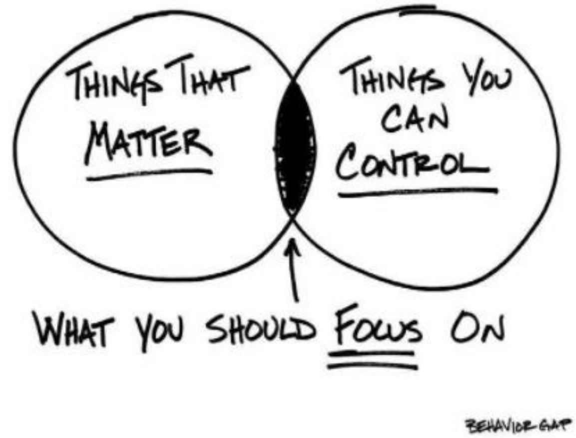
The Next Bear Market

Perhaps you have found yourself asking the following question recently: How is the stock market continuing to increase, hitting all-time high after all-time high, despite the seemingly unending barrage of bad news? Or how about this one? A market decline must be coming soon; what should I do to prepare? Remember that the equity markets will go up and they will go down – and the long-term trajectory is more up than down. Over the past 93 years, the market has had a positive return in 70 years, or 75% of the time. The flip side to this, of course, is that the market had a calendar-year negative return 25% of the time, and we as rational and prudent investors should expect that (even though it may feel scary).

The timing and magnitude of the next bear market will surprise everyone – supposed "experts" and amateurs alike. We certainly will not predict when the next market decline will be – and even if we tried to predict it, we would almost certainly be wrong. Where we focus instead is on ensuring that the structure of your portfolio is exactly right to enable you to achieve your goals over time. This means ensuring that you have the proper mix of stocks and bonds – stocks to create purchasing power (above inflation), and bonds to serve as dry powder for those inevitable moments of volatility and decline (and subsequent recovery… that often seems to be left out of the story). It further means ensuring that we are good adherents to the tenets of behavioral finance, including not trying to time the market, not panicking during market declines or even during increased



volatility, and not pretending we can predict the future. Whether it's the equity market or anything else, we focus on what we can control.

The only way one can be sure to capture a portfolio's long-term return is to ride out equities' temporary volatility. Additionally, when they occur, significant market declines present wonderful opportunities to patiently purchase equities to enhance your lifetime return by acquiring large numbers of bargain-priced shares from those who panic. As strenuous as the emotional demands of a buy-and-hold-and-rebalance approach can be on an investor, it remains the optimal strategy for getting the full returns to which you are entitled.

When the moments of volatility and decline come – whether that is tomorrow, next year, or 10 years from now – remember that since 1926, there have been 17 bear markets and 17 subsequent robust recoveries (see graphic next page) and that the next bear market will have exactly the same result.

The 50-Year Battle for a Better Way to Invest

From David Booth, executive chairman and founder of Dimensional Fund Advisors, a bit about the history of Dimensional, indexing as a strategy, and Dimensional's improvement thereon.

Mac McQuown recruited me to help create the very first indexed portfolio in 1971. I was 24 years old and living in San Francisco, where more people my age were following the Grateful Dead than the stock market. The think tank Mac set up felt like a start-up, although it was long before anyone would use that term. We were excited by the opportunity to turn academic research into a new way of investing. Many people thought we would fail. Some even called what we were trying to do "un-American."

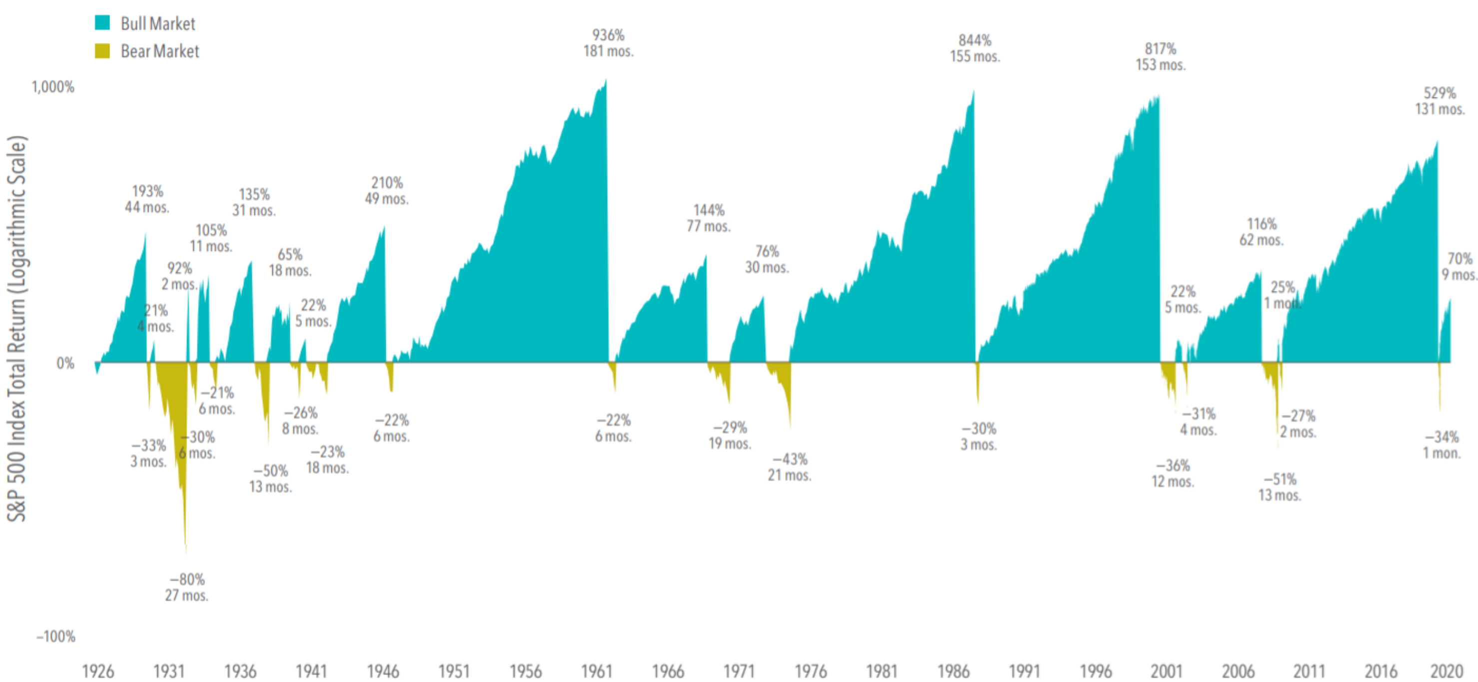
But we didn't worry about the attacks; we focused on how indexing could improve the lives of investors. The fund offerings available at the time were actively managed portfolios that tried to outguess the market and were expensive, lacked diversification, and performed poorly. So-called star managers sold investors on their ability to win against the market; they sold products as opposed to solutions. Problem was, there was no compelling evidence they could reliably beat the market. We were confident that indexing – a highly diversified, low-cost investment solution that relied not on a manager's ability to pick winners but on the human ingenuity of hundreds or thousands of companies – would change lives for the better.

Fifty years later, $9.1 trillion is invested in index mutual funds and exchange-traded funds (ETFs). This represents 51% of the total $17.9 trillion in equity ETFs and mutual funds. Six of the original academic consultants Mac hired to work on that first index fund went on to win Nobel Prizes. I have worked with four of them at Dimensional.

When we started Dimensional in 1981, indexing was beginning to catch on. But the primary index used was the S&P 500, made up of 500 of the largest companies in America. My colleague Rex Sinquefield and I thought investors could be better served by adding small-capitalization stocks to the mix since they were underrepresented in portfolios and offered diversification and expected return benefits. We were the first to treat small-cap companies as a separate asset category. It was an exciting idea, but it made many people nervous. An academic paper circulated saying the performance of small-cap stocks couldn't be captured because of

17 Bear Markets … and 17 Recoveries

S&P 500 INDEX TOTAL RETURNS
January 1926–December 2020



trading costs. Many academics, even those who worked with us, were skeptical that we could deliver on our big idea of creating a small-cap strategy. After 40 years of results, the skepticism about our ability to deliver has subsided.

There was perceived risk in trading against professional investors who might take advantage of us with all their knowledge and experience. But we found a way to turn trading to our advantage: flexibility.

Flexibility is one of the key differences between index investing and Dimensional Investing and where so much of our innovation has taken place. Because we weren't beholden to tracking any particular index, we could harness the power of markets and even beat the indices. The protocols, systems, and teams we've developed – as well as the experience we've accumulated – have been shown to be applicable to a wide range of strategies, from fixed income to value to international investing.

So what happens next? Where will we be in 50 years? I've built a career in finance without making predictions, but I do believe that technological innovation is lowering barriers to entry for everyday investors and enabling greater personalization. In 1971, there was one index fund. In 1981, there was one small-cap strategy. Today, investors have more access to customized portfolios than ever before.

For me, working in finance has always been about improving people's lives. We created indexing to improve upon stock picking. We created Dimensional to improve upon indexing. Each day, we strive to help our clients in new and better ways. That's why I thought 1971 was the most exciting time to be in this business. Then I thought 1981 was the most exciting time to be in this business. But the truth is, it's every day, as long as we're able to keep helping people in innovative ways.

Flood Insurance 101

We recently have seen natural disasters such as tornados, hurricanes, and tropical storms becoming more severe in areas that have not seen weather events of that magnitude in recent memory. Front and center, of course, is Hurricane Ida, which led to significant devastation not only along the coast but locally in communities across Pennsylvania and New Jersey. Some of you may be asking what homeowners insurance covers, what flood insurance covers, and whether or not flood insurance is advisable for you. Your team at Rockwood, in coordination with best-of-class insurance agents, will certainly recommend the optimal coverages for you, but we also want to highlight some key points for your information:

- **What is the definition of "flood"? "**Flood" is defined as the temporary condition of water covering two or more acres of normally dry land or covering two or more properties. Flood waters can be from overflow of water (either inland or tidal), unusual and rapid accumulation, or runoff of surface water or mudflow. Flood water can also come from the collapse or subsidence of land along the shore.

- **What is the cost of flood damage?** According to the Federal Emergency Management Agency (FEMA) website, FEMA.gov, one inch of floodwater can cause up to $25,000 in damage to dwelling and contents.
- **What does a flood insurance policy cover?** The most common flood policy is purchased through the National Flood Insurance Program (NFIP), which is part of FEMA. This policy provides coverage for residential properties and has a maximum limit of $250,000 for dwelling coverage and $100,000 for contents; note that contents in the basement are not covered. If the standard NFIP policy does not provide enough coverage to protect your assets, you can purchase excess flood insurance for up to the full replacement cost of your home.
- **How do flood insurance and homeowners insurance work together?** Typically, homeowners policies specifically exclude damage caused by flood. A good homeowners policy will have coverages for other water-related causes of damage, such as sump pump failure or sewer/drain backup.
- **Does flood insurance cover my barn, garage, shed, pool house, etc.?** Flood insurance extends dwelling protection to other structures, subject to a 10% limit. As an example, if you had $250,000 in dwelling coverage for your residence (the maximum under the NFIP policy), your barn would be covered for $25,000. If this level of coverage is not sufficient, you can obtain a separate policy.
- **In the event of another Ida, what should I do?** We recommend contacting your insurance agent directly, as she or he will be able to advise on what falls under each of your homeowners and flood policies in order to maximize your recovery and minimize the inconvenience to and burden on you.

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