying them back later at a lower price.

Recent European legislation has meant ordinary investors have had greater access to derivatives via investment funds. In turn, this has led to a number of new funds being launched that have an 'absolute return' perspective.

Where funds, or some of their underlying assets, borrow to invest ('gearing') or hold derivatives, this can make the fund more volatile and the fund prices could move sharply up or down at times.

## Absolute returns

Absolute return funds aim to mitigate risk by using cash and other defensive asset classes. They use both long and short investing strategies (see below) and benchmark against cash. Absolute return funds have an unconstrained and flexible investment strategy and aim to provide positive returns over rolling periods of 12 months.

Funds successfully employing shorting techniques in a bear market may find they get left behind once the bear ends and markets pick up again.



### Shorting

Shorting means betting against the market rising, but history shows that markets rise in the long term (otherwise there would be no market). This makes successful shorting difficult to sustain.

Please note that not all fund types are available in every jurisdiction.



# standing up to the bear – other options

## your defensive options

### Alternative assets

Alternative asset investments are those that have low correlation with (or similarity to the performance of) more traditional asset classes, and therefore have the potential to perform very differently. They may include assets such as commodities, precious metals, timber, wine and infrastructure.

In the past it has been difficult for individual investors to access alternative investments, due to high minimum investments. The advent of specialist 'alternative investment funds' has changed this. Some investment funds will focus on specific alternative assets whilst others may blend a range of alternatives, to further smooth volatility.

If you are prepared to look beyond the four main asset classes (eg cash, fixed interest, property and equities), alternatives offer opportunities for further diversification and can, potentially, reduce the volatility of your portfolio – always useful in a turbulent market.

### Structured products

'Structured product' is a generic term for a type of investment that is designed to achieve a specific set of objectives with a particular risk/reward profile. They can offer you some certainty over risk reduction, capital protection and known potential returns.

There is a wide range of structured products available, but common features include a degree of capital protection and the potential for growth or income. They tend to run for five or six years, at which point they pay out.

The main attraction of structured products is their ability to participate in the upside whilst protecting against the downside.

In a bear market the capital protection is particularly attractive for the cautious investor who is concerned about direct exposure to the markets. However, some structured products can be more complex than others and you'll need to take expert advice.



### Capped returns

In exchange for principal capital protection, there will be a limit on the return you could have made with full market exposure. This may become more important if markets take an upward turn.

Please note past performance is not a guide to the future. Where a fund invests in securities designated in a different currency, the value of the fund may rise and fall purely as a result of exchange rate fluctuations. The value of investments and the income from them can go down as well as up. You may not get back as much as you invested.

# grin and bear it

Royal Skandia and Skandia Ireland provide access to various types of funds and products discussed in this brochure, although not all funds may be available in every jurisdiction where our products are distributed. You can find out all you want to know about Royal Skandia and Skandia Ireland through your financial adviser.

In the event of a bear market, a cool head and an eye on the longer term may serve you well. With the help and expertise of your financial adviser in devising a sound investment strategy, there's no reason why you shouldn't come through the experience relatively unscathed.

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