Could momentum help manage bear market risk?

Blog

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In our Bear market guidebook, we reached several important conclusions. Most importantly, bear markets are difficult to predict, and can result in devastating short-term returns, but they are also rare and short-lived. We also found that simple portfolio diversification—owning enough core fixed income—is an effective way to limit "bear market damage" without incurring a significant drag on portfolio growth during bull markets.

Even so, many investors would like to do more than simply survive bear markets, and would like to allocate to strategies that benefit from them. The problem with these strategies is that they tend to be expensive to own during bull markets. Is there anything we can do to reduce the cost of protection? One possible solution is to make portfolio adjustments in reaction to market conditions, such as momentum.

Let’s take a look at one popular measure of momentum: the 200-day moving average ("200DMA") of the S&P 500. The chart below shows the impact of using a very simple trading rule—owning the S&P 500 if it is above its 200DMA, and switching the portfolio allocation if it is below that level, using month-end observations (trades are done at the closing price of the first day of the following month). Here are some high-level observations:

- These strategies would have hypothetically helped to reduce downside risk to a maximum 12-month loss of -23% versus -43% for the S&P 500 over this period.
- The strategies have been less consistent than they appear, underperforming a simple buy-and-hold investment in 2/3rds of all 12-month periods, by an average of 2-4%. The saving grace is that when the timing strategies outperformed, they did so by an average of 10% (switching to bonds) and 4% (switching to 50% bonds, 50% stocks).
- This timing mechanism would have switched its allocation about 45 times in 40 years. Many of these trades were "false positives," failing to add value. For example, since the end of 2010, it would have signaled 9 trades, despite no bear market. These "whipsaws" would have led to cumulative underperformance of 46% (switching to bonds) and 23% (switching to a 50/50 portfolio).

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Conclusion
As with all attempts to time markets, it's important to be cautious and recognize practical limitations. For investors considering strategies such as these, we would recommend limiting implementation to only a small part of the portfolio.

Because this hypothetical simulation does not include tax consequences of realizing capital gains—and forgoing growth on money paid to your local tax authority—much of the hypothetical benefit would have been eroded if implemented in a taxable account.

For some investors, one alternative to making wholesale allocation changes would be to use this strategy to allocate a very small part of the portfolio to direct hedges, such as protective put options. In our view, direct hedges may offer more value than long-duration Treasuries in certain environments, but they can be very expensive to own during bull markets, so it is important to implement them carefully and systematically.

Figure 1 - Momentum can help to manage the cost of hedging
Growth of USD 100 in four strategies, since 31 December 1979

UBS, MorningstarDirect, as of 30 June 2019. Bonds are intermediate-duration Treasuries, stocks are the S&P 500.
Appendix

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