

The Inevitable Bear

3 Steps to prepare your practice for a bear market

Bear markets are an inevitable part of investing. As humans, we tend to underestimate the likelihood of an event the longer we go without experiencing that event. Since it has been over 15 years since the last TRUE bear market it is likely very few clients are prepared for a real bear market. (**We define a TRUE bear market as one which lasts more than 9 months and includes an economic recession.**) In addition to the loss in assets from the decline, many advisors' practices are not prepared to withstand the emotional impact a bear market will have on their clients. Here are some simple steps to implement before the bear market begins.

1.) Obtain the "risk pulse" of each client

Contact each of your clients to see how they've been feeling about the volatile markets. Don't assume they are OK because you haven't heard from them. Contacting them enables you to tell them you're monitoring the markets and will make appropriate changes to their allocations as necessary (see Step 3). Here are some possible questions to ask your clients:

- How did you feel about the market declines in the first part of 2025 and the overall increase in market volatility?
- With the recent market volatility and declines, do you have any concerns about the portfolio you and I put together for you?
- Would you be able to stick with our plan if the losses continued for another year?

Remember: As humans when we get uncomfortable, we are more likely to make emotional decisions. Risk surveys such as Riskalyze or general "risk tolerance" questions answered during a bull market often do not measure the true risk tolerance of a client. It's always good to check-in with a client following a correction in the stock market to get a real feel for their tolerance.



Inside this report

We take a look at practical steps advisors should be taking now to prepare their clients for a bear market.

Summary Points

- Some adjustments are needed for clients' investments at this time
- Understanding risk tolerance and diversification is necessary to avoid clients abandoning their strategies during a bear market
- The optimal portfolio is one which keeps clients invested, vs delivering the highest returns

2.) Review the impact of a bear market

Because the last TRUE bear market was over 15 years ago, it is easy for all of us to forget what a bear market in the near future would look like (bear markets are inevitable. The more distance between them, the more likely it is we will see one). Keep in mind, a recessionary bear market could show losses more than twice what we experienced in 2022 and more than triple what we saw in early 2025. Questions you should be asking yourself:

- If I were to triple the losses from the 1st part of 2025 in my client's investment portfolios, would that exceed the expectations I set for my clients?
- Are there any clients that could not afford a doubling of the losses from 2022?
- Were there investments/managers in their portfolios that performed better/worse than I would have expected during the first part of 2025?
- Do I know why those investments performed better or worse?



Remember: It is easy to pick investments/managers in a bull market and equally easy to lose track of which investments truly provide diversification during a bear market. Too often most asset classes become correlated at the time you need them to be non-correlated the most -- when stock markets are falling.

“A recessionary bear market would likely show losses more than twice what we saw in 2022.”

Optimal is not the “best”

Clients are more likely to give up on a portfolio, or parts of it during times of trouble.

Therefore the best portfolio is not the optimal portfolio, but rather the one that the client can stick with through the market's ups and downs.

-Best Does Not Mean Optimal,
CFA Entreprising Investor,
January 9, 2019

Traditional vs. Behavioral Finance

Most advisors were trained in traditional financial theories. We were all taught the *best* way to structure portfolios. This has resulted in advisors dictating to clients what they SHOULD do with their money and how they SHOULD react to losses (stay the course, think long-term, ignore the noise, etc.)

Behavioral finance has become popular in recent years. Many firms have said they embrace this new discipline, but their advice continues to be telling clients what they SHOULD do. The key to a true behavioral approach is adapting client portfolios to what clients are likely to do even if it is not the “best” on paper.

Remember: We are all human and prone to emotional decisions. The more stress we have, the more likely we are to react emotionally. A behavioral approach to investing helps offset those emotional reactions.

Simple way to screen for risk tolerance

Clients are humans and humans understand things better with visuals. Humans also think in dollars and not percentages. In determining risk tolerance and portfolio allocations, consider using poker chips to illustrate the size of the portfolio, including colored chips for different asset buckets. Begin removing chips from their portfolio and ask the client to let you know at what point they'd become uncomfortable with the losses in their portfolio. That point is the risk target for your allocations.



3.) Determine each client's portfolio adjustments

There is no such thing as a “one-size-fits-all” approach to portfolio allocations. Too often advisors want to lump all of their clients into similar portfolios based on their own biases or opinions. To truly prepare for a bear market, each portfolio should be customized to the financial plan, cash flow strategy, and investment personality. See the sidebar to the left for some general tips detailing ways to make adjustments, but first you must ask:

- Do I know how each client's portfolio matches the true risk tolerance of the client?
- Do I have components inside the portfolio (and do my clients understand those components) designed to help clients stick to their plan regardless of where we are at in the market cycle?
- Do my portfolios have a well thought out plan to adapt to whichever direction the market heads next?
- Do I have the time/energy/resources/desire to constantly monitor the investment portfolios (including outside managers)?
- Am I more valuable in front of clients or in the back office managing the investments and operations of the investment portfolios?

Remember: We have limited time as advisors and should be dedicating everything to our highest and best use. Any time spent on other activities is time that could have been used to grow your practice.

Portfolio Allocation Tips

When looking to adjust client's portfolios, advisors need to consider the following:

- 1.) Understand the downside risk of the portfolio (maximum potential loss) and make sure it fits to the client's personality.
- 2.) To develop a truly diversified portfolio, make sure you look at downside correlation among investments (including outside managers)
- 3.) Realize not all bonds provide downside protection. Corporate bonds can lose over 20% in a recessionary environment. Look to active bond managers that can move to lower risk bonds if necessary.
- 4.) Look for investments or managers that can adapt to the market and each client's specific situation.
- 5.) Use behavioral tricks to keep clients focused on long-term goals.

-SOURCE: Bloomberg,
January 11, 2019

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Jeff is Chief Investment Officer for SEM Wealth Management. Since joining SEM in 1998, he has worked with advisors to help structure client portfolios. While studying for the CFA exam in 2016 Jeff helped launch SEM's Behavioral Approach, which included adding two additional investment management styles and placing the focus on the financial plan, cash flow strategy, and personality of each individual client.

Jeff also writes a weekly blog, which can be found at TradersBlog.SEMWealth.com

Ways SEM Can Help

SEM Wealth Management offers many tools for advisors to assist them in preparing their practice for both bull and bear markets. Some of those tools include:

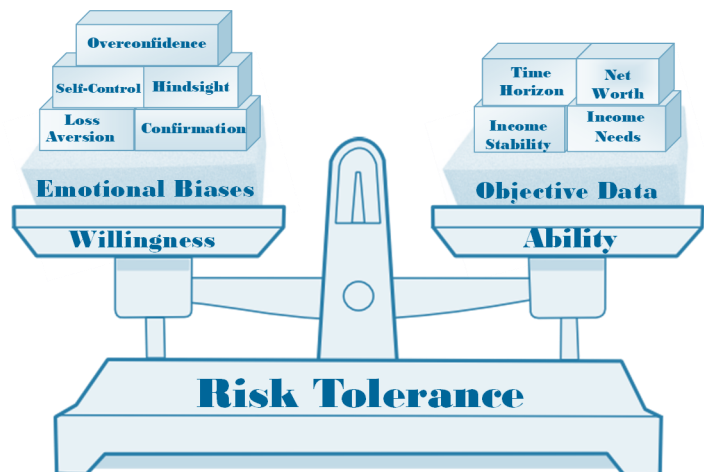
- Risk screening tools to help identify the true risk tolerance and investor type of each client
- 3 distinct investment management styles with 15 models to use as building blocks to create customized portfolios
- Portfolio reviews of prospective client accounts indicating risk level and possible areas of concern
- Free financial planning tool (WhatsMyScore.net)
- Weekly report showing which clients logged in to check their balances (indicating possible emotional clients)

For more information, go to SEMWealth.com.

Risk Tolerance: Your Primary Fiduciary Duty

The SEC requires all advisors to act as a fiduciary, which among other things means a duty of care to provide only suitable advice. Therefore, determining suitability is one of the most important things advisors do when managing a client's account. In addition to determining the ability & willingness to assume risk for each client, advisors must also then allocate assets to portfolios designed to match the overall suitability of their clients.

-SOURCE: Trusting Clients' Financial Risk Scores, CFA Institute



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