HOULIHAN
ASSET MANAGEMENT LLC

Taming the Bear

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Lowering volatility in a down market

As the economy and financial markets continue to wane, investors grow increasingly fearful. Violent, false rallies are quickly met with brutal selling pressure. Investors' fragile hopes are engulfed with despondency. Negative headlines are pervasive. Inflation is a punch line. Account statements go unopened. In other words, this is a textbook Bear Market (defined as a 20%+ drop from previous high point). The 'good' news is that Bear Markets are usually relatively brief (12-24 months) and they always end. This time will likely be no different.

Sans attempting to put a positive spin on the matter (leave that to CNBC) we can be realistic and level headed. Sure there are serious domestic and international concerns. Is the banking system a mess? Yes. Is the economy hurting? Yep. Is the Dollar on life support? Check. Are energy prices killing the consumer? You bet. The point of this is not to regurgitate the obvious but rather point out *there's always going to be something*. Whether it is terrorist attacks, Y2K, currency meltdowns, World Wars, Dot com implosions or you fill in the blank; there is no Utopian Age. In 2015 it will be something else.

Getting back to finances, the aforementioned examples are exactly why there is a risk premium in equity investing. Sure, CD's and AAA rated bonds preserve capital and pay modest rates of return. They have their appropriate uses. But to really maintain purchasing power and build real wealth most investors need alternatives. While equities are considered a 'risky' asset class, this risk can be mitigated with fundamental techniques. Let's examine a few.

- **Diversify**. Sounds basic but is universally ignored. We recommend owning different asset classes (bonds, cash, real estate, currencies, and commodities) and owning low correlated assets within each class. (E.g. owning GM and Ford is not diversification). Balanced mutual funds do the trick for those opposed to individual stocks.
- **Limit Exposure**. Don't hold more than 8% of one single stock. Tell tale sign – if you check a stock ticker incessantly, you own too much of it. Capital gain rates are currently low – take advantage and prune big winners.
- **Upgrade Portfolio Quality**. Bear markets provide excellent opportunities to buy discounted, high quality companies/funds. Reduce the more speculative investments; they usually get murdered in down markets.
- **Think Dividends**. Conduct due diligence to make sure a company's dividends are secure. Secure dividends + stable cash flow = lower downside risk. Steady, liable income cushions unrealized capital losses.
- **Understand Correlation**. Basically, how do asset classes react to one another? For example, commodities have almost an inverse correlation to stocks. While considered 'risky', they actually *lower* the portfolio's volatility.
- **Understand Beta**. Beta is just a crude measure of portfolio return compared to the overall market. For example, if the S & P 500 was up 1% and your portfolio was up .8%, your portfolio's Beta was .80 for the day. The lower the Beta, the less correlated and volatile the asset to the overall market.
- **Buy Partial Positions**. No need to buy all at once – consider buying 1/3 at a time. Think like a bunny and nibble.
- **Use Stop Losses**. While not promoting portfolio turnover and a lengthy Schedule D, setting stop losses 5-10% below a purchase price can remove emotion and mitigate big losses.
- **Sell Covered Calls**[i]. Great way to earn income in sideways and bear markets. Also sets a disciplined sell price for a rising stock. If interested, we can explain the mechanics and if they make sense for you.
- **Sell Put Options**[ii]. Again, beyond the scope of this discussion but when utilized properly, selling Puts can be very effective. [note: selling puts cannot be done in retirement accounts]
- **Hedge Your Bets**. The proliferation of ETF's allow the retail investor to effectively 'short' asset classes, indexes and sectors. While not appropriate for everyone, it is available.
- **Hold Some Cash**. Boring and paying very little but will provide portfolio ammunition and help you sleep more soundly. 15-25% is ample.

Bear Markets are agonizingly painful. They are seemingly endless and wealth deflating. But they can also be an opportunity if recognized and properly respected. Adhering to a few of our aforementioned suggestions will not only lessen the Bear's Growl but also help preserve capital.

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[i] *Taking Cover*, Fiscal Fitness, July 2000
[ii] *Put Away Your Risk,* Fiscal Fitness, October 2001