Can you keep your buy-and-hold convictions during a bear market? If you can't, it's better to know sooner—while we're still in a bull market—rather than later.

What the Gold Market Reveals: The Anatomy of a Bear Market

By Mark Hulbert

If the market cycle is viewed as an oscillation between the extremes of fear and greed, today's is a greed market in stocks. Fear doesn't even make it onto most investors' radar screens. To be sure, investors say they know that stocks don't rise to the moon and that bear markets do happen. But they blithely dismiss bear markets' significance by predicting that they will ride them out.

But how can they be so sure? How do they know what a bear market really feels like?

These are crucial questions because they go to the heart of long-term investing. If today's stock investors don't have what it takes to stay the course, they're likely to sell out near the bottom of the next bear market, thereby losing the benefits of the market's long-term move up. That would be the worst of all possible outcomes. They therefore need to find out now whether they truly will be long-term investors.

To find out, they can't look back to see how they behaved during the 1973-1974 bear market, because few of today's investors were investing then. That's why I chose to focus this article on the current gold market. It's now in the 17th year of a severe bear market, one that has seen the price of gold drop from $875 per ounce to its current $320.

The newsletter industry is a perfect place in which to gain this perspective because many newsletter editors got their start in the 1970s by recommending gold. Having made huge fortunes for themselves and their subscribers as gold ran up far beyond their wildest expectations, they understandably fell in love with the yellow metal—not unlike the love affair current investors are having with equities. Many of these editors confidently predicted that gold would eventually trade for thousands of dollars per ounce. They reasoned that, from a long-term point of view, it therefore didn't really matter what price you paid when you got on board.

Does any of this sound familiar to today's stock investors?

Sentiment in a Bear Market

A funny thing happened on the way to gold above $1,000, needless to say. And yet bullish hope springs eternal. On each and every occasion since 1980 in which gold's price has risen, sentiment among the gold timers has jumped significantly. Each time, true believers quickly became convinced that this was, finally, the beginning of the long-heralded bull market.

Figure 1 provides an illustration of this phenomenon at work. It plots the price of gold bullion over the last decade alongside the average market exposure recommended by the gold timers tracked by the Hulbert Financial Digest. (Here's how we calculated this average exposure: a gold timer that was bullish was graded as +100%; a timer in cash was graded as 0%; and a timer that completely shorted the market was graded as –100%.) Notice that each time gold's price would jump by a few dollars, bullish sentiment jumped accordingly—and sometimes skyrocketed.

You can see how this pattern has played itself out over and over again over this decade. Examine what happened earlier this year, for example, after gold in January dropped below $350 per ounce, for the first time in three years. In February, gold's price recovered, rising by about $10 per ounce, and bullish sentiment skyrocketed from below 30% to nearly 70%. We know now that gold's rally turned out to be short-lived. Again, in May, the yellow metal staged a rally, though this time more modestly than in February. Nevertheless, bullish sentiment jumped by almost as much again.

Such behavior is the psychological hallmark of a bear market. Every rally is thought to be the beginning of the bull market. If a bull market climbs the proverbial wall of worry, a bear market descends a wall of hope. Bear markets end when the majority of investors and advisers throw in the towel, at which point the market bottoms out.

Stock market investors who were investing during the 1973-1974 stock bear market will immediately recognize the

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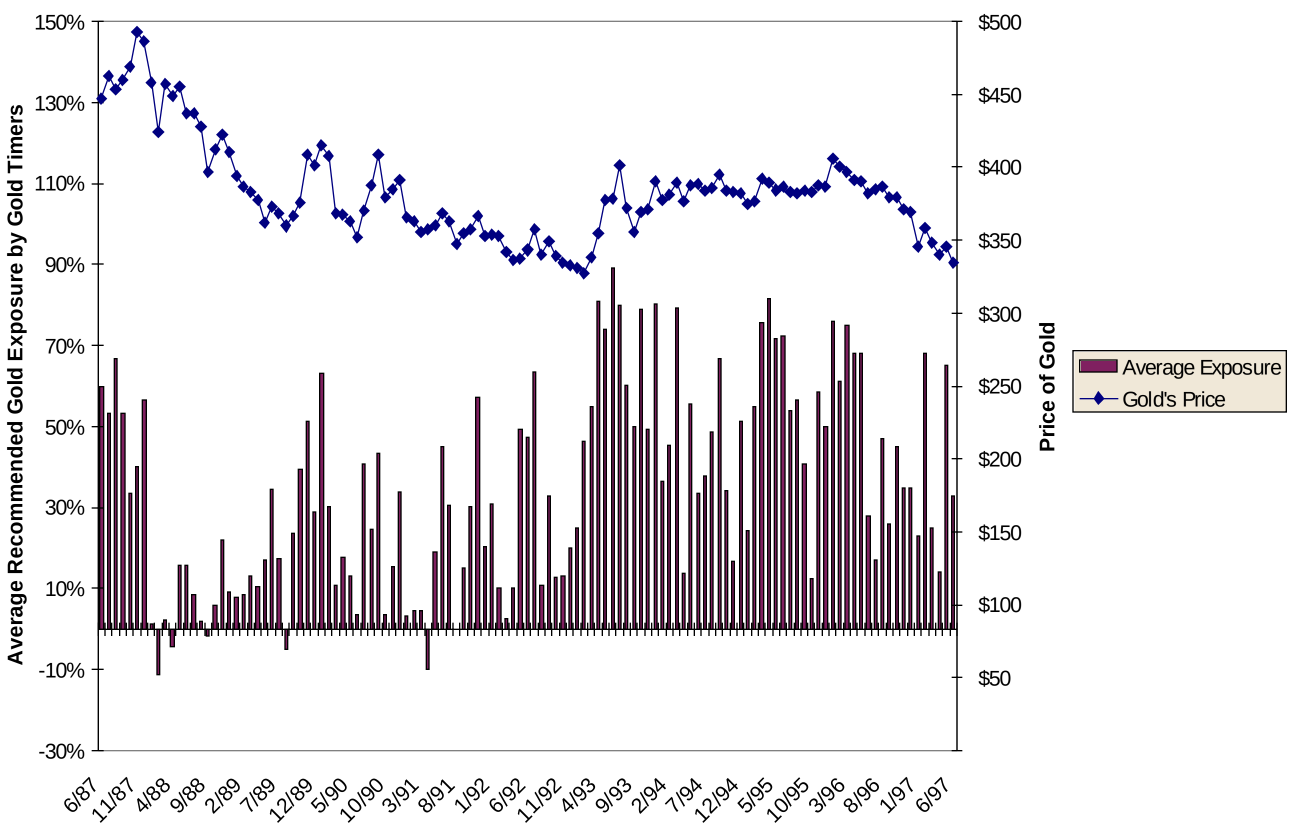
Figure1.
Gold Timer Recommendations and the Price of Gold



parallels to today's gold market. As the stock market dropped throughout 1973 and 1974, advisers and individual investors alike treated every correction as the beginning (or resumption) of the bull market. When the market's average price-earnings ratio dropped to 7, for example, there was a widespread chorus that it couldn't possibly drop any lower. The same was heard when the average price-earnings ratio dropped to 6, and to 5. (Today's average price-earnings ratio, in contrast, is around 17.)

The average price-earnings ratio at the market's December 1974 low: 4.8. At that time, according to Investors Intelligence, the percentage of investment advisers who were bullish on stocks was below 5%. At the very bottom, a true believer in long-term buy-and-hold investing was a very rare phenomenon.

Modern-Day Converts to Buy and Hold

Today, in contrast, the virtues of buying and holding stocks are extolled everywhere—not only among newsletter editors but also in the pages of the financial press and on financial television as well. I'm cynical, however. For starters, consider that the situation is exactly the reverse in the gold arena. In the late 1970s, belief in buying and holding gold was widespread, and market timing wasn't as popular. Today you can't find anyone who believes in buying and holding gold, and everyone is a market timer.

My strong suspicion is that many of these late-day converts to buy-and-hold won't be buying and holding stocks at the bottom of the next bear market. It's important for you to determine now whether you truly can ride out a secular bear market, rather than awaiting the bottom of the next bear market to decide you don't have what it takes to be a long-term buy-and-hold investor at your current level of stock exposure. If you don't have what it takes, you have two options: Either you can reduce your portfolio's stock exposure to whatever comfort level is necessary so that you can ride out any bear market, or you can enlist the services of a market timer who you think will protect you from some of the downside of a bear market.

You may think that the second of these options is the obvious choice, but it may turn out to provide less downside protection than you expect. Take a look at the accompanying table, which reports the performance of the gold timers tracked by the Hulbert Financial Digest over the last eight years. Notice that while all but two of the gold timing systems the HFD has followed over these eight years have exceeded the return of buying and holding gold, only one has actually exceeded what they could have achieved by being invested in 90-day Treasury bills.

My guess is that after a secular equity bear market, the results of stock market timers would be broadly similar.

Another way of putting this result: Though you can reduce some of the bear-market risk by following a market timer, probabilities are high that in a bear market you nevertheless will underperform what you could otherwise achieve in a savings account.

Table I.
Pure Timing Performance of Gold Timers:
June 30, 1989, to June 30, 1997

(When in the market, each newsletter earned the return of gold bullion; when in cash, each newsletter earned the 90-day Treasury-bill rate.)

Newsletter—Timing System	Annualized Gain (%)
Professional Timing Service—Gold—Cash on sell signals	6.37
Cash (90-Day Treasury Bills)	**5.12**
Bob Brinker's Marketimer	5.12
Mutual Fund Strategist	4.76
Fund Exchange Report	4.20
Futures Hotline/Mutual Fund Timer—Intermediate Term Model—Shorting on sell signals	4.13
Ruff Times—Short Term Trend—Cash on sell signals	3.73
Futures Hotline/Mutual Fund Timer—Fund Trading—Cash on sell signals	3.56
Addison Market Letter	3.43
Prof. Tape Reader—ST Gold Model—Cash on sell signals	3.23
Prof. Tape Reader—LT Gold Model—Cash on sell signals	2.76
Timer Digest—Cash on sell signals	2.37
Fabian Premium Investment Resource	1.90
Market Logic—Cash on sell signals	1.87
Prof. Tape Reader—ST Gold Model—Shorting on sell signals	1.49
Timer Digest—Shorting on sell signals	1.36
Elliott Wave Theorist—Gold Investors—Cash on sell signals	0.13
Prof. Tape Reader—LT Gold Model—Shorting on sell signals	–0.40
Dines Letter—Short-Term Gold Signals—Cash on sell signals	–1.14
Market Logic—Shorting on sell signals	–1.29
Buy-and-Hold (Gold Bullion)	**–1.35**
Elliott Wave Theorist—Gold Traders—Sometimes short on sell signals	–2.74
Dines Letter—Short-Term Gold Signals—Shorting on sell signals	–3.13

The Bottom Line

Very few investors who are in the stock market today have lived through a long-term bear market. So they don't know what one really feels like, or how difficult it is to stay invested throughout one. But the current gold bear market, as well as the history of stock bear markets, teaches us that secular bear markets make even the most die-hard buy-and-hold investors seriously question their convictions.

We don't know when the next stock bear market will take place—but sooner or later it will. We all need to give serious thought now, while we're still in the bull market, as to whether our buy-and-hold convictions are compelling enough, and held with sufficient conviction, that we would be willing to adhere to them throughout a serious bear market.