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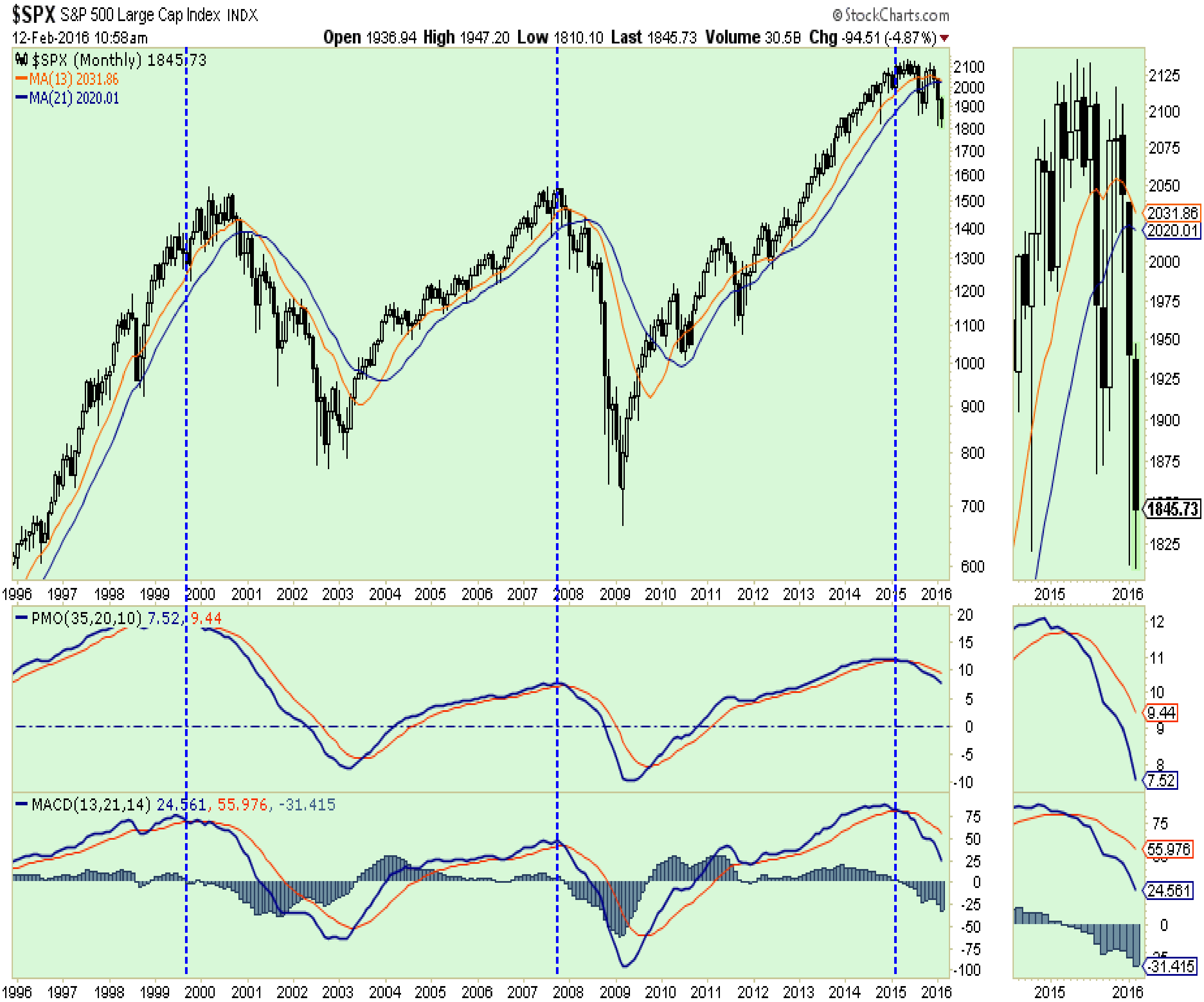
BEAR MARKET HAS STARTED

The action this past week has been, to say the least, dismal. However, the major lows that have been support for the bull market since 2009 continue to hold for now, but are under attack. We continue to watch these lows closely as a failure would likely accelerate selling. This week, I am going to take a look at major sectors, asset classes, and markets to analyze the risk/reward of having money invested in any specific area. In every bear market, there are always opportunities, we just have to find them. However, before I get into that, let me discuss why I believe we have currently entered into a bear market cycle. Last week, my friend Joe Calhoun at Alhambra Partners •wrote a brilliant piece discussing what a bear market actually is:

> **"The definition of a correction as down 10% and a bear market as down 20% though are just arbitrary numbers agreed upon by no one and everyone.** And those thresholds, despite recent history, are met quite frequently. 10% corrections come around every couple of years and most of them are over before most investors get a statement that might scare them into doing something stupid. 20% bear markets are also pretty routine, coming along roughly 1 year out of 4. Corrections and bear markets are generally over pretty quickly, even the ones that turn into financial crises. **The 2008 bear market, from peak to trough, lasted 17 months; it only felt like a lifetime.** The real enemy of investors is not these fairly routine 10 or 20% downturns. ***The real enemy is the bear market that is associated with a recession or crisis, the one that knocks your equity block down by 40 or 50%. And actually, it isn?t even the depth that is the real enemy. For most investors the enemy is time.*** Whether you are a younger investor still accumulating assets or a pre-retiree about to depend on your nest egg for income or a retiree already doing so, bear markets eat up your most precious commodity ? time. Recovering from large drawdowns when you are young is obviously easier ? if you stick to a plan and don?t get laid off in the recession that caused it. ***But if you are about to retire, a bear market may mean you have to keep working for a few more years, putting a little tarnish on your golden years. If you are already retired it may mean something even more devastating ? running out***

of money before you run out of years.* So, is this already a bear market? If we are measuring it for the S&P 500 in terms of price the answer is no. But in terms of time? I think, for a lot of people, we?re already there. *In short, the trend has changed, the inflection point between trending higher and trending lower is long gone. If you?re still looking for it, I?m sorry to be the one to tell you but you missed it."

The chart below shows what Joe is talking about:



Notice that prior to both previous bull market peaks, price momentum turned from positive to negative. **Likewise, at almost the exact peak, as NOW, the 13-Month moving average changed from a positive to a negative slope.**•Let's step back and take a look at the longer-term development and we can see the same behavior. The chart below is the 200-400 day moving average crossover I have discussed previously.

Importantly, as I have annotated, at the peak of the previous two bull markets, both the long-term Wm%R and Full Stochastics registered a trend change which was ultimately confirmed by the 200-dma crossing below the 400-dma. **You were given plenty of warning to exit the markets BEFORE losing 20% of your money to validate the onset of a bear market.•***(Notice that during the correction in 2012, the registered sell signals of the Wm%R and Full Stochastics were never confirmed by a 200-400 dma crossover.)* **Currently, both primary sell signals are in place and with only a 5-point spread between the 200 and 400 dma, the confirmation of a bear market will be registered in the days ahead UNLESS there is a rapid rise towards old all-time highs.** Given the current fundamental, technical and economic backdrop there is little reason to expect such a sharp rise to occur.

63%•CHANCE OF LOSS IN 2016

However, let me add a bit of statistical analysis to the discussion from my new friend [Salil Mehta] from the Statistical Ideas blog:

> "**A good chunk of Wall Street strategists have yet again quickly changed their minds on their 8% 2016 forecasts (markets are instead DOWN 8%.)** Now that's a 12-month commitment! The 16% gap *(8% fantasy minus -8% reality)* predicts nothing about the future, and anyway, the gap is in the middle of the recent pack! So let's explore all of the 10.5-month returns *(from mid-February through December),* from year 2000 onwards. **The evidence shows that there is an awesome 63% chance for a negative 2016 (as illustrated below, 38 percentage points of which are due to additional negative returns from here).** But what on earth could those cunning

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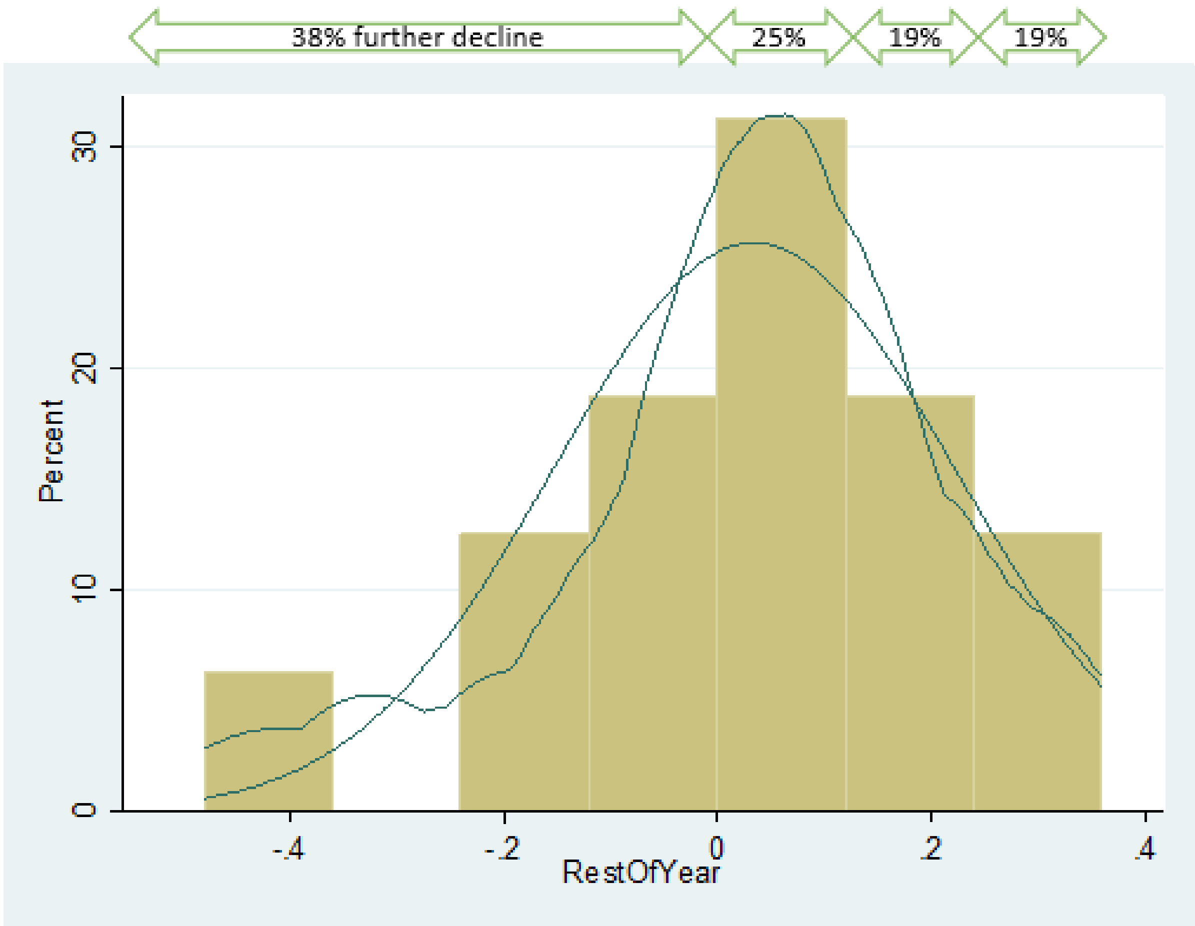
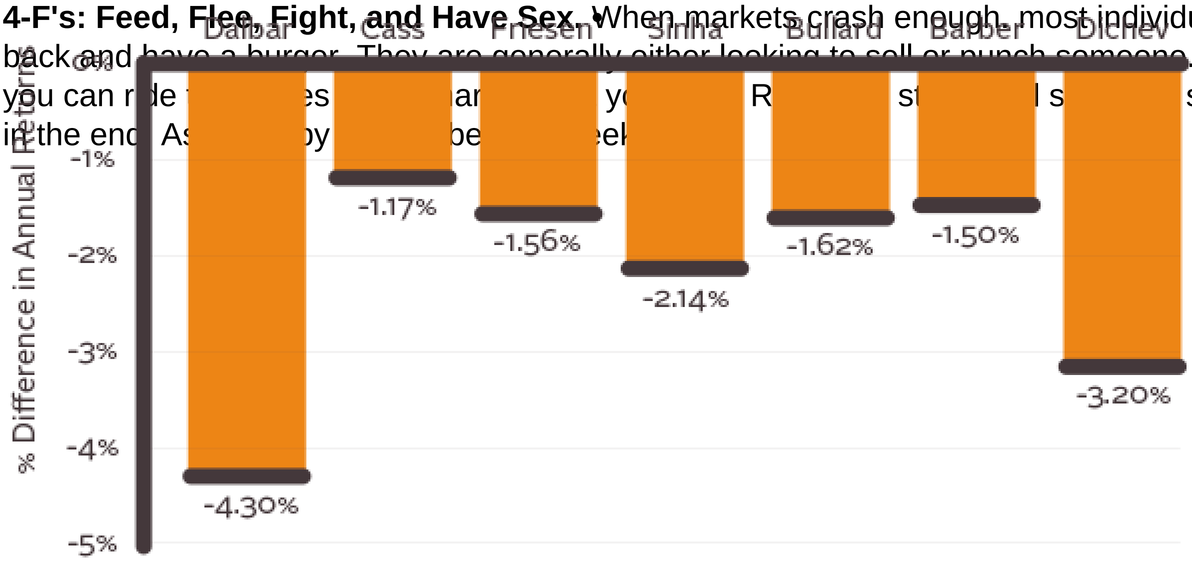


As he

concludes:

> *"Get used to more of this.• It's like a fortune cookie that never changes."*

He is absolutely right. As I have addressed so many times in the past, •whenever you hear the words *"we like this long-term," "long-term returns," or "over X-period the average rate of return has been..."* - **RUN!** Investing for the *"long-term"* is a very nice premise on the surface. **The problem is that psychology and genetically, you can not invest that way. You are ultimately ruled by the 4-F's: Feed, Flee, Fight, and Have Sex.** When markets crash enough, most individuals don't kick back and have a burger. They are generally either looking to sell or punch someone. You may think you can r[illegible] same outcome in the end. As [illegible]



ESTIMATES OF THE BEHAVIOR GAP

The behavior gap measures the loss that the average investor incurs as a result of emotional responses to market conditions. Several academics have studied and estimate the gap to be between 1.17% and 4.30% per annum.

The reason for this under performance, despite the best of intentions to be a long-term investor, was best summed up by Mike Tyson:

> ***"Everyone has a plan until they get punched in the face."•***

You may believe you can weather the ups and downs in the market, but when you lose 30, 40 or 50% of your money, plans change.

REDUCING RISK, LOOKING FOR OPPORTUNITY

This is a potentially confusing point for investors. How could we be reducing risk on one-hand but looking for opportunity on the other? •Good question. •Let me explain. Investors always make some fairly common mistakes in their portfolio management:

- They buy something without a target to sell *(target gain or stop loss).*
- They assume if they sell something they can never buy it again.
- If they sell something at a loss, it is now forbidden fruit.
- If they sell something at a gain, and it goes higher, they jump back in.
- By not selling a loser they don't have to admit they were wrong.
- By not taking gains in winners, it confirms their "genius," until it reverses to a loss.

- Etc., so forth, and so on.

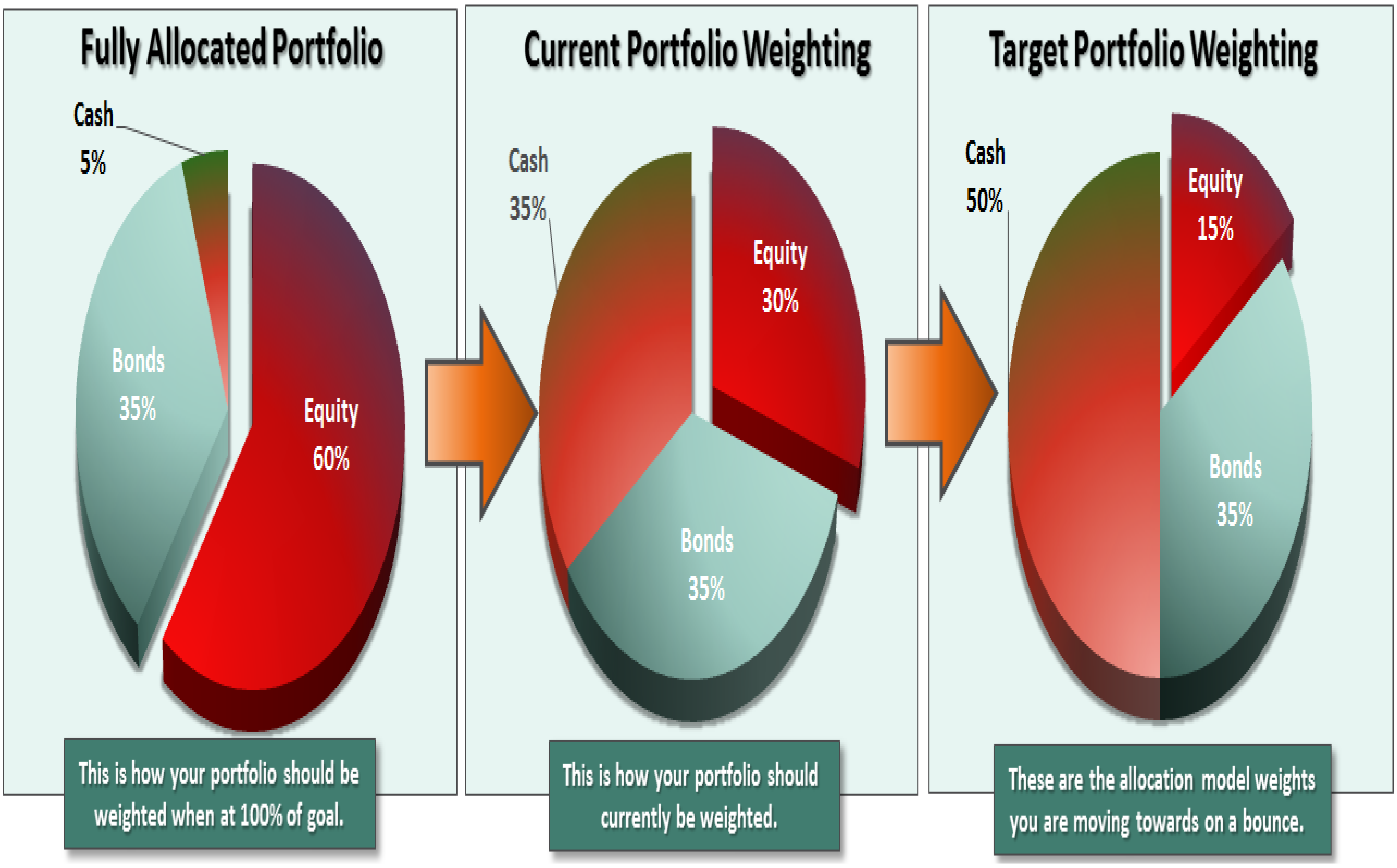
These are all emotionally driven responses. Most bad habits of investors, individuals and professionals, revolve around their *"ego."*•This is particularly the case of professionals who ostensibly believe they are *"smarter they the average bear."*•As a portfolio manager my job is actually very simple:**Avoid major draw downs.**•By doing just this one thing you can literally outperform the market over the long-term.

- **NO**...you will not beat the market from one year to the next which is a stupid goal anyway.
- **NO**...you will not sell at the peaks and buy at the bottoms.
- **NO**...you will not have regular appearances on CNBC.
- **YES**...you will achieve your long-term goals.

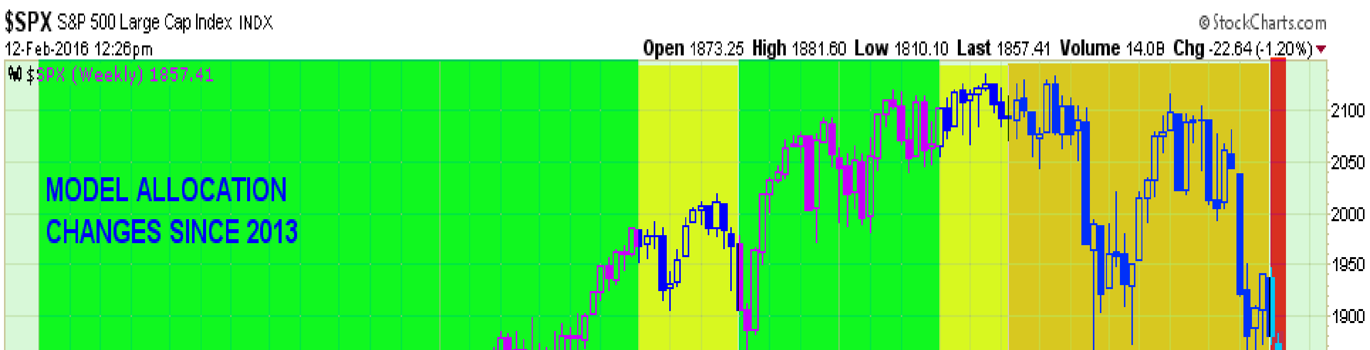
With this in mind, [last week I stated:]

> "The problem is that the expected rally was much less than previously anticipated. **Therefore, ANY RALLY in the next week, OR A BREAK below the recent lows, requires that the allocation model moves to its final target levels of 25% exposure as shown below. The current market environment is NOT conducive to an overweight allocation to equity risk currently."**

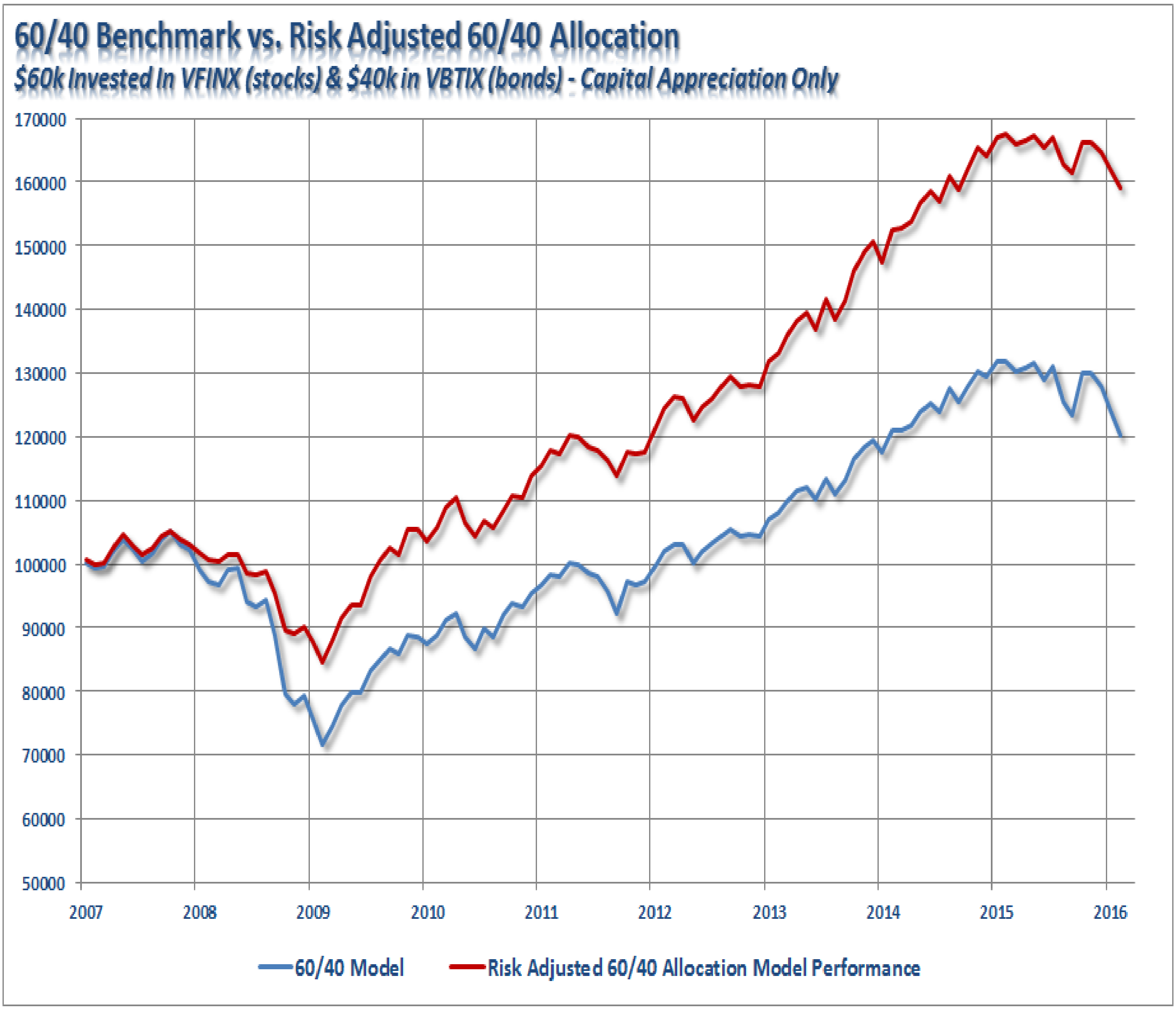
Therefore, if you have not done so as yet, on any rally this coming week reduce equity exposure in portfolios to target levels.



The next chart tracks the changes I have been discussing since the beginning of 2013 just in case you are a newer reader.



The next chart tracks the changes going back to 2007 of a hypothetical 60/40 stock/bond allocation versus the same model adjusted for the changes to manage downside risk.



As you will notice, not surprisingly, the bulk of the outperformance over the long-term was generated in 2008. **By reducing portfolio risk further this week, it now gives me cash, and substantially lower volatility, with which I can start looking for opportunities.** That's right, I am suggesting selling into any rally over the next few days to further reduce portfolio risk. **Importantly, I said reduce risk. I did not say eliminate it.**•With the market oversold short-term, and the Federal Reserve an unknown wild card, I do not want to be completely out of equities just in case *"possibilities"* overtake *"probabilities."* **Like playing the lottery, there is an almost non-existent possibility I could pick the winning combination. The probabilities are heavily weighted against that outcome**. By reducing risk, I can take my time to look for higher reward-to-risk opportunities to reinvest capital in the future. **If I am wrong,** and the market doesn't decline further as expected, when the market regains it *"bullish step,"* I can start buying again with a slightly higher relative degree of safety. **If I am right,** and the market does have a further bear market correction, I will be able to reinvest capital at substantially reduced valuations down the rode.

THE MONDAY MORNING CALL

The good news is that you can *"walk, rather than run, to the exit."*•As shown in the chart below, on a very short-term basis the market is oversold and the bounce on Friday was JUST enough to close above the October lows support at 1860. Any continued rally next week should be used to further reduce equity risk and rebalance portfolios.

Unfortunately, we have had a series of failed one-day rallies over the past couple of months, so it is advisable to not try and game the market at this juncture. I continue to suggest taking actions to reduce risk in portfolios by taking the following actions on ANY RALLIES:

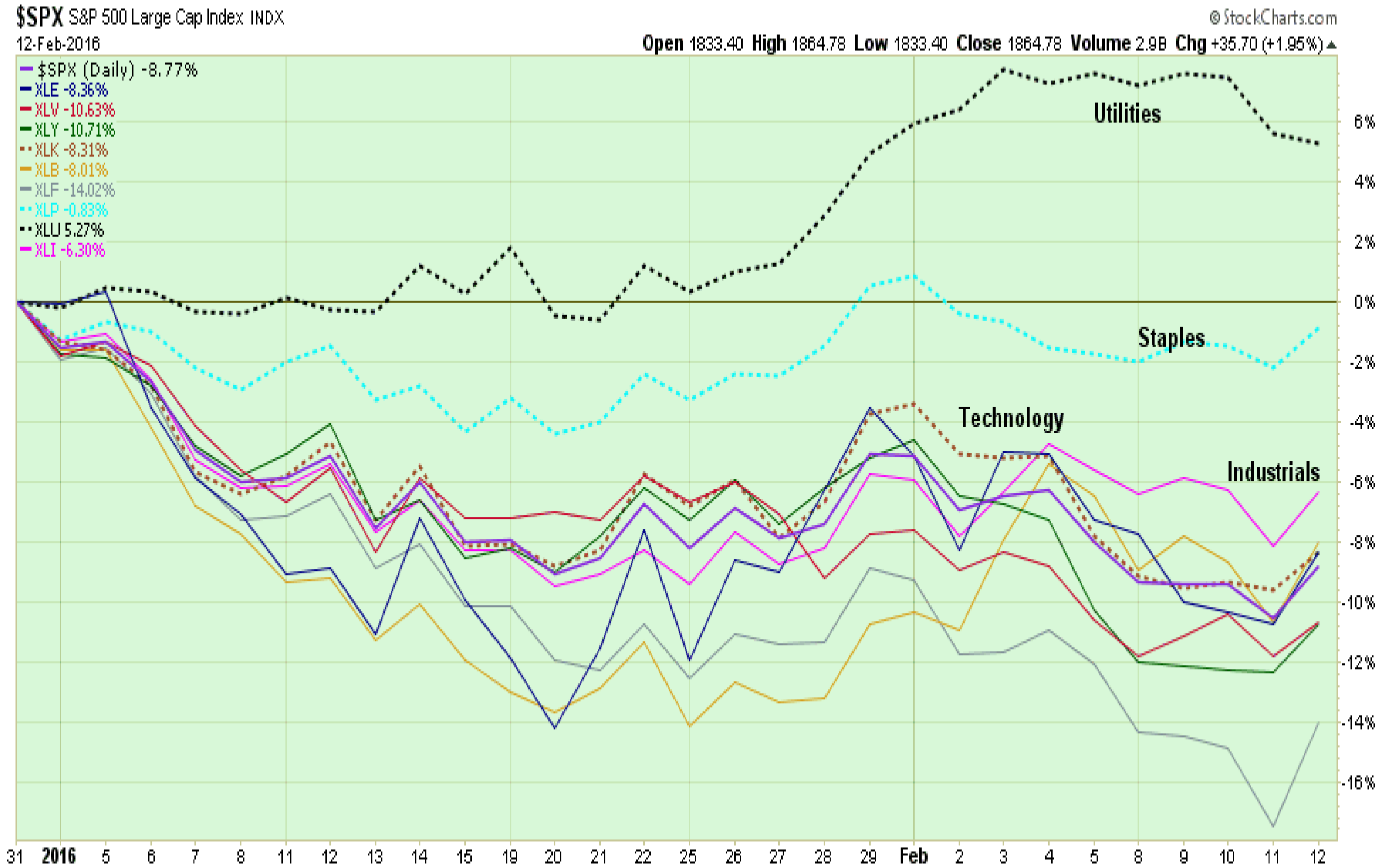
- *Trim back winning positions to original portfolio weights: **Investment Rule: Let Winners Run***

- *Sell positions that simply are not working (if the position was not working in a rising market, it likely won?t in a declining market.)* ***Investment Rule: Cut Losers Short***
- *Hold the cash raised from these activities until the next buying opportunity occurs.* ***Investment Rule: Buy Low***

MOMENTUM TELLS THE STORY

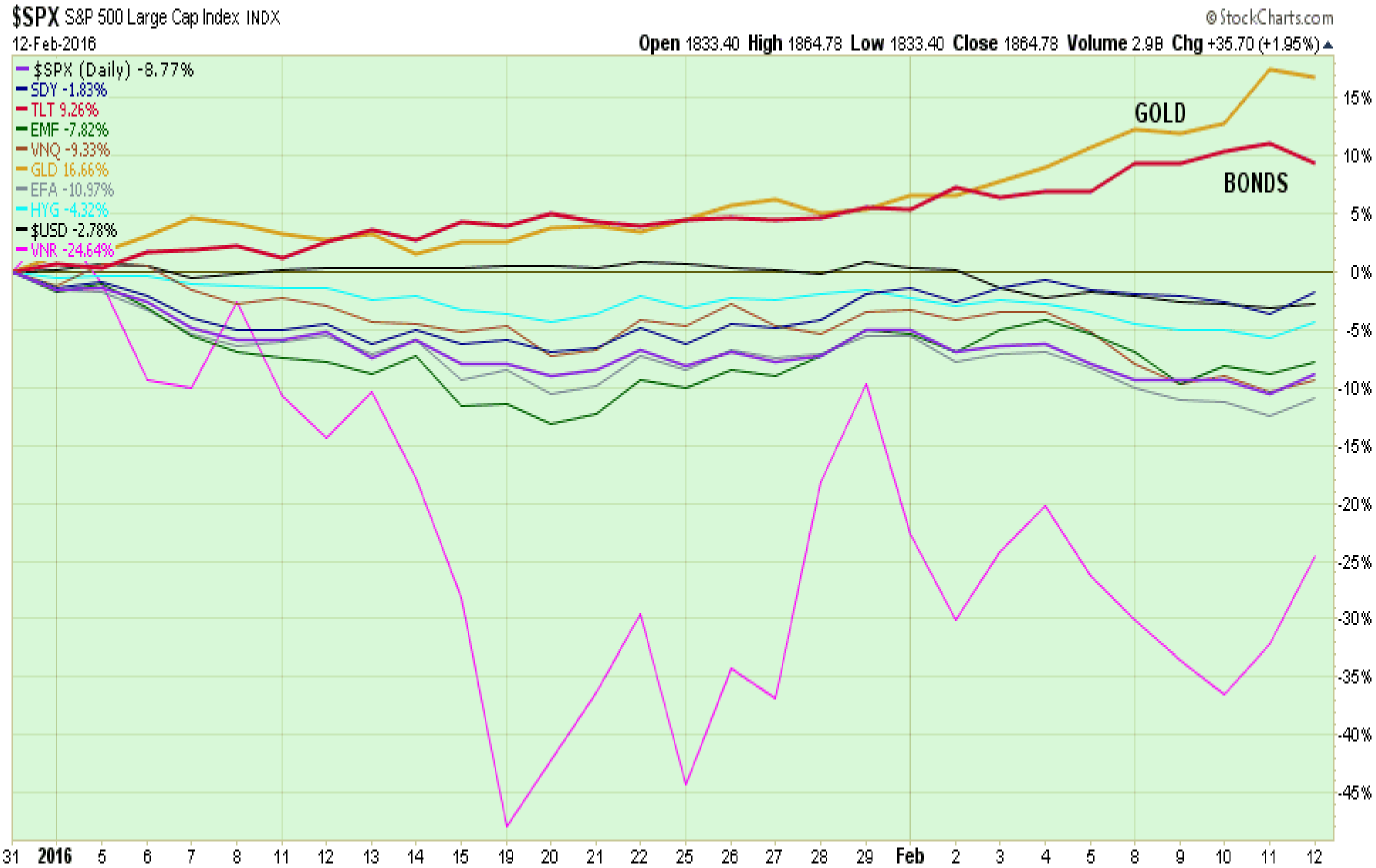
In Gary Antonacci's book, **Dual Momentum Investing**, he combines two measures of momentum into a single portfolio management structure. One of the ideas he lays out is relative momentum which is the price momentum of an asset versus that of another. In effect, it is a measure of relative strength. However, what we do know is that relative strength of an asset versus a comparative index can tell us where opportunities may be available. •The first chart below is each sector of the S&P 500 versus the S&P 500 index. Each sector is divided into the index to provide a relative strength measure. **When the ratio is higher than its 12-month moving average, the sector is outperforming its index and deserves some further attention.** *(Note: I didn't say buy it. I said it deserves further attention and analysis. •This is simply an "alert system.")*

Not surprisingly, we find **Utilities and Staples** leading the charge, with **Technology** beginning to wane. Interestingly, money is also finding its way into Industrials. Hold on a second. This doesn't mean these sectors are making money. It just means they are performing better than the overall index. **Winning by not losing as much, is not winning.**•The chart below shows the price performance of each major sector of the S&P 500 since the beginning of this year.



As suspected, only Utilities have had a positive return on a year-to-date basis. The deterioration in the overall market suggests that there is more pain to come. **Also, money is hiding in Utilities as a safety play.Utilities are extremely overvalued and, like investors found out with MLP's, they are not a replacement for bonds.**•Moving on, let's look at major asset classes in the same manner.

As with Utilities above, we are watching money seek safety inside of *"dividend stocks."* But unlike utilities, dividend stocks are not posting gains overall this year. **What is making money, as *"fear"* rises in the markets, is Gold and Bonds.•**



While Gold has shown some signs of life as of late, it is still too early to add this asset class to portfolios. **At the beginning of 2012, I wrote in this missive that investors should exit Gold.** While Gold is improving, it is still trapped in a long-term downtrend. When the downtrend is reversed the reward/risk ratio will once again be favorable to add this asset class back into portfolios. **Gold is a very speculative and volatile asset class.** Gold is NOT a hedge for inflation. Gold is NOT an alternative currency. Gold will not protect you in an economic meltdown. **For that, you should own•lead with which you can get all the gold you want.•**

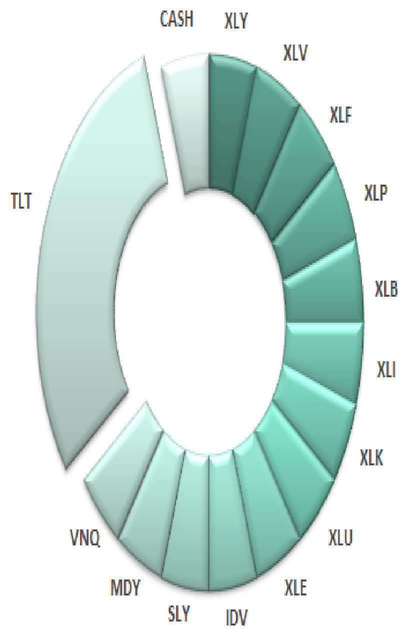
We may be approaching a point soon where gold can be added to portfolios, but that time is not now. Furthermore, **it is important to note that in 2008, as shown above, Gold lost more than 30% of its value during the panic to *"sell out"* of the market. •It was not a "hedge" against the decline.** That will likely happen again if a similar correction in the markets occurs. Overall, this is still a very dangerous market. Deterioration is still prevalent both economic, fundamentally and technically. **Caution is highly advised until a more bullish set-up emerges.•**

S.A.R.M. Model Allocation

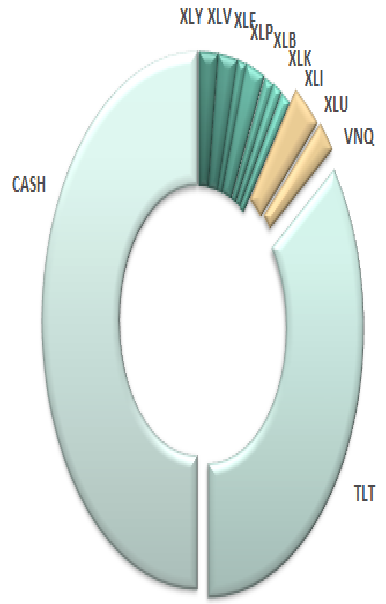
If you are new reader to this missive, [click here and review previous explanations of the S.A.R.M. Model.•]() I have adjusted the model allocation to account for the rebalancing of bonds, REITS, and Utilities in portfolios. We will still want to use the current reflexive rally to take actions to rebalance portfolio models accordingly. **During THIS•bounce** in the market, adjust weightings as follows:

S.A.R.M. Model Allocation (Assume 60/40 Allocation To Equal 401k Plan Manager)

Symbol	Name	Model Weight	SARM Analysis	Adjusted Weight
XLY	Discretionary	5.00%	Weakening	2.00%
XLV	Healthcare	5.00%	Improving	2.00%
XLF	Financials	5.00%	Lagging	1.00%
XLP	Staples	5.00%	Leading	2.00%
XLB	Materials	5.00%	Lagging	1.00%
XLI	Industrials	5.00%	Weakening	1.00%
XLK	Technology	5.00%	Weakening	1.00%
XLU	Utilities	5.00%	Leading	3.00%
XLE	Energy	5.00%	Lagging	0.00%
IDV	International	5.00%	Improving	0.00%
SLY	Small Cap	5.00%	Lagging	0.00%
MDY	Mid Cap	5.00%	Lagging	0.00%
VNQ	Real Estate	5.00%	Leading	2.00%
TLT	Bonds	30.00%	Leading	35.00%
CASH	Money Market	5.00%	--------	50.00%



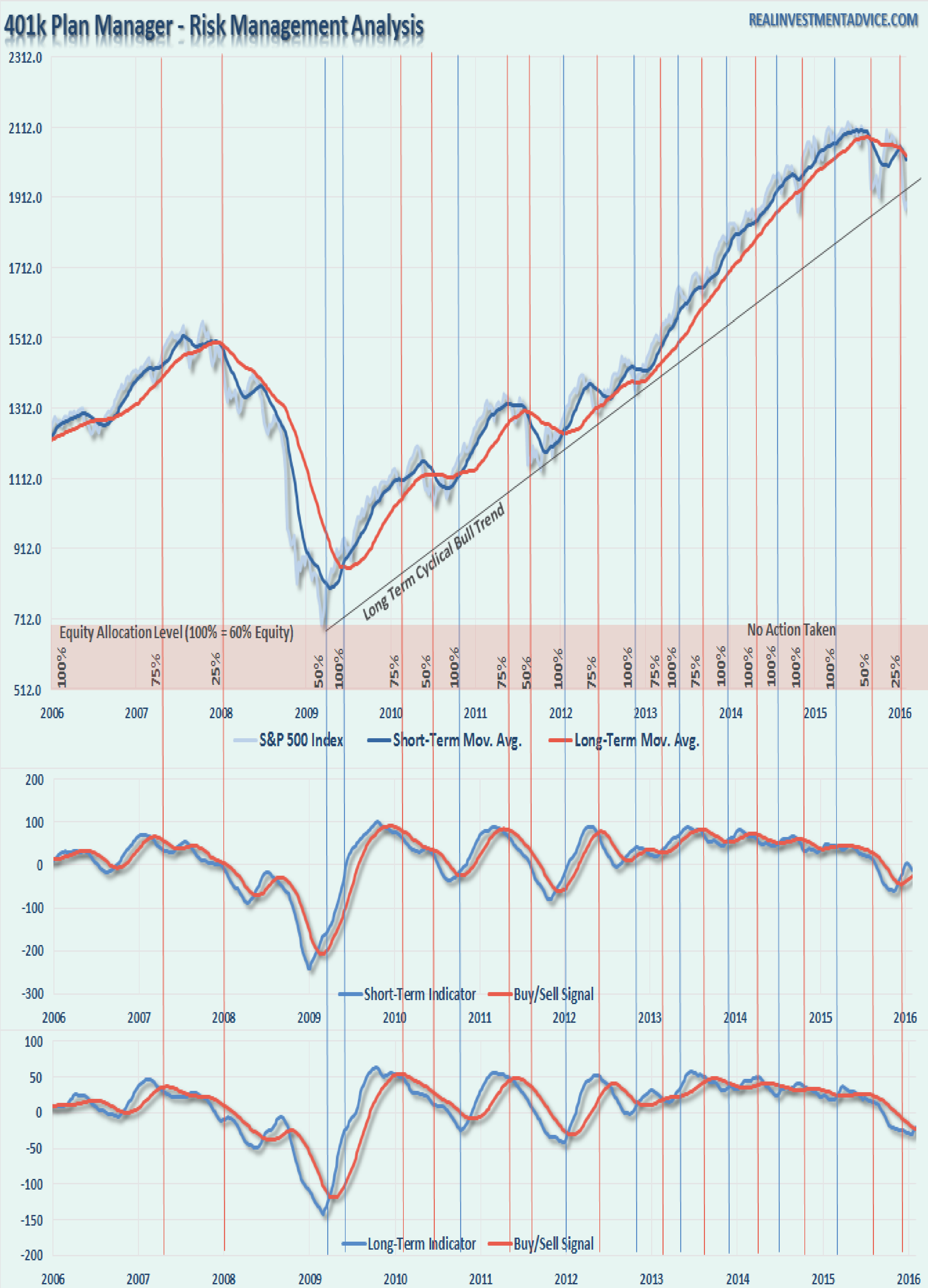
Fully Allocated Model



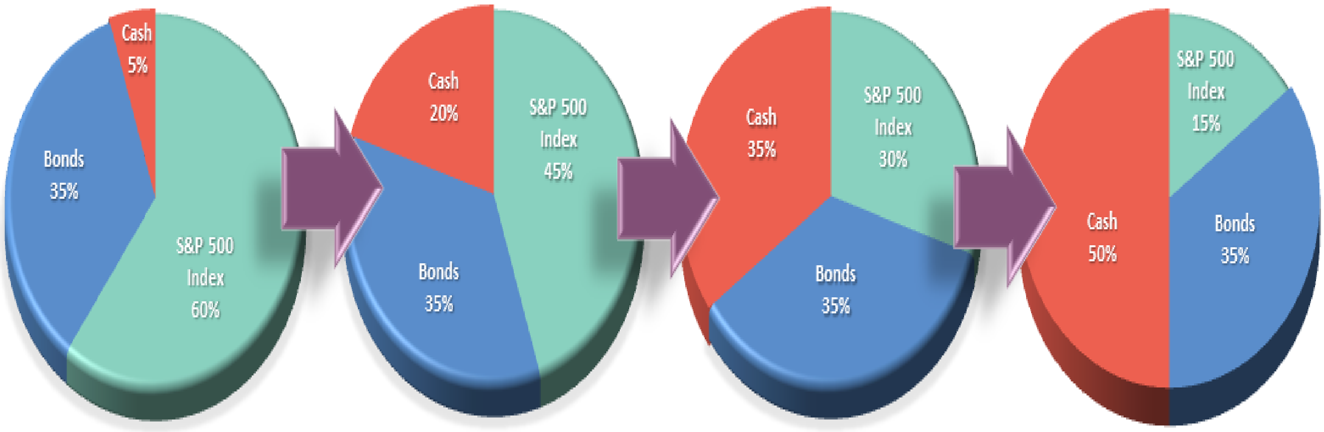
Risk Adjusted Model

During this rally, cash will be increased to•50% of the portfolio from•45%, with 35% in bonds, and the rest in equities. **It is completely OKAY if your current allocation to cash is different based on your personal risk tolerance. This is just a guide.** As you can see, **there are not DRASTIC movements being made.** Just incremental changes to reducing overall portfolio volatility risks. **However, if the expected bounce fails at resistance, then further reductions will be required in accordance with the risk reduction modeling.** Remember, as investors, our job is not to try and capture every single relative point gain of the market as it rises. While we certainly want to participate in the rise, **our JOB is to protect our capital against substantial losses in the future**. A methodology that regularly harvests gains, reduces risk and keeps the portfolio focused on longer-term goals will lead to a more successful outcome.

THE REAL 401k PLAN MANAGER



As you will notice, I never advocate being 100% out of the market. However, I will recommend a market neutral strategy once a confirmed bear market trend is established. As I have discussed many times in the past, it is far too difficult to reverse course when the market changes from a negative back to a positive trend. Emotions keep us from taking the correct action. There are 4-steps to allocation changes based on 25% reduction increments. As noted in the chart above a 100% allocation level is equal to 60% stocks.



TIME TO RAISE MORE CASH

As I have repeatedly discussed over the last couple of weeks, the market has **NOW BROKEN**•the long-term trend support. **A change in TREND is critical** and suggests that the bull market advance that began in 2009 is over. •As shown in the chart above, the technical deterioration is significant. **As stated above, it is now time to raise cash levels and lower equity risk to the final level this coming week.•The current market environment is NOT conducive to an overweight allocation to equity risk currently.** Remember, **it is far easier to add capital back into the markets as opportunities become more visible, rather than trying to figure out how to make up previous losses.**•If you need help after reading the alert; don?t hesitate to contact me
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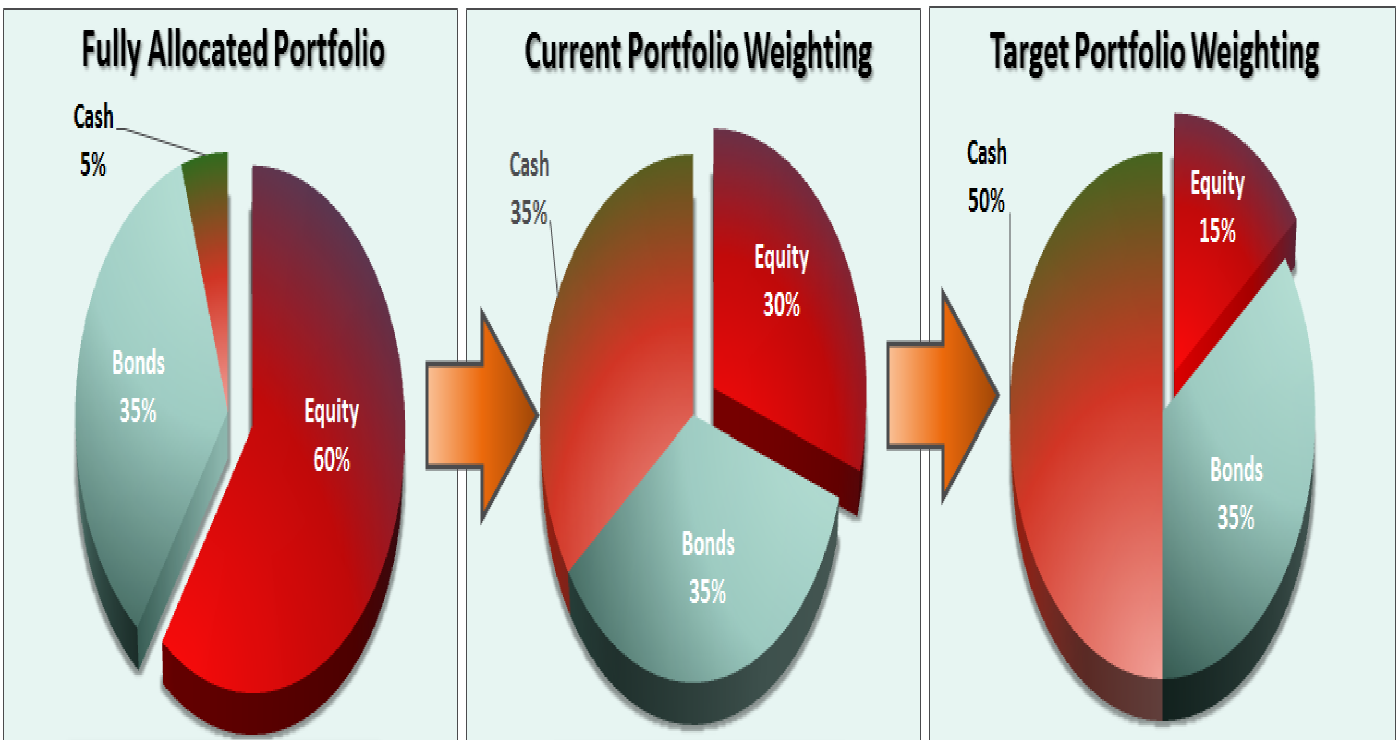
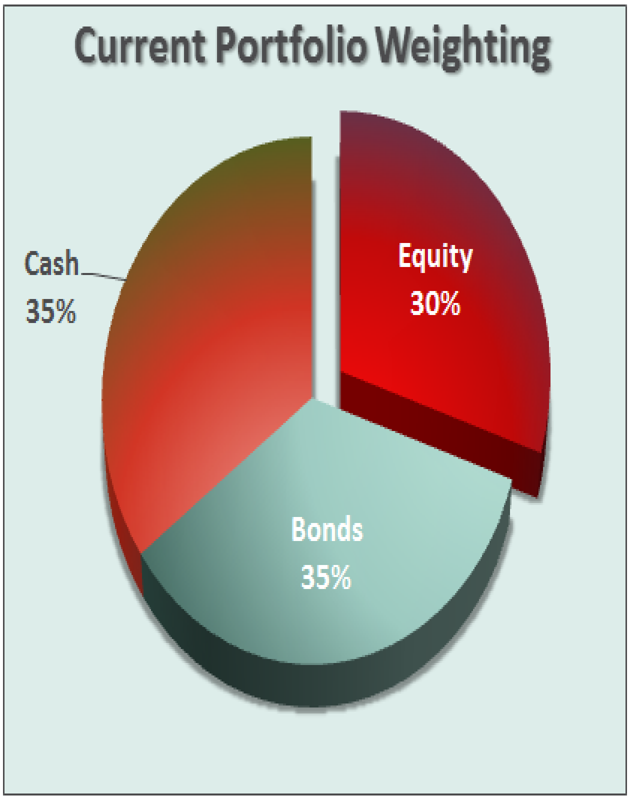
Current 401-k Allocation Model

The chart below shows the transition from a fully allocated 401k plan to the target allocation you want to work towards over the next week.



The 401k plan allocation plan below follows the K.I.S.S. principal. By keeping the allocation extremely simplified it allows for better control of the allocation and a closer tracking to the benchmark objective over time.



Current 401k Allocation Model

35.00% **Cash + All Future Contributions**

Primary concern is the protection of investment capital

Examples: *Stable Value, Money Market, Retirement Reserves*

35.00% **Fixed Income (Bonds)**

Bond Funds reflect the direction of interest rates

Examples: *Short Duration, Total Return and Real Return Funds*

30.00% **Equity (Stocks)**

The vast majority of stock funds track an index.
Therefore, select on ONE fund from each category.
Keep it Simple.

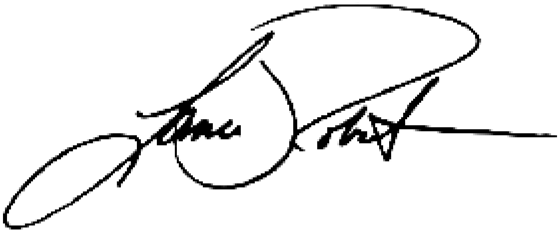
15% Equity Income, Balanced or Conservative Allocation
15% Large Cap Growth (S&P 500 Index)
0% International Large Cap Value
0% Mid Cap Growth

401k Choice Matching List

The list below shows sample 401k plan funds for each major category. In reality, the majority of funds all track their indices fairly closely. Therefore, if you don't see your exact fund listed, look for a fund that is similar in nature.

Common 401K Plan Holdings By Class

Cash	*Stable Value*	**Equity**	
	Money Market	**Large Cap**	*Vanguard Total Stock Market*
	Retirement Savings Trust		*Vanguard S&P 500 Index*
	Fidelity MIP Fund		*Vanguard Capital Opportunities*
	G-Fund		*Vanguard PrimeCap*
	Short Term Bond		*Vanguard Growth Index*
			Fidelity Magellan
Fixed Income	*Pimco Total Return*		*Fidelity Large Cap Growth*
	Pimco Real Return		*Fidelity Blue Chip*
	Pimco Investment Grade Bond		*Fidelity Capital Appreciation*
	Vanguard Intermediate Bond		*Dodge & Cox Stock*
	Vanguard Total Bond Market		*Hartford Capital Appreciation*
	Babson Bond Fund		*American Funds AMCAP*
	Lord Abbett Income		*American Funds Growth Fund Of America*
	Fidelity Corporate Bond		*Oakmark Growth Fund*
	Western Asset Mortgage Backed Bond		*C-Fund (Common Assets)*
	Blackrock Total Return		*ALL TARGET DATE FUNDS 2020 or Later*
	Blackrock Intermediate Bond		
	American Funds Bond Fund Of America	**Balanced Funds**	*Vanguard Balanced Index*
	Dodge & Cox Income Fund		*Vanguard Wellington Fund*
	Doubleline Total Return		*Vanguard Windsor Fund*
	F-Fund		*Vanguard Asset Allocation*
			Fidelity Balanced Fund
International	*American Funds Capital World G&I*		*Fidelity Equity Income*

Lance Roberts  Lance Roberts is a Chief Portfolio Strategist/Economist for Clarity Financial. He is also the host of ?The Lance Roberts Show? and Chief Editor of the ?Real Investment Advice? website and author of ?Real Investment Daily? blog and ?Real Investment Report?. Follow Lance on Facebook, Twitter and Linked-In