Bear Market Insurance
With markets in turmoil, a prophet of doom has reason to feel vindicated. But is his fund a prudent investment?

By Bob Frick

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David Tice says he'd like to be a bull, he really would. "I'm generally an optimistic person," says Tice, the manager of the Prudent Bear fund. But in his view, the U.S. economy is finally paying the piper for an 18-year-long credit bender, a wanton borrowing binge that's pumped up the price of everything from stocks to houses. As Tice sees it, the credit bubble is finally, inevitably, ending in a financial hangover that will paralyze the markets, chop stock prices in half and last as long as the Great Depression.

Most economists and market prognosticators don't buy into Tice's dire forecast. Sure, we're probably in a recession, and stocks are perilously close to bear-market territory. But most experts believe that the bear market and recession will be relatively short-lived and that the next expansion and bull market will get under way soon. As far as Tice is concerned, however, those Pollyannas have "drunk the Kool-Aid" of blind optimism.

These are heady times for Tice, an intense but affable man who speaks with a Texas drawl. Although his is still a minority view, more of his critics are coming around to the notion that the U.S. is sitting atop a massive and dangerous credit bubble. And his fund (symbol BEARX), which beat the stock market by eight percentage points in 2007, is crushing the market so far this year by 16 percentage points.

Not all 50-odd bear funds are created equal. Most are inverse index funds -- that is, they are designed to track a particular market benchmark in reverse. For example, Direxion Nasdaq-100 Bear 2.5 X -- which is designed to return two and a half times the inverse of the Nasdaq 100 index -- topped the roster of mutual funds the first ten weeks of 2008 with a gain of 63%. It lost 36% in 2007.

A handful of bear funds invest actively and even try to make money when stocks rise. Prudent Bear eked out an annualized return of 1% over the past five years to March 10, even as Standard & Poor's 500-stock index gained 11% a year. Over that period, no other actively managed anti-market fund came close to matching Prudent Bear's numbers. For example, Grizzly Short lost 9% annualized, and both Comstock Capital Value and Comstock Strategy lost 11% to 12% annualized.

Longer term, Prudent Bear's record shines in market down years and stinks in up years. From 1996 (its first full year) through 1999, the fund never trailed the S&P 500 by fewer than 37 percentage points in any single year. During the 2000-02 bear market, in which the S&P 500 lost 47%, the fund earned 166%.

How it works

Prudent Bear has three basic strategies. It bets against the entire market by selling short index futures and buying put options on indexes. It also sells short individual stocks (short-sellers borrow a stock, sell it and hope to buy it back at a lower price). Finally, Prudent Bear invests in precious-metals stocks, a traditional hedge against political instability, rising inflation and a weak dollar. At the moment, the $1.2-billion fund has about 10% of its assets in precious-metals stocks. These investments are probably the main reason for the fund's positive results over the past five years, during which the Dow Jones Precious Metals index returned 24% annualized.

The fund bets against individual stocks, too. Some of the fund's short sales are a product of Tice's big-picture analysis. For example, he shorted H&R Block last year because he felt the tax preparer owned a time bomb in its Option One mortgage business. Tice shorts other companies because he doesn't like some part of their business. For example, a company may have too much debt or may be growing too rapidly.

During the past year, companies shorted by Prudent Bear for such reasons included Cheesecake Factory, Harley-Davidson and Urban Outfitters.

What makes a good short? Step into the conference room at the Dallas office of David W. Tice & Associates one Tuesday morning. An analyst proposes that the fund short a communications company with a major customer on the skids, a heavy debt load that needs to be refinanced, slowing growth and, best of all, a "buy" recommendation from every Wall Street analyst who covers it. The icing on the cake is that the company (whose name has been withheld at Tice's request) continues to expand its business. Tice decided to short the stock.

Shorting stocks is risky business because so much can go wrong. One thing going wrong this day is that several of Prudent Bear's shorts are rising because of short squeezes. Tice and his market strategist, Doug Noland, figure that hedge funds are being forced to buy stocks that they had previously shorted. Their buying pressure is pushing up share prices.

Squeezes, general market rallies and a half-dozen other twists can singe bears in a flash. Tice calls Noland his "minister of defense" because he's adept at tiptoeing among these market crosscurrents. "What we do is tough, and there's no miracle strategy," says Noland.
Do you need one?

If bear funds are so risky, what is the point in owning one? Using a bear fund to time the market successfully -- jumping in when you think prices are poised to tumble, bailing out when you think stocks are ready to rebound -- is a tricky, if not impossible, business.

Morningstar analyst David Kathman says investors can best use bear funds to cushion their portfolios against big losses. But, he adds, you should "use them only as a small part of your portfolio -- maybe 5%."

Some advisers say no to Prudent Bear in particular. "Who is to say that Prudent Bear will conveniently guess just the right amount of common stock to short and the right amount of gold stock to go long?" asks Don Martin, of Mayflower Capital, in Los Altos, Cal.

The fund is also expensive. Its annual expense ratio is 2.33%, well above the average of 1.34% for diversified U.S. stock funds. In addition, critics say the fund is too volatile -- about 70% more than the S&P 500 over the past ten years. But adding Prudent Bear to a portfolio otherwise loaded with stocks reduces volatility. Consider a package that has 30% in Prudent Bear (that's the amount Tice recommends) and 70% in an S&P 500 index fund. Over the past decade, the portfolio would have returned an annualized 4% -- one percentage point per year less than the S&P -- but would have done so with 43% less volatility.

The most powerful argument against owning Prudent Bear, or any bear fund, is market history. Over the long term, stocks deliver higher returns than other investments. The stock market, on average, rises seven years out of ten, and bear markets are generally short-lived. So if you're a long-term investor with a well-diversified portfolio, you'd have to believe the market was heading for long-term trouble to justify owning a bear fund. But with recession looming, credit markets imploding and stocks sinking fast, now is a good time to ask: Who's drinking the Kool-Aid, the bulls or Tice?

After spending a day with Tice, you believe he's sincerely pessimistic. Tice, 53, admits that his focus on the underbelly of publicly traded companies was initially a business decision. After earning an accounting degree and an MBA from Texas Christian University, he worked several jobs in finance before moving to New York City, where he sold the Behind the Numbers research service in 1988. Starting the service, which recommends companies to short and which he sold several years ago, was "really a decision based on supply and demand," says Tice. "I saw all these buy recommendations and very few sell recommendations."

Tice launched Prudent Bear in 1996, the same year that then-Federal Reserve chairman Alan Greenspan made his famous "irrational exuberance" speech. Greenspan wondered aloud whether a mania was driving prices of stocks and other assets so high that the inevitable bursting of the "financial asset bubble" would bring down the economy at the same time.

Easy credit run amok

Tice says he couldn't have said it better himself. But instead of putting the brakes on the economy, Tice says, the Fed "let the good times roll," endorsing a policy of easy credit that helped push asset prices even higher.

Tice admits to looking "pretty stupid" starting a bear fund in the middle of a massive bull market (U.S. stocks returned 18% annualized in the 1990s, their best decade ever). When tech stocks started collapsing in 2000 and the bear emerged, the Chicken Little jabs at Tice stopped -- for a few years, anyway. But in 2003 he predicted that the credit bubble would burst and that the day of reckoning was at hand. The market disagreed and surged 29% that year.

What Tice didn't count on, he says, was that easy credit in the housing market would create yet another bubble: the subprime-mortgage bubble. Feeling flush because of ever-rising home prices, Americans continued to pour more money into stocks, boosting share prices. "We bears underestimated the financial system's ability to lend money to deadbeats," says Tice.

Although the subprime-mortgage market began deflating in the spring of 2007, other excesses allowed the credit bubble to keep inflating, Tice says. For example, investment firms, including Wall Street brokerages, hedge funds and private-equity funds, continued to raise debt to finance takeovers and mergers. This kind of lending "kept the financial alchemy going," says Noland.

In the Prudent Bear worldview, much of the financial system is rotten. The subprime bubble was the first domino to fall. Now, lending by banks and brokerage firms has dried up. Tice predicts that as credit disappears, corporate profits will sink, more firms will go bankrupt, layoffs will rise, home equity will dry up, and stock prices will fall. A steep recession -- or worse -- could last ten years, he says.

Critics agree with Tice to a point, but they part company on how the debt crisis will play out. Economist Ed Yardeni concedes that the economy is going through "a pretty painful transition." But instead of Tice's vision of an excruciating Great Unwind, Yardeni sees the credit crisis as a game of Whac-A-Mole: As problems arise, the authorities will beat them down. The Fed, for example, keeps pumping money into the financial system to keep the credit markets operating. Other parts of the government are leaning on mortgage lenders to tighten standards and at the same time cut breaks for overextended homeowners.

Further, says the perpetually optimistic Yardeni, consider the source. The Prudent Bear's managers are "biased and they exaggerate," he says. "These guys get it right every 4 years or so for 6 to 12 months. What's annoying is that when they're right, they make their scenario even grimmer."

Maybe so. But it's hard not to believe Tice when he says he'd like nothing more than for America to manage its finances sensibly. When that happens, he pledges, "we could go to shareholders and say, 'You know, we can become the Prudent Bull fund.'"

http://www.kiplinger.com/magazine/archives/2008/05/prudentbear.html?kipad_id=1

INVESTING

How Much Risk Are You Willing to Take?

PERHAPS YOU have all of your assets in a money-market fund because you fear losses in the stock market. Although your money is safe, you won't keep up with rising prices over the long term because of another peril—inflation risk. So how much risk, and what type of risk, should you take in your investments? The answer ultimately is an individual choice, but there are some general guidelines.

First, recognize that you can't avoid all risk in investing, but you can manage it. Investors face several types of risk, including inflation risk and credit risk, which is the chance that a bond issuer might default. Another is event risk, which is the peril of unforeseen happenings, such as when Apple's iPods made portable CD players obsolete.

Inflation risk can be tamed by having a sufficient allocation to stocks or to mutual funds that invest in them. Over time, stock market returns have outpaced inflation. You can mitigate credit risk by owning a diversified bond portfolio in a mutual fund or exchange-traded fund. By holding the debt of multiple issuers, you reduce the effect of any single default. Alternatively, you can own U.S. Treasury securities, which are backed by Uncle Sam. Event risk can be controlled by owning equity mutual funds that invest in a wide variety of industries.

Probably the peril that investors fear most is market risk—the hazard that the entire market heads south, taking your nest egg with it. In the short term, market risk is very real. Take the 1929 stock market crash, for instance. From the end of 1928 through 1932, stocks lost 71.7% of their value.

But the longer you hold stocks, the less risky they are. Research firm Ibbotson Associates looked at every rolling ten-year period from 1926 (there have been 72 so far: 1926–35, 1927–36 and so on) and discovered only two in which Standard & Poor's 500-stock index posted an average annual decline. Both were during the Depression. The worst average annual return was -0.89% in the decade ended 1939.

Of course, no one wants to lose almost 1% a year for a decade. But if you build your portfolio with different types of assets, some investments will zig while others zag. Ibbotson examined the same 72 rolling ten-year periods with a portfolio of 50% stocks and 50% long-term bonds. The result: not a single losing period. The worst average annual total return was 1.99%, in the ten years ended 1974, while the best was 16.96% in the ten years ended 1991.

Similarly, in rolling 13-year time periods over the past 50 years, a mix of 80% stocks and 20% intermediate-term government bonds has produced an average 10.7% annual return, according to Stuart Ritter, a planner at T. Rowe Price. The worst 13-year period posted a 3.6% annual return.

Assessing Your Risk Tolerance

Financial planners often spend a lot of time with clients discussing their risk tolerance. Planner Don Martin, of Mayflower Capital, in Los Altos, Cal., says that most new clients say that they are not afraid of taking risks. "People will say that to save face," he says. Martin gives clients a questionnaire designed to get beyond their automatic responses.

Ritter says that the client's time horizon should be the main factor in determining asset allocation. The closer you are to whatever you need to use the asset for, he says, the less risk you can afford to take.

To assess your own risk tolerance, Rutgers University has an online quiz (**www.njaes.rutgers.edu/money/riskquiz**) that can help. After you answer a series of questions regarding hypothetical investment possibilities, you'll receive a score that shows your tolerance for risk. The assessment then suggests various categories of investments.

Remember, if your portfolio is tilted toward "risk free" money-market funds, it will take longer to reach your goals. As Adam Smith wrote in *The Wealth of Nations,* "The ordinary rate of profit always rises more or less with the risk." **K —JOSEPH LISANTI**

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Turn Your Nest Into a Retirement Nest Egg

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Regarding how a reverse mortgage fits into your long-term financial picture:

…Many financial planners also say there's little point in paying the fees for a reverse mortgage and then buying an annuity. "Most annuity companies charge way too much in annual fees and in initial commissions," says Donald Martin, a certified financial planner with Mayflower Capital, in Los Altos, Calif. …

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