

Bear Market Start May Offer a Strong Finish for Young Investors

By Christine Fahlund

Would you rather start investing for retirement during a bull market or a bear market?

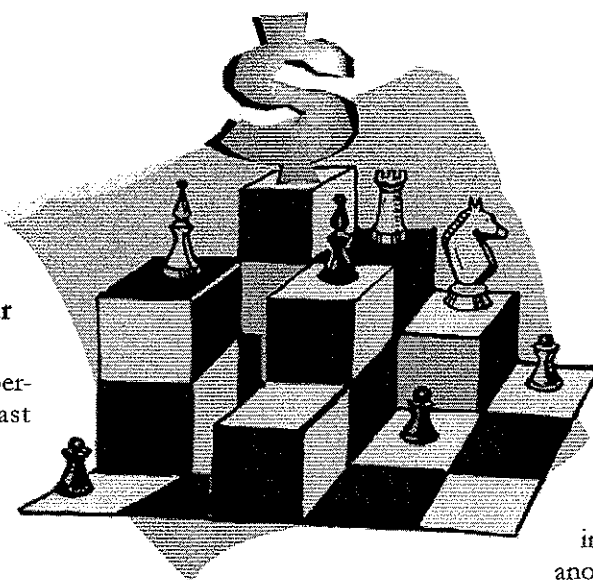
After the historically poor performance of equities in the last decade—marked by two ferocious bear markets with overall losses greater than any other time since the Great Depression—some young investors might be considering a reduction in—or total elimination of—their exposure to stocks.

However, they may be surprised to learn that, in the past, such downturns have presented investors with rare opportunities to benefit from healthy future returns.

A new study by T. Rowe Price shows that bear markets have provided a substantial advantage for investors who are decades away from retirement. Specifically, the study found that those who began systematically investing in equities in past severe bear markets were significantly better off 30 years later than investors who began in bull markets. Naturally, this effect is even more pronounced if the initial bear markets were followed by big bull markets.

Those who began investing at the start of this decade may be discouraged, but they could have two powerful forces in their favor: the cyclicity of markets and the ability to accumulate a lot of shares early in their career.

In the past, investors who were able to maintain their investment program throughout a prolonged period of weak performance were poised to benefit when markets recovered.



Bear or Bull?

The new analysis examined four hypothetical investors who each contributed \$500 per month (15% of a \$40,000 annual salary) into a retirement account invested in a portfolio that replicated the S&P 500 index over a 30-year period. One investor started in 1929, one in 1950, another in 1970, and one in 1979.

A hypothetical \$10 share price was used at the beginning of each period and was indexed to follow the actual monthly fluctuations of the S&P 500. All dividends were reinvested in additional shares.

The two “bear market” investors who began making contributions in 1929 and 1970 started just before two of the worst bear markets in modern history.

Like today’s young investors, they may have felt discouraged after their first decade: The S&P 500 had an annualized total return of -0.9% from 1929 to 1938—the second worst 10-year period in history—and only 5.9% in the recessionary ’70s.

By 1979, for example, mainstream thinking had turned so cynical that “BusinessWeek” magazine proclaimed “The Death of Equities” on its cover.

However, there were two silver linings for these bear-market investors.

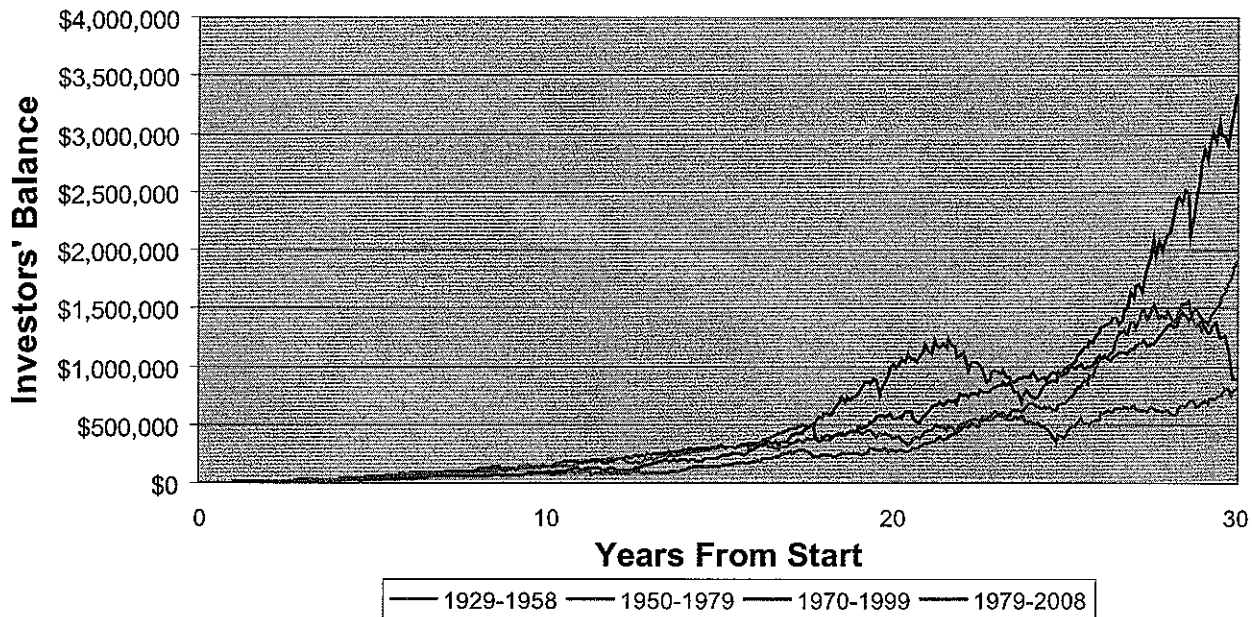
First, they had the opportunity to buy at low prices on average and thus accumulate more shares early on, putting them in a better position to gain from future bull markets.

Second, by making systematic investments and reinvesting

Figure 1. Slow Starts Can Still Show Strong Finish

Account fluctuations of four different hypothetical investors contributing during four different 30-year periods. Each investor contributes \$500 per month (or 15% of a \$40,000 annual salary) into a retirement account that replicates the performance of the S&P 500 index over a 30-year period. A hypothetical \$10 share price was used at the beginning of each period and was indexed to follow the monthly fluctuations of the S&P 500. All dividends were reinvested in additional shares.

The investors who began contributing in 1929 and 1970 started at the beginning of decades with ferocious bear markets. Yet their ending account balances were more than double those of the two investors who began contributing at the start of decades with strong bull markets, in 1950 and 1979.



dividends, they ended their first decade of investing with modest returns.

Their total contributions of \$60,000 over their first 10 years grew, respectively, to \$88,255 by 1938 and to \$86,047 by 1979. (It is important to note that an investor who owned fewer securities compared with the S&P 500 may not have done as well. In addition, the return earned for a systematic investment plan is different than the return earned for someone who invests a lump sum at the beginning of the period and simply reinvests dividends.)

The two other "bull market" investors had a very different experience. By starting in 1950 and 1979, they were on the verge of two of the most rewarding decades for equity investing.

The S&P 500 returned 19.4% annualized from 1950 to 1959 and 16.3%

from 1979 to 1988. Their \$60,000 in contributions by the end of those decades grew to \$152,359 and \$137,370, respectively

However, they were accumulating fewer shares at a higher average cost during these robust decades. Moreover, their average returns over the next 20 years were much lower than the returns earned over the subsequent 20 years by the other two investors.

Thus, despite their strong starts, their ending balances after 30 years were remarkably less than half that of the two investors who began investing at the start of bear markets (see Figure 1).

The Great Depression decade of the 1930s marked the beginning of the worst 30-year period for equity investing. Yet, the S&P 500 provided a respectable 8.5% annualized return from 1929 to

1958. The investor who stuck to this systematic investment plan over that 30-year period ended up with a total return of 960%.

The investor who started in 1970 had a remarkable total return of 1,753% over 30 years because he benefited mightily from the unusually strong returns earned in the 1980s and 1990s. In sharp contrast, the investors who began in the bull market decades (the 1950s and 1980s) earned less than 400% over 30 years.

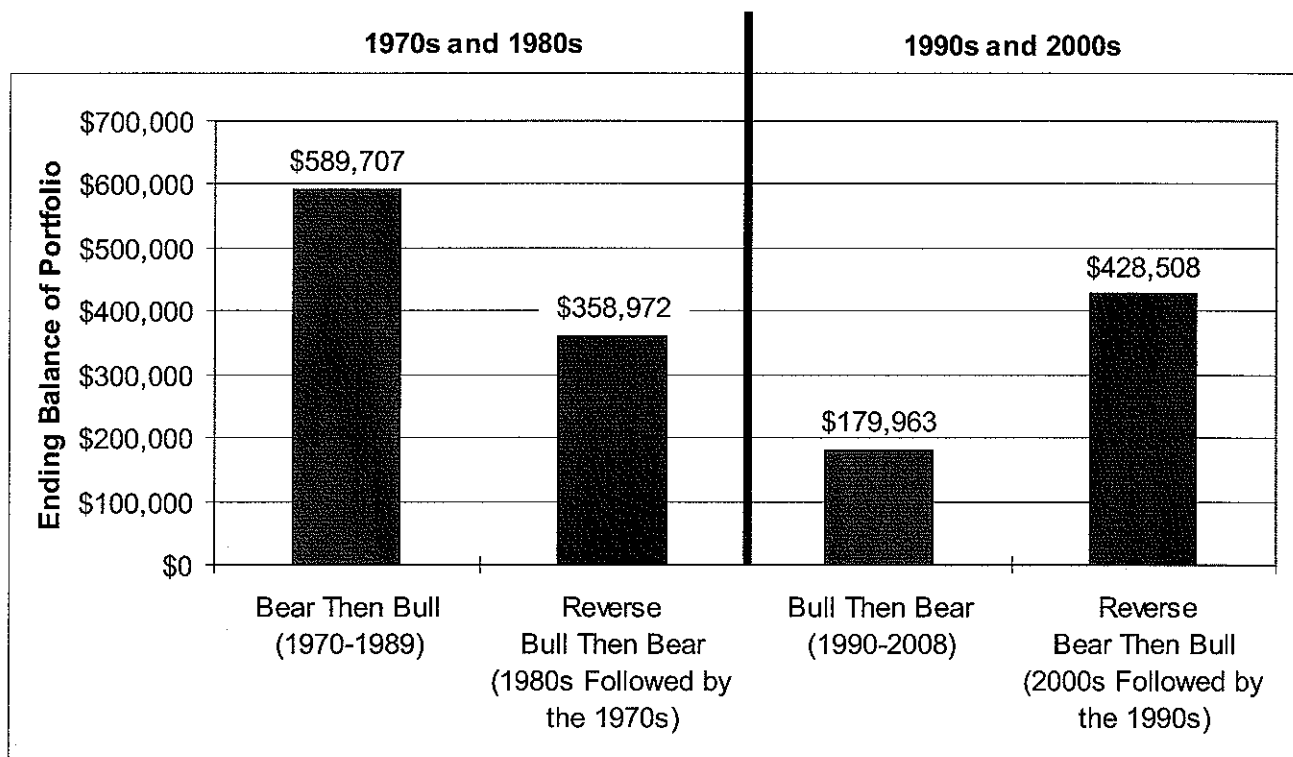
A poor start doesn't necessarily equate to a smaller nest egg. History, indeed, demonstrates just the opposite.

Some have questioned whether today's young investors will ever recover from such steep losses and low account balances.

However, our research shows that

Figure 2. Bull/Bear Market Sequence Matters

How returns differ if a bear market or weak decade is followed by a bull market or strong decade, and vice versa. Each hypothetical investor contributes \$500 per month (or 15% of a \$40,000 annual salary) into a retirement account that replicates the performance of the S&P 500 index. Those who invested throughout a bear-then-bull sequence did much better than those who began investing during bull markets. (Balances are in pretax dollars.)



many who began investing in horrific markets significantly benefited from that over the long run, assuming they maintained their investment program.

Sequence Matters

To further illustrate the opportunity that bear markets could offer, the study also examined how returns could differ if a bear market or weak decade is followed by a bull market or strong decade, and vice versa.

For example, an investor who contributed \$500 monthly from 1970 to 1989 (\$120,000 in total) in a portfolio

replicating the S&P 500 index ended up with an account value of \$589,707 (see Figure 2). That index had an annualized total return of 11.6% during this period.

But, what if the decades were reversed—with the modest performance of the 1970s (including the steep 1973–1974 bear market) following the 1980s bull run? In that case, the account value at the end was much less, \$358,972, even though the index's annualized return for the 20-year period was still 11.6%.

Similar results were produced when the study compared the 19-year period from 1990 to 2008. The investor who

began contributing in 1990 ended up with half the balance compared with what he would have had if the decades were reversed—the weak returns from 2000 through 2008 were followed by the exuberant gains from 1990 through 1999.

The sequence of returns matters more than people may think.

Starting systematic contributions to your retirement account in a bear market can be tough, but it gives you the opportunity to purchase a larger number of shares for the same amount of money, which could prove very beneficial by the time you retire. ▲

Christine S. Fahlund, Ph.D. and CFP, is a senior financial planner and vice president of T. Rowe Price Group, an investment management firm based in Baltimore, Maryland.