Seven Ways to Bear-Proof Your Portfolio

Seven Ways to Bear-Proof Your Portfolio by Jeff Dicks [was originally published in 425 Business]() on April 8, 2019.

About once a decade here in the Pacific Northwest, we encounter what's been dubbed Snowmaggedon, where, as we witnessed in February, locals load up on groceries; city officials prep and treat roads, bridges and walkways; and families cozy up and stay close to home.

The key is to stay warm, safe, and limit any risks the cold weather brings. In many ways, preparing for Snowmageddon is quite similar to prepping your investment portfolio for the next bear market. These, too, come roughly once a decade, and what's critical is that you make the necessary preparations prior so your portfolio is properly allocated. Here are some quick tips to help buffer your investment portfolio:

1) Hold an appropriate asset allocation.

One of the best ways to protect your portfolio is by holding the appropriate amount of stocks relative to bonds. A simple rule of thumb is to subtract your age from 100, which tends to be the rough percentage of stocks you should own. Younger investors have a much longer time horizon and more ability to take risk or weather large drawdowns. Conversely, as you get closer to, or if you already are in retirement, you're likely living off your portfolio, have a shorter time horizon, and less ability to take on risk. It also makes sense to pay attention to where the stock market is in its bull/bear cycle. While precisely timing tops and bottoms is impossible, methodically reducing stock exposure after long bull markets and when recession risks are rising (like now), is advisable.

2) Rebalance your portfolio.

As your portfolio allocation changes with market fluctuations, another prudent tactic is to rebalance back toward your target weight. After years of equity outperformance, it makes sense to review your asset mix and make sure you are not overexposed to stocks. On the flip side, if you get into a bear market for stocks, it typically makes sense to rebalance your equity weight back up to your target. Relative performance between stocks and bonds moves in long cycles and tends to mean revert. You can increase performance over time, and lower volatility, by rebalancing tactically. Unfortunately, many investors do the opposite, adding to their stock holdings after large up-moves and often selling during market dislocations (such as we saw in Q4 of 2018).

3) Limit leverage.

It's important to be extremely careful when using leverage within your portfolio. During bear markets, leverage can amplify your downside, cause margin calls, and force you to sell your investments at precisely the wrong time. The biggest blow-ups tend to occur when leverage has been used. Use leverage wisely or not at all.

4) Raise cash when valuations are extreme.

When market valuations reach a certain level, it makes sense to carry a portion of your investment portfolio in cash or short-term bonds. The reasoning is two-fold: First, your portfolio will hold up better during a decline. Second, you will be able to use those reserves to invest at lower levels of the market. Valuations also tend to move in long cycles, and if a historically high level for a given metric is attained, shifting partially into cash and/or government bonds can help reduce downside risks. A few example metrics would be price-to-sales, Warren Buffett’s favorite market cap-to-GDP, and a cyclically adjusted price-to-earnings. Regardless of the metric, a reasonable rule is to allocate a small portion to cash when a given metric, or even better, a series of metrics, moves into the top decile (10 percent of readings) relative to history.

5) Choose mostly high-quality stocks.

When it comes to your stock portfolio, allocate the majority of your capital toward companies that generate stable and consistent cash flow. Companies that maintain a steady level of earnings tend to hold up better during bear markets. Also, helping on the downside would be holding a portion of your stock allocation in reliable dividend generators. The dividend payments will act as a downside cushion by adding an element of income to total return. Sure, it’s OK, and even recommended, to have a portion of your equity portfolio in smaller (or even larger) companies that are in the growth phase of their life cycle. However, keeping these types of issues a modest portion of your portfolio can help limit downside volatility.

6) Devote research hours to your bond portfolio.

The bond portion of your portfolio should provide stable income and limit overall portfolio volatility, but should not be an area you simply set and forget. If you invest in corporate debt, it’s critical to continually review and analyze the underlying financials, balance sheets, and business models for the companies to whom you are lending. The last thing you want on the bond side of your portfolio is a blow-up. Moreover, during large equity drawdowns, the high-yield market (i.e., junk bond debt) tends to go down in lockstep. Eventually, this can set up an extraordinary buying opportunity. History has shown that junk bonds can generate equity-like returns coming out of bear markets and/or recessions. However, at this stage of the economic cycle, high-yield debt can be quite risky.

7) Have a sell discipline.

Incorporate a sell discipline for your portfolio. This could be based on a percentage loss, a violation of a key support level, or even hitting a target price point. The key is to minimize your losses and avoid companies that go to zero. Minimizing losers in your portfolio is just as important as selecting winners. Our preferred approach in this regard is using three-year support, i.e., the lowest level a stock has traded at on a multi-year basis. If a stock breaks through this level, we generally sell.

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