Bracing for the **Inevitable** Bear Market

(It Is Coming Soon!)

After a good long run with the bulls, mounting evidence shows that the U.S. stock market is treading on bear territory. **How should investors prepare?**

KERNS

ACTIVATE YOUR PORTFOLIO

EXECUTIVE SUMMARY

When the market delivers positive returns, it is easy for investors to start thinking the good times will never end. But even during these uptrends, investors should be thinking long-term about how their portfolios are prepared to perform during the next type of market, because it will strike – often with little warning.

This white paper outlines the steps to building a responsive portfolio that's prepared for a variety of market scenarios – good and bad. **We believe a bear market is coming sooner rather than later, so there's no better time than now for investors to construct a portfolio that's flexible enough to potentially capitalize on a market downturn yet quickly participate when the market rebounds once again.**

TABLE OF CONTENTS

3 | Defining a Bear Market
4 | Developing a Plan
4 | Building the Right Portfolio
6 | Advantages of Active Investing During Bear Markets
7 | Getting Back into the Market

When the market delivers positive returns, investors often tilt their portfolios toward riskier investments like high-flying equities. It is easy to start thinking the good times will never end. But even during these bull markets, it is important to be long-sighted and remember that markets are cyclical.

No matter whether the bulls or the bears currently rule, investors should consider how their portfolios are prepared to perform during the next type of market, because it will strike – often with little warning. This means building a portfolio that may: a) reap the benefits of a rising market, b) react in a timely manner to protect assets during a declining market, and c) get off the sidelines quickly when a new bull market begins.

After a good long run with the bulls, mounting evidence shows that the U.S. stock market may be treading on bear territory. There is no better time than now for investors to ensure their portfolios are ready.

Defining a Bear Market

Most experts agree that a downturn of 20% or more in multiple broad market indexes – such as the Dow Jones Industrial Average, Standard & Poor's 500 Index, and NASDAQ Composite – over at least 60 days constitutes a bear market.

Using that definition, the U.S. stock market has seen 25 bear markets since 1929, lasting an average of 10 months. The average stock market loss during these downturns was 35%, but they have ranged from 21% (1949) to 62% (November 1931 – June 1932). The two bear markets today's investors are likely most familiar with are the ones that brought a 58% decline from 2000 to 2002 and a 57% decline from 2007 – 2009.

What is a Market Correction?
Temporary market declines of 10% or more during an uptrend usually suggest corrective action. The market naturally adjusts to an overvaluation of assets. If the market downtrend lasts less than two months and does not exceed 20%, it is considered a correction, not the start of a bear market.

Bear markets are difficult to predict and can occur due to a wide variety of reasons, such as political events, weak economies, or liquidity issues. A major factor that often turns a market correction (a temporary market decline of at least 10% during a market uptrend) into a bear market is investor sentiment. Investors try to guess what other investors are thinking. If a shareholder thinks others are selling to get out of assets before they lose more value, he or she sells as well. And so the mass sell off begins, further depressing stock prices.

Though pinpointing the start of a bear market is impossible, they are inevitable. And statistically, we are due for one in the very near future. Historically, bear markets occur every 3.5 years, but the most recent one started in 2007. Since a bear market may be lurking soon, how should an investor prepare?

Developing a Plan

Since bear markets are inevitable and every investor is likely to experience several, investors should ensure their portfolios are prepared for them.

During periods of prolonged bull markets, many investors get complacent. Either they have yet to experience a significant downturn or they have forgotten how painful one can be. They abandon the notion of planning for a plunge and invest as if the markets will continue to rise. Conversely, other investors are so stung by the last decline that they re-enter the market reluctantly and tardily after fleeing for perceived "safe" investments like cash or gold. These investors miss out on a sizable portion of the eventual upturn. The moral here is that a portfolio should be flexible enough to potentially capitalize on both bear and bull markets.

Mathematics of Declines	
Investment Loss	Investment Gain Required to Break Even
7%	8%
25%	33%
33%	50%
50%	100%
75%	300%
90%	900%

The chart above illustrates the corresponding investment gain required to make up an investment loss. For example, if an investor's portfolio were to decline in value by 50%, he or she would need to earn an investment return of 100% on that remaining value, assuming now additional deposits, just to get back to where they started.

Stock market losses can be devastating and life changing, especially for investors with a shorter time horizon who do not have time to try and make everything up during the next bull market. Since they may rely on their investments for everyday living expenses, a catastrophic decline can significantly alter their lifestyle.

Investors who are not prepared for a downturn may panic and make irrational investment decisions when a bear market occurs. It is never wise to invest based on emotion. Investors who do may sell everything and go to cash at or near the market low point, essentially buying high and selling low – one of the biggest blunders of investing. They make this mistake because they do not have a portfolio they trust to minimize losses during market downturns while still participating in the upside.

Building the Right Portfolio

What type of assets should investors hold to give them the best opportunity to minimize bear market losses and maximize bull market returns?

Portfolios should be well-diversified. This strategy works – but it has to be the right type of diversified assets. Traditionally, a diversified portfolio meant just a varied mix of stocks and bonds (the conventional approach is 60% to stocks and 40% to bonds). But the world is becoming increasingly interconnected, which means these asset classes are moving more and more in tandem – especially in bear markets. Traditional diversification does not always control risk.

Thus, now more than ever, it is important for investors to include non-correlated assets such as alternative investments and strategies, whose return characteristics differ fundamentally from traditional asset classes. Owing to these distinctive

characteristics, these assets tend to move separately from stocks and bonds.

Alternatives are now increasingly available to every day investors, and the industry has nearly doubled since 2005 and is expected to grow to at least $13.6 trillion by 2020.

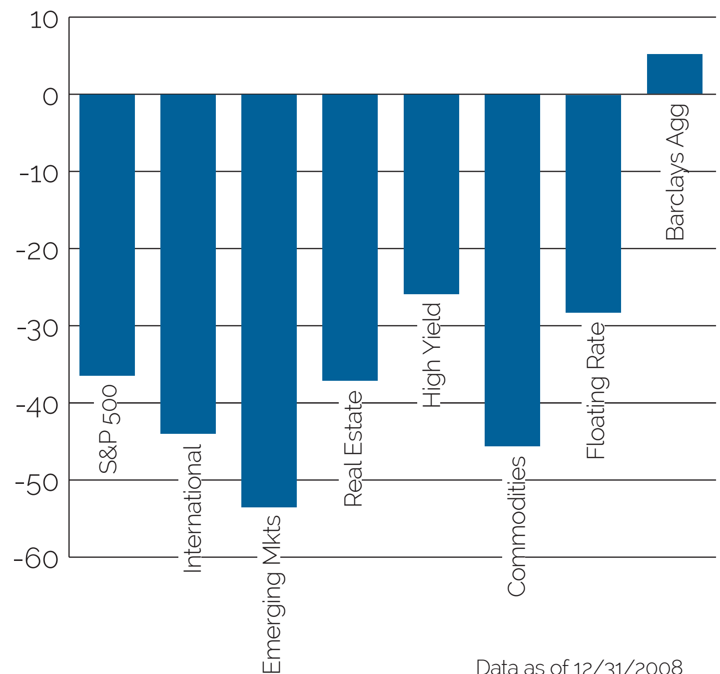
Alternative investments include venture capital, private equity, inverse funds, hedge funds, real estate investment trusts (REITs), commodities, and real assets such as precious metals, natural resources, and art. In addition, today's mutual funds and ETFs that have the flexibility to invest in these alternative asset classes can behave like an alternative investment.

In the past, alternative investments were difficult for a retail investor to access. They were typically reserved for institutions and endowments, which have used them to improve their portfolio diversification and potentially increase their risk-adjusted returns. But that has changed throughout the last decade. Alternatives are now increasingly available to every day investors, and the industry is expected to grow fivefold to at least $13.6 trillion by 2020.

We believe a portfolio that can best endure and profit from large market swings is one that includes a diversified mix of stocks, bonds, and alternatives. Investors should seek funds that actively manage risk during major market declines, such as funds that control market exposure by shorting or using inverse ETFs, which are designed go up in value when the market declines.

Conventional diversification wisdom (the 60/40 stock-to-bond portfolio) failed investors in 2008, as markets declined in lockstep[1]

The indices shown are for informational purposes only and are not reflective of any investment. As it is not possible to invest in the indices, the data shown does not reflect or compare features of an actual investment, such as its objectives, costs and expenses, liquidity, safety, guarantees or insurance, fluctuation of principal or return, or tax features. Past performance is no guarantee of future results.



Advantages of Active Investing During Bear Markets

Investors should seek out a fund that's poised to participate significantly in markets that offer upside growth and minimize participation during deep downward movements that can have life changing consequences for investors.

Markets are efficient over time, but the conventional buy and hold approach simply does not work when a bear market hits. For investors with a much shorter time horizon, buy and hold losses can be catastrophic.

Over the past ten years, investors have increasingly sought out passively-managed index funds like ETFs in place of actively-managed mutual funds that seek to beat a market benchmark. These index funds may offer lower cost, but what is their value when the market tanks? If the S&P 500 Index is down 20%, so too will be the fund that tracks that index, as the fund manager must adhere to the stated objective of tracking a benchmark's return regardless of market direction. These funds do have a place in today's portfolios, as they offer diversification and low cost exposure to equities, market segments, and styles that investors may not otherwise be able to access. But they cannot protect on the downside the way many actively-managed mutual funds can. It is therefore important for investors to seek out both types to build a well-balanced, responsive portfolio.

That said, not all active funds outperform during bear markets. Rather, investors should seek one that is poised to participate significantly in markets that offer upside growth and minimize participation during deep downward movements that can have life changing consequences for investors. These types of funds are generally unrestricted to a specific style box, which means they can "go anywhere" and take long or short positions on any type of asset in any part of the world. This strategy can be particularly advantageous during a bear market, as the fund can go short in an effort to control exposure or use cash to be defensive.

Conversely, some active mutual funds have a long-only constraint, which means managers can only invest in stocks they believe will rise, while avoiding those they believe will decline. This may sound like an ideal strategy, but the more flexible mandate of long/short funds actually gives the manager additional tools to attempt to generate returns and manage risk. Funds using a long/short strategy aim to have lower long-term volatility and risk profiles than the overall stock market.

Getting Back into the Market

The 25 bull markets since 1929 have sent stocks up an average of 107%. By staying in cash too long, investors take all of the losses of a bull market and miss out on the early gains from a bull market.

Having a solid bear market plan and building a portfolio that is prepared for a downturn reduces the risk that an investor will still be on the sidelines when the market eventually rebounds.

Far too often, investors panic and go entirely to cash on their own during a severe market decline (often near the market low – as previously mentioned) and then are too nervous to re-enter the market. This is yet another reason investing in a fund that is focused on both downside protection and upside capture is advantageous. Investors can better prepare their portfolios for all market conditions.

Bear markets are scary, but so is missing out on the upswing. Consider this: the 25 bull markets since 1929 have sent stocks up an average of 107%. By staying in cash, investors take all of the losses of a bull market and miss out on the early gains from a bull market. This strategy of buying high and selling low leads to disappointing investment performance.

Many investors do not have the time, tools, or knowledge, to build and maintain a bear market-resistant portfolio. Investors should therefore look for funds that do that work for them by including solid strategies to recognize and make adjustments early when bear markets start and when they end.

Kerns Capital Management, Inc. manages the KCM Global Macro Trends mutual fund ("KCMTX"), a fund without style box restrictions that is free to control its equity exposure with short positions, as well as invest in bonds, alternatives, and foreign investments.

Investors should carefully consider the investment objectives, risks, charges and expenses of the KCM Global Macro Trends Fund. This and other important information about the Fund is contained in the prospectus, which can be obtained by calling 800.945.2125. The prospectus should be read carefully before investing. The KCM Global Macro Trends Fund is distributed by Northern Lights Distributors, LLC, member FINRA/SIPC. Kerns Capital Management, LLC is not affiliated with Northern Lights Distributors, LLC.

Mutual Funds involve risk including possible loss of principal. The Fund may invest in small, less well-known companies, which may be subject to more erratic market movements than large-cap stocks; foreign securities, which are subject to currency fluctuations and political uncertainty; and derivative securities, which may carry market, credit, and liquidity risks. The Fund may use leveraging and/or hedging techniques that could fail if changes in the value of the derivative do not correlate with the securities being hedged. The Fund may also engage in short selling activities, which are more risky than "long" positions because the potential loss on a short sell is unlimited. These risks may result in greater share price volatility.

[1]Corresponding indexes – S&P 500: Standard & Poor's 500 Index (an unmanaged composite of 500 large capitalization companies widely used by professional investors as a performance benchmark for large cap stocks.) International: MSCI Europe, Australasia, and Far East Index (designed to measure the equity market performance of developed markets outside the U.S. & Canada, including Europe, Australasia and the Far East.) Emerging Markets: MSCI Emerging Markets Index (captures large and mid cap representation across 23 emerging markets countries.) Real Estate: FTSE NAREIT All Equity Total Return Index (a free-float adjusted, market capitalization-weighted index of U.S. Equity REITs.) High Yield: Barclays US Corp High Yield Bond Index (index is representative of the universe of fixed-rate, non-investment grade debt.) Commodities: S&P GSCI Total Return Index (a tradeable index for investment in the commodity markets and a measure of commodity performance over time.) Floating Rate: CSFB Leveraged Loan Index (represents tradable, senior-secured, U.S.-dollar-denominated non-investment-grade loans.) Barclays Agg: Barclays Capital U.S. Aggregate Bond Index (broad base index used to represent investment grade bonds being traded in the U.S.)

3086-NLD-1/26/2016

Kerns Capital Management
9821 Katy Freeway, Suite 400
Houston, TX 77024
800.945.2125
kcmtx.com