Although they are a natural part of the investing experience, there's a certain taboo about discussing bear markets and recessions, as if acknowledging them increases the likelihood of experiencing one. (Getty)

It's never too early to prepare for a bear market

17 December 2024, 8:32 pm CET, written by UBS Editorial Team US Editorial Team

When it comes to understanding market risks and their impact on investment success, there is an elephant in the room—or rather, a bear.

A "bear market" occurs when there is a greater-than-20% peak-to-trough drop in the S&P 500. Although the 20% threshold is arbitrary, crossing this level has historically been an important dividing line between painful-but-short-lived corrections—where recovery time is measured in months—and the years-long recovery period for bear markets.

Although they are a natural part of the investing experience, there's a certain taboo about discussing bear markets and recessions, as if acknowledging them increases the likelihood of experiencing one. Our research suggests that this taboo is counterproductive. In studying bear markets closely, you will learn that they aren't as dangerous as they seem.

It's important to note that there is no panacea for bear markets. Almost all investors will experience at least a handful of bear markets—both in their working years and during retirement—and they will be painful. But there's a difference between pain and damage, and our research tells us that bear market protection doesn't have to be expensive—especially if investors are proactive.

However, bear markets needn't be a threat to financial success. In fact, for the well prepared, they can be an opportunity to improve long-term returns.

No matter how well intended or designed, the strategies that provide the most potent protection against equity downside risk also tend to be the most costly in terms of sacrificing long-term growth potential.

That's particularly true if the goal is to hedge against all downside movements, instead of only against the long and deep sell-offs that characterize bear markets. That's because—in order to make sure that there is a high negative correlation during all downside episodes—a strategy must risk also having a high negative correlation when markets go higher. In a world where stocks usually go higher, strategies that seek to go "short" or directly hedge equities seem doomed to fail. This cost is especially high for strategies that employ leverage to "make the most" of their short windows of opportunity.

As a result of these challenges, we don't usually recommend direct hedges as a part of our strategic or tactical asset allocation. It's important to prioritize cost-effective protection before moving onto less-reliable or costlier hedging strategies.

Here are some "damage mitigation" strategies, in declining order of efficiency:

1. Think structurally
Make sure that your portfolio is taking the right amount of risk to meet your short- and long-term objectives.

2. Plan strategically
The most direct way to manage equity risk is to trim some stocks from the portfolio in favor of a higher allocation to core bonds.

3. Consider hedges
There are many strategies that could mitigate the portfolio's downside exposure if used to replace a part of the equity allocation.

4. Manage liabilities prudently
If used carefully, borrowing strategies can be highly beneficial to improving bear market returns.

Although bear markets are painful, it usually only takes a few years for the stock market—and even less time for balanced, diversified portfolios—to fully recoup bear market losses. Even in a worst-case "super bear market," market losses are temporary for investors who are able to stay the course.

For a deeper read, download the full whitepaper, "**Bear market guidebook: How to manage risk and harness opportunity in a market downturn**."

After reviewing this research, you can work with your financial advisor to make sure you're prepared. It's never too early —and rarely too late—to plan.

The document and the information contained herein is intended for UBS internal use only and solely for the UBS employee to whom it was provided. It may in no circumstances be distributed outside of UBS. Information contained in this document has not been tailored to the specific needs, investment objectives, personal and financial circumstances of a client or any other recipient outside of UBS. This document shall not be construed to include any legal or tax advice, investment research, sales prospectus, an offer or a solicitation of an offer to enter in any investment activity. Neither UBS nor its directors, employees or agents accept any liability for any loss or damage arising out of the use of all or any part of this document. For further information, please contact the document owner.

Important information
As a firm providing wealth management services to clients, UBS Financial Services, Inc is registered with the U.S. Securities and Exchange Commission (SEC) as an investment adviser and a broker-dealer, offering both investment advisory and brokerage services. Advisory services and brokerage services are separate and distinct, differ in material ways and are governed by different laws and separate contracts. It is important that you carefully read the agreements and disclosures UBS provides to you about the products or services offered. For more information, please visit our website at www.ubs.com/workingwithus.
© UBS 2024. All rights reserved. UBS Financial Services Inc. is a subsidiary of UBS AG. Member FINRA/SIPC.
There are two sources of UBS research. Reports from the first source, UBS CIO Global Wealth Management, are designed for individual investors and are produced by UBS Global Wealth Management (which includes UBS Financial Services Inc. and UBS International Inc.). The second research source is UBS Group Research, whose primary business focus is institutional investors. The two sources operate independently and may therefore have different recommendations. The various research content provided does not take into account the unique investment objectives, financial situation or particular needs of any specific individual investor. If you have any questions, please consult your Financial Advisor. UBS Financial Services Inc. is a subsidiary of UBS AG and an affiliate of UBS International Inc.