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RUSSELL *investor*

A global leader IN MULTI-MANAGER INVESTING

BATTLING A *bear market*

The last couple of years have been difficult for investors, as many have seen their portfolios lose value. As a result, investors may question their initial investment strategies and wonder if they will be able to meet their long-term goals.

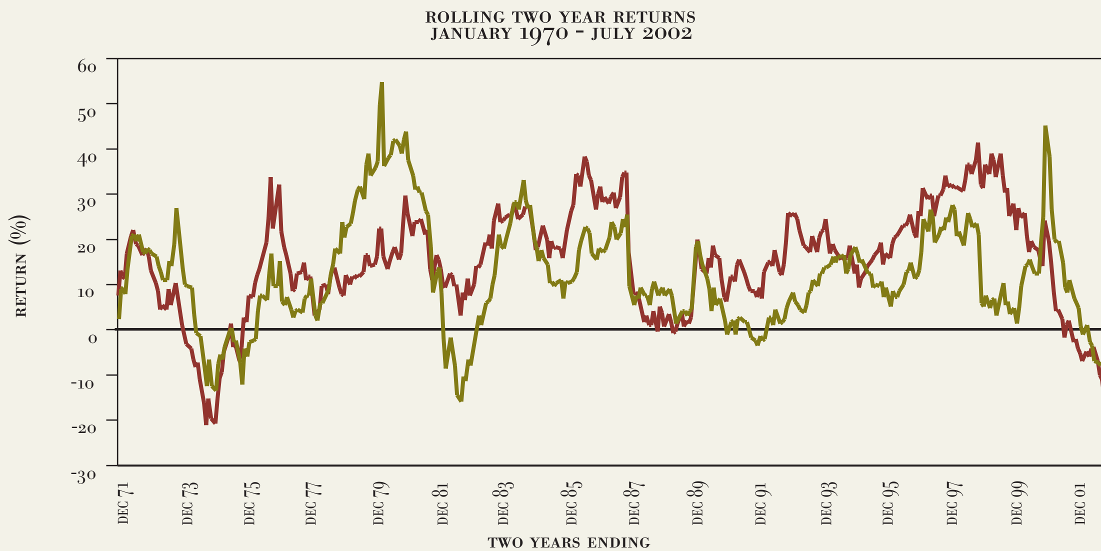
It's only human to feel emotional when you see your investments decline, especially after the market euphoria of the late 1990s. But now is not the time to panic. The key to conquering a bear market is to act rationally, stay diversified, and stay invested.

"It may not be an optimal time to buy because who knows exactly when the bottom will hit. But it could be one of the worst times to sell," says Ernie Ankrim, Frank Russell Company's chief portfolio strategist.

That being said—investors have a right to feel anxious after suffering through one of the most severe bear markets in history. Figure 1, on the following page, illustrates the rolling two-year annualized returns of both the Canadian and US equity markets from January 1970 through July 2002. After experiencing astonishingly positive returns up until 2000, the market's recent two-year downturn has resulted in one of the worst 24-month periods since the 1970s. This type of ferocious bear market has not been seen in almost 30 years.

Although this has been a painful downturn, investors can take some comfort in knowing that the current market losses are the exception, not the norm in equity market behaviour.

1 | *infrequent* BEAR MARKETS



S&P 500 S&P/TSX

It is indeed a time of uncertainty, but equity markets in the short term are affected more by sentiment than they are by actual fundamentals. The current bear market boasts several positive factors that indicate signs of optimism.

"I don't think you could have a really more different economic and geopolitical environment today than we had in 1973 to 1974. For example, that period had a very weak economy–with the whole classic stagflation era, energy price shocks, and a President forced out of office. Today, we really don't have that bad an economy, we have very stable oil prices, and we have incredibly low inflation. While there have certainly been geopolitical issues that occurred, especially in the Middle East and Sept. 11th, we are certainly not facing the kind of crisis of confidence in our fundamental governmental institutions that were issues back then. So my rational side says that if I were to survey the world today, I think the world's a more desirable place for equity investors than it was in 1974," says Randy Lert, Russell's chief investment officer.

HISTORY *lessons*

Although the fundamentals of the market may not be as dire as feared, investors must still deal with conflicting emotions when faced with adversity. A look at past bear markets may put the current downturn into perspective and reassure investors that history is on their side.

Since 1956 the Canadian equity market has recorded 13 bull markets and 14 bear markets. Bear markets during this period have averaged –22.8% and lasted 9 months. On the other hand, bull market gains have averaged 88.9% and have lasted close to 33 months. The bull markets thus provide a larger percentage change and are, on average, over three times longer in duration than the bear markets.

Perhaps the most revealing lesson history teaches us is that bear markets have been a predominantly short-term concern. Over longer time frames, the markets have shown less volatility and produce better returns. As shown in Figure 2, a relatively short time frame such as the three-year rolling returns of the S&P 500, reveals seven periods of negative returns from 1938 to 2001. Over a slightly longer term perspective, the five-year rolling returns of the S&P 500 display only one period of negative returns. The benefits of long-term investing are even more evident when examining the 10-year rolling returns of the markets and just as compelling when reviewing 15-year rolling returns. So in essence, history suggests that a long-term perspective is the best mindset to have when dealing with a bear market.

2 rolling returns FROM 1938-2001				
ANNUALIZED RETURN	3 YEARS	5 YEARS	10 YEARS	15 YEARS
0%-Negative	7	1	0	0
0%-5%	2	5	4	1
5%-10%	14	12	12	12
Greater than 10%	39	42	39	37

SOURCE: S&P 500 INDEX

WHY *stay invested*

History also teaches us that one of the best ways to make long-term gains is to simply stay invested, even though it is a challenge to resist cashing out or changing strategies in difficult times.

One of the strongest arguments for staying invested is the notion that market gains are often swift and unpredictable. Market timing can have a decidedly negative impact on an investor's long-term returns.

Selling into a down market will almost guarantee that you'll miss out on a potential market recovery. Investors that pull out of the market are likely doing so at a loss and risk being out of the market if rallies do occur. If the market rebounds, the losses that you may recoup are difficult to earn back if you're not invested. Abandoning your strategy to time the market has consistently proven to be detrimental in the long run.

Staying invested also gives you a greater chance of overcoming the veiled threat of inflation. Even if you are approaching retirement, this does not necessarily mean that your portfolio doesn't need growth.

Despite its current low levels, inflation has averaged 4.2% annually from 1950 to 2000 in Canada. This means, on average, investors have needed to produce a return of 4.2% every year just to maintain their purchasing power. While past performance is no guarantee of future results, stocks have historically provided the best returns relative to other asset classes. From 1950 through 2000, Canadian stocks returned 12.9%, an 8.7% premium over inflation.

STRATEGIES TO *tame the bear*

Remaining calm and staying invested does not necessarily mean that you have to passively wait out the downturn.

You can re-evaluate your risk tolerance. Risk has a bad reputation, but without some form of risk, there would be no catalyst for growth in capital markets.

Once your level of risk has been determined, it is wise to reassess your comfort with volatility by discussing with your Advisor whether your current asset allocation strategy is still appropriate. A new asset mix may be required, or you may simply want to rebalance back to your original asset mix.

How you allocate your portfolio has the most influence on its performance over time. Strategic asset allocation strives to maximize return at an acceptable level of risk by diversifying among different asset classes and styles that do not move in tandem or are not perfectly correlated.

The asset classes you choose and the percentage of your portfolio that you allocate to each depends on your goals, investment horizon and risk tolerance. With the help of your Advisor, you can customize an asset mix that is tailored to suit specific investment objectives and your tolerance for risk. Usually, the longer your investment horizon, the more risk you can take on in your investment portfolio, assuming you are comfortable with the markets' volatility.

Dollar Cost Averaging (DCA) is the antithesis of trying to time the market. With DCA, you invest the same amount of money each period. When an investment's unit value falls, your money buys more units. When the price increases, the periodic investment buys fewer units. The idea is that you end up with more shares, purchased at the average price over the time period.

By adding to your holdings in the midst of a bear market, you increase the number of shares you hold. The more shares you hold, the more you stand to gain if the next bull market comes along.

RUSSELL'S *strategy*

Staying invested over the long haul is much easier when an investor holds a fully diversified portfolio that is appropriately tailored to their personal objectives and risk-tolerance. Russell's core investment philosophy adheres to the fact that diversification across multiple asset classes, investment styles, and money managers, provides better consistency of returns. This strategy is followed in all market environments and has been a hallmark of Russell for over 30 years.

By implementing a strategy that features these investment fundamentals, the Sovereign Investment Program allows investors to own a total portfolio that is highly diversified, maintains market participation, and offers long-term growth potential.

OUTLASTING *the bear*

One of the oldest pieces of investment advice is to "buy low and sell high". It sounds so simple that one could hardly argue with it. But when the bear market starts to roar and stock prices fall, fear sets in and most investors run for the hills. The real problem is human nature, which leaves us susceptible to rash and impulsive investment decisions that potentially harm our portfolios in the long run.

Stock markets have experienced a number of severe bear markets, and each time the markets have eventually regained strength and went on to new highs. In order to take advantage of this potential growth investors must curb their emotions, maintain a long-term perspective, stay true to a diversified investment plan such as Sovereign, and most importantly, stay invested.

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