

# ARE WE IN A BULL MARKET BEGINNING OR A BEAR MARKET CORRECTION?

By Mark Hulbert

Since March, small-cap growth stocks have outperformed small-cap value stocks by an average of 89 basis points per month. This is more reminiscent of the speculative behavior prior to major market tops than the beginning of a new bull market.

Does the rally that began this past March represent the beginning of a new bull market? Or is it merely a correction within an on-going bear market?

There is no consensus answer to these questions among the investment newsletters monitored by the Hulbert Financial Digest. But a few newsletter editors have suggested that this issue can be analyzed by comparing market leadership in the current rally with the investment styles that have led the way out of prior bear markets.

I took these newsletter editors' suggestions to heart in preparing this column. And what I found was a significant difference between how this stock market has behaved since March, and how it behaved at the end of each of the prior bear markets.

## THE DATA

For these comparisons, I relied on historical data compiled by finance professors Eugene Fama and Kenneth French, of the University of Chicago and Dartmouth (available at [http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data\\_library.html](http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html)). The database contains the monthly returns back to mid-1927 of various investment styles based on stocks' market capitalizations and where those stocks fall on the spectrum of value versus growth.

For my study, I focused on the major bear markets that have occurred since the beginning of their database, encompassing 80 years. I defined a bear market as a peak-to-trough decline that lasted more than 12 months and during which the average stock lost more than 20%. Over this time period, there were five of these major bear markets, not counting the one that began in 2000:

- 1) 1929 through 1932, 2) 1940 through 1942, 3) 1968 through 1970, 4) 1973 through 1974, and 5) 1980 through 1982.

On average, these five bear markets lasted 2½ years and brought the stock market down by nearly 50%.

In the most recent bear market, in comparison, the Wilshire 5000 total return index declined by nearly 46% from the March 2000 market top to the October 2002 market low.

## COMPARISONS

Table 1 reports how the various investment styles performed over the six months prior to the beginning of each of the five bear markets starting in 1929, as well as over the six months after the bear markets' end.

Several distinct patterns emerge. Over the six months prior to bear markets—in other words, at bull markets tops—growth stocks typically perform much better than value stocks. This has been true both among large-cap and small-cap stocks.

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**TABLE 1. INVESTMENT STYLE PERFORMANCE AROUND BEAR MARKETS\* VS. TODAY'S MARKET**

Investment style performance before and after major bear markets\* between 1929 and 1982, compared to today's market (March through August 11, 2003).

	Large Cap			Small Cap		
	Growth	Value	Value's Advantage	Growth	Value	Value's Advantage
	(Monthly Average %)					
Entire Period: June 1927 to June 2003	0.92	1.21	0.29	1.06	1.48	0.42
Before Bear Market: 6 months prior to market top	2.49	1.35	-1.14	3.17	0.95	-2.22
After Bear Market: 6 months after market bottom	5.74	6.86	1.12	6.67	7.34	0.67
Today's Market: March 11 to August 14, 2003	4.27	4.58	0.31	6.66	5.80	-0.89

\*Declines lasting for longer than 12 months and in which average stock declined by more than 20%.

Source for all data except 2003: Prof. Eugene Fama (University of Chicago) and Prof. Kenneth French (Dartmouth). Source for 2003 data: Performance of the Russell 1000 Growth & Value and Russell 2000 Growth & Value indexes.

What makes this pattern particularly noteworthy is that it is significantly at odds with how these styles have performed at other times. Notice from Table 1 that, over the entire 76 years from mid-1927 to mid-2003, value outperformed growth in the large-cap sector by an average of 29 basis points per month, and among small caps by 42 basis points per month (equivalent to annualized differences of 3.5% and 5.2%, respectively).

The advantage growth stocks have just before the start of a bear market is also in contrast to their distinct disadvantage as bear markets are ending (and bull markets are beginning). In Table 1 you can see that, on average over the six months after the bottom of major bear markets (at the beginning of bull markets), value has exhibited a big advantage over growth, among both large- and small-cap stocks. The advantage that value has over growth at the end of bear markets is significantly greater than the long-term average advantage.

These patterns are not particularly surprising. Speculative excesses typically characterize bull market tops. That's when investors pay the least attention to companies' balance sheets. Growth stocks—i.e., those trading at the highest ratios of

price to book value—will be more popular than value stocks.

At the end of a bear market, however, investors tend to favor companies that are trading for low price-to-book ratios. These are the companies with the strongest balance sheets, and thus the ones best able to survive during troubled economic times. As the market shifts from a bearish posture to a bullish one, investors are more likely to invest in these stocks than in growth stocks.

### THE CURRENT MARKET

Where do we stand now, relative to this historical cycle?

There are distinct differences between how stocks have performed since March and how they have performed emerging from prior bear markets. As you can see from Table 1, value stocks have not been nearly as strong since March as they have been after previous bear markets.

Among large caps, for example, value stocks have performed no better than their long-term average (a 31 basis points per month advantage over growth stocks, almost identical to the 76-year average of 29 basis points per month). By the same token, since March their monthly average performance advantage over growth stocks has

been 81 basis points less than during the six-month periods following prior bear market bottoms.

This pattern is even more dramatic among small-cap stocks. Since March, small-cap growth stocks have outperformed small-cap value stocks by an average of 89 basis points per month. This is more reminiscent of the speculative behavior prior to major market tops than the beginning of a new bull market.

Does this analysis guarantee that the rally that began in March will quickly fizzle?

Of course not. But the analysis does imply that the October 2002 market lows are not the final lows of the bear market.

A good historical analogy might be to the early 1970s. Following a serious decline that ended with the Dow at 631 in May 1970, the stock market rose by more than 60% over the next 18 months. But it was a very speculative rally, with an inordinate amount of attention going to growth stocks such as those that were part of the so-called Nifty Fifty.

That rally proved to be unsustainable, and it created the preconditions for the 1973-74 bear market. The Dow didn't hit its final low of that multi-year decline until December 1974 when it hit 578. ♦