Perennial.

February 2017

The (Coming) Bear Market

Dear Clients and Friends,

The title of this letter suggests we are making a prediction about the future downward movement of stock prices. We are; and here it is: we are 100% certain there will be another bear market; but we have no idea when it's coming.

We Can't Predict, But We Can Plan

As you might surmise from our "prediction," we believe that it is impossible for you or us or anyone to predict when the next bear market will come.[1] While we view this belief as axiomatic, we know that a great many of our peers, as well as many in the media, earn their living by making exactly these kinds of predictions – in our opinion, at a great disservice to their audiences. To borrow from economist John Galbraith, when it comes to making short-term market predictions, we think there are two kinds of people: those who *know they don't know* (we put ourselves in this category) and those who *don't know they don't know*.

Let's face it, we all find it tempting to continuously make short-term predictions about markets. We tell ourselves: if only we could figure out when the next downturn will come, imagine the money we could save, let alone make. So we think and think and try our hardest to figure out the inner workings of a global economy and all its multitudinous parts; but eventually we (hopefully) realize that it is far too complex a task for any single person or firm to figure out. Our heads hurt, and we give up on the puzzle, but often without giving up on our accompanying predictions.

Indulge these temptations if you must, but please, only as idle chit chat at cocktail parties and not when you're about to make serious decisions about your investment plan. Otherwise, your predictions are likely to cause you serious economic harm if they lead you to sell investments in a way that derails you from your long-term goals.

As Warren Buffet once remarked, "market forecasts are poison and should be kept locked up in a safe place, away from children and also from grown-ups who behave in the market like children." Said less harshly, your predictions won't help prepare you for the (coming) bear market; only good planning can do that.

[1] Let us be clear: some market pundit will certainly predict the timing of the next bear market *but it will most likely be by pure luck alone*. It has been said that if you put enough monkeys in a room in front of typewriters, they could eventually reproduce all the works of Shakespeare. Similarly, there are thousands of market pundits making predictions every day; and with so many predictions being made all the time, eventually a few (again by pure chance) will be right. The point is that there is no way to know in advance which pundit will be the lucky one; and that for every prediction that turns out to be correct, there will literally be thousands that do not – a veritable graveyard of financial predictions that is rarely analyzed later.

Something Wicked This Way Comes

Bear markets – stock market declines of 20% or more – are a part of our economic reality in a free market capitalist system. There is no escaping them. Since World War II, there have been thirteen bear markets (or about one every five years) with an average decline of 32%. Thirty-two percent! As the table below illustrates, these periods produce violent downward moves in stock prices:

Thirteen Bear Markets Since the Second World War

Start	End	Months	% Change
May 1946	May 1947	12	-28.5%
June 1948	June 1949	12	-20.6%
August 1956	October 1957	14	-21.6%
December 1961	June 1962	6	-28.0%
February 1966	October 1966	8	-22.2%
November 1968	May 1970	18	-36.1%
January 1973	October 1974	21	-48.2%
November 1980	August 1982	21	-27.1%
August 1987	December 1987	4	-33.5%
March 2000	September 2001	18	-36.8%
January 2002	October 2002	9	-33.8%
October 2007	November 2008	13	-51.9%
January 2009	March 2009	2	-27.6%
Average		**12**	**-32.0%**

Source: BofA Merrill Lynch, Bloomberg

We tend to block out these periods in our minds because they are so painful, but please take a moment to relive in your head one or two of the more recent ones. Perhaps the financial crisis of 2008 or the internet bubble of 2000 are especially fresh.

Now, please imagine yourself in the middle of the next major correction: the market has been falling for months. As is always the case in bear markets, there is a strong and seductive narrative out there – a story told by "experts" – about why your investments are down; why they will continue to fall; and why they will never come back again because "this time is different." Are you likely to panic and sell your investments at or near the bottom? How have you behaved in the past? <u>How you conduct yourself during bear markets will have a HUGE impact on your lifetime returns</u>.

Surviving and even prospering during a bear market – the topic of this letter – comes down to one simple proposition: <u>You need an investment plan you can stick with in tough times.</u>

The rest is commentary.

A Plan You Can Stick With

We believe there are four components to building an investment plan you can stick with during bear markets:

1. Right Mindset
2. Right Investments
3. Right Asset Allocation
4. Right Rebalancing Plan

Right Mindset – For an Investment Plan You Can Stick With

Urban Meyer, venerable coach of the Ohio State University football program, has a philosophy for dealing with hardship that he asks each of his players to internalize and incorporate into their approach to each practice, game and offseason workout. It's captured succinctly in the following formula:

EVENT + REACTION = OUTCOME

Meyer teaches his players that every outcome they experience in life is the result of how they react to an event in their life. In other words, it's not what happens to us, but our *response* to what happens to us that makes all the difference.

We like this formula as a mental framework for preparing for bear markets: the "EVENT" is obviously the bear market; our "REACTION" is how we adjust our portfolios during the bear market (for better or usually worse); and the "OUTCOME" is the results, or how we faired, when it's all over. Our REACTION is the only part of the left side of the equation that we, as investors, can control. Like many events in our lives, bear markets are entirely out of our control and their timing invariably catches us off-guard.

We have no smart choice but to watch a bear market unfold as dispassionately as we can. "Don't just do something, sit there," we are fond of saying. And here's why: every time we find ourselves immersed in one of these market downturns, it invariably feels like things will never get better. And yet, they always do. Whatever the cause – collapsing tech bubbles, terrorist attacks, housing market debacles, banking crises, and so on – the market ultimately heals itself, recovers and eventually makes new highs (as it is doing now). An essential component of having the right attitude for bear markets is an unqualified belief that short term market declines are temporary; the long term advance is permanent.

Another important part of having the right mindset is maintaining a long-term perspective. Since each of us will be investing for the rest of our lives, our time horizon is de facto very long, regardless of how it might seem on the short time scale of the day-to-day. Your financial and investment plan must reflect this (perhaps uncomfortable) fact. Philosopher comedian Chris Rock once observed, "Some people say life is short and that you could get hit by a bus at any moment... Bull %#@!, life is long. You're probably not gonna get hit by a bus. And you're gonna have to live with the choices you make for the next fifty years."

In a world riddled with short-termism, a long-term perspective is, in our view, the last great arbitrage in investing.

Right Investments – For an Investment Plan You Can Stick With

In a prior client letter on security selection[2], we argued that you should buy high quality stuff that you understand well and derive psychic income from; then, don't overpay for it. Our simple eighteen-word investment framework works, but please don't take our word for it. Just think for a moment about how you behaved during the last bear market. What kinds of things did you sell at or near the bottom? Were they the stocks of high-quality companies whose businesses you understood well or were they the "sirens," [3] our term for lower quality investments that tempted you to "slum it" and buy them during the good times?

All investing, especially equity investing, is first and last a battle with your emotions. A thoughtfully constructed and diversified portfolio of fairly-priced, high quality companies that you understand well is your sword in this battle; 'psychic income' is your shield. If you hold only investments that fit our eighteen-word investment framework, you can sleep well at night, even during bear markets. On the other hand, a portfolio of "sirens" – fads and tips and things you don't understand – will not serve you well. When the going gets tough, most of us are just far more likely to dump these "investments" at large losses. Then, after we've been scared out of them, how do we reasonably determine when to buy them back? It's bad enough to get scared out of one's investments during a downturn, but it's a whole other matter to get scared out of investing altogether. In our line of work, we sometimes meet people who have gone years (sometimes even decades!) without any meaningful exposure to equities following a single, catastrophic moment of panic during a market downturn. Holding the right investments is a critical part of avoiding this paralytic behavioral investing mistake.

Right Asset Allocation – For of an Investment Plan You Can Stick With

In a prior client letter on asset allocation[4], we suggested that you must be an owner, not a loaner to the maximum extent that your emotions will allow. A lifetime decision to own more stocks than bonds will make a huge difference in your long-term financial health. However, if your asset allocation is weighted too heavily toward stocks, you are likely to experience more downward volatility than you can handle and make poor behavioral choices at or near the market lows. We are all human, and when it comes to investing, our emotions can get the best of us. We love to buy stocks when they are high and sell them when they are low – more on this below.

A "robust asset allocation" is our term for a mix of stocks and bonds that can survive any market cycle. A portfolio of 100% stocks is simply too volatile for many of us to hold on to when times get tough. If you're in this camp, keeping a portion of your portfolio in fixed income[5] as an anxiety management tool – as a kind of financial Xanax for bear markets – is probably a good idea. While owning fixed income will not meaningfully grow your wealth in the long run, holding it will likely save you from destroying your wealth by liquidating your portfolio during downturns.

Right Rebalancing Plan – For an Investment Plan You Can Stick With

Do you want to know the ultimate secret to being a great investor? BUY LOW, SELL HIGH. Feeling a little disappointed with our answer? Please read on.

---

[2] You may access this letter entitled "Security Selection" at http://perennial.com/about-us/.

[3] The term "siren" comes from Greek mythology: the Sirens of ancient Greece were dangerous creatures that lured sailors with their enchanting music and voices to smash their ships upon the rocks of their island.

[4] You may access this letter entitled "Asset Allocation" at http://perennial.com/about-us/.

[5] We include cash in fixed income since cash is, in effect, a loan you make to your bank that pays no or low interest.

Stocks are an example of what economists call Giffen goods – a product that people consume *more of* as the price *rises* and vice versa. That we tend to want to hold more stocks as their prices rise and less as their prices fall violates a basic law of supply and demand. We might intellectually understand that it's best to buy low and sell high, but in practice, we often do exactly the opposite because our emotions get in the way. The only way to protect ourselves (from ourselves) is to set a fixed, robust asset allocation in advance of large market moves and then rebalance it periodically during and after. Rebalancing is the best way to ensure that we are continuously buying low and selling high, which is precisely the opposite of what our emotions are hard-wired to do.

Let's assume for a moment that you begin investing with an asset allocation that is 50% in stocks and 50% in bonds. Let's also assume that for the first five years you are invested, you enjoy a bull market and stocks go up 100% during that period; and for simplicity, let's assume your bonds don't change in price. Lastly assume you make no trades – buys or sells – during this time. At the end of the five years, your new weightings would be 67% in stocks and 33% in bonds. Even though you did not buy a single thing during these five years, the appreciation of your stocks has effectively made you longer the market at much higher prices – and that's before your emotions got the best of you, and you decided to buy even more stocks (Giffen goods) at higher and higher prices.

Now imagine a bear market arrives. With your outsized exposure to stocks utterly out of sync with your risk tolerance, you have a recipe for disaster: you are far more likely to make bad decisions during this downturn, and these decisions could have an enormous negative impact on your lifetime returns.

If, on the other hand, you had committed to periodically rebalance along the way (say anytime the percentages varied by more than five points), you would have remained at your robust weightings of 50%/50% – all the while selling high and buying low as the market performs its gyrating mischief. In this way, the market is there to serve you and not the other way around.

Now, when a bear market comes, your weightings are suitable to your risk tolerance because you have been rebalancing along the way – they are robust. Not only are you much less likely to make behavioral mistakes as the market trends downward, but you will also have dry powder with which to step in and buy stocks at attractive prices. The simplistic table set forth below demonstrates how buying – not selling! – at the lows can result in your being better off when the market returns to its previous highs:

The Effect of Rebalancing During Bear Markets

Column	A	B	C	D	E	F	G	H
	Starting % Allocation	Starting $ Amounts	Assumed Decline	Subsequent $ Amounts	Subsequent % Allocation	Rebalancing to 50%	Recovery to Highs	Subsequent $ Amounts
Stocks	50%	500,000	-32%	340,000	40%	80,000	47%	617,647
Bonds	50%	500,000	0%	500,000	60%	(80,000)	0%	420,000
Total	**100%**	**1,000,000**		**840,000**	**100%**			**1,037,647**

Source: Perennial; column A shows the starting asset allocation. B shows the corresponding dollar amounts. C shows the assumed stock market decline – 32% in this case, equal to the average bear market decline since WWII. D shows the subsequent dollar amounts after the bear market. E shows the subsequent asset allocation. F shows the rebalancing – i.e., the buy and sell amounts – needed to get back to the starting weighting of 50% / 50%. G is the amount of market price recovery necessary to get back to the previous high; in this case, a 47% increase from the bottom is required to make up for the assumed 32% decline. H shows the final dollar amounts.

The best part about rebalancing is that you don't even have to figure out if stocks are cheap or expensive along the way. Changes in your asset allocation due to market fluctuations will tell you that; in other words, changes in your weightings will tell you if you should be buying or selling. Rebalancing relieves you of the decision fatigue that often results from trying to make seemingly arbitrary decisions about whether you should be tinkering with your portfolio based on the news or narrative of the day (Hint: you should not be).

OUTCOME: Go Forth Unafraid

Hopefully we've persuaded you that bear markets are just a part of life and nothing to be especially feared. In fact, if considered correctly, bear markets provide disciplined investors extraordinary, long-term opportunities. If you are sixty years old, there is a good chance you will be investing for another thirty years or more, which means that you will likely have to live through at least a few more serious market downturns. With the right mindset, asset allocation, investments and rebalancing plan, we believe that you can prosper during these difficult periods.

We like to remind our clients that to do well in investing, you don't need to be a stock market genius or hold an advanced degree. You don't even need to wear a suit to work. You just need a well-designed, thoughtful financial plan; faith in that plan and in yourself; the patience and timeframe to let your plan do its job; and, importantly, a long-term perspective *so you can stick with your plan*. Once these components are in place, you can sit back, relax and go about living a life that is meaningful to you.

We wish you the best of luck in the (coming) bear market…

"Sometimes you'll play lonely games too. Games you can't win 'cause you'll play against you."
– Dr. Seuss

Respectfully submitted,

Christopher J. Heintz
(212) 218-4223
cheintz@perennial.com

Scott F. Strasser
(212) 218-4222
sstrasser@perennial.com

Shyamli Milam
(212) 218-4224
smilam@perennial.com

Disclosures and Legal Disclaimer

Perennial Advisors, LLC ("Perennial") is a Registered Investment Adviser with the Securities and Exchange Commission. SEC registration does not imply a certain level of skill or training. This letter is confidential, intended only for the person to whom it has been provided and contains general information not suitable for everyone. The contents of this letter should not be construed as personalized investment advice.

This letter represents the current, good faith views of Perennial Advisors. The opinions of the firm are subject to change without notice. There is no guarantee that the views and opinions expressed will come to pass. The information herein has been developed internally and/or obtained from sources believed to be reliable; however, Perennial does not guarantee the accuracy, adequacy or completeness of such information. Market conditions, strategic approaches and other key factors upon which the views presented in this letter are based remain subject to fluctuation and change. Consequently, it should be noted that no one can accurately predict the future of the market with certainty or guarantee future investment performance. The information in this letter may contain projections or other forward-looking statements regarding future events, targets or expectations regarding the strategies described herein, and is only current as of the date indicated. There is no assurance that such events or targets will be achieved, and may be significantly different from those described and shown herein.

This letter is only as current as the date indicated (February 1, 2017), and may be superseded by subsequent market events or for other reasons. Perennial assumes no obligation to update such information. Nothing contained herein constitutes investment, legal, tax or other advice nor is it to be relied on in making an investment or other decision. This letter should not be viewed as a current or past recommendation or a solicitation of an offer to buy or sell any securities or to adopt any investment strategy. No investment strategy can guarantee performance results, and there are no assurances that the investment objectives described herein will be met. **Past performance is no guarantee of future results. All investments are subject to investment risk, including loss of principal invested.**

This letter and its contents are the proprietary information of Perennial, and any reproduction, in whole or in part, without the prior written consent of Perennial is prohibited. Additional information about Perennial is available upon request as well as through our Form ADV, which is available at the SEC's Investment Adviser Public Disclosure (IAPD) website.