How Bear Markets Actually Boost Returns over the Long-term for Sound Investors

The remarkable surges and swoons of the stock market continued throughout 2016. While most investors loathe flat and down-market periods like we had early in 2016, wise investors understand that these periods actually help build wealth over the long-term, especially in environments of low price-to-earnings (P/E) ratios. Those who acted on this were rewarded later in the year.

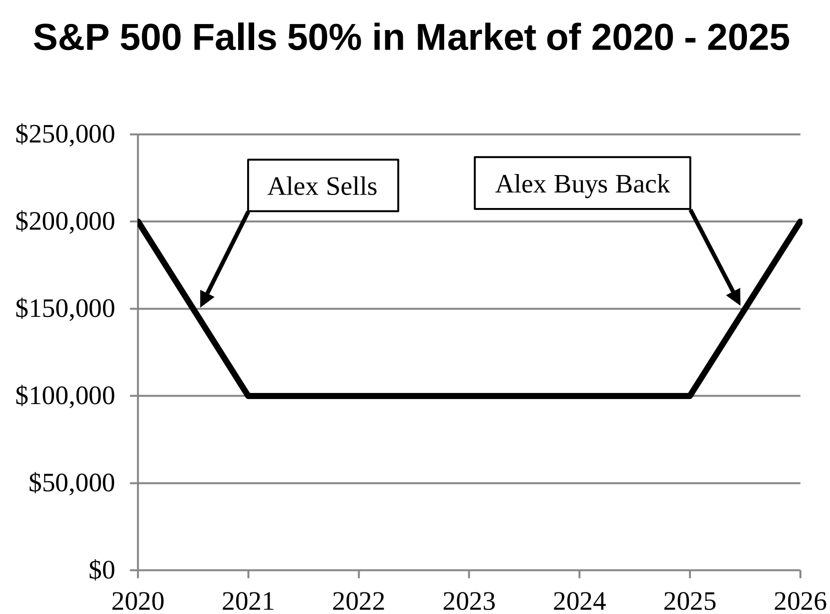
How is this possible? How can a market that stays flat or dips be better than a slow, steady march upward? The key lies in the power of constant market re-investment through savings contributions and the stealth effect of dividends.

During their working lives, our clients build retirement accounts through monthly contributions to their 401(k) plans or Sharper Granite accounts. These funds also constantly generate dividends which get reinvested. The benefit of buying low-value stocks is tremendous. We will briefly explain this wealth-building effect and see how it underscores the importance of three investing guidelines:

1. Contribute to retirement (or college) funds on a regular basis.

2. Invest in dividend-producing companies.

3. Do not try to time the market.

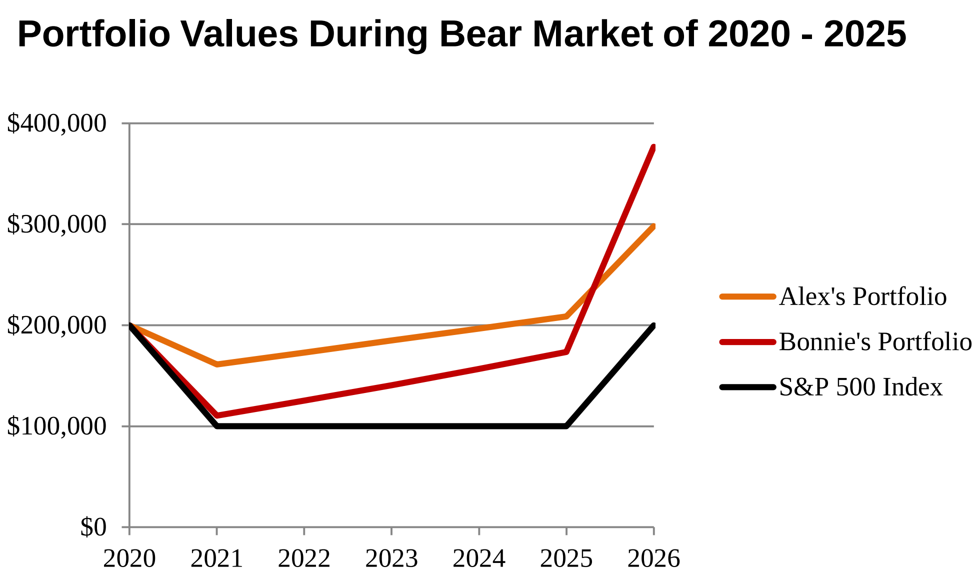


Imagine two investors in the year 2020, Alex and Bonnie, who each begin with $200,000 worth of S&P 500 Index stock in their retirement savings. They are both good savers and contribute $10,000 per year to their retirement funds no matter what. In the first half of 2020, a severe correction drives the stock market down 25%.

Alex stays on top of his investments and studies his accounts frequently. He reads a lot about the world's issues and believes more trouble is on the horizon, so Alex converts all of his stock to cash. While "market timing" is a dangerous game, in this instance Alex is right about market direction, and by the end of 2020 the S&P 500 Index falls all the way to 50% of its original value. Alex is proud of himself for avoiding half of the market fall. He feels sorry for those like his friend, Bonnie, who simply stayed invested through the bear market.

Now, this bear market turns out to be severe. While the average bear lasts one year, this bear lasts six. After its one-year decline in 2020, the market sits at its low point for four years before finally rising back to its original level throughout 2025. As the market regains its health in 2025, Alex gets back in at the same level he left, and, in another apparent example of incredible market timing, he rides the market back up to its original level.

At the end of our study, as 2025 closes, Alex now has his original $200,000 along with six annual $10,000 contributions to his bank savings account. He also gained some bank interest over the years and received six months of stock dividend interest after he got back into the market. Assuming that savings and dividend rates are similar to those today, he now has $298,000. This is $38,000 more than the $260,000 he contributed over six years and represents a 27% return on investment over the course of six years.[1]



What happens to Bonnie? She maintains her high-dividend portfolio through the six years, doing nothing other than contributing $10,000 annually to her portfolio.

While Bonnie made no "market moves" as Alex did, she had a couple of factors working in her favor. First, her dividends and contributions were buying more stocks at depressed price levels. Second, the dividend yield that stocks paid was higher while the stocks were depressed. This is because while corporations lower dividends somewhat during recessions, they rarely lower dividends proportionally to match the severe change in stock price.

Next, with a prolonged recession as in this example we assume that many firms lower their dividend rate somewhat, and we factor that negative effect into Bonnie's portfolio.[1]

While the market is down, the improved dividend yield and annual contributions enrich Bonnie's portfolio with low-cost stocks, and by the end of 2025, when the market finally returns to its pre-2020 level, Bonnie has $376,000. This is $116,000 more than she contributed and $78,000 more than Alex has! Her gain represents an 83% return on investment over the course of six years.[1]

While Alex was feeling good about his situation for six years, Bonnie was making over three times the investment return by doing nothing. And there is more. These numbers are on a *pre-tax* basis. On an *after-tax* basis the return difference is more dramatic. Because Bonnie's returns came mostly from capital gains and qualified dividends, the tax rate applicable to her investment returns (0% to 15% federal tax rate) was much lower than Alex's, whose returns came mostly from interest which is fully taxable as income (up to 35% federal tax rate).

In this example the terms are simplified, but in reality most investors do not time the market as well as Alex did and wind up even worse off relative to boring Bonnie. The real stock market gyrates more than the smooth line represented here. "Head-fakes" and news headlines tempt many into market maneuvers, which is why the average active investor has earned at least 1.5% per year less than the average passive investor in the past.[2]

> ***"Market cycles, although difficult for investors' psyches, generate wealth for long-term stockholders. These gains come not through timing the market but through the reinvestment of dividends… the extra shares purchased during bear markets cause returns to rocket ahead when stock prices finally recover."*** [3]
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> — **Jeremy Siegel,** Wharton School of Business at Penn

Savvy investors like Warren Buffett actually work this effect in reverse, investing opposite of Alex. Buffett invests more during bear markets. Professor Jeremy Siegel at the Wharton School of Business, a friend of Buffett, analyzed the benefit of dividends and discovered how wealth is created by investors like Buffett during these bear market periods.

Following a euphoric 1920's stock market rise, in 1929 the S&P 500 Index crashed and then plodded through the Great Depression, World War II, and several other economic challenges before finally reaching its 1929 level a full 25 years later in 1954. That 25-year period was the longest between stock market peaks.

Siegel shows that the investor who did nothing through those years did not just get back to even, but actually realized an annual return of over 6% per year though the effect of reinvesting dividends at depressed stock price levels. $100,000 invested at the worst possible time, September 1929, grew to $440,000 by 1954 even though the S&P 500 Index was the same value. This return was four times that of short-term bonds, two times that of long-term bonds, and nearly two times that which stocks would have returned had the market remained flat and not dipped during that 25-year period.[3]

The wisest investment strategies are often the simplest. Contribute to savings on a regular basis, buy high-dividend stocks, and avoid movements in and out of the market.

Notes and Acknowledgements:

1. Assumes savings interest rate of 1%/year. Assumes dividend rate of 3% when S&P 500 Index is at pre-crash levels in 2020 and 2025, and 4% after S&P 500 Index falls 50% (assumes corporate dividend cuts prevent the yield from doubling to 6%). Assumes annual $10,000 contributions are made at the beginning of each of the six years.
2. Mier Statman, Ph.D., Professor of Finance, University of Santa Clara, 2011
3. *The Future for Investors*, Jeremy J. Siegel, Ph.D., Professor of Finance, Wharton School of Business at Penn University